

## Chapter 1 – Non-tax treaties: Domestic courts and treaty interpretation

”הקנה תחבולות ונבון לקח ניוסף חכם ישמע  
להבין משל ליצהחיד תמן דברי חכמים ומ.”

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### 1.1. Introduction

This chapter provides an overview of some of the questions treaty interpretation by domestic judges raise in general. First, the nature of the rules governing treaty interpretation by domestic judges will be dealt with, raising some interesting questions: Are these rules real binding norms or mere guiding maxims? Do they derive from international or national law? Are domestic judges bound by these rules? Attention then shifts to the content of these rules, and to a selection of specific topics such as evolutionary interpretation, the role of preparatory works and the interpretation of treaties in multiple languages, which are not always as easily understood by a domestic judge.

### 1.2. The nature of the rules governing treaty interpretation by domestic courts

#### 1.2.1. Interpretation as part of a wider exercise of applying a treaty to concrete facts

A well-known truism says that "interpretation is an art, not an exact science". [4] Yet, the arts are also subject to a certain order and it is therefore not surprising that throughout the ages scholars have developed a set of rules by which the genuineness of a particular reasoning can be corroborated or falsified. A sub-set of those rules is that of governing interpretation of treaties. They determine whether an interpretation can be upheld or whether it flies in the face of international legal logic. The interpretation of treaties is accordingly the intellectual operation aimed at understanding a treaty, at refining its meaning and at determining its scope, in a declaratory manner, i.e. it is a process that elucidates what is and not what should be. [5] Interpreting a treaty is thus not the same thing as revising, improving or modifying the treaty. The rules of treaty interpretation help us to distinguish the elucidation of a treaty provision from its outright distortion or perversion. After underlining the fact that "[it] is the duty of the Court to interpret the Treaties, not to revise them", the International Court of Justice stated in its 1950 advisory opinion on the *Interpretation of Peace Treaties with Bulgaria, Hungary and Romania*:

[the] principle of interpretation expressed in the maxim: *ut res magis valeat quam pereat*, often referred to as the rule of effectiveness, cannot justify the Court in attributing to the provisions [...] a meaning which [...] would be contrary to their letter and spirit. [...] [It] does not justify the Court in exceeding its judicial function on the pretext of remedying a default for the occurrence of which the Treaties have made no provision." [6]

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3 "A wise man will hear, and will increase learning; and a man of understanding shall attain unto wise counsels to understand a proverb, and the interpretation; the words of the wise, and their dark sayings." *Proverbs, 1.5-6, King James translation.*

4 The International Law Commission paraphrased this truism in its 1966 Draft Articles on the Law of Treaties with commentaries, when speaking about the many maxims in international interpretative practice: "In other words, recourse to many of these principles is discretionary rather than obligatory and the interpretations of documents is to some extent an art, not an exact science." *Yearbook of the International Law Commission, 1966, Vol. II, p. 218.*

5 Yasseen, M.K., "L'interprétation des traités d'après la convention de Vienne sur le droit des traités", 151 *Recueil des Cours (1976-IH)* p. 9

6 ICJ, *Interpretation of Peace Treaties with Bulgaria, Hungary and Romania (Second Phase)*, advisory opinion of 18 July 1950, *ICJ Rep.* (1950) pp. 229-230.

The interpretation of a treaty is part of a wider exercise by the judge, consisting of the qualification of the facts or situation, during which he also qualifies concrete situations in the light of the rules contained in the treaty and determines whether they fall within its scope, and the operation of applying the rule if the facts really correspond to the hypothetical situation envisaged *in abstracto*. [7]

### 1.2.2. The attitude of domestic judges

Domestic judges are, according to Art. 4(1) Draft Articles on Responsibility of States for Internationally Wrongful Acts ("DARS"), [8] to be considered as State bodies in the same way as the executive and legislative branches of government, and their actions or omissions - including misapplication of a treaty due to errors in the interpretation thereof - can therefore trigger the responsibility of the State. Hence, when they are called upon to interpret international agreements, this interpretation (as well as the question of the existence and validity of the treaty) is governed by rules of international law and not by national rules and principles of interpretation. [9] Similarly, international courts will, for that matter, apply national rules of interpretation when they have to decide on the meaning and scope of domestic law. [10] There is indeed a parallel between the nature of the law involved and the rules of interpretation applicable to it. Intuitively, this seems reasonable: a norm that is the result of sometimes protracted negotiations between multiple sovereign States should be interpreted differently, in a less unilateral fashion [11], than a norm emanating from the sovereign will of a single State. [12] This basic assumption has not always received the unanimous support of legal scholars. [13] Furthermore, the conscious or unconscious tendency of national courts (even more marked in common law countries) to follow concepts, methods and precedents of municipal law, even when they must apply law which does not originate in their domestic legal systems, has often led to divergent developments of identical provisions. [14] However, there now seems to be a consensus in legal doctrine and in domestic courts on the different nature of interpretation of purely domestic norms and norms originating in the international legal order. Even in those countries, such as the United Kingdom, where treaties do not have *propre vigore* effect in the domestic legal order, [15] domestic courts continue to employ a broader approach when interpreting the incorporating statute than is habitual in statutory interpretation [16] and "similar in a general way to [the approach] of international tribunals and international law". [17] The principles of good faith and *pacta sunt servanda* constitute the core elements in treaty interpretation by domestic judges in different legal systems, despite differences in the jurisprudential foundations for such an attitude. [18]

Nevertheless, even if most domestic courts accept that they ought to apply the rules of international law (or at least a specific set of domestic rules inspired by the international rules) on interpretation when confronted with a treaty, the non-application or incorrect application of these rules by the domestic judge will most likely only lead to the invalidity of the judgment if this also entails a breach of the interpreted treaty itself, which is not necessarily the case. [19] The correct application of the rules on treaty

7 Yasseen, op. cit., p. 10.

8 Draft Articles on Responsibility of States for Internationally Wrongful Acts, adopted by the International Law Commission at its fifty-third session (2001); Report of the International Law Commission on the work of its Fifty-third session, *Official Records of the General Assembly, Fifty-sixth session, Supplement No. 10 (A/56/10)*, chap. IV.E.1.

9 Erades, L., *Interactions between international and municipal law: a comparative case law study*, The Hague: T.M.C. Asser Institute, 1993, pp. 955-956.

10 PCIJ, *Case concerning the payment of various Serbian loans issued in France*, judgment of 12 June 1929, *P.C.I.J. Rep., Series A*, Nr. 14, p. 46.

11 Conforti, B., *Diritto internazionale*, 5th ed., Naples: Editoriale scientifica, 1997, pp. 105-108.

12 This differentiated interpretative approach is also evidenced in *R. (Al Fawwaz) vs. Governor of Brixton Prison*, where Lord Slynn stated that "to apply to [...] treaties the strict canons appropriate to the construction of domestic statutes would often tend to defeat rather than to serve [their] purpose", *UKHL* 2001, 69, para. 39.

13 Mestre, A., "*Les traités et le droit interne*", 38 *Recueil des Cours* (1931-IV) p. 299 supported the view that treaty law should be treated in the same way as domestic law by domestic judges.

14 Schreuer, C.H., "The interpretation of treaties by domestic courts" 45 *British Yearbook of International Law* (1971) p. 26.

15 Sinclair recalls that the English courts are only rarely called upon to interpret and apply international treaties directly, referring to the classic judgment in *The Parlement Belge* (4 P.D. (1879) 154-155) (Sinclair, I.M., "The principles of treaty interpretation and their application by the English courts", 12 *International and Comparative Law Quarterly* (1963) p. 525).

16 Shaw, M.N., *International law*, 5th ed., Cambridge: University Press, 2003, p. 141.

17 Brownlie, I., *Principles of Public International Law*, 6th ed., Oxford: University Press, 2003, p. 46, who refers to House of Lords, *Fothergill v. Monarch Airlines Ltd.*, 3 WLR (1980) p. 209 and High Court of Australia, *Commonwealth v. Tasmania*, 46 ALR (1983) p. 625.

18 Yambursic, E.S., *Treaty Interpretation. Theory and Reality*, New York: University Press of America, 1987, pp. 35-36.

19 See the judgment of the Belgian *Cour de Cassation*, *Cigna*, 30 March 2000, reproduced in *European Transport Law* 2000, p. 392, in which the Court stated that "*la violation des règles d'interprétation des traités ne donne lieu à cassation que si, ce faisant, le traité faisant l'objet de l'interprétation a été violé*".

interpretation is, after all, not an aim in itself, but only a means to achieve another goal, i.e. the quest for the correct meaning of the terms of a treaty. This does not mean that the rules are devoid of legal character, but only that their non-application is only sanctioned under certain circumstances.

### 1.2.3. Referral for interpretation

If domestic judges hold that they must apply a particular treaty and that further interpretation of it is needed, they ought to be able to interpret that treaty autonomously from other branches of government. The practice of referring to the executive - in particular, the Minister of Foreign Affairs [20] (as was the case in France) [21] - for an authoritative interpretation of an international agreement has, by now, not only disappeared from the legal orders of European States, [22] it has also been condemned by the European Court of Human Rights. In the case of *Beaumartin vs. France* (1994), for example, the Court upheld the view that this practice led to a situation in which a body referring for such an authoritative interpretation no longer satisfy the requirement of independence from the executive (and also from the parties if the executive is a party to the dispute). Therefore, such a body no longer merited the designation "tribunal" within the meaning of Art. 6, para. 1, ECHR. [23] At the time of the Court's judgment, France's *Conseil d'Etat* had already ceased this practice. [24] Such a practice also seriously saps the alleged *Völkerrechtsfreundlichkeit*, [25] i.e. the amity toward international law of a so-called "monist" country. Indeed, it amounts to undermining the supremacy of international law over municipal law, since the executive might provide a reading that saves the full application of domestic legislation even if this were not warranted by the judiciary's autonomous interpretation of the treaty.

The referral doctrine was based on a particularly strict view of the theory of the separation of powers. It maintains a rigorous separation between the interpretation of a treaty on the one hand and the qualification of facts in the light of the treaty and the subsequent application of the treaty (supra, 1.2.1.) on the other. In this view, the former is a competence of the executive as the State body responsible for relations with foreign powers, and the latter a task of the judiciary. A rather logical consequence of this practice was the adoption by the judiciary of the theory of the *acte clair*, which induced it to the strict application of a treaty upholding a very literal reading of the text in order to avoid the obligation to pose a preliminary question to the Minister of Foreign Affairs for further interpretation. [26] This flows from the fiction that there is no need for interpretation whenever the meaning of a text is, by itself, already clear (infra, 1.3.2.). Therefore, the referral for interpretation to the Minister of Foreign Affairs was rather rare. If, however, judges have the competence to interpret the treaty themselves, the rationale for such a restrictive attitude will most likely disappear. Judges who have the power to interpret must no longer apply the treaty very literally. To the contrary, they can use the whole spectrum of interpretative means to come to a reasonable and balanced interpretation and application of the treaty.

We must distinguish this situation of referral to the executive from the referral of preliminary questions concerning the interpretation of treaties to international courts, among which eminently figures the European Court of Justice, [27] and from the referral of certain questions to national (constitutional) courts, which might also involve the interpretation of treaties, especially of human rights treaties with provisions

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20 It is clear that the same reasoning applies in the case of referral to other ministers such as the referral to the Minister of Finance for a binding interpretation of the provisions of a double taxation treaty.

21 De la Rochere, J.D., "France" in Jacobs, F.G. and Roberts, S., *The effect of treaties in domestic law*, London: Sweet & Maxwell, 1987, pp. 49-53.

22 The doctrine remains, however, part and parcel of the legal systems of a number of countries, most notably former French colonies that follow the French model of government. In such a situation, we can concur with Malanczuk's reserved attitude towards the view that all those countries have really recognized the priority of treaties over national legislation (Malanczuk, P., *Akehurst's Modern Introduction to International Law*, 7th rev. ed., London: Routledge, 1997, p. 67). The referral for interpretation is similar to but not identical with the practice of the executive certificate where a court defers to the judgment of the executive "on certain acts or facts of state" (Dugard, J., *International Law. A South African Perspective*, 3rd ed., 2005, p. 70), such as the recognition of a foreign State or government.

23 ECtHR, *Beaumartin vs. France*, judgment of 24 November 1994, *E.Ct. H.R. Rep. Series A* 1994, No. 296, para. 38.

24 *Conseil d'Etat, GISTI*, judgment of 29 June 1990, 94 *Revue générale de droit international public* (1990) p. 879. Buffet-Tchakaloff, M.F., "L'interprétation des Traités internationaux par le Conseil d'Etat. L'arrêt GISTI", 95 *Revue générale de droit international public* (1991) pp. 109-124.

25 Bleckmann, A., "Die Völkerrechtsfreundlichkeit der Deutschen Rechtsordnung", 32 *Die öffentliche Verwaltung* (1979) p. 309.

26 Buffet-Tchakaloff, op. cit. note 24, p. 111.

27 Art. 234 EC Treaty. Other examples are the preliminary rulings procedure within the Benelux (Art. 6 Treaty concerning the establishment and the statute of a Benelux Court of Justice, signed at Brussels on 31 March 1965) or before the EFTA Court of Justice (Art. 34 Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice signed at Oporto on 2 May 1992).

that are similar to constitutionally endorsed human rights. [28] Apart from possible concerns about process economy, [29] such referrals to specialized judicial institutions raise fewer objections than the referral to the Minister of Foreign Affairs, since they either contribute to the uniform interpretation of international (European) law by all State parties or involve more knowledgeable judges in cases that only very rarely dealt with lower courts and tribunals. They are, moreover, not a derogation from the principle that the interpretation and application of treaties are, in essence, a *judicial* activity.

#### 1.2.4. Authoritative and authentic interpretation

Apart from requests for preliminary rulings to international courts - which are, in fact, a rather uncommon feature in international law - a treaty provision can also have been interpreted and applied before by an international court or (arbitral) tribunal at the occasion of a dispute between States or an "internationalized" dispute between a State and an individual or a multinational company. Apart from the dispute in which the application for such a preliminary ruling was made, the interpretation of the international court will not have binding force but will evidently constitute an authoritative, [30] yet not authentic, interpretation of the treaty that the national judge must take duly into account. This is in line with Art. 38, para. 1(d) of the ICJ Statute, according to which jurisprudence is only a "subsidiary means for determining rules of [international] law," and not a binding one. The designation of *authentic* interpretation of a treaty is in line with the adage *cuius est condere, eius est interpretari*, restricted to agreements between the parties to the treaty. The principle of authentic interpretation is also endorsed in the so-called general rule of interpretation (infra, 1.3.2.). A unilateral interpretation issued by one of the States parties to a treaty - whether it is the State of which the judge is a State body - is not an authentic interpretation. [31]

#### 1.2.5. The paradox of the formal source of the rules on treaty interpretation

With the exception of treaties with a preliminary ruling mechanism involving an international judicial body, it will be up to the domestic judge to interpret the treaty; this is the case, even if the parties have issued an authentic interpretation. It is not implausible that while the authentic interpretation might limit the ambiguity of a provision, there can still be room for further interpretation (perhaps even of the instrument embodying the authentic interpretation itself). The judge must then look for guidelines for his interpretation. In several - but not all - jurisdictions, these guidelines will originate directly in international law. As pointed out by Klabbers, "one among many curious things about interpretation of treaties is that the rules on interpretation of treaties are themselves laid down in a treaty", [32] i.e. Arts. 31 to 33 of the 1969 Vienna Convention on the Law of Treaties (VCLT). [33] In line with the International Court of Justice [34] and the Appellate Body of the World Trade Organization, [35] a large majority of international legal scholars currently supports the customary character of the rules on interpretation. This means that they are applicable regardless of the ratification by a particular state of the VCLT. We shall therefore not dwell further on the seemingly paradoxical situation in which seeking the correct meaning of the rules on treaty interpretation implies the application of the same, or of a previous set of interpretative rules, leading to what Klabbers called an "infinite regression". The paradox is created by the peculiarities of the system

28 E.g. the preliminary ruling of the Belgian *Cour d'Arbitrage* in the case *Vergauwen & Avondroodt* of 22 July 2004, *Moniteur beige* 19 October 2004: "Toutefois, lorsqu'une disposition conventionnelle liant la Belgique a une portée analogue à une ou plusieurs des dispositions constitutionnelles précitées, les garanties consacrées par cette disposition conventionnelle constituent un ensemble indissociable avec les garanties inscrites dans les dispositions constitutionnelles en cause."

29 This is in particular the case when there is a coincidence of several preliminary procedures, see Spreutels, J., "Le concours de questions préjudicelles (*Cour d'arbitrage, Cour de justice des Communautés européennes et Cour de justice Benelux*", in Arts, A., Verougstraete, I. et al. (eds.), *Les rapports entre la Cour d'arbitrage, le Pouvoir judiciaire et le Conseil d'Etat*, Bruges : Die Keure, 2006, p. 295.

30 This is particularly the case with the very extensive case law of the European Court of Human Rights.

31 In the arbitral award in the 1921 *David J. Adams* case, the arbitral tribunal stated that "[t]he fundamental principle of the juridical equality of States is opposed to placing one State under the jurisdiction of another State. It is opposed to the subjection of one State to an interpretation of a Treaty asserted by another State. There is no reason why one more than the other should impose such a unilateral interpretation of a contract which is essentially bilateral. The fact that this interpretation is given by the legislative or judicial or any other authority of one of the parties does not make that interpretation binding upon the other party." *R.I.A.A.* vol. 6, p. 89.

32 Klabbers, J., "International legal histories: the declining importance of *travaux préparatoires* in treaty interpretation?", 50 *Netherlands International Law Review* (2003) p. 270.

33 Vienna Convention on the Law of Treaties, done at Vienna on 23 May 1969 (entry into force: 23 May 1969). There are currently (November 2006) 107 parties to the VCLT.

34 ICJ, *Case concerning the territorial dispute* (Libyan Arab Jamahiriya/Chad), judgment of 3 February 1994, *ICJ Rep.* 6 (1994) para. 41.

35 "Appellate Body Report: United States - Standards for Reformulated and Conventional Gasoline", WT/DS2/AB/R (20 May 1996).

of the sources of international law, which differs fundamentally from the organization of national legal orders. It is also virtually impossible to maintain that rules of procedural or formal international law - such as the rules on treaty interpretation - would precede the whole corpus of substantive international law. The only commonly accepted theory of a hierarchy between rules of international law, though it is far from unanimous, [36] is the concept of *jus cogens* norms, [37] i.e. peremptory norms of general international law, and the rules on treaty interpretation are certainly not norms "from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character". [38] There is no doubt that the provisions of a treaty or the practice within an international organization may deviate from the rules on treaty interpretation. In fact, this often happens, the role of the Commentaries to the OECD Model Convention in the interpretation of tax treaties being an example. [39]

### 1.2.6. The policy dimension of treaty interpretation

Before we take a closer look at the rules governing treaty interpretation, the authors must point to the eminently policy dimension of treaty interpretation. [40] A judge's choice for a particular interpretation is often, in essence, a policy choice. Even though interpretation is said to have the objective of ascertaining the parties' intentions, it may well be that the parties never had common intentions, and that the treaty was left deliberately vague in order to appease everyone, which is rather unfortunate as soon as the treaty comes into play in a dispute before a (domestic) judiciary. It is also possible that a judge is confronted with a new situation the original drafters of the treaty had never considered. It is then through interpretation that the situation can be subsumed under the original wordings of the treaty. Since interpretation is, as has been said before, "not an exact science", the outcome of this process will differ, depending on the (e.g. restrictive or extensive, textual or teleological) interpretation the judge follows. Rules of interpretation, therefore, in a way, aim to put limits to the arbitrary discretion of a judge to "remake" an agreement.

[41] At the same time, they constitute a legitimization of a judge's decision, since they grant rationality and "foreseeability" to the reasoning. Another aspect of the policy dimension of interpretation is the fact that it can take into account specific concerns of a polity. Those concerns may change over time (as discussed below at 1.3.3.). They may even differ from place to place, for if a treaty is not promoting uniform legislation, its uniform interpretation by domestic courts in different countries is not necessarily an end in itself. [42] This holds particularly true for broadly formulated agreements, such as the European Convention on Human Rights, whose rights and fundamental freedoms might be realized differently in different societies. For instance, the freedom of religion and the related right to wear religious symbols may be assessed differently in different societal contexts. [43]

## 1.3. The content of the rules [44]

### 1.3.1. General remark

In international law, just like in domestic legal systems, a variety of maxims and principles, often in Latin, [45] exist concerning the interpretation of rules. Many of these principles are, in fact, nothing more than techniques that are expressive of common sense and of normal grammatical usage. [46] A comprehensive

36 See e.g. the recent contribution by Glennon, M.J., "De l'absurdité du droit impératif (*jus cogens*)", 110 *Revue générale de droit international public* (2006) pp. 529-536.  
37 See among many others R. Kolb, *Théorie du ius cogens international: essai de relecture du concept*, Paris: PUF, 2001.

38 Art. 53 VCLT.

39 Ault, H.J., "The role of the OECD commentaries in the interpretation of tax treaties", in C. van Raad and Alpert, H. (eds.), *Essays on international taxation in honour of Sidney I. Roberts*, Deventer: Kluwer Law International, 1993, pp. 63-68; Van der Bruggen, E., "The power of persuasion: notes on the sources of international law and the OECD Commentary", 31 *Intertax* (2003) pp. 259-270; Vogel, K., "The influence of the OECD Commentaries on Treaty Interpretation", 54 *Bulletin for International Fiscal Documentation* (2000) pp. 612-616.

40 The policy-making in the judicial process has been identified and analysed in an eminent manner in Van Gerven, W., *Het beleid van de rechter*, Antwerp: Standaard, 1973.

41 Hogg, J.F., "The International Court: Rules of Treaty Interpretation", 43 *Minnesota Law Review* (1959) p. 369.

42 Jacobs, F.G., "Introduction", in Jacobs and Roberts, op. cit. note 21, p. xxxi.

43 ECtHR, *Leyla Sahin vs. Turkey*, judgment of 10 November 2005, paras. 109-111 (online at [www.echr.coe.int](http://www.echr.coe.int)).

44 The VCLT's provisions concerning treaty interpretation are annexed to this chapter.

45 Examples of such Latin maxims are the adages "*ut res magis valeat quam pereat*" (principle of effectiveness), "*inclusio unius est exclusio alterius*", "*contra proferentem*", "*ab absurdo*"...

46 Oppenheim, L., Jennings, R. and Watts, A., *Oppenheim's international law*, 9th ed., Harlow: Longman, 1992, p. 1270.

codification of those maxims entails the risk that they "become unwieldy instruments instead of the flexible aids which are required". [47]

Furthermore, those "many maxims and phrases [...] are merely *prima facie* guides to the intention of the parties and must always give way to contrary evidence of the intention of the parties in a particular case." [48] And indeed, the rules governing the interpretation of treaties contained in the VCLT [49] do not attempt to codify these maxims [50] but try to achieve a balance between the three main "schools of interpretation", i.e. the "founding fathers school" (upholding a subjective approach, which looks at the parties' intentions), the "textual school" (upholding an objective approach, which looks at the ordinary meaning of the words), and the "teleological school" (upholding an approach that looks at the object and purpose of the treaty).

### 1.3.2. The general rule

According to its heading, Art. 31 VCLT contains the so-called "general rule of interpretation". [51] The article draws to a certain extent on all three aforementioned schools, but adopts primarily the textual or objective approach, by stating in its first paragraph that treaties "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". This is in line with many pronouncements of the International Court of Justice, which stated in 1950 that

[t]he first duty of a tribunal which is called upon to interpret and apply the provisions of a treaty, is to endeavour to give effect to them in their natural and ordinary meaning in the context in which they occur. If the relevant words in their natural and ordinary meaning make sense in their context, that is an end of the matter. [52]

Several elements have been distinguished within this "general rule": [53]

- the principle of good faith, which is a corollary of the general good faith obligation from Art. 26 VCLT;
- the taking of the terms in their ordinary meaning (except if it is established that the parties intended a particular meaning deviating from the ordinary meaning of the terms, e.g. in an article with definitions for the purpose of the treaty), which is not determined in the abstract but "in their context" and which may be a very technical meaning, e.g. the "international tax language" that has been developed under the influence of the OECD Model Convention; [54]
- the importance of the context (further defined in 1.2.1. above) and which not only includes the text, preamble and annexes of the treaty itself but also connected agreements; and
- the duty to take into account certain matters that are extrinsic to the treaty (see below).

It is sometimes submitted that there is no need to resort to interpretation if the treaty's meaning is in itself sufficiently clear, or, in the words of Vattel, "*la première maxime générale sur l'interprétation est qu'il n'est pas permis d'interpréter ce qui n'a pas besoin d'interprétation*". [55] This view is also expressed in the adage *interpretatio cessat in claris*, but, although it is confirmed in international and national jurisprudence,

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47 Brownlie, op. cit. note 17, p. 602.

48 McNair, A.D., *The law of treaties*, Oxford: Clarendon, 1986, p. 364.

49 The relevant Arts. 31, 32 and 33 can be found in an annex to this chapter.

50 The VCLT at the same time does not contain a prohibition to resort to these maxims, but they are subsumed under the term "supplementary means of interpretation" in Art. 32.

51 Though another of those famous interpretative Latin maxims is "*rubrica non est lex*".

52 ICJ, *Competence of the General Assembly for the Admission of a State to the United Nations*, advisory opinion of 3 March 1950, *ICJ Rep.* 1950, p. 8.

53 Oppenheim, op. cit. note 46, p. 1272.

54 Vogel, K., *Klaus Vogel on double taxation conventions*, 3rd ed., London: Kluwer Law International, 1997, p. 37 Nr. 70.

55 De Vattel, E., *Le droit des gens ou principes de la loi naturelle*, 1758, Vol. 2, para. 263.

[56] it is of limited usefulness since "the finding whether a treaty is clear or not is not the starting point but the result of the process of interpretation". [57] As mentioned before, interpretation is part of a wider process in which the judge is also called upon to qualify the facts in the light of the treaty and apply the treaty provision to the concrete situation. The different aspects of this process are interrelated and there are but few provisions that are drafted in such a way that there is no possible situation in which there are uncertainties about its bearing. Therefore, the adage does not really offer much guidance to the interpreter.

The concept of authentic interpretation has already been mentioned (supra, 1.2.4.). The aforementioned principle *cuius est condere, eius est interpretari*, which means that "the right of giving an [authentic] interpretation of a legal rule belongs solely to the person or body who has power to modify or suppress it", [58] is currently incorporated in the requirement of Art. 31, para. 3(a) VCLT to take into account, together with the context, "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions". Such authentic interpretations are not infrequent, and domestic judges have used them. [59] Not only the treaty's express common interpretation, but also the subsequent practice in applying the treaty and "any relevant rules of international law" applicable between the parties may be considered. However, both in the case of expressly drafted interpretative agreements and informal agreements distinguishable from subsequent practice due regard should be given to the principle of legal certainty of the citizens (infra, 1.3.4.). Indeed, domestic judges are in a different position from international judges and principles of a constitutional nature aimed at protecting the interests of individuals, such as the principle of legal certainty, can override the rules on treaty interpretation.

### 1.3.3. Evolutionary interpretation

A considerable amount of time has lapsed since some of the main structuring legal instruments of the current international community (Charter of the United Nations, European Convention on Human Rights, the International Covenants) were concluded. This has caused the time factor in the process of treaty interpretation to gain importance. [60] From the beginning, these treaties were intended to remain valid for an indeterminate, longer period of time. Both the International Court of Justice, which stated that "an international instrument must be interpreted and applied within the entire legal system prevailing at the time of the interpretation" [61] and the European Court of Human Rights, which recalled "that the Convention is a living instrument which [...] must be interpreted in the light of present-day conditions", [62] have paid attention to this question (supra, 1.2.6.). There is no compelling reason why domestic judges cannot resort to an evolutionary interpretation. The limits of this possibility are less fixed by international law than by domestic constitutional law and more in particular the extent to which such an interpretation is possible without some form of parliamentary participation. [63]

Even though it originated primarily in this context, the evolutionary interpretation of treaties should not necessarily be confined to human rights conventions and constitutions of international organizations.

[64] It can be extended to other legal instruments, both bilateral and multilateral, laying down lasting basic rules concluded for a longer period of time, including double taxation agreements. [65] In a number

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56 See the application of this maxim in a tax case involving the "unambiguous wordings" of the 1964 tax treaty between Belgium and France in Court of Appeals of Ghent, *K.M/Belgian State*, 103 *Jurisprudence fiscale* (2003) p. 9.

57 Oppenheim, op. cit. note 46, p. 1267.

58 PCIJ, *Delimitation of the Polish-Czechoslovakian frontier (question of Jaworzina)*, advisory opinion of 6 December 1923, *P.C.I.J. Rep., Series B*, Nr. 8, p. 37.

59 *Tribunal de Mons* 10 February 2004, J.E./Belgian State, 104 *Jurisprudence fiscale* (2004) p. 624.

60 Bernhardt, R., "Evolutive Treaty Interpretation, Especially of the European Convention on Human Rights", 42 *German Yearbook of International Law* (1999), p. 12.

61 ICJ, *Legal Consequences for States of the Continued Presence of South Africa in Namibia (South West Africa) notwithstanding Security Council Resolution 276 (1970)*, advisory opinion of 21 June 1971, *ICJ Rep.* 1971, p. 31.

62 ECtHR, *Tyler v. United Kingdom*, judgment of 25 April 1978, *E.Ct.H.R. Rep.* Series A 1978, No. 26, p. 15.

63 Bernhardt, op. cit. note 60, p. 24.

64 Yet, Aust links the teleological approach adopted by the ECJ and the ECtHR, deviating from the rules of the VCLT, with the possibility offered in Art. 5 VCLT to take into account the relevant rules of the organization and states that this is even more the case in the presence of regional international organizations having powers over the social or economic structure of their member States. Aust, A., *Modern Treaty Law and Practice*, Cambridge: University Press, 2000, p. 196. In this reasoning, there would be less room for teleological interpretation in the case of bilateral (double taxation) agreements.

65 In that sense Bernhardt, op. cit. note 60, pp. 24-25.

of examples, particularly in the case of international commercial law conventions, [66] the drafters of a convention deliberately foresaw evolutions in interpretation and therefore applied a "general principles" [67] methodology in the articles to empower domestic courts to fashion for themselves substantive solutions for gaps in a convention's regulatory scheme, thus contributing to the emergence of an "international common law" around the frame of the treaty, [68] which will inevitably evolve. Indeed, evolutionary treaty interpretation may well be "the adequate and necessary response to the changing character of international law and the intensified cooperation between States". [69] The rapid evolution of the law and the extension of international law to almost every aspect of life complicate the possibilities to encompass every situation in traditional international agreements and to renegotiate them to keep pace with domestic developments. Less detailed agreements, combined with evolutionary interpretation (preferably involving an international judicial body that ensures uniformity in this interpretation) provide a flexible answer.

### 1.3.4. The role of preparatory works in treaty interpretation

The time factor, inherent in the aforementioned concept of evolutionary interpretation, also comes into play when dealing with the question of the role of preparatory works (often referred to by the French term "*travaux préparatoires*") in treaty interpretation. The question concerns, in particular, whether these *travaux* maintain their relevance or disappear from sight (either immediately or some time after the entry into force of the treaty). Article 32 VCLT explicitly mentions "preparatory work of the treaty and the circumstances of its conclusion" among the supplementary means of interpretation that are to be used either to support the interpretation obtained by means of the general rule or when the general rule leads to ambiguous, obscure or manifestly absurd or unreasonable results. The drafting of this rule on the use of preparatory works represented a caesura with previous legal thinking, which considered the *travaux* to be, in the words of Lauterpacht, "*un élément fondamental, peut-être le plus important, en matière d'interprétation des traités*". [70] Such a view is a logical consequence of a subjective approach that looks primarily to the intentions of the parties. Since the VCLT expressed a preference for the textual approach, the *travaux* are only to be taken into account in the case of ambiguity. There are a number of reasons why the role of preparatory works has been downplayed, among which are the fact that often countries have never participated in the negotiation process, [71] the sometimes obscure quality of the *travaux* [72] and that, due to the proliferation of international agreements, the *travaux* will now in a number of cases be not much more than a number of remarks sent between different officials by electronic mail. [73] However, still, notwithstanding the wordings of this article, it has been submitted by an author as eminent as the former president of the International Court of Justice, Judge Schwebel, that it flows from the duty to interpret a treaty in good faith contained in the general rule that a court should "correct" treaty provisions whose ordinary meaning is clear when the preparatory works indicate that this ordinary meaning does not correspond to the parties' intention. [74] More in general, international legal scholars indeed continue to rely on historical arguments, and, despite the wordings of the VCLT, tend to include the preparatory works of a treaty in its context, thereby enhancing the role of the *travaux*. [75]

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- 66 United Nations Convention on Contracts for the International Sale of Goods, done at Vienna on 11 April 1980 (entry into force: 1 January 1988). There are currently (November 2006) 67 parties to the Convention.
- 67 Art. 7, Sec. 1 of the aforementioned UN Convention on contracts for the international sale of goods gives a lot of leeway for dynamic interpretation by the judiciary by stating that "questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.
- 68 Van Alstine, M.P., "Dynamic Treaty Interpretation", 146 *University of Pennsylvania Law Review* (1998), p. 687.
- 69 Bernhardt, op. cit. note 60, p. 25.
- 70 Lauterpacht, H., "*De l'interprétation des traités*", *Annuaire de l'Institut de Droit International* 1950-11, p. 397.
- 71 Either because they were not interested at the time of the negotiations or because they had not yet achieved independence. The latter situation applies to the majority of States within the present-day international community that was still under colonial domination at the time of the adoption of the Charter of the United Nations, the constitutions of most global international organizations and a number of important law-making agreements.
- 72 There are considerable divergences in the quality of preparatory works: conventions drafted in the framework of international organizations can often benefit from their meticulous recording practices, but this is not always the case when treaties are drafted outside this existing institutional context (e.g. in an international conference ad hoc).
- 73 Especially in the case of bilateral agreements - such as double taxation treaties - a large amount of the communication may happen informally.
- 74 Schwebel, S., "May preparatory work be used to correct rather than confirm the 'clear' meaning of a treaty provision?", in J. Makarczyk (ed.), *Theory of International Law at the Threshold of the 21st Century: essays in honour of Krzysztof Skubiszewski*, The Hague: Kluwer Law International, 1996, pp. 541-547.
- 75 Klabbers, op. cit. note 32, p. 288.

Nevertheless, considerations of legal certainty induce the domestic judge to caution and a parsimonious use of preparatory works, since they are much less accessible to the public than those of national legislation. There is indeed a fundamental difference between treaty interpretation in interstate dispute settlement where in many (but not all) cases the parties to the dispute have themselves taken part in the drafting process of the treaty and both will more or less equally have access to the *travaux* and treaty interpretation in internal disputes, either between individuals or, as is the case in tax law, between individuals and the State. The same reason why previous publication is a requirement in many legal orders for the invocability of a treaty against individuals [76] (but not against the State) presses for the exclusion of holding not properly published materials, such as the *travaux préparatoires*, whatever their relevance may be internationally, against individuals. [77] This also holds true for the use of other extrinsic elements in the process of treaty interpretation, such as formal or tacit subsequent interpretative agreements between the parties (supra, 1.3.2.).

### 1.3.5. The interpretation of treaties drafted in more than one language

A final point of interest is the interpretation of treaties drafted in more than one language. [78] It can be easily presumed that there are more pluri-lingual treaties than treaties having only one authentic version: virtually every new multilateral treaty with a global reach is normally drafted in six languages, [79] and also many bilateral agreements are concluded in more than one language. Tax treaties are generally entered into in the languages of both Contracting States. Occasionally, an additional "neutral" language, usually English or French, [80] shall be binding in the case of differences. [81]

The domestic judge is not expected to interpret the text in each of the versions: according to Art. 33 VCLT, the text is equally authoritative in each language and its terms are presumed to have the same meaning in each linguistic version. Although the thesis that each State is only bound by the text in its national language must be dismissed, [82] it is common practice that a domestic judge will primarily rely on the authentic version in the language of the procedure. [83] At the international level we witness, in fact, a similar practice at the International Court of Justice, which tends to only have regard to the French and English versions of a treaty text and not to the other authentic versions. This is even the case in disputes between two countries that both have a common official language in which an authentic version of a treaty has been drafted. [84] Domestic judges are not required to be polyglots who are fluent in each authentic language of each treaty that has been concluded by their State. The presumption of the equality of the different authentic versions is a rebuttable presumption [85] and parties to a dispute before a domestic judge may produce proof that there are discrepancies between the versions. Furthermore, Art. 31, para. 1, VCLT calls for an interpretation of treaties in good faith and this should induce domestic judges to a cautious approach, urging them to consult other language versions whenever there is ground to believe that the version relied on does not adequately represent the correct meaning of the treaty. The fact that a judge represents a State body, whose misapplication of the treaty can entail State responsibility (supra, 1.2.2.), also requires care when relying on a single language version. There is, however, only limited

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76 This requirement can either be contained in a constitutional provision, such as Art. 93 of the Dutch Constitution or in a general principle of law "uncovered" by jurisprudence, as is the case in Belgium (Cassation, *Boileau*, 11 December 1953, *Pasicrisie beige* 1954, 1, 295).

77 Engelen, F., *Interpretation of Tax Treaties under International Law*, Amsterdam: IBFD Publications BV, Vol. 7 Doctoral Series, p. 551.

78 Hilf, M., *Die Auslegung mehrsprachiger Verträge*, Berlin: Springer, 1973, pp. xi and 249.

79 Arabic, Chinese, English, French, Russian and Spanish.

80 For the *petite histoire* of international law, it is curious to see how Prussia and Japan indicated ... Dutch as the neutral language in Art. 22 of their Friendship, Commerce and Navigation Treaty of 21 January 1861: "*Der gegenwärtige Vertrag ist vierfach in Deutscher, Japanischer und Holländischer Sprache ausgefertigt. Alle diese Ausfertigungen haben denselben Sinn und dieselbe Bedeutung, aber die Holländische soll als der Original-Text des Vertrages angesehen werden, dergestalt, daß, wenn eine verschiedene Auslegung des Deutschen und Japanischen Textes irgendwo einträte, die Holländische Ausfertigung entscheidend sein soll.*"

81 Vogel, K., *Klaus Vogel on double taxation conventions*, 3rd ed., London: Kluwer Law International, 1997, p. 38, Nr. 72.

82 Yasseen, op. cit. note 5, p. 109.

83 Hilf, op. cit. note 78, p. 83.

84 ICJ, *Case concerning maritime delimitation and territorial questions between Qatar and Bahrain - Jurisdiction and admissibility*, judgment of 15 February 1995, *ICJ Rep.* 1995, p. 6, paras. 34-40.

85 Hardy, J., "The Interpretation of Plurilingual Treaties by International Courts and Tribunals", 37 *British Yearbook of International Law* (1961) p. 116.

attention for other language versions and divergences are not very likely to come to the surface before a domestic judge. <sup>[86]</sup> This situation has been appropriately criticized, in the sense that

[there] is a need not for a presumption allowing the interpreter of a treaty to justify his own ignorance and rely only on the version in his native tongue, but for an incentive to consult and compare several language versions. If undertaken on a sensible scale (for example: consultation of two or three language versions) the difficulties of comparison are real but hardly insurmountable. <sup>[87]</sup>

In the case of divergence, the VCLT has not opted for a solution in favour of the language of the negotiations preceding the conclusion of the treaty as the so-called "original" language of the treaty or for the clearest text. Instead, the meaning which best reconciles the different versions, having regard to the object and purpose of the treaty, will prevail, and this will often - but not necessarily - be the lowest common denominator. In other words, if there is a version with a more restricted meaning, that version will have the upper hand unless it frustrates the object and purpose. <sup>[88]</sup>

It often occurs that a treaty is officially translated in the national language of a country and that this translation is submitted together with an authentic version to parliamentary approval and later also published in a national official journal. <sup>[89]</sup> When domestic judges then have to interpret the treaty, they should have no regard to this official translation, for the State is only bound by the authentic version and the official translation serves no other goal than to provide a first notification to the public of the general tenor of the treaty's content. There is no presumption of similar meaning between an authentic text and a translation. <sup>[90]</sup> Furthermore, discrepancies between the authentic text(s) and such an official translation are not uncommon. <sup>[91]</sup> In this situation, the rules of the VCLT on the interpretation of pluri-lingual treaties do not apply, since the text has never been authenticated in both languages. The official translation has no relevance from an international law perspective. <sup>[92]</sup> It is however, a common - though regrettable - practice that domestic judges will only consider the official translation, without even contemplating the authentic version of the treaty. <sup>[93]</sup>

## 1.4. Conclusion

When interpreting a treaty, the domestic judge shall be guided by a set of principles of international law instead of national rules of interpretation. Those principles are contained in Arts. 31 to 33 of the 1969 Vienna Convention on the Law of Treaties. Nevertheless, due regard should be had for the fact that a domestic judge is in a different position from international dispute settlement bodies. Reasons of legal certainty call for caution in the use of elements that are not accessible to the general public when interpreting treaties, such as preparatory works. As a matter of principle, domestic judges may rely on the authentic version of a treaty in the language they are most apt to understand, as long as this is done in good faith and unless the parties to the dispute contest the identical meaning of the different versions.

Lastly, as more and more agreements are aimed at forming a comprehensive legal framework for an indeterminate period of time, evolutionary interpretation is expanding from its traditional stronghold of the human rights treaties to other segments of international law, among perhaps double taxation conventions.

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<sup>86</sup> Tabory, M., *Multilingualism in international law and institutions*, Alphen aan den Rijn: Sijthoff & Noordhoff, 1980, p. 199.

<sup>87</sup> Kuner, C.B., "The interpretation of multilingual treaties: comparison of texts versus the presumption of similar meaning", 40 *International and Comparative Law Quarterly* (1991) pp. 963-964.

<sup>88</sup> PCIJ, *The Mavromatis Palestine Concessions*, Judgment No. 2, judgment of 30 August 1924, *P.C.I.J. Rep.*, Series A, Nr. 2, p. 19.

<sup>89</sup> E.g. for Belgium Art. 8 *Loi du 31 mai 1961 relative à l'emploi des langues en matière législative, à la présentation, à la publication et à l'entrée en vigueur des textes légaux et réglementaires* (*Moniteur belge* 21 June 1961).

<sup>90</sup> Kuner, op. cit. [note 87](#), p. 955.

<sup>91</sup> Van Eeckhoutte mentions a number of divergences in the authentic English text and the Dutch translation of the Rome Statute of the International Criminal Court (Van Eeckhoutte, D., "*Bekendmaking van verdragen: voorstel tot genezing van een ziekte*", *Tijdschrift voor Wetgeving* 3 (2002) note 78).

<sup>92</sup> Degan, V.D., *L'interprétation des accords en droit international*, The Hague: Nijhoff, 1963, p. 86.

<sup>93</sup> Hilf, op. cit. [note 78](#), p. 200.

## 1.5. Annex: Articles 31-33 of the Vienna Convention on the Law of Treaties

### Section 3. Interpretation of treaties 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 interpretation of a 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 shall 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;
- (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 which 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 shall 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.

## Chapter 2 – Some comparative notes on tax litigation

### 2.1 Introduction

A comparative look into the structure of European tax judiciaries shows a fairly thin common thread: the absence of juries. Besides that, very different solutions apply.

In some countries special courts handle tax litigation, [2] while in some others courts of general jurisdiction decide over tax cases, although in the latter case controversies concerning tax law are routinely assigned to sections or judges experienced with that subject matter. [3] Lay judges are sometimes members of the panel, but again only insofar as they are experienced in the technicalities of fiscal law. [4]

Access to courts is often postponed to an out-of-court recourse to the tax authorities, [5] but this form of internal, non-judicial redress is not always developed in the same way. Actually, the more developed is the system of internal redress, the less specialized is the court handling jurisdiction for judicial review of the activity of tax authorities.

Lastly, no special rule governs access to courts of last resort. Access is therefore granted as a matter of right, or at the discretion of the court, following the general rules governing access in ordinary cases.

### 2.2. Attitudes to legal issues

The attitude towards many legal issues varies as well, mainly depending on the respective legal traditions. British common law courts draw from their tradition the idea that as a general (but not mandatory) rule it is up to the parties to call for a point of law, even when no jury is empanelled: an inherent power of the judge to raise issues of law is seldom used; applicability of tax treaties or foreign laws must always be claimed by the interested party. [6]

Continental civil law courts, on the contrary, generally share the opposite view that legal issues are a domain of the judge: the *ejura novit curia* principle implies that parties do not even need to mention the law; the principle of party prosecution applies only to facts and does not necessarily entail party control over the evidentiary materials. [7] The burden of proof, in fact, in Continental courts is generally a purely objective means of distributing between the parties the risk of uncertainties in fact-finding: a party's burden of proof, can be complied with through evidence introduced by the other party, or even by the judge *sua sponte*.

### 2.3. Burden of proof and rules of evidence

The rules governing the burden of proof are sometimes influenced by traditional policy considerations, requiring the taxpayer to fully prove the case. [8] However, the opposite view is now prevailing, partly fuelled by the ECJ case law: [9] the burden of proof generally lies within the tax authorities; the burden of

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2 Compare Favi, L., "Italy", chap. 12, 12.1.2.; Rust, A., "Germany", chap. 11, 11.1.1.; Metzler, V., "Austria", chap. 9, 9.1.1.; Avery Jones, J.F., "The courts and tax treaties in common law systems", chap. 3, 3.1., all in this volume.

3 See Marres, O., "Netherlands", chap. 13, para. 13.1. in this volume; obviously, administrative courts count here as courts of general jurisdiction (therefore, this group includes France: see Martin, P., "Tax treaties: The perspective of civil law countries", chap. 4, para. 4.1.1.2., in this volume)

4 See Favi, op. cit.

5 Compare Martin, id., 4.1.1.3.; Marres, id.; Ribes Ribes, A., "Spain", chap. 14, 14.1. in this volume; special courts (see note 2) are often developments of non-judicial systems of internal redress, yet may still look very similar and therefore their independence can be doubtful (see, on the Italian tax judiciary, Favi, op. cit.), and their judgements can be subject to judicial review from courts of general jurisdiction (on the British system see Avery Jones, op. cit.)

6 See Avery Jones, op. cit.

7 Compare Rust, 11.2.6.; Martin, 4.4.2.1.; Marres, 13.2.6.; Favi, 12.1.3., op. cit.

8 See Avery Jones, 3.1.; Ribes Ribes, 14.2., op. cit.

9 A leading case is *Ministero delle Finanze c. Soc. San Giorgio*, 9 November 1983, C-199/82 (compare Daniele, "Indebito comunitario e ordinamento italiano", *Foro it. IV* (1984) pp. 298 et seq.; Scarpa, "Illegittimità della norma nazionale che osti all'esercizio dei diritti attribuiti dall'ordinamento comunitario", *Giust. civ. I* (1984) p. 18 et seq.; Maresca, "L'integrazione fra il diritto comunitario e il diritto interno nella disciplina della ripetizione dell'indebito in materia fiscale comunitaria", *Dir. prat. trib. II* (1984) p. 3 et seq.; Raiti, *La collaborazione giudiziaria nell'esperienza del rinvio pregiudiziale comunitario*, Milan: Giuffrè, 2003, p. 415 et seq.)

proof of the taxpayer is limited to, e.g. the factual basis for exemptions or applicability of tax treaties, and, generally, facts that can more easily be proved by the claimant. [10]

To this latter end, foreign evidence is generally available, the main problem being the requirement of an official translation of the content of documentary evidence: some countries still require the use of national language. [11] The rules governing the taking of evidence abroad, however, may vary, depending on the nature of the relationship between the two countries: when cooperation treaties are in force, the tax authorities enjoy a wide-ranging investigative power; otherwise, the burden of proof tends to lie with the taxpayer. [12]

In the field of proof taking, however, from a comparative point of view, Italian law reveals a surprising feature: the ban on taking of witnesses. At first glance, this may look like a blatant violation of basic procedural safeguards.

The rule is often justified on rather feeble grounds. Some scholars say that there is no need for oral evidence in tax litigation because only documentary evidence is relevant, [13] but this view is rather tautological: the ban of oral evidence can be unconstitutional on substantive as well as on procedural grounds, as far as a relevant fact may be proven through a witness; even when the relevant fact is the formation of a document, a witness statement of its formation may well be relevant.

In a recent decision, the Italian Constitutional Court held that the ban on taking of witnesses in tax litigation parallels the ban on oral evidence for the proof of some facts, pursuant to the civil code general rules, but thus overlooked the core of the issue: as a general rule, the party cannot call a witness to prove one of those facts, but when there was documentary evidence - lost with no fault by the interested party - the content of the document can actually be proved through witnesses. [14]

The Court added that oral evidence is unnecessary, and tried to prove it, showing that before the ban the taking of witnesses in tax litigation was a very rare event. [15] But this argument actually runs to the contrary opinion: at least in some cases witnesses were called and therefore the ban is relevant, because at least in some cases it can determine the outcome of the litigation.

Supporters of the ban, however, tend to justify it mainly on a different ground: they say that the ban covers only the formal way of taking the witness and not the use of written statements as evidence, formed by public authorities, collecting witness declarations on the disputed facts. [16] Even this justification, however, seems weak from a constitutional point of view: firstly, the taxpayer does not participate in the taking of the evidence; secondly, the taxpayer does not share the compulsory power over witnesses of the public authorities.

On these points, the Italian Constitutional Court said: firstly, that the taxpayer can participate in the discussion over the evidentiary value of the document and therefore is not deprived of the fundamental right to be heard; secondly, that the tax court has a duty to order the public authorities to collect every relevant witness statement called by the taxpayer, and report in writing, and therefore the right to proof of the taxpayer is adequately protected. [17]

Moreover, two rather significant and often (but not always) unspoken reasons for the ban sometimes seem to be considered decisive: that the witness is not a reliable evidence in tax litigation [18] and that

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10 Compare Martin, 4.2.2. et seq., 4.4.; Rust, 11.1.2.; Marres, 13.1.2.; Metzler, 9.1.2.; for Italian case law see, e.g. Cassazione 5 November 2001, no. 13665, *Giur. imposte*, (2002), p. 50 et seq.

11 Compare Martin, 4.2.5.2.; Ribes Ribes, 14.5.; Favi, 12.3., op. cit.; in Germany, however, a translation is required only when a member of the court or a party does not understand the foreign language, see Rust, 11.1.2.5., op. cit.

12 See particularly Martin, 4.2. et seq., id.

13 See, e.g. Glendi, "I poteri del giudice nell'istruttoria del processo tributario", *Riv. trim. dir. proc. civ.* (1985) p. 947; compare Corte costituzionale, 12 January 2000, no. 18, *Rass. trib.*, (2000) p. 557 et seq. (with a critical comment of Russo, "Il divieto della prova testimoniale nel processo tributario: un residuo storico che resiste all'usura del tempo"); *Giur. cost.* (2000) p. 128 et seq. (with a critical comment of Fazzalari, "Prova testimoniale o dichiarazioni di terzi adotte dall'amministrazione?")

14 Corte costituzionale, id., no. 18, quoted Art. 1659, 1846, 1888, 1919 c.c. but apparently neglected Art. 2725 c.c. (see on the latter as a general exception to every substantive ban on taking of witnesses, e.g. Taruffo, "Prova testimoniale (dir. proc. civ.)", in *Enc. dir.*, XXXVII, Milan, 1988, p. 746)

15 See Corte costituzionale, no. 18, id.

16 See Glendi, op. cit., p. 949

17 See Corte costituzionale, no. 18, op. cit.

18 See, e.g. Lamber, "L'istruzione probatoria nel processo tributario", *Boll. Trib.* (1975) p. 1493

the formal examination of the witness pursuant to the general rules of civil procedure is particularly unfit for the detection of perjury, particularly because the judge must approve in advance the entire sequence of the questions with the participation of the parties, and therefore the witness never meets unexpected questions. [19]

In any case, both these reasons fall short in justifying the ban because they take it too far: the risk of perjury is general and the safeguard against it lies in the general rule that the judge must cautiously evaluate the witness credibility. Better safeguards - such as the common law-style cross-examination and the like - can be useful in tax litigation, as well as in any other field of the law.

But the ultimate reason for the ban actually lies in a fundamental feature of the judicial authority in Italian legal culture: its bureaucratic and hierarchical structure. This feature derives primarily from the Napoleonic reforms, [20] but in some aspects dates back at least to the Middle Ages: [21] the Italian bureaucratic culture, therefore, developed even more fully than that of France. A good example comes from the recruiting system: selecting candidates through a competition based on legal knowledge is an epitome of the French judiciary; but the Italians came up first with the idea of relying only in the results of a several-days-long display of legal knowledge - favourable to the younger candidates - so that the winners would spend their whole lives inside the judiciary, trying to reach the higher levels of the judicial pyramid [22] (while the British still pick their judges from the experienced bar and promotions to a higher court are comparatively rare).

When procedural rules derive from structural features of the judiciary, they influence the legal culture so deeply that they tend to apply even in cases dealt with by special judges: as well as the common law tax proceedings are similar to jury trials, from the Continental perspective, even when no jury is empanelled - so that judges seem to spend their time in lengthy discussions over useless hypothetical points - Italian tax litigation follows the procedural rules of the hierarchical bureaucracy even when lay judges participate in the panel. Therefore, even in tax litigation a typical rule of the bureaucratic culture applies in Italy: that every case is entitled to a full double examination on the merits and access to the court of last resort on issues of law, including those concerning the violation of the legal standards of the fact-finding process (access of right to the Cassation Court is even guaranteed by constitutional law).

Clearly, when a first-instance judicial decision on the merits can always be fully and deeply re-examined by a superior judicial authority, the taking of evidence cannot be repeated because it would cost too much. Therefore, oral evidence is always used, in the ultimate and decisive stage of the litigation, through its written recollection, sometimes formed many years before.

In this condition, the need for oral evidence cannot be taken too seriously. [23] The common-law style cross-examination, introduced in the Italian criminal procedure in 1988, is a transplant from a foreign legal culture that soon proved itself very expansive and, most importantly, hardly compatible with the view that every case must have a full treatment. [24]

## 2.4. Concluding remarks

Providing the parties in tax litigation with the right to call witnesses might prove as well very expensive if the role of the witness is taken seriously. As always, when the party can use many procedural weapons, many parties may discover that they lack the resources to use any weapon at all.

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19 See, with a critical posture, Barbuto, "Processo inquisitorio o dispositivo davanti alle commissioni tributarie?", *Il fisco* (1996) p. 8229

20 On the influence of the *grande loi* of 1812 in Italy see e.g. Denti, "Dottrine del processo e riforme giudiziarie fra illuminismo e codificazioni", *Riv. dir. proc.* (1981) p. 217 et seq.

21 On the relationship between the structure of the Continental judiciary and the rules of procedure, and for further details on its history, see the seminal work of Damaska, *The Faces of Justice and State Authority*, New Haven, Connecticut: Yale University Press, 1986, p. 29 et seq.

22 This method applies in Italy since the enactment of law no. 6878 of 8 June 1890; France adopted it only with a decree of 13 February 1908 (see Perrot, *Institutions judiciaires*, Paris: Montchrétien, 1995, 7th ed., p. 310)

23 See Damaska, op. cit. p. 51

24 For some comparative critical notes on the problems of the Italian apostasy from the Continental tradition in criminal procedure see Damaska, *Evidence Law Adrift*, New Haven, Connecticut: Yale University Press, 1997, translated in Italian as *Diritto delle prove alla deriva*, Bologna: Il Mulino, 2003, p. 107

It is quite obvious that all these differences may negatively affect the effectiveness of tax treaties. The remedy, however, lies in the very difficult task of harmonizing not only the rules of procedure but also the structures of the judiciaries - and, ultimately, the legal cultures. <sup>[25]</sup>

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<sup>25</sup> For a recent account of the perspectives of a European harmonization of civil procedure see Storme (ed.), *Procedural Laws in Europe Towards Harmonization*, Antwerp: Maklu, 2003

## Chapter 3 – Tax treaties: The perspective of common law countries

### 3.1. Common law tax appeals generally

#### 3.1.1. Introduction

Reading the national reports in this volume - all from civil law countries - makes me, as a common law lawyer, feel as if I live in a different world. To give just one example relating to tax appeals to the highest courts: in France 120 judges of the *Conseil d'Etat*, which deals with administrative law, decide about 1,000 tax appeals per annum; in the UK 12 judges in the House of Lords, which deals with all branches of law for both England and Scotland (a separate legal system), hear five or six tax appeals per annum (out of a total of about 75 appeals).

This difference is not merely that in the UK, the higher courts can be, and are, highly selective about whether to hear an appeal; the first instance direct tax tribunal for serious cases for the whole of the UK, the Special Commissioners, heard only 77 appeals in 2005. I do not have an answer to the reason for these differences but I believe they are important to our understanding of how tax appeals are approached in different countries. If we restrict ourselves to a comparison of the common law and civil law approaches to interpretation of tax treaties in isolation - such as the extent to which the OECD Commentaries are used by courts - I doubt if we shall not find many fundamental differences; but, I suggest, it is necessary to look at these questions in the wider legal context of the significant differences between common law and civil law on how appeals are heard and decided, which may indirectly affect the approach and, even in some cases, lead to different results.

To give some further examples of the UK system that I believe are different from civil law systems:

- tax law is part of ordinary law, not administrative law;
- the burden of proof of facts is almost always on the taxpayer, which is different from normal civil litigation; facts must be proved to the balance of probabilities;
- the proceedings are primarily oral with witness evidence; the court relies entirely on the legal and factual arguments of the parties put forward at the hearing, but counsel have a duty to the court to refer to case law that is against their case; essentially there is a "day in court" (which may well exceed one day) when all the facts and arguments are considered - the court does nothing in the way of investigating the merits of the case before that, although at the hearing the judge can take an active role in questioning counsel on their arguments of law;
- judges will restrict their decisions to the points argued and set out fully in the decision the process by which the decision is reached;
- in the tax tribunal and lower courts, a single judge is normal, and in higher courts, where there is a panel of judges, dissenting judgments can be given; it necessarily follows from the small number of appeals on any one legal topic that the judges in the courts hearing appeals from the tax tribunal are all generalists;
- higher courts are selective about whether they will hear an appeal; appeals to the courts are on a point of law only, but there is still extensive oral argument on the law;
- there is also no equivalent to a *juge rapporteur* or advocate-general providing additional views to the court;

- decisions of higher courts bind lower courts and so, in deciding a case, a higher court is not merely deciding the case but is also laying down guidance for the future for lower courts, with the consequence that it is most unlikely for a higher court ever to meet the same point more than once;
- the number of cases is far smaller (but also each one much longer) than is the case in civil law countries; most cases are therefore settled without litigation, in part because of the time and money involved in an appeal, but also because the tax authority operates in a way that encourages settlement of tax disputes.

As I believe that a civil law reader may find many, or even all, of these strange, I shall therefore start with a brief description of how tax appeals in general are conducted in the UK.

### 3.1.2. The system of tribunals and courts for tax appeals in the UK

In common with much of the system of justice in the UK, the first stage in a tax appeal is to a tribunal. <sup>[2]</sup> Tribunals are part of the court system but are less formal than courts. For example, there is no restriction on who can appear for a taxpayer in the tax tribunals and the strict rules of evidence that apply in court do not apply in the tribunal. There are separate tribunals for direct and indirect taxes; historically, these were dealt with by two different tax authorities, which merged in 2005. The direct tax tribunal <sup>[3]</sup> consists of two tribunals, the General and the Special Commissioners, both of which have been functioning for over 200 years. <sup>[4]</sup> The General Commissioners are a lay tribunal who sit with a clerk who is usually legally qualified. The Special Commissioners are a legally qualified tribunal comprising four full-time Commissioners in London (of whom I am one) and two in Manchester, plus a pool of 27 part-time Commissioners. Normally, we sit on our own but in particularly heavy cases two may sit. <sup>[5]</sup> In many cases, the taxpayer can choose whether to appeal to the General or Special Commissioners, but there are certain matters, including claims for double taxation relief, <sup>[6]</sup> that are reserved to the Special Commissioners. The Special Commissioners in practice hear most of the serious tax cases at first instance. The number of cases is quite limited: for 2005, the *Simon's Tax Cases (Special Commissioners' Decisions)* reports (which reports all their decisions comprehensively) include 77 cases throughout the whole of the UK and the decisions comprise 881 printed pages. <sup>[7]</sup> Because most disputes are settled by negotiation those that are determined by the tribunal can be quite old, the delay being caused by the negotiations, not in having the appeal heard by the tribunal. <sup>[8]</sup>

Recently a committee recommended a reform of all tribunals in the UK that would become a two-tier system, <sup>[9]</sup> which the Government adopted in a White Paper, <sup>[10]</sup> and further consultation has taken place over the details for the tax tribunals in an advisory Stakeholders' Committee. <sup>[11]</sup> It is expected that a tribunal similar to the Special Commissioners would be a second-tier tribunal, hearing appeals from the first tier and probably hearing some major cases at first instance. A Bill containing the legislation dealing with the reform was introduced into the House of Lords on 17 November 2006, which means that it is now likely to go ahead.

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<sup>2</sup> "The Leggatt Committee Report", Tribunals for Users (March 2001), noted the existence of 137 different tribunals in the UK.

<sup>3</sup> As this chapter is concerned with direct tax, the VAT and Duties Tribunal, which deals with all indirect taxes, is only dealt with in passing.

<sup>4</sup> For the origins of the Special Commissioners, see the writer's "The Special Commissioners from Trafalgar to Waterloo", [2005] BTR 40 and "The Special Commissioners after 1842: from administrative to judicial tribunal", [2005] BTR 80

<sup>5</sup> The Chairman has a casting vote if they disagree. For an example, see *Jones v Garnett* [2005] STC (SCD) 9. In indirect tax appeals, except where the issue is a pure point of law, a legally qualified Chairman normally sits with a non-legally qualified member, such as an accountant, surveyor or other person with qualifications relevant to the subject matter of the appeal (but two Chairmen cannot sit). It is expected that some of these differences between the two tribunals will disappear as part of the reform, see text at [note 9](#)

<sup>6</sup> TMA 1970 s. 46C(3)(e)

<sup>7</sup> In the VAT and Duties Tribunal, in 2005 for the whole of the UK, there were 273 VAT appeals (including 13 civil fraud cases) and 216 VAT penalty appeals; 17 customs duty and 90 excise duty appeals. (Since there is no equivalent of the General Commissioners in indirect tax appeals these figures may give a better picture of the total number of appeals at first instance.) Not all these decisions are reported but they are all on the Tribunal's website ([www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)). It is not therefore possible to give the number of pages of decisions for comparison with the Special Commissioners.

<sup>8</sup> In the Special Commissioners' 2005 reports, the last period to which the appeal related was 1989 - 3; 1991 - 2; 1995 - 3; 1996 - 2; 1997 - 5; 1998 - 5 1999 - 4; 2000 - 11; 2001 - 13; 2002 - 11; 2003 - 6; 2005 - 2 (those of 2005 are both appeals against refusals to renew sub-contractors' certificates)

<sup>9</sup> See [note 2](#)

<sup>10</sup> "Transforming Public Services: Complaints, Redress and Tribunals", Cm.6243 (July 2004)

<sup>11</sup> The minutes are available on the General Commissioners' website: [www.generalcommissioners.gov.uk/reform.htm](http://www.generalcommissioners.gov.uk/reform.htm)

From the Special Commissioners there is an appeal to the ordinary courts but only on a point of law. What is a point of law that is capable of being appealed against is fairly widely interpreted. The facts as found by the tribunal cannot be disputed, except on the ground that there was no evidence to support them, for which the tribunal's notes of the evidence may be required (although in important cases a shorthand writer's transcript of the evidence is taken usually with each day's transcript being available to the parties that evening). The position is less strict when inferences are made from the primary facts found. An appeal court can upset such an inference on the basis that it is a point of mixed fact and law.

The hierarchy of courts above the Special Commissioners is that in England, the appeal is to the High Court (one judge sitting alone), the Court of Appeal (three judges) and the House of Lords (five judges); <sup>[12]</sup> in Scotland, effectively, the High Court is missed out and the appeal lies to the Inner House of the Court of Session (three judges), which is the equivalent of the English Court of Appeal. In the first two levels - the tribunal and the High Court - there is therefore a single judge; above that, where there is more than one judge, each judge is free to give a separate judgment (although often this will merely agree with another judge) and dissenting judgments can be given. No doubt some negotiation takes place to reach a common judgment but if a judge fundamentally disagrees, he will dissent. <sup>[13]</sup> Such dissents are helpful to courts in deciding whether to give permission to appeal (and to the parties deciding whether to appeal). <sup>[14]</sup> Under the proposed reform of tribunals, an appeal would lie from the upper-tier tribunal to the Court of Appeal in England, thereby cutting out the High Court (and the procedure would, as now, be the same in Scotland). It takes approximately a year between each of the appeal stages.

To give an idea of the (small) volume of appeals to the courts, in 2005 for the whole of the United Kingdom there were 13 direct tax cases <sup>[15]</sup> in the High Court, <sup>[16]</sup> seven in the Court of Appeal and Court of Session in Scotland together, and six in the House of Lords (out of a total of 74 cases decided by the House of Lords). The number of judges is correspondingly small: 17 High Court judges (in the Chancery Division, which includes tax among many other subjects in its jurisdiction), 37 Lords Justices in the Court of Appeal in England plus nine judges in the Inner House of the Court of Session in Scotland (both dealing with all branches of the law), and 12 judges (Lords of Appeal in Ordinary) in the House of Lords (dealing with all branches of law throughout the UK). Clearly, with such small numbers there is no possibility of specialist sections of courts dealing only with tax, or even specialist judges, which is significantly different from the position described in the country reports from civil law countries. An appeal lies from the tribunal to the High Court without any permission, but above that an appeal requires the permission of either the court appealed from or to, which seems to me to be a significant difference from civil law courts. The House of Lords in particular is very selective about what appeals it will hear; for example, there was a 31-year gap between the last two tax treaty cases that it heard. I understand that in civil law systems, the highest court has to hear any appeal - with a corresponding enormous number of appeals compared to the number in the common law system.

As an alternative to appeals to the courts, in European law cases references are increasingly being made from the tribunal (and also the courts) to the European Court of Justice, a recent example from the Special Commissioners being *Cadbury Schweppes*, relating to the compatibility of CFC legislation with European law. <sup>[17]</sup> Although some European law cases, including *Marks and Spencer plc*, <sup>[18]</sup> have started in the

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<sup>12</sup> The House of Lords will be separated from the House of Lords as a legislative chamber and will become a Supreme Court in 2009. In Scotland, in effect, the appeal from the Tribunal is to the Court of Appeal, the inner House of the Court of Session.

<sup>13</sup> For example, in *Agassi v Robinson* [2006] STC 1056, 1064 Lord Walker's speech records: "I have found it a difficult case, and I have hesitated whether to carry my doubts to the point of dissent."

<sup>14</sup> A recent interesting example is *Condé Nast v Customs and Excise Comrs* [2006] STC 1721 in which there was a strong dissent in the Court of Appeal in an earlier similar case (*Fleming v Customs and Excise Comrs* [2006] STC 864) that was at the time under appeal to the House of Lords. The Court of Appeal in *Condé Nast* felt obliged to follow the majority decision in the earlier case, but clearly found the dissenting judgment more persuasive.

<sup>15</sup> The equivalent statistics for indirect tax cases in 2005 was 31 cases, split as to House of Lords (3), Court of Appeal plus Court of Session in Scotland (8) and High Court (20).

<sup>16</sup> The figure includes three appeals from the General Commissioners, the rest being from the Special Commissioners (except for one inheritance tax case that started in the High Court, which is possible, though unusual, for that tax). If the figures were constant from year to year they would indicate that about 12% of Special Commissioners' decisions are appealed.

<sup>17</sup> The reference is reported at [2004] STC (SCD) 342 and see also [2006] STC (SCD) 35 in relation to factual differences, and the ECJ decision is Case C-194/04; and also *HMRC v Vodafone 2* [2006] STC 483 (appeal against reference made by the Special Commissioners)

Special Commissioners, in many cases major groups of companies in the UK have in large numbers [19] come together in group litigation in the High Court, a procedure for obtaining a decision in a test case that binds all parties to the litigation, [20] on the compatibility of UK tax legislation with European law, which had the advantage that some remedies, such as damages and restitution, are available that are not in the Special Commissioners. [21] There are currently six such examples of group litigation and references to the ECJ have so far been made in four of them, and in another, the ECJ decision preceded the original group litigation order. [22] That decision has given rise to a number of subsequent cases in the UK courts, many in - or on their way to - the House of Lords, within the scope of the group litigation. [23] So far as the group litigation procedure is concerned, the House of Lords decided [24] that if the company is in time for appealing to the Special Commissioners, [25] it had to do so rather than apply to the High Court. The result is likely to be that more litigation concerning compatibility with European law will take place before the Special Commissioners in future, although because many such issues have already been referred to the ECJ in the course of the group litigation or are pending before UK courts following such references, taxpayers are probably waiting for the results of these before raising other issues.

### 3.1.3. Tax law is not part of administrative law

Not only is tax law not part of administrative law in the UK, [26] but the tax appeal tribunals have no administrative law jurisdiction in direct taxes, and only limited jurisdiction in the field of VAT and customs and excise duties. Administrative law does exist in England in the action for judicial review of an administrative decision but in its present form this dates only from 1981. There is a part of the High Court that deals with administrative law cases. Any administrative law points arising in a tax appeal must be started separately before that court. Any appeals from that court lie to the ordinary higher courts and so there is no strict separation of ordinary and administrative courts, as there is, for example, in France. [27] Administrative law decides whether a decision was such that no reasonable tax authority could have taken, or that the decision took irrelevant matters into consideration, or failed to take relevant matters into account. [28] It is interesting that in administrative law evidence is given only by affidavit and not by witness evidence. If tax had been classed as administrative law in the UK, the approach to evidence in tax appeals might have been much closer to the civil law.

Another relevant difference is the absence of an equivalent to the French *Commissaire du gouvernement* who, it is understood, can make their own factual enquiries, e.g. about accounting treatment. In the UK, this would need to be done by means of expert evidence. The majority of tax appeals in the UK are brought before tribunals and courts which solely determine whether the taxpayer or the tax authority is right in law. The fact that a public authority is a party does not make a tax appeal any different from other civil litigation. [29] Separate administrative law cases relating to tax are relatively unusual: there were only

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18 [2003] STC (SCD) 70 for the Special Commissioners' decision.

19 The loss relief group litigation order ("GLO") currently includes 95 claimants, involving 70 corporate groups and more than 1,000 individual companies, see *Re Claimants under Loss Relief Group Litigation Order* [2005] STC 1357 at [6]. Over 100 claimant groups are involved in the ACT GLO, see the article cited in [note 21](#) at p. 327

20 "The key features and normal effect of any GLO are that it identifies the common issues which are a pre-condition for participation in a GLO; it provides for the establishment and maintenance of a register of GLO claims; it gives the managing court wide powers of case management, including the selection of test claims and the appointment of a lead solicitor for the claimants or the defendants, as appropriate; it provides for judgments on test claims to be binding on the other parties on the group register; and it makes special provision for costs orders." Lord Walker in *Autologic* at 86 (see [note 24](#))

21 Full details are contained in Sir Andrew Park "A Judge's Tale: Corporation Tax and Community Law", [2006] *BTR* at 322

22 The ECJ decision in *Hoecht AG v IRC* Case C-397/98 and C-410/98 was the cause of the ACT GLO.

23 Including *Pirelli Cable Holding v IRC* [2006] STC 548 (House of Lords), *Deutsche Morgan Grenfell Group plc v IRC* [2006] 3 WLR 781 (HL), *NEC Semi-Conductors Ltd v IRC* [2006] STC 606 (CA and under appeal to the HL), *Sempre Metals Ltd v IRC* [2005] STC 687 (CA and under appeal to the HL), *Aegis Group plc v IRC* [2006] STC 23

24 *Autologic Holdings plc v IRC* [2005] STC 1357

25 The Special Commissioners' rules do not provide for Group Litigation Orders but something on the same lines could probably be achieved.

26 It therefore comes as a surprise to us in the UK that tax is not included within "civil rights and obligations" in Art.6 of the Human Rights Convention because in civil law countries tax obligations derive from administrative rather than civil law, see *Ferrazzini v Italy* (App. No. 44759/98) [2001] 1314 ECHR.

27 In other civil law countries considered in the national reports it seems that tax law is part of administrative law but it is not always the case that it is dealt with by a separate system of administrative courts.

28 Although the issue of the decision being wrong in law can be raised in administrative law, in tax this issue will always be appealed to the tribunal, which procedurally takes precedence.

29 Except in relation to the burden of proof, see the next section.

two direct tax cases in 2005. [30] A good example in the UK of a successful application of administrative law in the tax field is a case where for more than 30 years the Revenue had accepted loss relief claims submitted by a large group of companies outside the statutory time limits; it was held to be an abuse of power to insist on the time limits without notice of the change. [31] This is interesting because the Court effectively decided that the Revenue had to continue acting in breach of the law until they had given reasonable notice that they proposed to change. I believe that this goes even further than French administrative law would have done, although in France the court could have awarded damages instead and so the net effect might be the same. In an ordinary tax appeal before the Special Commissioners and the courts on appeal, the taxpayer would have been bound to lose on these facts since the statutory time limit would have to be applied.

This writer's understanding of why this is different in civil law is the civil law theory, deriving from France after the Revolution and inspired by the American Constitution, [32] that officials are given wide discretions, including power to make a wide variety of regulations, [33] which are controlled by a separate system of administrative law applied by different courts, an interesting example of civil law that was originally judge-made. The common law theory, deriving from Dicey, [34] used to be that officials did not exercise discretions and Parliament did not give them power to make regulations; their actions were controlled purely by whether they are within the general law. These extreme differences no longer apply and common law has moved considerably towards a system of administrative law, but not to the extent of classifying tax law as administrative law, a matter that has not even been discussed in the UK. Today, many Ministerial discretions in common law countries are controlled by administrative tribunals. [35] In England, the tax tribunal cannot, except where the statute provides, [36] even review the exercise of discretions, which requires a separate administrative law action for judicial review in the High Court with a three-month time limit, [37] thus sometimes requiring parallel proceedings. [38] It is likely that as part of the reform of tribunals the scope for the tribunal reviewing decisions will be widened to save having to start two sets of proceedings.

I believe that this difference affects the approach in each system of law. In France, tax law gives more scope for the exercise of the court's discretion because it is part of administrative law in which the court's role is to strike a balance between two competing factors. The *Conseil d'Etat's* decision to allow prospective overruling of a regulation [39] is perhaps an extreme example of how far the court is prepared

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30 The first dealt with the constitution of the tribunal - a case had been remitted to the Special Commissioners by the court after one of the two Commissioners who had originally heard the case had died. The second about a taxpayer against whom a penalty had been imposed for non-compliance with a notice; under the legislation no further appeal could be made against the notice, and the taxpayer raised human rights points by way of judicial review of the imposition of the penalty. In addition, in 2005 there were five judicial review cases relating to VAT. Three of these concerned interest on VAT repayments, on which the tribunal has limited jurisdiction, and another case concerned whether the Revenue should make an interim payment of VAT when a case has been referred to the ECJ, over which the tribunal has no jurisdiction; a further case was an unusual one as a challenge by an Irish supplier of phonecards to a change of interpretation of the law by the Revenue. The report of these cases takes up 76 printed pages.

31 *Rv IRC ex p. Unilever plc* [1996] STC 681

32 This consists of the rigid separation of powers of the executive, the judiciary and the legislature. Napoleon willingly adopted the system as he was keen to have control over his administrators. In spite of its origins, French administrative law provides serious guarantees of the liberties of the subject against the government.

33 *Décrets, règlements, règlements d'administration publique, ordonnances, arrêtés*. Parliament is limited in its law-making power by the Constitution. The term "competent authority" found in tax treaties, which is not particularly appropriate in common law, seems to have this type of official in mind.

34 Prof. A.V. Dicey (1835-1922), particularly, *Lectures Introductory to the Study of the Law of the Constitution* (1885)

35 In tax, the tribunals have much more in common with the courts because no discretions are given to ministers in tax. The French social security tribunals closely resemble the UK administrative tribunals and are regarded in France as being part of private rather than administrative law, see Neville Brown, L. and Bell, J.S., *French Administrative Law*, 4th ed., Oxford: Clarendon Press, 1993, p. 27

36 Which, in direct tax, is to a negligible extent; there are many more examples of the tribunal being able to review the exercise of discretions in VAT and customs duties and excise duties.

37 In Australia, by contrast, the tribunal has jurisdiction over the exercise of discretions. In the administrative reforms of the 1970s the Board of Review was replaced with the Administrative Appeals Tribunal but the situation concerning attacks on exercises of discretion on appeals from tax assessments effectively remained the same. Hence, if taxpayers want to attack the exercise of a discretion, they go to the AAT, which is commonplace. The Administrative Decisions (Judicial Review) Act 1977 extended, modified and clarified the general position of administrative review in federal matters. In relation to tax it draws the line as to when one can attack exercise of discretions other than through the standard appeal process for tax assessments, i.e. in issues that do not really involve assessments such as whether a taxpayer can use a substituted accounting period for tax purposes. This is done through courts and so is limited to traditional type administrative law grounds as changed by the statute.

38 In *International Masters Publishers Ltd v HMRC* [2006] STC 1450 the taxpayer sold a combined CD and book, which raised issues about whether a concession for goods supplied with zero-rated books or magazines applied (a matter for judicial review only), and if not, whether there was a single predominant supply of either a CD or a book (a matter for a tax appeal). By the time the taxpayer appealed the second issue to the tribunal and then the High Court, it was out of time to raise the first issue in the same High Court proceedings. The only way for the taxpayer to have protected its position would have been to start separate proceedings in relation to each issue.

39 11 May 2004, Association "ACI" p. 197 (of the *Recueil Lebon*, the *Conseil d'Etat* records)

to create law; the possibility has been mentioned in the House of Lords in relation to judicial decisions but never applied; [40] it would in any event be impossible to apply the principle on the basis of judge-made law to a regulation. One would expect the opposite to apply with the common law courts being much more prepared to create judge-made law, but we are not comparing like with like: tax is administrative law in France and ordinary law in the UK.

### 3.1.4. The burden of proof

Tax litigation differs from other litigation, under which normally the party alleging a fact must prove it, [41] because, with tax, all the facts begin in the hands of the taxpayer. This is the reason why in the UK in tax appeals the burden of proof of facts is almost always [42] on the taxpayer, so that in an appeal taxpayers start from scratch in having to prove their case in fact and law to the tribunal. The foundation for this rule is one of the earliest income tax provisions, which was originally enacted in 1803 and is still in the legislation today - that an assessment "stands good" unless displaced by evidence. [43] There is nothing to prevent the Revenue from producing evidence in the course of an appeal that the assessment should be increased, and if the evidence is accepted, the tribunal must increase it. [44]

This burden of proof is known as the legal burden. If taxpayers fail to discharge it they will inevitably lose the appeal. A contrast is made between the legal burden and the evidential burden, i.e. the obligation to adduce sufficient evidence to justify a finding of fact that the person requires. It is often said that the evidential burden shifts during the proceedings. This can be illustrated from a case in which the taxpayer produced its books that showed that certain receipts, which the Revenue considered that it had received, were not found there. [45] The taxpayer then submitted in the tribunal that the "burden of proof" shifted to the Revenue to prove fraud. On appeal, the Vice-Chancellor (the head of the Chancery Division of the High Court, to which tax appeals lie) criticized the use of the expression "burden of proof" when it should have been the evidential burden, and even that concept he did not find useful:

As a matter of practical common sense, if the company's documents showed no receipt or entitlement to receipt and the commissioners accepted the oral evidence, in the absence of further evidence it would be understandable that the commissioners would be likely to come to the conclusion that Lotus had discharged the burden of proof which was on them. This might be expressed technically as a shift in what (to my mind unfortunately) is frequently called the evidential burden of proof. The evidential burden of proof is not the same as the basic burden of proof. According to well-known principles, the burden of proof lies normally on the person alleging the fact, but in the present case it is established on the person seeking to set aside the assessment. That burden of proof in technical terms stays throughout where it starts. If, on the other hand, evidence is given which in the absence of other evidence or other factors would be sufficient to discharge the burden, then as a matter of ordinary common sense and judicial method the tribunal will decide that the burden of proof has been discharged. That is all that is meant by a shift in the evidential burden.

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40 *Re Spectrum Plus Ltd; National Westminster Bank plc v Spectrum Plus Ltd and others* [2005] 4 All ER 209

41 This rule is found in tax in France, Italy and the Netherlands and, if there is still doubt after the court has investigated the facts, in Germany, see the country reports.

42 An example of an exception is where the tax authority has made assessments outside the normal period on discovering loss of tax. Another is that the taxpayer does not have a burden of proving a negative: 'the proving of a negative, a task always difficult and often impossible, would be a most exceptional burden to impose on a litigant.' *Joseph Constantine Steamship Line Ltd v Imperial Smelting Corporation Ltd* [1942] AC 154, per Lord Russell at 177

43 43 Geo. 3 c.99 (1803) which was incorporated by reference into the 1803, 1805, 1806 and 1842 Income Tax Acts; then legislated as TMA 1880 s.57; 1918 s.137; 1952 s.52; and currently TMA 1970 s.50(6): "If, on an appeal, it appears to the majority of the Commissioners, present at the hearing, by examination of the appellant on oath or affirmation, or by other evidence (a) that the appellant is overcharged by a self assessment. . .or (c) that the appellant is overcharged by an assessment other than a self-assessment, the assessment...shall be reduced accordingly, but otherwise the assessment... shall stand good.

44 TMA 1970 Sec. 50(7): "if, on an appeal, it appears to the Commissioners - (a) that the appellant is undercharged by a self assessment...or (c) that the appellant is undercharged by an assessment other than a self-assessment, the assessment...shall be increased accordingly." Compare Germany where this is not permitted.

45 *Brady v Group Lotus Car Companies plc* [1987] STC 184 which concerned the receivership of the manufacturer of De Lorean cars in Northern Ireland that had been substantially funded by grants. A US De Lorean company paid \$17.65m to GPD, a Panamanian company; \$8.5m was paid by it to Mr De Lorean personally; GPD assigned to Lotus Cars Limited the development work on the car at agreed charging rates. The Revenue suspected that the balance of \$9.15m had gone to Lotus or had been diverted by Lotus to its owner.

In my experience, every time the phrase 'evidential burden' is used it leads to error, particularly when the tribunal in question consists of laymen; for myself I think it could well be done without. [46]

The judge explained the true position in the following way:

In my judgment the position was that the burden lay throughout upon Lotus to show that the assessments were wrong. The documents and the evidence of the executives showed no receipt or entitlement to receipt, and in the absence of other factors (and I stress those words) the commissioners would have been entitled, and I think probably bound, to hold in favour of Lotus. But if the Inland Revenue showed circumstances which cast doubt on the whole position, the correct question which the commissioners should have asked themselves was not: 'Have the Inland Revenue proved fraud?' but 'In all the circumstances, including the background circumstances, the documents and the oral evidence, have Lotus shown the assessments to be wrong? At no stage in my judgment could any shift in the evidential burden require the Revenue positively to prove fraud in order to succeed; all that is required, even if the evidential burden be shifted, would be for the Revenue to show circumstances which might leave the commissioners in doubt, on a balance of probabilities, whether Lotus (either itself or through its officers) in fact received or was entitled to receive payments giving rise to the assessments. [47]

The taxpayer having shown that the alleged receipt was not in the accounts, it might be said that the evidential burden shifted to the Revenue to provide evidence that the taxpayer did receive it. The Tribunal would then decide on the balance of probabilities whether the taxpayer did receive it.

While there is nothing to prevent agreement of facts between the taxpayer and the tax authority for the purpose of an appeal, this is normally restricted to non-controversial facts, even where in correspondence the tax authority would have not disputed other facts. The House of Lords has criticized too much agreement of facts where these are crucial to the case:

The facts were, to say the least, unusual and a difficult issue of fact arose for decision. In these circumstances any competent advocate experienced in tax matters would have realised that, if the Revenue were to succeed on the grounds unsuccessfully argued before Walton J and the Court of Appeal, it was essential to leave the taxpayers to prove their case before the commissioners by oral evidence. The background to the transactions in question could then have been thoroughly explored in cross-examination. This might very well have elicited material to support the conclusion of fact reached in the dissenting judgment of Lawton LJ. Instead the Revenue allowed the case to proceed before the commissioners on an exiguous agreed statement of facts. In the result the Revenue have only themselves to blame that, so far as the debts are concerned, neither Walton J, nor the majority of the Court of Appeal, nor any of your Lordships feel able to interfere with the inference which the commissioners drew from the facts so agreed. [48]

Witnesses are therefore called in virtually every case at first instance. The statistic for the direct tax appeals that I heard in 2005 is that 20% of appeals were on a point of law only with all the facts agreed and no witnesses, and in the remaining 80% I heard an average of 2.2 witnesses per case (one by video link), with the number per case varying from 1 to 6. [49] Occasionally, the number of witness is extremely high. I can recollect one, in which the motive test for controlled foreign companies was in issue, where

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46 At p.196g.

47 At 197 et seq.

48 *Reed v Nova Securities Ltd* [1985] STC124, 126d, per Lord Bridge.

49 Broken down as follows: 0 witnesses 4 cases; 1 witness 9 cases; 2 witnesses 3 cases; 3 witnesses 1 case; 4 witnesses 1 case; 5 witnesses 2 cases; 6 witnesses 1 case. In addition, three witness statements were admitted unopposed (which are included as witnesses in my average)

there were 12 witnesses whose evidence lasted 11 days out of the total 17 days for the hearing of the appeal. Witnesses will normally produce a signed statement of their evidence in advance. This is normally taken as the person's evidence without reading it out. Evidence will invariably be given on oath. Most of the time is taken with cross-examination in which the representative of the other party, normally the tax authority, will question the witnesses with a view to testing the truth of every aspect of the evidence. It is extremely rare following cross-examination for a witness statement to end up without any qualification, and so the facts found do not necessarily reflect the statements.

Similarly, it is not uncommon to find that transactions have not been carried out in exactly the same way as provided for in the documents, or that the documents do not reflect the true nature of the transaction. As an example of this last point, in one of the 2005 cases with which I was concerned a document on its face created a condition precedent to obtaining some consents, but this interpretation was inconsistent with the accounts, the board minutes, other agreements entered into by the taxpayer at the same time and with what the taxpayer was apparently trying to achieve; it was construed as creating a condition subsequent.

Another example is that in a recent avoidance case a company assigned book debts that were due for payment in a few days to an employee as remuneration and claimed that this was a benefit in kind not chargeable to National Insurance Contributions. [50] The document assigning the debts appointed the employee as the attorney of the company to collect the debts and the company wrote a letter to the employee saying that it would assist the employee in their collection. The Special Commissioners found that there was no intention that the debtor should be told about the assignment or that the employee should take any part in the collection of the debts. The documents did not reflect the true intention of the parties. Finding facts differently from the witness statement or the documents must sometimes give rise to a different final result but it is difficult to estimate how common this is because the tribunal is never faced with deciding it on a different basis.

The strict rules of evidence applicable in the courts do not apply in the tribunal. However, the tribunal is free to decide what weight to give evidence, such as evidence obtained by the representative asking a leading question (a question that suggests the answer) to his own witness.

The Special Commissioners issue standard directions relating to such matters as documents, witness statements and skeleton arguments, which the parties are free to vary to suit the case. In practice, the standard directions are more suitable to smaller cases and large cases are normally dealt with by tailor-made directions. There is power for the Special Commissioners to impose a penalty of up to £10,000 for failure to comply with its directions. [51]

Normally because of the burden of proof being on taxpayers, they must bring the evidence forward to prove their case. But in some cases the tax authority may suspect that everything is not what it seems from the documents disclosed and they will obtain a direction from the tribunal for disclosure requiring the taxpayer to disclose all their documents (except documents for which legal professional privilege is claimed) and to confirm on oath that there are no other relevant documents. Less frequently, the same direction may be made against the tax authority, which additionally has the opportunity of claiming public

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50 *Spectrum Computer Supplies Limited v HMRC*, Spc 559, available at: [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)  
51 In indirect tax appeals there is also a very effective power to allow or dismiss the appeal for breach of directions.

interest immunity, [52] an example of a successful claim for which being for unpublished sections of their internal manuals in a recent VAT case. [53] This type of disclosure is routine in civil litigation where both sides have relevant documents.

An example of a type of case where a taxpayer may not want to produce evidence relates to a tax provision that if a person works for their own company in providing services to a third party, they are treated as an employee of the third party if they would have been classed as an employee if they had contracted with the third party without their own company. The third party's interests are not the same as those of the taxpayer and it has sometimes been difficult to obtain its evidence.

A party can apply for a summons to a potential witness who is unwilling to attend voluntarily. This is less useful to the party as one cannot (normally) cross-examine one's own witness.

A recently discovered source of useful documentary evidence is from e-mails where people tend to be uninhibited in what they write, which sometimes gives a better picture than other documentary evidence. In the ordinary courts, the rules for disclosure of documents now refer expressly to documents stored on servers and back-up systems, including documents that have been deleted but that can be recovered by a forensic IT expert. [54] Such a rule is likely to be applied by analogy in the tax tribunals. In one VAT avoidance case where it was relevant how a certain figure was arrived at, a director wrote in an email: "...I feel that we must 'milk' this opportunity for as much as we can... My recommendation is to go for 20%."

[55] The danger of emails is not restricted to the taxpayer; the tax authority is equally at risk. In a case which turned on the reasonableness of a VAT decision by the tax authority (incidentally an example of the tribunal effectively applying administrative law, which is more common in VAT) the tribunal was able to see all internal emails within the tax authority showing how the decision was reached, which the tribunal found was an unreasonable one. [56]

Sometimes, though not frequently, the tax authority will put taxpayers to formal proof of all their documents, so that they will have to call the maker of the document as a witness. Naturally the tax authority has considerable powers that they use to obtain information if the taxpayer is not willing to provide it, or if it has to be obtained from third parties, such as banks. The Tribunal can also require production of documents, although use of this by the Special Commissioners is rare, as they expect the tax authority to first exhaust their powers.

Where foreign law is relevant this must be proved as a question of fact by expert evidence from someone qualified in the foreign jurisdiction who would give evidence (which could be by video conference) and be cross-examined. Expert witnesses can give their opinion as opposed to giving only factual evidence. The rules provide for disclosure to the other party in advance of expert evidence so that the other party has the opportunity of calling its own expert. Frequently, each party therefore calls an expert who does not

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52 The approach to this issue has recently become stricter. "That new approach constitutes a change in the practice to be adopted by Ministers, but fully respects existing legal principles, as developed by the courts, and is subject to the supervision of the courts. It also accords with the view expressed by the present Lord Chief Justice that,

[...] public interest immunity should only be claimed for the bare minimum of documents for which the claim of serious harm can be seen to be clearly justified.

The Government intend that the test shall be rigorously applied before any public interest immunity claim is made for any government documents. It is impossible in advance to describe such damage exhaustively. The damage may relate to the safety of an individual, such as an informant, or to a regulatory process; or it may be damage to international relations caused by the disclosure of confidential diplomatic communications.

Normally it will be in the form of direct and immediate harm to, for example, the nation's economic interests or out relations with a foreign state. In some cases, it may be indirect or longer-term damage to which the disclosure of the material would contribute, as in the case of damage to a regulatory process. In any event, the nature of the harm will be clearly explained.

This new, restrictive approach will require, so far as possible, the way in which disclosure could cause real damage to the public interest to be clearly identified. Public interest immunity certificates will in future set out in greater detail than before both what the document is and what damage its disclosure would be likely to do - unless to do so would itself cause the damage that the certificate aims to prevent. That will allow even closer scrutiny of claims by the court, which is always the final arbiter....

(Statement in the House of Commons by the Attorney-General, 18 December 1996.)

53 The Revenue's internal manuals are published generally but with the exception of some passages. A taxpayer applied for disclosure of those passages relevant to its case, which the Revenue opposed on the grounds of public interest immunity. The Revenue's claim was upheld by the Tribunal: *Prudential Assurance Company Limited v HMRC* (2006) VAT Decision 19675, see [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)

54 Practice Direction 31 as amended by 40th update to the Civil Procedure Rules, October 2005

55 *Courts plc v Customs and Excise Comrs* (2004) VAT Decision No. 18746; see [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)

56 *Prudential Assurance Co Ltd v HMRC* (2006) VAT decision No. 19607; see [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)

agree with the other party's expert, with the result that the Tribunal has to evaluate this just as with any other point of disputed evidence and make a decision on the balance of probabilities. Fortunately, such occurrences are rare, but in one case the Special Commissioners did have to resolve a disputed point of Scots law, which in England is treated as foreign law. They set out the two experts' reports in their decision and explained the reason for preferring one of them. [57]

It follows from the burden of proof that if a party does not prove a necessary fact they lose. It is not possible for the tribunal to find facts itself; indeed, the court may not decide the case on the basis of its own knowledge if the point is not proved as a fact (or is something so obvious that it may take judicial notice of it). My understanding is that in civil law a court or Advocate-General will often find facts independently of the parties.

This author's understanding of civil law derives from the following quotation in an extremely interesting article, "A Comparative View of Standards of Proof" [58]:

The preparatory judge, called *le juge de la mise en état*, in practice seldom uses the statutory powers to investigate, and so controls more than directs factual investigation in the pre-trial phase. Although the French system is quite adversarial, the parties lack any substantial methods of discovery, a US innovation [59] that the French disdain. 'Since the lawyers are not only disinclined but powerless to engage in real factual investigation and since the court is reluctant to use the powers which it enjoys, the perception of fact by the court tends to be based entirely on an evaluation of documents submitted by the parties and exchanged between them....While the exchange of documents may sometimes serve to uncover useful evidence, it is not seen as a device whose principal aim is the discovery of evidence....' [60] As a result, a party's case usually consists of documents already in the party's possession.

It seems that civil law judges could order attendance of witnesses but normally do not. It is said that this reflects the more inquisitorial procedure in civil law, but the article points out that the differences between inquisitorial and accusatorial are exaggerated, and it suggests that in practice, in relation to facts in non-criminal cases, civil law judges leave it to the parties to present the facts. While the article refers to civil law rather than administrative law, my impression from the national reports in this volume is that in civil law countries witnesses in tax cases are extremely unusual. The tax authority will have accepted facts in the course of their investigations and these carry over to the appeal proceedings since the taxpayer is not normally likely to dispute them. From my experience of disputed evidence, I would expect this to affect the result.

### 3.1.5. The standard of proof

Related to the burden of proof is the standard of proof. In common law, [61] in civil (i.e. non-criminal) cases the balance of probabilities is "more likely than not"; [62] in criminal law it is "proof beyond reasonable doubt". [63] The UK applies the balance of probabilities in an elastic way, so that the more unlikely the matter to be proved (dishonesty is the example sometimes seen in tax cases) the stronger the evidence needs to be for the balance of probabilities to be satisfied, but it is still only the balance of probabilities. This was graphically explained by Lord Hoffmann in a House of Lords case:

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57 *Major v Brodie* [1998] STC 491

58 Cleremont, K.M. and Sherwin, E., "A Comparative View of Standards of Proof, 50 *Am. J. Comp. L.* 243 (hereinafter "A Comparative View"). The historical reason for the difference is discussed at 255

59 I suspect that its origin is English but I would certainly agree that it is used more forcibly in the US.

60 Quotation from Beardsley, "Proof of Fact in French Civil Procedure," 34 *Am.J. Comp L.* 459 (1986)

61 Interestingly, we can apparently include Quebec, Louisiana and Scotland as having the common law rule, see the article in [note 58](#) at note 76

62 The US admits the existence of an intermediate standard of "much more likely than not"

63 See "A Comparative View" ([note 58](#))

It would need more cogent evidence to satisfy one that the creature seen walking in Regent's Park [in London] was more likely than not to have been a lioness than to be satisfied to the same standard of probability that it was an Alsatian. [64]

The standard of proof in common law is much discussed, perhaps originally because it needed to be explained to a jury, although juries are not much used now in civil cases and never in tax cases. [65] It would be possible in a tax case for there to be a prosecution for tax evasion followed by [66] a tribunal appeal, which would determine the amount of tax that had been evaded. I am not aware of any case where a person has been convicted for evading tax that the tribunal subsequently found was not in fact due, but the possibility exists.

A case may be, and often is, decided on the basis that the taxpayer has the burden of proof but has not discharged it. Two examples of the difference between the criminal law and civil law standard of proof can be seen. One is that penalties for fraud can be brought to the tribunal where fraud has to be proved to the civil standard (the balance of probabilities, with due regard to the unlikelihood of the matter to be proved, here dishonesty), rather than the criminal standard that would have applied if there had been a prosecution. The second is that the Assets Recovery Agency can take over the Revenue's powers to assess tax where the Director of the Agency has reasonable grounds for suspecting that income arises as a result of criminal conduct; [67] the normal tax appeal system applies to such assessments. Recently, a man who had been acquitted of criminal charges of VAT fraud agreed a settlement with the Agency to pay £18m (EUR 176,000) plus a villa in Marbella and four racehorses. [68] Although this is a settlement not an appeal, and concerns confiscation to a civil burden of proof rather than the Agency's tax jurisdiction, the result in a tax appeal could easily have been similar because of the difference in standard of proof that led to his acquittal on the criminal charge.

By contrast, to again quote from the article "A Comparative View of Standards of Proof:

In continental European law, no distinction is made between civil and criminal cases with regard to the standard of proof. In both, such a high degree of probability is required that, to the degree that this is possible in the ordinary experience of life itself, doubts are excluded and probability approaches certitude. [69]

Although one can find theoretical differences between this and the common law criminal law test of proof beyond all reasonable doubt, the article states that in practice they are likely to be equivalent. The common law non-criminal standard of proof to the balance of probabilities is a far lower standard. The difference allows joint civil and criminal proceedings in French law in tort (*delict*) cases, which are also criminal. In the common law there would have to be two sets of proceedings with different burdens of proof. Sometimes, outside the tax field, an unsuccessful criminal prosecution will be followed by a successful civil action by the victim, the difference entirely caused by the burden of proof.

The article points out that it is difficult to find commentary on the topic in France. The Code Civil and the Code of Civil Procedure are silent on it, and nor do courts elaborate on it. One might expect that in civil

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64 *Secretary of State for the Home Department v Rehman* [2002] 1 All ER 122, 141a.

65 "A Comparative View" (see note 58) discusses the origins of the difference (at p. 255 et seq.) and suggests that in the late 18th century judges began instructing juries in detailed Lockean (referring to John Lock, *An Essay Concerning Human Understanding*) terms of probability and degrees of certainty. The authors point to the fact that Quebec follows the common law approach as a result of the common law introduction of jury proceedings.

66 Normally the prosecution would come first to avoid the possibility of evidence being given in the tribunal that could prejudice the taxpayer in the prosecution. In *McNicholas Construction Company Ltd v C & E Comrs* (1997) VAT Decision 14975, the tribunal dismissed an application by the Commissioners to postpone the hearing until the outcome of possible criminal proceedings, holding that the hearing would not frustrate the public interest in bringing criminals to justice. However, the Crown Court hearing the subsequent criminal proceedings considered that the evidence disclosed publicly at the tribunal was an abuse of process. Consequently, the defendants could not receive a fair trial.

67 Proceeds of Crime Act 2002

68 Assets Recovery Agency Press release, 3 Oct 2006

69 Nagel, "Evidence" in 7 *Encyclopaedia Britannica: Macropaedia* 1, 2 (1974), quoted in "A Comparative View" at 246

law where a higher standard of proof is required than the common law balance of probabilities, more attention would be given to proof of facts but the opposite is the case.

### 3.1.6. Representation of the parties

Before the Special Commissioners in 2005 one or both parties were represented by a barrister in 38% of cases (by a QC in 22%); by an accountant (or member of the Chartered Institute of Taxation) in 19%; the taxpayer appeared in person (or with a friend or relative) in 25%, [70] which currently seems to be increasing - it was 12% in 2002 and 20% in 2004; and the Revenue were represented by their Appeals Unit comprising Inspectors of Taxes, whose job is to present cases in the tribunals, or by a member of the Capital Taxes Office (who is legally qualified) who presents inheritance tax cases, in 56% of cases, and by a barrister in the remainder. Three cases in 2005 were decided on paper, but only one of these was the appeal itself (relating to a taxpayer resident abroad), the other two relating to subsequent aspects of a previous appeal and related to determining figures or costs.

On appeal from the tribunal to the courts it is necessary for the parties to be represented by a barrister (or a solicitor with a right of audience in court), unless the party appears in person, which occurred in only three direct tax appeals in 2005. [71]

### 3.1.7. Legal arguments and the importance of case law

It follows from the above approach to fact that the proceedings are primarily oral and, I should add, take place at a single hearing, which I believe is another difference from civil law. Legal argument used to be entirely oral but in recent years written argument has become more extensive, although certainly not to the extent of eliminating oral argument. The representatives of the parties usually produce skeleton arguments but they expect to expand on these orally, citing orally, though not necessarily reading them out in full, the relevant passages in any cases they produce. This is equally true of appeals to the courts on a point of law.

Case law in the High Court and above is binding in its reasoning on the tribunal and lower courts. [72] This looks to the underlying principle, not the similarity of facts. As a consequence of the emphasis on facts, a decision will find the facts first and then proceed to find in other cases principles relevant to such facts. As an eminent Scots judge, Lord Cooper, said

The civilian naturally reasons from principles to instances, the common lawyer from instances to principles. The civilian puts his faith in syllogisms, the common lawyer in precedents; the first silently asking himself as each new problem arises, 'What should we do this time?' and the second asking aloud in the same situation, 'What did we do last time?' [73]

I believe that this statement is also true of administrative law in civil law systems. However, the *Conseil d'Etat* will also reason by finding a principle in its precedents, although without naming them, and its decisions are also treated as binding on other courts. I suspect that the difference between the two systems to which Lord Cooper refers is a distinction without a difference in the end result, since principles will always relate to facts, and it is unlikely that an existing principle will be based on identical facts.

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70 In two of these (3%) the taxpayer was an accountant.

71 The taxpayer in one of which was a barrister appearing for herself.

72 Decisions of the tribunal are in theory outside the system of binding precedent but in practice normally the tribunal will follow its earlier decisions, and if the tax authority does not appeal they are likely to follow the decision unless there was some other reason against appealing. The High Court is not bound by other decisions of the High Court but also normally follows them. The Court of Appeal is normally bound by its own decisions, as is the House of Lords. There has been the possibility since 1966 of the House of Lords not following its own decisions, but this has happened only once in a tax case (*Vestey v IRC* [1980] STC 10). Scots courts are not bound by English decisions but normally follow them in the interests of uniformity, but sometimes differences in underlying law result in a different tax result between Scotland and England.

73 "The Common law and the Civil Law - a Scot's View", 63 *Harvard LR*, 468, 470, cited in Zweigert. K. and Kötz, H, *Introduction to Comparative Law*, Oxford: Clarendon Press, 1998, trans. T. Weir, 3rd ed., p. 259 (hereinafter "Zweigert and Kötz")

One difference that may exist lies in the willingness of common lawyers to distinguish cases based on apparently similar facts. [74]

It is a professional duty of representatives to produce relevant cases whether or not they are in favour of the party producing them. Because of the common law tradition of case law there is likely to be extensive reference to past case law in any appeal; in 2005 before the Special Commissioners there was on average eight case law authorities cited per case, the largest number cited in one case being 47. The judges in the common law system are not treated as knowing the law. Normally these authorities are copied in full for the tribunal, which has the advantage that the tribunal can mark the passages referred to and make marginal notes.

Normally the decision is restricted to the points of law that have been argued. It would be most unwise for a judge to decide a case on a point that had not been argued, but it is possible to ask the parties for further argument if a further point occurs to the judge when writing the decision. Where a party is unrepresented the judge can ask counsel for the other party to present arguments in support of the unrepresented party's case. An *amicus curiae* is occasionally appointed where the point is important to many cases but the taxpayer is unrepresented. The court is bound to raise points going to its jurisdiction even if not raised by the parties. It is possible for a new point of law to be raised in a subsequent appeal that was not raised before the tribunal, [75] but if that point of law requires further facts to be found, the party will lose on the point, although it is most unlikely, but not impossible, that the court will remit the case to the tribunal to find those facts; so far as facts are concerned, the parties get only one bite at the cherry. The ability of a court to raise issues of law during the hearing does not go as far as raising the question whether a tax treaty applies, because the benefit of a treaty must be claimed by the taxpayer, and if it has not been claimed, they cannot be entitled to any treaty relief (see below).

Because of the importance of case law all decisions of the Special Commissioners are immediately reported in full in a separate series of law reports, *Simon's Tax Cases (Special Commissioners' Decisions)* and on the tribunal's website ([www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)). All decisions of the courts in tax cases are reported in two series of law reports, *Simon's Tax Cases*, which reports the cases as they are decided, and *Tax Cases*, which waits until all appeals are concluded and then reports the case with the appeals one after the other, which is therefore more convenient to read in retrospect but is no use for current cases that are currently going through the appeal process. Law reports will include a headnote summarizing the decision including the facts [76] and legal reasoning, without any comment followed by the full decision. The headnote is used in practice as a quick way of starting to read the case; it is never used as a substitute for the full decision. Law reports never include comments, but legal journals will include comments on cases separately from any reports. Many High Court and Court of Appeal decisions are available on publicly available websites, including [www.bailii.org](http://www.bailii.org) and, for House of Lords cases, [www.Parliament.gov.uk](http://www.Parliament.gov.uk). In addition, legal publishers have decisions on their own websites, which are available by subscription.

### 3.1.8. Form of the decision

Decisions are given in writing. The decision will include full findings of fact, a summary of the arguments and, on appeal, an analysis of the decision under appeal, and the reasons for the decision. Because of this, decisions can be lengthy. Much of the decision will be taken up with findings of fact. For example in *UBS*, a treaty case in which the facts were not in dispute, the decision records an agreed statement of facts plus extracts from a witness statement that the Revenue accepted, amounting in total to just over four printed pages, which is very much at the lower end of the spectrum; in one decision I gave last year the summary of the facts ran to seven printed pages. As already mentioned, in 2005, 77 Special Commissioners' cases are reported running to 881 pages of print in the *Simon's Tax Cases (Special*

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74 Zweigert and Kötz p. 269

75 A recent treaty case, *UBS AG v HMRC* [2006] STC 716, was decided by the High Court on a point relating to whether the tax treaty had in the relevant respect been incorporated into law that the taxpayer had disclaimed before the Special Commissioners.

76 I believe that this is another distinction from civil law, see Zweigert and Kötz p. 264-5.

*Commissioners' Decisions*) report, an average of 11 printed pages per decision with a variation from two to 40 pages. [77] The type of written decision can be seen on the tribunal's website. Special Commissioners have a self-imposed deadline of two months after the hearing to write their decision. The possibility exists for Special Commissioners' cases to be reported anonymously but the requirements for this are strict; it is likely to happen in only two or three cases a year.

In the courts, the report of direct tax cases [78] in 2005 in *Simon's Tax Cases* (which is comprehensive) amounted to 527 pages, or 21 pages per case. [79] There is no possibility of anonymization at this stage; full details will be published.

### 3.1.9. Length of cases

Appeals are fixed by appointment to suit the convenience of the parties, their witnesses and representatives. Because of the number of witnesses, tax cases tend to be lengthy. It is difficult to generalize but in 2005 the length of cases before the Special Commissioners varied from one day to 13 days, [80] with a mean of 1.8 days per case. Very often cases will have been listed for longer periods to avoid the case over-running, in which case it is often difficult for all parties and the tribunal to fix another date in the near future, which is difficult for the tribunal but inevitable in some situations. Normally, I will be booked to sit for about four days a week, actually sit for three days and write decisions and read the papers for the next case for the remainder of the time.

Since appeals to the courts are on a point of law only, the proceedings tend to be much shorter, the longest being two or three days, other than in exceptional cases.

### 3.1.10. Costs

A disadvantage of these oral proceedings is that they are costly. Normally, in civil litigation the loser will be ordered to pay the winner's costs, limited to those that are necessary to winning the case, in practice perhaps two-thirds of what the party spends; there is a system of "taxing" costs down to this level by going through an itemized bill. Costs are a matter of the court's discretion and costs might not be awarded if, for example, a party fails to disclose their case in advance. However, in direct tax (though not in indirect tax) [81] appeals, the tribunal stage is always at the party's own expense; the normal rule then applies to appeals to the Courts. [82] This is partly historical on the basis that the tribunal is the fact-finding stage. In large appeals, this creates a considerable unfairness for the winner. [83]

### 3.1.11. Summary

In summary, the tax appeal system with its oral proceedings tends to result in a small number of lengthy and very thorough hearings, with a consequent pressure not to appeal but to settle. The tax authority, however, is used to operating in this way.

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77 In 2005 there were reports consisting of the following numbers of printed pages: 40 (2 cases), 35, 31, 28, 25, 24, 22, 21 (2 cases), 20, 17 (4 cases), 15 (2 cases), 14, 12 (2 cases), 11, 10 (4 cases), as well as a number of shorter ones.

78 The equivalent statistics for VAT cases in 2005 is House of Lords 3 cases (42 printed pages in the report); Court of Appeal (and Court of Session in Scotland) 8 cases (162 pages); High Court 19 cases (238 pages). In addition there will be a handful of customs duty and excise duty cases.

79 Broken down into: House of Lords 6 cases (103 printed pages in the report); Court of Appeal (plus Court of Session in Scotland) 7 cases (154 pages); High Court 13 cases (270 pages)

80 In 2005 there were appeals lasting the following number of days: 13, 12, 5 (1 case), 4 (4 cases), 3 (3 cases), 2 (10 cases), and 1 (51 cases). The longest case ever before the Special Commissioners took 184 days.

81 In indirect tax cases the balance is much better. Normally the winning taxpayer has its costs paid by the tax authority, while the winning tax authority does not normally ask the tribunal for a direction that the taxpayer pays its costs. The tax authority does ask for costs in large cases.

82 There is an oddity that if a taxpayer is assisted in the preparation of the case not by a lawyer but by a tax expert, the costs that can be awarded in court are limited, see *Agassi v Robinson (Inspector of Taxes) (Bar Council and another intervening)* [2006] STC 580. This does not apply in the Tribunal.

83 For an extreme example, see *Carvill v IRC* [2000] STC (SCD) 143 in which Mr Carvill, an individual, won at his own expense his (second) appeal under TA 1988 s 739 after a hearing lasting 13 days. He was more fortunate about costs of a subsequent appeal that the Revenue abandoned at the last minute, see *Carvill v Frost* [2005] STC (SCD) 208

## 3.2. Incorporation of tax treaties into domestic law

In considering the courts and tax treaties there is an important threshold matter, which is that, under the UK dualist system, tax (and other) treaties require to be incorporated into internal law before they can affect taxpayers. Instead of legislating for each of the UK's (more than 100) tax treaties by Act of Parliament, a section of the Taxes Act provides for the giving effect to treaties by Order in Council: [84]

Subject to the provisions of this Part [of the Taxes act 1988], the arrangements [*i.e.* the tax treaty] shall, notwithstanding anything in any enactment, [85] have effect in relation to income tax and corporation tax in so far as they provide - (a) for relief from income tax, or from corporation tax in respect of income or chargeable gains... [86]

An Order in Council is made in exercise of the royal prerogative but since the Bill of Rights 1689 prevents the Crown from dispensing with laws without the authority of Parliament, the approval of Parliament, here meaning the House of Commons since it relates to taxation, is necessary, [87] which usually happens with only a short debate in a committee in Parliament. [88] The advantage of this procedure is that effect is given to the treaty much more quickly than it would be if enacted as primary legislation. The disadvantage is that the treaty has effect only so far as the primary legislation permits, which is a question of interpreting domestic legislation not the treaty. In some cases it is clear that a treaty provision is wider than the primary legislation; because of the limitation to income tax and corporation tax (and by reference, capital gains tax), effect cannot be given in internal law to the application of a treaty following Art. 2(4) of the OECD Model to "substantially similar taxes" imposed after the treaty, or Art. 24(6) applying to "taxes of every kind and description." But more often the result is less clear. [89]

In many cases a dispute relating to a tax treaty will therefore involve both, whether the provision of the treaty has been given effect in internal law, a question of interpretation of internal law, and the

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84 TA 1988s.788

85 These words prevent inadvertent override. They have applied since the UK's first comprehensive treaty with the US in 1945. For an example of the effectiveness of a deliberate override, see *Padmore v IRC* (No. 2) [2000] STC (SCD) 356 (Special Commissioners)

86 TA 1988 Sec. 788(3). Non-corporate capital gains are included by reference by TCGA 1992 Sec. 277

87 It is interesting that Parliament has accepted that social security treaties can be effective without any further Parliamentary approval. Social Security Act 1975 s.143 provides:

143.- (1) For the purpose of giving effect to any agreement with the government of a country outside the United Kingdom providing for reciprocity in matters relating to-

(a) payments in respect of interruption of employment by unemployment, sickness or otherwise;

(b) payments in respect of the need of handicapped persons for attendance, the confinement of women, widowhood, orphanhood, retirement, old age, or death; or

(c) the payment of compensation or benefit to employed persons in respect of industrial or similar injuries,

Her Majesty may by Order in Council make provision for modifying or adapting this Act in its application to cases affected by the agreement.

(2) The modifications of this Act which may be made by virtue of subsection (1) above include provision-

(a) for securing that acts, omissions and events having any effect for the purposes of the law of the country in respect of which the agreement is made have a corresponding effect for the purposes of this Act (but not so as to confer a right to double benefit);

(b) for determining, in cases where rights accrue both under this Act and under the law of that country, which of those rights is to be available to the person concerned;

(c) for making any necessary financial adjustments.

See *Stevens, Gamham and Payne v IRC* [2004] STC (SCD) 311 for a decision that a treaty provision increasing the period for paying social security contributions to the UK after leaving the UK was valid.

88 For a full description of the procedure and the reasons for it, see Roxan, I., "Country Survey: United Kingdom", in *Tax Treaties and Domestic Law*, Amsterdam: IBFD Publications BV, 2006, Vol. 2 EC and International Tax Law Series, particularly pp. 313-319. The author draws attention to the curiosity that treaties are published as Statutory Instruments, although strictly the statute is not the authority under which the Order is made. Since then, FA 2006 Sec. 176 requires the Order to have been approved by a resolution of the House of Commons.

89 In *UBS AG v HMRC* [2006] STC 716 the tribunal had found the treaty provision to be outside the enabling provision but the High Court decided that it was within it, based on an argument that the taxpayer had disclaimed before the tribunal.

interpretation of the treaty provision, potentially requiring different approaches to interpretation. <sup>[90]</sup> While normally these are separate issues, on occasion one of them can assist the interpretation of the other, although this is limited to situations where the enabling provisions are very specific. This can be shown by a most recent case that was decided by the House of Lords reversing both the High Court and the unanimous Court of Appeal, *Pirelli Cable Holding NV v IRC*. <sup>[91]</sup> The ECJ had decided in another case <sup>[92]</sup> that it was discriminatory to allow payment of dividends from UK subsidiaries to UK resident parent companies (which for convenience are here called "group election dividends") without payment of advance corporation tax ("ACT"), but to deny it when the dividends were paid to EU-resident parent companies. This caused a conundrum in relation to the Treaty because the draftsmen of the Treaty had not foreseen that a dividend could be paid to a Dutch parent company without paying ACT. The issue was whether if the group election dividends were paid to a Dutch parent company without paying ACT the Dutch parent company was entitled to the tax credit provided for in the Treaty. In this case the internal law enabling provision was useful in interpreting the Treaty, although it involves the unusual situation of the Treaty giving a benefit not available in internal law, rather than the usual situation of its reducing an internal law tax charge. The reason why the enabling provision dealing with the granting of tax credits to non-residents assists in interpretation of the Treaty is that it is both extremely specific and it is tied to a particular internal law provision:

Treaties have effect in so far as they provide "...(d) for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231 in respect of qualifying distributions made to them by companies which are so resident."

The treaty provision requiring interpretation was:

A Dutch resident company controlling 10 per cent of the voting power of a UK company which receives dividends from a UK resident company is entitled to "...a tax credit equal to one half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he received those dividends..."

One can imagine that the enabling provision was drafted with a proposed treaty wording in mind. They share the same purpose:

The evident purpose of s 788(3)(d) and of art. 10 of the DTAs is to give a tax credit (of a certain sort) to a non-resident shareholder who receives a dividend from a United Kingdom company. It is central to the concept of the United Kingdom granting a tax credit to the shareholder in respect of a dividend that some United Kingdom tax should have been paid (or at least payable) in respect of that dividend. It would be an abuse of language, and contrary to common sense, to speak of granting a tax credit when no such tax has been paid. Moreover the DTA would not then, in this sort of situation, be relieving double taxation. <sup>[93]</sup>

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<sup>90</sup> Examples of the treaty provision not having been incorporated into internal law are: *Sun Life of Canada v Pearson* [1984] STC 461, 516b (credit for foreign tax not available to a permanent establishment since Sec. 788(3) gave relief "subject to the provisions of this Part" [of the Taxes Act 1988], one of which was that only residents qualified for relief; the law has since been changed); *R v IRC ex p. Commerzbank* [1991] STC 271, 277f (repayment supplement not within Sec. 788(3), although the discrimination was not within the nationality provision of the non-discrimination article); *NEC Semi-Conductors Ltd v IRC* [2006] STC 606 at [45] onwards (ACT not corporation tax in respect of income or chargeable gains within Sec. 788(3)); *Pirelli Cable Holdings NV v IRC* [2006] STC 548 (enabling provision did not permit refund of tax credit where no ACT had been paid, but nor did the treaty); and possibly the Special Commissioners' decision in *Bricom Holdings Ltd v IRC* [1996] STC (SCD) 228, 236-7 (tax on controlled foreign companies is not corporation tax (a matter left open by the Court of Appeal [1977] STC 1179, 1196) and if it is a tax "substantially similar to" corporation tax it is not within Sec. 788, although the charge was not contrary to the treaty)

<sup>91</sup> [2006] STC 548

<sup>92</sup> *Metallgesellschaft Ltd v IRC* and *Hoechst v IRC*, Cases C-397/98 and C-410/98, [2001] STC 452

<sup>93</sup> Per Lord Walker at 105

Normally treaty interpretation would be mainly concerned with the treaty wording but here that wording was closely related to internal law through the enabling provision referring to an internal law provision. The only way to understand it was to start with the scheme of internal law. The scheme was that in all cases where the recipient was entitled to a tax credit ACT would have been paid. Internal law does not specifically make payment of ACT and payment of the tax credit conditional on each other but in the only situation where no ACT was paid, group election dividends, no tax credit was given. Since group election dividends are defined by internal law as dividends between members of a UK resident group of companies, it was not in the contemplation of the draftsmen of the Treaty that the situation of group election dividends being paid to a Dutch parent company could ever arise. The Treaty was therefore drafted on the assumption that ACT would have been paid, and the Dutch parent company was given an entitlement to the tax credit. European law intervened and made group election dividends paid to a Dutch parent company a possibility.

Three provisions of internal law are relevant that can be summarized as follows:

1. Section 231: subject to Sec. 247, a resident company receiving a qualifying distribution is entitled to a tax credit.
2. Section 247: group election dividends are excluded from Secs. 14 or 231.
3. Section 14: ACT is payable on a qualifying distribution, which includes a dividend.

Therefore neither ACT nor the tax credit under Sec. 231 is payable on a group election dividend. The treaty enabling provision refers to Sec. 231 and it can be concluded purely from internal law that the Treaty cannot have effect to make a tax credit under Sec. 231 available on group election dividends. One could stop there and say that, whatever the treaty said, the Dutch parent company would never be able to receive the tax credit; indeed, two of their Lordships approached it on that basis, <sup>[94]</sup> but they also agreed with another two of their Lordships who considered the treaty interpretation question (and a fifth agreed with all of them). Looking at the Treaty, the situation envisaged by the draftsmen was:

1. ACT would be payable on a dividend to a Dutch parent company because it is outside the definition of a group election dividend, this being restricted to UK resident companies.
2. There is no difficulty in applying the treaty hypothesis that a UK resident individual had received "those dividends" i.e. dividends on which necessarily ACT had been paid. All that is required is to assume that a dividend paid to a Dutch company is instead paid to a UK resident individual. If it had been, the individual would have been entitled to a tax credit under Sec. 231.

Accordingly, the Dutch parent company is entitled to half the tax credit.

In relation to group election dividends on which no ACT has been paid, which was not in the minds of those negotiating the Treaty, the issue becomes:

1. because of European law, no ACT is payable on the dividend to the Dutch parent company;
2. under internal law, no tax credit is payable on a group election dividend;
3. applying the treaty hypothesis, would a UK resident individual have been entitled to a tax credit had it received "those dividends", i.e. group election dividends on which no ACT had been paid because of the group election? The hypothesis is impossible; an individual cannot receive a group election dividend that can be paid only by a subsidiary to its parent. The only ways to apply the hypothesis are:

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<sup>94</sup> This was the approach of Lords Hope and Walker. Lord Hope relied primarily on Sec. 231 being subject to Sec. 247, and Lord Walker also on the qualifying distribution aspect.

*Either* one assumes that the individual can receive a group election dividend (which is the effect of the hypothesis that is within the intention of the parties, that an individual rather than the Dutch parent company receives the dividend). If so, that individual would *not* have been entitled to a tax credit on "those dividends" because they are group election dividends, which are excluded from Sec. 231, and so nor is the Dutch parent company. This is the ordinary meaning of language approach. <sup>[95]</sup>

*Or* one assumes that the individual receives a different type of dividend on which ACT has been paid, in which case the individual would have been entitled to a tax credit and so therefore is the Dutch parent company. But since "those dividends" are actually group election dividends, about which Sec. 231 says that one is not entitled to a tax credit, giving such a tax credit to a non-resident parent company would put that company in a better position than a UK resident parent company. A purposive interpretation <sup>[96]</sup> requires it to be assumed that the internal law connection between ACT and the tax credit should be maintained in the Treaty. <sup>[97]</sup> Alternatively, one can start with the enabling provision. This gives effect to the Treaty for conferring a tax credit under Sec. 231 on qualifying distributions. If the correct interpretation of the Treaty were that the individual was entitled to the tax credit, it would not be a tax credit *under* Sec. 231 because group election dividends are specifically excluded from that section, <sup>[98]</sup> and so it would be outside the enabling provision.

The ordinary meaning was used to arrive at the preferred interpretation (the one above beginning "*Either*") and the purposive interpretation was used to show that the alternative interpretation was wrong. The purposive interpretation of the Treaty was supported by the statutory interpretation of the treaty enabling provision; if the interpretation of the Treaty under "*Or*" were right, the Treaty could not have that effect in internal law anyway. Alternatively, one can start with the enabling provision and say that the Treaty cannot have the effect of conferring a tax credit under Sec. 231 on a group election dividend, and so there is no need to ask whether that is the correct interpretation of the Treaty. Lord Walker, who relied solely on the enabling provision to decide the case, pointed to two factors to which he considered that the lower courts had not given sufficient weight:

One is that in applying the DTAs it is necessary to look, not only at their terms, but also at the language of s 788(3)(d) [the treaty enabling provision], which uses a technical expression of domestic tax law, "qualifying distribution." <sup>[99]</sup>

Lord Nicholls, who decided the case on the purposive interpretation of the Treaty, relied on the treaty enabling provision as a statement of the purpose of the Treaty; the high level purpose being to afford relief from double taxation and the purpose of the particular provision being to confer on non-residents the right to a tax credit under Sec. 231. <sup>[100]</sup> They therefore positively encouraged using the enabling provision as part of the interpretative process. The only satisfactory solution is the one that satisfies both the enabling provision and the treaty interpretation, which is the interpretation under "*Either*." Both aspects assist the interpretation of the other; one cannot separate treaty interpretation from the statutory interpretation of the enabling provision.

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<sup>95</sup> This was Lord Scott's approach in [67]-[68].

<sup>96</sup> See text around [note 101](#) for a discussion about whether this is within the Vienna Convention's principles of interpretation.

<sup>97</sup> This was Lord Nicholls' approach.

<sup>98</sup> Where there is a group election dividend "...the election dividends shall be excluded from sections 14(1) and 231..." (Sec. 247(2)). Although not directly excluded from the expression "qualifying distribution" Lord Walker considered [at 103] that the meaning of that expression was affected, which would be an additional reason for its being outside the enabling provision. Giving the tax credit to non-residents is also outside Sec. 231 but the context is that this restriction is being overridden: "...for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231..."

<sup>99</sup> At 103. The other factor was the scheme of internal law under which payment of the tax credit always requires payment of ACT, the relevance of which to interpretation is discussed in the next paragraph of the text.

<sup>100</sup> At 11

The reliance on the scheme of internal law generally for a purposive interpretation of the Treaty might be argued to be wider than allowed by the interpretative provisions of the Vienna Convention. The scheme of internal law is certainly not "context" within Art. 31(2) and in Art. 31(1) "its object and purpose" seems to refer to The treaty as a whole. It might be said that the lower courts relied less on internal law and more on the ordinary meaning of the Treaty (although they might be criticized for not focusing on the hypothesis of the *individual* receiving "those dividends"). As Peter Gibson LJ said in the Court of Appeal:

Is it really to be supposed that every statutory qualification enacted from time to time in the UK fiscal legislation to the availability of a tax credit under s 231 qualifies the entitlement conferred by the DTA to the limited relief of double taxation by the tax credit as provided for in the DTA? We think not. <sup>[101]</sup>

The approach of the High Court and the Court of Appeal was closer to that of the Vienna Convention. But it is suggested that the House of Lords' approach is to be preferred because of the intimate connection between internal law and tax treaties, particularly in cases like this where the treaty is extending to non-residents the internal law right to payment of the tax credit which internal law restricts to residents, but arguably more generally as exemplified by Art. 3(2) of the Model. The enabling provision gives effect to a treaty provision "for conferring on persons not resident in the United Kingdom the right to a tax credit under section 231 in respect of qualifying distributions made to them by companies which are so resident." What the treaty does can therefore only be understood by reference to internal law. <sup>[102]</sup> This treaty provision is written with the internal law provision in mind; it is quite different from the enabling provision applying to treaty articles in general. Lord Nicholls pointed to the quoted words as a statement of the purpose of the particular treaty provision. <sup>[103]</sup> And as Lord Walker pointed out, this uses a technical expression "qualifying distribution" and so it is difficult to argue that treaty interpretation should be carried out without regard to the scheme of internal law.

A similar problem arose in *UBS* relating to the same paragraph of the enabling provision. While at first the taxpayer disclaimed reliance on it as the vires for the treaty provision in question before the Special Commissioners, presumably as a result of their decision, it relied successfully on it in the High Court. <sup>[104]</sup>

Another case, *NEC Semi-Conductors Ltd*, <sup>[105]</sup> relates to similar dividends but concentrates on the ACT issue because it is an attempt to move the debate to third countries. If group election dividends can be paid without ACT to a UK parent company, is it discriminatory under the tax treaty that to charge ACT on dividends to non-EU parent companies? Here the Court of Appeal's analysis did not make the connection between ACT and tax credits, the Japanese treaty not providing for any payment of the tax credit (although the US treaty does provide for tax credits in a similar way to the Dutch treaty considered in *Pirelli*, which was decided a few days later). The case is under appeal to the House of Lords.

It will be seen from these examples that it is sometimes hard to separate internal law from the treaty interpretation since one can understand the treaty only by reference to internal law. It should be recognized that these examples are probably in the minority. In other cases the treaty interpretation can be made without reference to internal law and then the enabling provision has to be checked to see whether internal law gives effect in domestic law to such treaty interpretation.

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<sup>101</sup> *Pirelli Cable Holding NV v IRC* [2004] STC 130 at 46

<sup>102</sup> See Lord Walker at 94

<sup>103</sup> At 11. "This analysis of art 10(3)(c) [of the treaty] accords with the intended purpose of the Netherlands convention as stated in s 788" [emphasis added]

<sup>104</sup> *UBS AG v HMRC* [2006] STC 716

<sup>105</sup> [2005] STC 606 CA.

### 3.3. Interpretation of tax treaties

#### 3.3.1. Introduction

It has been shown above how few direct tax appeals are heard in the UK. Of these, the number of tax treaty cases is minute and, so, many interesting treaty points have never been considered. The IBFD database lists 32 cases since 1956, which breaks down to five where the final decision is by the Special Commissioners, [106] 13 by the High Court, eight by the Court of Appeal, five by the House of Lords (the last two cases in the House of Lords being in 1975 and 2006, with a gap between them of 31 years), and one by the Privy Council [107] on appeal from what was then Ceylon (now Sri Lanka). Most of these decisions relate either to fitting oddities of UK law into treaties, particularly in relation to the imputation system and dividend tax credits, [108] or particular non-standard treaty provisions, including four cases on an unusual provision of the 1945 UK-US treaty, a case on the standard UK double taxation relief article, two cases on treaty articles relating to professors and one on the unique former Irish treaty (1926). Although these can raise interesting points of interpretation they are unlikely to be of interest in other countries and, if all these oddities are eliminated, there are only about seven important cases on mainline points in the Model Convention. These include the effect of the non-discrimination article on (a) foreign tax credits for permanent establishments, [109] (b) the absence of interest on tax repayments to a non-resident, [110] and (c) a branch profits tax in Sri Lanka paid on distributions from the branch to the head office, [111] whether the business profits article prevents taxation of a UK resident partner in a treaty-resident partnership on its share of the partnership profits (on different wording of the definition of person from the Model); [112] what assets are attributable to the permanent establishment of a reinsurance company, [113] the meaning of place of effective management; [114] and the meaning of beneficial ownership. [115] There are also a few unimportant cases such as dealing with credit for tax due but not actually paid and on a termination payment where the taxpayer should have claimed relief in the other country. [116]

The most important point to make about treaties is that they differ significantly in style from domestic legislation that tries to cover every eventuality and leaves little room for filling in gaps. Treaties on the other hand spell out principles to be applied by the court. While both are interpreted purposively, the difference in nature of what is being interpreted means that there are differences. As the House of Lords said in a non-tax treaty case:

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 is an Act of Parliament which deals with purely domestic law. It should be interpreted, as Lord Wilberforce put it in *James Buchanan & Co. Ltd v. Babco Forwarding & Shipping (UK)*

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106 Special Commissioners' cases were not reported before 1994 but this factor is likely to exclude a handful of cases, having regard to the number after that date.

107 The Privy Council is the final court of appeal from a now-decreasing number of Commonwealth countries.

108 Six cases (*Union Texas, Getty Oil, Pirelli, NEC, UBS, Océ*); other cases involved the former preceding year basis of assessment under which the taxable profit was based on the accounts for the period ended in the previous tax year (abolished for companies in 1965 and for individuals, etc. from 1997-98), two cases; foreign insurance company taxation, two cases; dual residence of trustees; credit for underlying tax (not a provision contained in the Model) for an investment in a German silent partnership; computation of credit on a change in exchange rate (essentially an internal law point); the CFC case is essentially in this category as it turns on internal law; the effect on an anti-avoidance provision taxing a resident on income of a non-resident when the non-resident has treaty protection from UK tax. One other case depends on the peculiarities of the other party's law, a Nazi decree removing nationality from German Jews, which was subsequently declared to have been invalid.

109 *Sun Life Assurance Co of Canada v Pearson* [1984] STC 461 (in the High Court only)

110 *R v IRC ex p. Commerzbank AG* [1991] STC 271

111 *Woodend (KV Ceylon) Rubber and Tea Co Ltd v Commissioner of IR* [1970] 2 All ER 801

112 *Padmore v IRC* [1987] STC 36; [1989] STC 493 (CA)

113 *General Reinsurance Ltd v Tomlinson* (1970) 48 TC 81

114 *Wood v Holden* [2005] STC 789; [2006] STC 443 (CA)

115 *Indofood International Finance Ltd v JP Morgan Chase* [2006] STC 1195 (Court of Appeal), in the course of a dispute about whether bonds were repayable to which no tax authority was a party.

116 *Sportsman v IRC* [1998] STC (SCD) 289; *Squirrel v HMRC* [2005] STC (SCD) 717

*Limited*, [1987] AC 141 at 152, 'unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptance'. [117]

Unlike France, we see no distinction between tax treaties and other treaties, and this passage has been applied to tax treaty interpretation.

Domestic law is restrictive about the use of supplementary means of interpretation [118] whereas the rules in the Vienna Convention on the Law of Treaties are much more permissive. This makes little difference in practice since supplementary materials hardly exist in relation to tax treaties.

Although in principle there seems no reason why there should be fewer factual disputes in treaty cases, this does seem to have been the case so far in practice, thus making some of the differences between common law and civil law appeals discussed above of less importance. [119] However, the approach to finding facts in treaty cases is in line with other tax cases. As already mentioned, in *UBS*, the decision records an agreed statement of facts plus extracts from a witness statement about how the appellant operated market-making in equities that the Revenue accepted (although it would have been nothing unusual if they had not done so and the witness had been cross-examined), amounting in total to just over four printed pages, which is very much at the lower end of the spectrum. The case was a fairly typical one lasting two days. [120]

It has already been mentioned how foreign law has to be proved as a fact, [121] which is not unlikely to arise in relation to tax treaty disputes. In *Memec v IRC*, the treaty interpretation issue concerned a distribution from a German typical silent partnership and raised the foreign law issue of the nature of a silent partnership. [122] Initially this was proved by an expert's report to which the parties agreed some additions and modifications, and so it was not necessary to call the witnesses.

This writer's understanding of civil law is that while the drafting of a treaty may be closer to domestic law, the courts are more reluctant to use the discretion they have in interpreting domestic law when interpreting a treaty because the other State may have a different view. The result of differences in approach to treaties from domestic law in both systems of law may indirectly lead to more similar results when it comes to treaty interpretation.

### 3.3.2. The need to claim the benefit of a treaty

An important factor is that it is a requirement of UK law giving effect to tax treaties that the benefit of a treaty must be formally claimed by the taxpayer. [123] This requires a claim to the Revenue and it is against refusal of that claim that a tax treaty appeal arises. There is therefore no possibility in the UK of the tribunal or court itself giving effect to a tax treaty without such a claim having been made by the taxpayer. This is different from a civil law court being able to give effect to a treaty ex officio.

### 3.3.3. The Vienna Convention on the Law of Treaties

The interpretation provisions of the Vienna Convention have frequently been accepted as relevant by the courts in relation to both tax treaties [124] and treaties in other branches of the law, [125] many of the latter

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117 *Fothergill v Monarch Airlines Ltd* [1981] AC 251 per Lord Diplock (at 281-282) and Lord Scarman (at 293)

118 See text at [note 127](#)

119 A recent Canadian case, *MIL (Investments) SA v The Queen* 2006 TCC 460, is an example of disputed facts in a treaty case.

120 Another typical feature was the time it took to reach the tribunal. The last year in dispute was 1996 and the appeal was heard by the Special Commissioners in 2005

121 See text around [note 58](#)

122 [1996] STC 1338, at 1342c (Special Commissioners and High Court); [1998] STC 754 (CA)

123 TA 1988 Sec. 788(6) "Except in the case of a claim for an allowance by way of credit in accordance with Chapter II of this Part, a claim for relief under subsection (3) (a) shall be made to the Board." In one circumstance a claim is deemed to have been made: for dual resident companies, where the treaty tie-breaker also determines internal law residence: "...it shall be assumed that (a) the company has made a claim for relief under the arrangements [the treaty], and (b) in consequence of the claim it falls to be decided whether the company is to be regarded [for the purposes of any double taxation relief arrangements as resident in a territory outside the United Kingdom and not resident in the United Kingdom]" (FA 1994 Sec. 249(2)). However, where the treaty requires a mutual agreement in order for the tie-breaker to operate, it seems that an actual claim is required otherwise there is nothing to which the other country could agree.

124 *IRC v Commerzbank* [1990] STC 285, *Memec v IRC* [1996] STC 1316 (High Court), [1998] STC 754 (Court of Appeal), *Sportsman v IRC* [1998] STC (SCD) 289 (Special Commissioners), *UBS AG v HMRC* [2006] STC 716 (High Court), *Indofood International Finance Ltd v JP Morgan Chase* [2006] STC 1195 (Court of Appeal), *NEC Semi-Conductors Ltd v IRC* [2004] STC 489 (High Court)

being cases on asylum seekers under the Geneva Convention Relating to the Status of Refugees. Most of the non-tax cases relate to the general approach to interpretation of treaties and the difference from the interpretation of internal law but several relate to the use of *travaux préparatoires*, the use of which is extremely limited in internal law, being restricted to use in cases where the legislation is ambiguous or obscure or leads to an absurdity, and then only to clear statements of the issue in question by a minister introducing the legislation. [126] One cannot use Parliamentary material to confirm the interpretation reached by other methods as one can under the Vienna Convention, and the Vienna Convention does not limit the type of supplementary material that can be used. The earliest case that mentioned the Vienna Convention concerned facts before the entry into force of the Convention but its provisions on interpretation were accepted as being a codification of existing rules on interpretation in international law. The Convention has not been incorporated into internal law but this does not seem to be necessary. The Special Commissioners' case of *Sportsman v IRC* [127] contains an interesting passage on "good faith" in Art. 31(1) of the Vienna Convention:

The expression 'good faith' might appear somehow odd and was discussed by Sir Ian Sinclair in his book *Vienna Convention on the Law of Treaties* (2nd edn, 1984) p. 120. It would seem to be accepted as merely meaning that the interpretation should not lead to a result that would be manifestly absurd or unreasonable. In short try to make it work sensibly.

The Special Commissioners continued:

Nor does ordinary meaning equiparate to a grammatical or dictionary definition. It has been said that the true meaning of a text is to be arrived at by taking into account all the consequences which normally and reasonably flow from that text (see *Sinclair* p. 121). There is no such thing as an abstract ordinary meaning of a phrase divorced from the place which that phrase occupies in the text to be interpreted.

In that case the taxpayer was trying to obtain credit for French tax that was payable but had not been paid under a treaty provision that "French tax *payable* under the laws of France and in accordance with this Convention ... shall be allowed as a credit against any UK tax computed by reference to the same income ... by reference to which the French tax was computed." One of the Revenue's main arguments, which was adopted by the Special Commissioners, was that "payable" did not qualify French tax but the words "under the laws of France and in accordance with this Convention". The French tax, on the ordinary meaning of credit, had to be paid for credit to be given. It would be contrary to the stated object of the treaty to prevent fiscal evasion if credit were to be given for tax that had not been paid. [128]

An unsuccessful attempt was made by the taxpayer in another Special Commissioners' case to invoke purpose to support his interpretation:

First, reference was made to the 'purpose' of the exemption granted by art. 21 [a treaty provision concerning visiting teachers]. It is, I think, generally recognised that it is intended to facilitate cultural

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125 A computer search shows three instances in the House of Lords, three (one relating to tax) in the Court of Appeal and two (one relating to tax) in the High Court in 2006 up to October.

126 *Pepper v Hart* [1992] STC 898. Before that decision, reports of Parliamentary debates could not be used at all as an aid to interpretation.

127 [1998] STC (SCD) 289, 293g.

128 By an amusing coincidence, in another tax treaty case, *Union Texas International Corp v Critchley* [1990] STC 305 paid was held to mean payable. The context was entirely different and concerned entitlement to be paid one-half the tax credit on dividends in the following treaty provision "subject to the deduction withheld from such payment and according to the laws of the UK of an amount not exceeding 5 per cent of the aggregate of the amount or value of the dividend and the amount of the tax credit paid to such corporation." Clearly, as the deduction was part of the calculation of the amount to be paid in respect of the tax credit, paid must mean payable, as the court decided.

relations between the contracting states; but the article takes effect only in accordance with its terms.  
[129]

In other words, purpose cannot contradict the ordinary meaning. This illustrates the UK courts' general approach of giving more weight to the words of the treaty in their context, which is what the Vienna Convention requires. As the Vienna Convention's Commentary states:

[Article 31] ... is based on the view that the text must be presumed to be the authentic expression of the intentions of the parties, and that, in consequence, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation *ab initio* into the intentions of the parties.

Interpretation of internal law looks for the intention of Parliament in the words used in their context but, as has been mentioned, [130] there is less use of other materials in interpreting internal law.

### 3.3.4. The OECD Commentary

There was originally little use made of the OECD Commentaries, but in 1981 they were relied on for the first time for confirmation of a view that the tribunal and court had already reached. [131] Today it would be most unlikely that the Commentaries would not be referred to in a treaty case. [132]

The precise weight to be given to the Commentaries has not been discussed. In *UBS* my colleague and I would potentially have given considerable weight to them on the basis of Art. 31(4) of the Vienna Convention ("A special meaning shall be given to a term if it is established that the parties so intended"), although in the circumstances the Commentaries gave little assistance. We said:

Article 24(4) of the 1977 Model is a short general statement that taxation on the permanent establishment is not to be "less favourably levied" and how that phrase operates in practice is explained in 35 paragraphs of the Commentary. It seems clear that the parties to the Treaty intended that such explanation should be more important than the ordinary meaning to be given to the terms of that phrase. [133]

This has the slightly odd result that under Art. 31(4) of the Vienna Convention the parties intend, as a binding agreement, the term to be given the meaning in the Commentaries, but since the Commentaries themselves say that they are not binding, [134] without being bound to do so. In other words, the Commentaries must be taken into account (even if they would not otherwise have been), but not to the extent of providing a binding result. Effectively it means that the Commentaries have "high persuasive value," as the Canadian Supreme Court said in *Crown Forest*. [135]

There has still been no discussion in the cases of the use of later Commentaries. On the only occasions where the court has referred to later Commentaries there is no discussion about the merits of doing so

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129 *Devai v IRC* [1997] STC (SCD) 31, 35e.

130 See text at [note 127](#)

131 *Sun Life of Canada v Pearson* [1984] STC 461 (Special Commissioners in 1981 at 483d, High Court at 510h, 513b (used for confirmation), 513e (Commentary relied on) and 515d (not relied on as that aspect of the treaty was not incorporated into internal law)); Court of Appeal [1986] STC 335, 346d, 346f (not critical to the decision) For subsequent examples see *R v IRC ex p. Commerzbank* [1991] STC 271, 276g (not critical to the decision); *Memec v IRC* [1996] STC 1336, 1357a (in the High Court only and a passing reference only); *NEC Semi-Conductors v IRC* High Ct at 28 (one of the reasons for deciding against the Revenue) CA at 37; *Indofood v JP Morgan Chase Bank* [2006] STC 1195 at 36 (CA); *Legal & General Assurance Society Ltd v HMRC* [2006] STC 1763; *UBS AG v HMRC* [2005] STC (SCD) 589 at 9 (Special Commissioners); [2006] STC 716 at 32; *Legal and General Assurance Society Ltd v HMRC* [2006] STC 1763 at 31 (to assist in the interpretation of a differently worded double taxation relief article from the Model)

133 *UBS AG v HMRC* [2005] STC (SCD) 589 at 10

134 "... they [the Commentaries] are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner 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." (para. 29 of the Introduction to the Model)

135 *Crown Forest Industries Ltd. v. Canada* [1995] 2 S.C.R. 802 at 55 per Iacobucci J.

and in any case there were no significant differences between that and the earlier Commentaries. <sup>[136]</sup> In *UBS* the Special Commissioners deliberately restricted their use to the Commentaries existing when the treaty was made.

### 3.3.5. Article 3(2) OECD Model Convention

This provision was first used in the first UK-US treaty (1945). <sup>[137]</sup> The slightly earlier Canada-US treaty (1942) contained definitions of: rentals and royalties, interest, dividends, pensions, and life annuities. It must have been clear that unless a different solution was found the number of definitions would continue to increase. <sup>[138]</sup> Article 3(2) broke that trend. The result is that in any case where the treaty relieves a category of income from tax, the relief corresponds exactly with the internal law taxing provision. <sup>[139]</sup> This is far more important than that the treaty category of income has the same scope in each State; the internal law charging provisions are most unlikely to be the same either. Indeed, the result of relying on internal law definitions is superior to the treaty containing a definition of a type of income, <sup>[140]</sup> which may well be different from the internal law definition used for taxing the income. If the treaty definition is wider than the internal law definition, the treaty relief will in addition apply to what in internal law is a different category of income. This will not matter, as the result will be that income within the wider definition is exempt. The problem arises where the treaty permits taxation of the income within the (wider) treaty definition. Here the additional width of the treaty definition falls within a different internal law category that in the particular circumstances internal law may not tax. In this case the treaty definition has no additional effect; it is still the income within the internal law definition that is taxed. Consequently, the result in the two States is still not the same in spite of the common definition.

### 3.3.6. Article 3(2): "the context otherwise requiring"

I have only one example of the "context otherwise requiring" in relation to Art. 3(2) and I would expect cases to be rare. The issue arose whether a partnership was a person, the treaty definition of which was that "'person' includes any body of persons, corporate or not corporate." <sup>[141]</sup> "Body of persons" was not defined. Domestic tax law in England does not include a partnership, <sup>[142]</sup> but the court decided that the context required that the internal law definition should not be used, and, accordingly, for the purposes of the treaty, a partnership was a body of persons. The last words of the treaty definition, "corporate or not corporate," would be ineffective if the internal law definition were used to exclude a partnership, which is an obvious example of a non-corporate body. The context, in the form of the last words of the definition of "person", required that the internal law meaning should not be used. Require is a strong word and implies that there is a strong reason for not using internal law.

Another example is whether English law, which frequently used the expression "beneficial ownership" in domestic tax law, should be used to interpret that term in a tax treaty. I think it is strongly arguable that beneficial ownership is a treaty concept that should be given a universal meaning unrelated to internal law in one country. <sup>[143]</sup> The Court of Appeal has held in a case involving a dispute between two parties and not the tax authority relating to a tax treaty that:

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<sup>136</sup> The quotation in *Sun Life of Canada* in the Court of Appeal (see [note 132](#)) said to be from the 1963 Commentary is in fact from the 1977 Commentary but there is no significant difference and the treaty was 1980. The quotation in *R v IRC ex p. Commerzbank* [1991] STC 271, 276g in relation to a 1964 treaty is from the 1977 Commentary but the difference from the 1963 Commentary is merely linguistic.

<sup>137</sup> See also on this topic the book of last year's conference, *Tax Treaties and Domestic Law*, G. Maisto, ed., Amsterdam: IBFD Publications BV, 2006, Vol. 2 EC and International Tax Law Series, p. 123

<sup>138</sup> There is an analogy with treaty source rules the number of which was increasing rapidly so that US and Australian treaties would define the source of up to eight types of income by about 1970. In the end, starting with the UK in 1967, the common law countries adopted a deemed source rule under which anything the treaty permitted a State to tax was deemed to have a source in that State.

<sup>139</sup> This is not intended to suggest that the effect of Art. 3(2) is confined to defining types of income.

<sup>140</sup> A treaty definition causes additional problem of difficulties of interpretation caused by the use of concepts unfamiliar in internal law, whereas there is usually a long history of internal law taxing concepts becoming settled. Also, if it refers to internal general law concepts, such as copyright in the definition of "royalty", differences in general law are still carried into the treaty definition, with the result that the treaty definition will not mean the same in both States.

<sup>141</sup> *Padmore v IRC* [1989] STC 493 on the UK-Jersey treaty.

<sup>142</sup> In English law a partnership is not a legal person; in Scots law it is, and a Scots partnership would be within the tax definition of body of persons. See Avery Jones, J., "Bodies of Persons", [1991] *BTR* 453 at 460

<sup>143</sup> J. David B. Oliver et al., "Beneficial Ownership", 54 *Bulletin for International Fiscal Documentation* 7 (2000) p. 310

The passages from the OECD Commentary and Professor Baker's observations thereon show that the term 'beneficial owner' is to be given an international fiscal meaning not derived from the domestic laws of contracting states. [144]

It is easier to find cases where the context requires that a definition contained in the treaty should not be used. Article XV of the 1945 UK-US treaty gave an exemption for certain dividends and interest. This was followed by a sentence providing an exception to that rule: "This exemption shall not apply if the corporation paying such dividend or interest is a resident of the other Contracting State." One of the definitions in the treaty was: "Resident of the UK means any person (other than ... a US corporation) who is resident in the UK for the purposes of UK tax ...." Suppose the payer of the dividend or interest is a US corporation, [145] the effect of including the definition of resident of the UK in the second sentence is that the sentence is meaningless because a US corporation can never be a resident of the UK as US corporations are specifically excluded from being a resident of the UK. In the reverse situation, of a UK corporation paying dividends or interest, in US law there is no possibility of a UK corporation being within the treaty definition of resident in the US. The Technical Memorandum [146] of the US Treasury Department pointed out at the time of the Protocol adding the second sentence: "The exception, while reciprocal in form, does not have effect in the case of US taxes." Thus, the second sentence of Art. XV had no effect in either country if the treaty definition was incorporated. The context therefore required that the definition should not be used in the sentence quoted, even though it would apply in the previous sentence. [147] Context in this case was based on the words of the treaty not having effect. The expression "context" has a potentially wider meaning than that in Art. 31 (2) of the Vienna Convention on the Law of Treaties and can cover the background, the non-tax, as well as tax, law as well as the words of the entire treaty. [148]

### 3.3.7. Article 3(2): "term"

It seems difficult to restrict the application of Art. 3(2) to the use of the exact term in internal law. There is little connection between the treaty categories of income and internal law categories. For example, "salaries, wages and other similar remuneration ... in respect of an employment" is not a term found in internal law since the internal law tax charge was, at the time most of the UK treaties were made, on the emoluments of an office or employment, and since 2003 is on earnings from an employment. [149] But if, as suggested by the Commentary, [150] one regards the treaty words as a concept equivalent to whatever income is taxed as employment income, the items fall within that category. Recently I had to deal with the treaty categorization of a termination payment to an employee, which in UK internal law is taxed as employment income subject to an exemption for a maximum monetary amount. I concluded that the employment income article applied saying:

Although the precise words 'salaries, wages and other similar remuneration' are not used in UK tax law, according to the Shorter Oxford English Dictionary the meaning of the word 'term' extends to 'any word or group of words expressing a notion or conception, or denoting an object of thought; an expression (*for* something).' Remuneration in respect of an employment corresponds to income that was at the time taxed under Schedule E. The termination payment, being a payment in lieu of notice, is the equivalent of remuneration and taxed under Schedule E is a similar way to remuneration

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144 *Indofood International Finance Ltd v JP Morgan Chase Bank* [2006] STC 1195 at 50. See the Revenue's draft guidance of 9 October 2006 on the effect of this decision on other treaties online at: [www.hmrc.gov.uk/news/indofood.pdf](http://www.hmrc.gov.uk/news/indofood.pdf)

145 Defined as a corporation ... created or organized in or under the laws of the US.

146 Note the use of this unilateral material by the court.

147 *IRC v Exxon Corporation* [1982] STC 356. The Treasury Department statement is quoted at p. 362].

148 Avery Jones, J. et al., "The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model", [1984] *BTR* at 14 and 90

149 More precisely on "general earnings" defined to mean earnings within the main tax charge and amounts treated as earnings under specific provisions, and on specific employment income under other specific provisions, see ITEPA 2003 Secs. 6 and 7

150 The Commentary says that most countries have generally understood that this term includes benefits in kind: Art.15 Comm para.2.1 (added in 1997)

(although with an exemption for £30,000), and so I consider that the termination payment is within article 15.1 cannot think of any reason why the context might otherwise require. <sup>[151]</sup>

One of the reasons why one must be flexible in interpreting "term" is that the governing language version of a treaty may be in a different language to one's domestic law. This occurs frequently where States that are unlikely to understand each other's languages often make the treaty in each language but also provide for a third language version, commonly English, to govern in cases of differences between the two language versions. <sup>[152]</sup> In this case the precise term in the treaty in a third language will never be found in either State's internal law, and so "term" must be wider than just "words".

### 3.3.8. The use of foreign court decisions

Courts in the UK are very used to dealing with foreign decisions in general, <sup>[153]</sup> and in particular in relation to non-tax treaty cases, especially multilateral treaties, weighing up the value of them in interpreting treaties. As Lord Diplock said in a decision of the House of Lords:

As respects decisions of foreign courts, the persuasive value of a particular court's decision must depend upon its reputation and its status, the extent to which its decisions are binding upon courts of co-ordinate and inferior jurisdiction in its own country and the coverage of the national law reporting system. For instance your Lordships would not be fostering uniformity of interpretation of the Convention if you were to depart from the prima facie view which you had yourselves formed as to its meaning in order to avoid conflict with a decision of a French court of appeal that would not be binding upon other courts in France, that might be inconsistent with an unreported decision of some other French court of appeal and would be liable to be superseded by a subsequent decision of the Court of Cassation that *would* have binding effect upon lower courts in France. It is no criticism of the contents of the judgments in those foreign cases to which your Lordships have been referred if I say that the courts by which they were delivered do not appear to me to satisfy the criteria which would justify your Lordships in being influenced to follow their decisions in the interests of uniformity of interpretation. <sup>[154]</sup>

My favourite example is a case in which an article was quoted that surveyed decisions in six countries on a particular provision of the CMR convention in which in the course of 30 decisions courts had reached 12 different interpretations. <sup>[155]</sup>

It might therefore be expected that foreign decisions would be used frequently in relation to tax treaties which, because they are based on the OECD Model, have more similarity than other treaties and are in this respect more like multilateral treaties. The experience is different, that only a handful of foreign decisions have been cited in tax treaty cases. <sup>[156]</sup> This does not seem to be out of line with other countries according to the "Country Surveys" in this volume.

The tax treaty examples where foreign decisions were cited are, first, one in which we declined to follow a US decision on similar wording in another treaty on the ground that the US court's method of interpretation that "the case law is clear that the meaning given a treaty by an appropriate government department

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<sup>151</sup> *Squirrel v HMRC* [2005] STC (SCD) 717 at 11

<sup>152</sup> See *Multilingual Texts and Interpretation of Tax Treaties and EC Tax Law*, G. Maisto ed., Amsterdam: IBFD Publications BV, 2005, Vol. 1 EC and International Tax Law Series, where the following cases of governing languages are given: p. 162 (22 Austrian treaties use English); p. 196 (42 Belgian treaties use English, or are solely in English, and three use French); p. 241 (28 German treaties use English); p. 263 (32 Italian treaties use English, 12 use French and one Russian); p. 298 (36 Dutch treaties use English and two use French); p. 318 (37 Swiss treaties use English). On the other hand, see p. 217 that no French treaties have a different governing language.

<sup>153</sup> This is particularly common in the case in judge-made law where if there is no English precedent on a particular point it is normal to look for Commonwealth ones.

<sup>154</sup> *Fothergill v Monarch Airlines* [1981] A.C. 251 per Lord Diplock p. 284

<sup>155</sup> *Ulster-Smith v Taunton Meat* [1977] 1 WLR 625

<sup>156</sup> *IRC v Commerzbank* [1990] STC 285, 302d on US-UK treaty: US decision (*Great-West Life Assurance v US* 49 AFTR 2d 82-1316) on same provision of US-Canada treaty which was not followed because the US courts give great weight to the interpretation given by the appropriate government department. *Mermec v IRC* [1998] STC 754

and government agency is of great weight"<sup>[157]</sup> has no equivalent in the UK, or, it might be added, in the Vienna Convention. The second is a reference to a decision in *Memec*<sup>[158]</sup> where the point in issue was whether the definition of dividend in the dividend article (expressed to be "as used in this article") was to be read into an article dealing with credit for underlying tax. A *Bundesfinanzhof* decision in which such a dividend was read into another article, dealing with the transitional provision on the treaty coming into force, was cited. The majority in the Court of Appeal distinguished the case on the basis that the other treaty provision concerned withholding tax and clearly imported the definition of dividend contained in the dividend article. The dissenting judge would have followed the case in any event on the ground that he considered that continental courts would have followed it. It is suggested that continental courts would not do this. The third is *NEC Semi-Conductors v IRC*<sup>[159]</sup> in which the taxpayer referred to unnamed decisions of the courts of the highest levels in the Netherlands and Sweden and the opinion of the *Commissaire du gouvernement* in an unnamed French case then pending before the *Conseil d'Etat*.<sup>[160]</sup> All of these were followed in deciding that the comparison to be made in the ownership paragraph of the non-discrimination article with "other similar enterprises" was with domestic-owned enterprises.

The small use of foreign decisions can be explained in part by the small number of treaty cases in which this might have been possible, the lack of a central register of such cases before the IBFD database, the small number of treaty cases contributing to the lack of expertise of practitioners in knowing where to find foreign decisions, and to language difficulties. If cases exist there is then the difficulty of differences in the style of decisions. We are used to judges effectively thinking aloud in their decisions and find the civil law condensed and abstract way of expressing decisions difficult. Another difficulty still to be faced is that we are used to decisions of higher courts binding lower courts, which may not be the case in the civil law jurisdiction of the decision, which makes the status of the decision difficult to determine, although as already mentioned, in France decisions of the *Conseil d'Etat* are effectively binding on lower courts.

There is a further problem in relation to tax treaties discussed in David Ward's chapter (see [Chapter 7](#)), which is that even though the treaty wording is the same the Commentary may have been different - sometimes substantially so - at the time of making the different treaty that is the subject of the foreign court decision. To the extent that the Commentary influenced the decision - which may not be apparent on the face of the decision in those civil law countries that do not set out their reasoning in full - it will be necessary for a court to take this factor into account in deciding whether to follow the foreign decision. This point has not so far arisen.

### 3.3.9. The other State's practice as an aid to interpretation

Subsequent practice has been used in non-tax treaty cases.<sup>[161]</sup> In relation to tax treaties, in a Special Commissioners' case it was stated: "Where an international convention contains ambiguities, the expressed view of the other party may provide some insight into its interpretation"<sup>[162]</sup> (although in the particular case the tribunal found that there was not in fact no such clear view). Since this was an argument put forward by the taxpayer, the other State's practice must have been different from the one that the Revenue were arguing for and if the other State's practice had been clear, all this would have shown was that the practice demonstrated that the two States did not agree on its interpretation. Practice is therefore likely to be an argument used by the Revenue and not the taxpayer. If the situation

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<sup>157</sup> *IRC v Commerzbank* [1990] STC 285, 302d in relation to the US decision in *Great-West Life Assurance v United States* 49 AFTR 2d 82-1316 interpreting a similar provision of the US-Canada treaty to the one in the US-UK treaty in issue in the case.

<sup>158</sup> *Memec v IRC* [1998] STC 754 on UK-Germany treaty: German (Bundesfinanzhof) decision on Germany-Switzerland treaty referred to and not followed (except in the dissenting judgment) because the provision in that case concerned the transitional provision from the previous to the new treaty dealing with withholding tax and it was necessary to import the definition of dividend in the dividend article. In the UK case the issue was not withholding tax but credit for underlying tax.

<sup>159</sup> [2004] STC 489 at 29 (in the High Court, but not the Court of Appeal) on UK-Japan, UK-US, UK-Switzerland (the case was part of group litigation)

<sup>160</sup> The cases were presumably: Netherlands *Hoge Raad* 27 April 1994 BNB 1994/ 207c; Sweden, *Regeringsrättens dom* No. 2225-1987, ET 19888/12 p. 401; France, *Conseil d'Etat*, 30 December 2003, *SA Andritz* (in which the Court followed the *Commissaire du gouvernement*)

<sup>161</sup> See e.g. *R v Secretary of State for the Home Department ex p. Robinson* [1998] QB 929. The material in question was the Handbook on Procedures and Criteria for Determining Refugee Status published by the Office of the United Nations High Commissioner for Refugees in 1979, relating to a treaty of 1951 and a similar European Council document of 1996 setting out a joint European position on the interpretation of "refugee". Reference was made to publications showing that this joint position was not confined to European countries.

<sup>162</sup> *Devai v IRC* [1997] STC (SCD) 31, 35j.

arose where after entering into a treaty, both States adopted the same practice, this would be a serious indication of an agreement between the parties made at the time of the treaty if, for example, the taxpayer was arguing against the interpretation adopted by both States.

A practice that started later than the treaty might indicate a subsequent agreement as to its interpretation, but the relevance of this in internal law is less than that in international law under the Vienna Convention because, if it were taken into account, this would mean that the meaning of the treaty had changed since Parliament approved it. Because of the attitude of the court to mutual agreements (explained in the following section), it seems that the courts are unlikely to be heavily influenced by both countries' later practice, if it does not accord with what the court thinks is the correct interpretation of the treaty.

### 3.3.10. Mutual agreements

A mutual agreement made in a specific case under the equivalent of Art. 25(2) of the OECD Model has effect "notwithstanding anything in any enactment," which puts the agreement legally on the same level as the treaty itself (or perhaps even higher, since the legislative provision giving effect to the treaty does so subject to the internal law double taxation relief provisions). [163] The absence of similar legislation relating to interpretative mutual agreements under the equivalent of Art. 25(3) (first sentence) of the Model strongly suggests that they are not intended to be binding. This was the view of the court in *IRC v Commerzbank* [164] in interpreting the UK-Germany treaty, where it said that a mutual agreement under similar wording in the US-UK treaty had no authority in the English Courts:

I should add, however, that this joint statement has no authority in the English Courts. It expresses the official view of the Revenue authorities of the two countries. That view may be right or wrong. Although art. XXA [165] authorises the competent authorities to communicate with each other directly to implement the provisions of the convention and 'to assure its consistent interpretation and application' it does not confer any binding or authoritative effect on the views or statements of the competent authorities in the English Courts. [166]

On the other hand, it could be argued that the treaty itself contains a sufficient delegation to the competent authorities to make such interpretative mutual agreements, so they are effectively part of the treaty. No further Parliamentary procedure would be necessary to give effect to them since Parliament would have authorized the delegation to the competent authorities to make such mutual agreements. [167] The Court's view in *Commerzbank* can be explained by the fact that the mutual agreement article adopted in 1966 of the former US-UK treaty (1945) applicable in that case provided:

The competent authorities of the Contracting Parties may communicate with each other directly to implement the provisions of the present Convention and to assure its consistent interpretation and application.

This should be contrasted with the more specific delegation to the competent authorities in Art. 25(3) of the OECD Model:

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[163] TA 1988, Sec. 815AA inserted by FA 2000, Sch. 30, para. 28, which has the effect of overriding internal law time limits and other bars to amending assessments. The provision giving effect to treaties in general is in TA 1988 Sec. 788(3), see text at note 87

[164] [1990] STC 285, 302b.

[165] Former US-UK treaty (1945), this provision added in 1966

[166] *IRC v Commerzbank* [1990] STC 285 at 302b.

[167] This is particularly arguable in the US-UK treaty (2001) which, after the equivalent of the first sentence of Art. 25(3) of the Model, says: "In particular the competent authorities of the Contracting States may agree: [eight items are then listed, such as the common meaning of a term]"

The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

It is therefore possible that the court would have given greater weight to a mutual agreement if the mutual agreement article had been in the form of the Model. It should be noted that the court's reasoning in the quotation above from the *Commerzbank* case is based on the treaty wording merely allowing communication rather than resolution of difficulties or doubts. Since there is no constitutional objection in the UK to a mutual agreement being a valid delegation to the competent authorities, it is possible that a mutual agreement made in accordance with a provision equivalent to Art. 25(3) has the same validity in internal law as it has in international law, but the point has not been decided. My view is that following legislation giving legal effect to a specific case mutual agreement, the court would not imply that an interpretative agreement had legal effect in the absence of any legislation similar to that governing specific agreements. <sup>[168]</sup>

No such interpretative agreements have been officially published in the UK, although sometimes an agreement is known to exist from publication in the other country and reference to it in books or articles in the UK. <sup>[169]</sup> It is not therefore possible to determine the number of such agreements.

### 3.3.11. Other material

Reference has already been made to the use of the US Technical Explanation to the same treaty. <sup>[170]</sup> More recently this was referred to by the Court of Appeal and supported the decision reached. <sup>[171]</sup>

It used to be the case that courts only rarely referred to literature but it has become more common to refer to commentators and authors in cases today. This change has had little effect on tax cases generally. <sup>[172]</sup> There are likely to be only two or three tax cases a year where articles are cited. <sup>[173]</sup> There are now three treaty cases referring to Vogel <sup>[174]</sup> and two to Prof. Philip Baker. <sup>[175]</sup>

## 3.4. Conclusion

As pointed out at the beginning of this chapter, the amount of tax litigation in the UK is minute compared to civil law countries and the number of appeals concerning tax treaties is correspondingly even smaller. The differences between the systems are so striking that it would be interesting to explore the reasons on another occasion. Unfortunately, the difference means that we are short of examples of many tax treaty issues, such as the use of later OECD Commentaries. The use of foreign decisions on tax treaties has also been limited even though there is no reluctance by courts to use them in interpreting non-tax treaties. I do not detect any difference in approach between tax and non-tax treaties generally and I would expect there to be more use of foreign decisions in tax treaty cases in future.

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<sup>168</sup> As a result of the change in the legislation in 2000, my view on this point has changed from that set out in Avery Jones, J., "The Relationship between the Mutual Agreement Procedure and Internal Law", 8 *EC Tax Review* 1 (1999) p. 4

<sup>169</sup> For some examples, see Avery Jones, J. et al, "The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention", [1979] *BTR* p. 333, [1980] *BTR* 13 Appendix 2, p. 22 et seq. In one case a mutual agreement with the US published in *BTR* by reproducing the publication of it in the US was referred to in court, see *IRC v Commerzbank* [1990] STC 285, 301].

<sup>170</sup> Text at [note 147](#)

<sup>171</sup> *NEC Semi-Conductors v IRC* [2006] STC 606 at 38

<sup>172</sup> For a notable exception, see the recent House of Lords decision in *Deutsche Morgan Grenfell Group plc v IRC* [2006] 3 WLR 781 about restitution and tax, which is full of academic references.

<sup>173</sup> To be compared particularly with Germany and Austria, where in most of the cases the courts review the relevant literature.

<sup>174</sup> *Memec v IRC* [1998] STC 754 at 768; *Wensleydale's Settlement Trustees v IRC* [1996] STC (SCD) 241 at 250; *UBS AG v HMRC* [2006] STC 716 at 30

<sup>175</sup> *Indofood v JP Morgan Chase Bank* [2006] 192 at 40 and 48] (High Ct), 1195 at 34, 37 and 38 (CA), and *Legal & General Assurance Society Ltd v HMRC* [2006] STC 1763 at 38, 40. The article by myself and my co-authors "The Non-Discrimination Article in Tax Treaties" [1991] *BTR* at 359, 421 and 31 *European Taxation* (1991) 309, and an article of my own were both cited before the Special Commissioners in *UBS* but are not referred to in the decision.

## Chapter 4 – Courts and tax treaties in civil law countries

### 4.1. Introduction

This chapter does not claim to deal with the behaviour of tax courts in all civil law countries. As is shown in the national reports, domestic law and court practice vary from one civil law country to another civil law country. Please note that a French tax judge makes the following comments in a French legal context.

#### 4.1.1. General comments about tax litigation in France

Tax litigation in France is divided between administrative courts and civil courts, mainly for historical reasons. Administrative courts deal with direct taxes and VAT, and generally with all taxes not specifically assigned by law to civil courts. Civil courts deal with transfer duties, stamp duties and the wealth tax. Administrative courts handle the vast majority of tax cases. First instance administrative courts received 23,523 tax cases in 2005, whereas first instance civil courts received 748 tax cases.

Administrative courts are composed of professional judges. There are 29 first instance administrative courts (*tribunaux administratifs*) in the European part of the country, one per administrative region and slightly more in the most populous regions. First instance decisions can be challenged before the eight administrative courts of appeals. Tax cases can then be brought for legal review (*cassation*) before the *Conseil d'Etat* acting as supreme administrative court. This legal review will be on points of law but also, to a certain extent, on points of fact.

According to local organization, tax cases will be handled by chambers totally or partially specialized in tax. Tax judges usually devote much of their career to tax, but they also deal, at one point or another, with administrative law cases.

The *Conseil d'Etat* handles around 800 tax cases per year (788 in 2004, 831 in 2005). Few of these cases deal with tax treaties or the EC Treaty (VAT cases involving the 6th Directive are more common). In 2005, tax treaties have been applied in eight cases and the EC Treaty was involved in three direct taxation cases. In 2004, these figures were ten for tax treaty cases and six for EC Treaty direct taxation cases, including the reference of the *Denkavit* case on outbound dividends to the ECJ.

The allocation of tax cases to administrative courts bears some procedural consequences. In accordance to standard administrative procedure, tax cases follow a written procedure. At the final hearing, lawyers usually decline the right to speak. Judges sometimes ask oral questions, but not in all cases. This final hearing is mostly devoted to listening to the opinion of the *commissaire du gouvernement* (who can be compared, *mutatis mutandis*, to the advocate-general before the ECJ). Legal research by the judges is extensive; administrative courts do not rely only on the submissions of the parties to the case.

Another consequence is the opportunity for taxpayers or professional organizations to use common administrative law procedures to challenge tax regulations or guidelines directly before the *Conseil d'Etat*, i.e. the supreme administrative court. Under the *recours pour excès de pouvoir* procedure, any person with sufficient interest can have an administrative decision quashed by an administrative court. Decrees signed by the Prime Minister, or any regulation issued by a minister, can and must be challenged directly before the *Conseil d'Etat* acting as a court of first and last instance. This procedure allows taxpayers or professional organizations to use a "fast track" to challenge regulations or guidelines that might be contrary to tax treaties or EC law. They do not have to wait for individual taxation and go through each stage of the court system.

A famous EC Treaty case came out of a direct challenge against the decree of 6 July 1999 implementing the exit tax created by the Finance Act of 30 December 1999. The argument was that the decree

could not legally implement a legislation that, so far as it applied to EC countries, violated the freedom of establishment provided for in Art. 43 of the EC Treaty. The *Conseil d'Etat* referred to the ECJ, on 14 December 2001, the issue raised by Mr de Lasteyrie du Saillant (RJF 2/02 n° 160). After the ECJ confirmed there was a violation of the EC Treaty (ECJ 11 March 2004, C-9/02, *de Lasteyrie du Saillant*), the *Conseil d'Etat* quashed the decree to the extent that it applied to taxpayers exercising their freedom of establishment in another Member State (*Conseil d'Etat* 10 November 2004, RTF 2/05 n° 135).

A recent case involved a direct challenge against a guideline issued by the Ministry of Finance for the application of the France-Brazil treaty of 10 September 1971. Article 22 of this treaty provided for a French tax sparing credit of 20% on Brazilian-source interest. A guideline of 5 December 1997 reversed a previous guideline of 8 December 1972 by stating that the tax credit was only a fixed rate in case of Brazilian taxation and did not apply if there was no Brazilian taxation of outbound interest. A French bank challenged this new guideline directly before the *Conseil d'Etat*, but lost the case, the *Conseil d'Etat* deciding that the treaty never granted a tax credit in the absence of Brazilian taxation (26 July 2006, *Natexis Banques Populaires*, RJF 11/06 n° 1421).

As a result, there are two channels for tax litigation: individual claims against a tax assessment and direct claims against a regulation or a guideline. Individual litigation is by far the most common.

When they have to deal with tax treaties, do tax judges behave in a specific way? Do they meet problems and establish solutions that are different from both other international treaties and domestic law?

## 4.2. Tax treaties and other treaties

### 4.2.1. Are tax treaties treated differently from other treaties?

Tax treaties are a category of international treaties and therefore courts apply to them the same rules under domestic law; for instance, Art. 55 of the Constitution, establishing the superiority of international treaties, when ratified and published, over French legislation. But some solutions are specific to tax treaties, deviating from the judicial treatment of other treaties.

#### 4.2.1.1. The subsidiarity of tax treaties

This concept of subsidiarity of tax treaties originates from the object of these treaties: the avoidance of double taxation. The tax treaty becomes useless if there is no right to tax in France under French tax law, because there is no risk of double taxation. This subsidiarity principle means that a French tax judge should look first at domestic tax law to check whether the income is taxable in France under domestic law. If not, there is no need to look at the tax treaty. This principle has been carefully worded in the *Schneider* case regarding the compatibility of the French CFC legislation with Art. 7 of the France-Switzerland tax treaty (*Conseil d'Etat*, 28 June 2002, *Schneider Electric*, RJF 10/02 n° 1080), although case law had used it before.

This means that the treaty is not a legal base for taxation, which may lead to double non-taxation if the treaty allocates tax jurisdiction to France but French domestic law does not provide for taxation. However, these consequences of the subsidiarity principle are mitigated by an Act of 28 December 1959, introduced into Arts. 4 bis, 165 bis and 209 of the general tax code, that allows taxation in France of income that falls under French tax jurisdiction because of the provisions of a tax treaty.

This subsidiarity principle has also led to the idea that income must be characterized first in domestic law before being compared to the categories of income distinguished by a tax treaty. This idea has been used in cases involving domestic tax fictions and the application of tax treaties to these fictions: the French branch tax (*Conseil d'Etat*, 31 January 2001, *Bank Polska Kasa Opieki*, RJF 4/01 n° 489), and the French CFC legislation (*Conseil d'Etat*, 28 June 2002, *Schneider Electric*).

#### 4.2.1.2. Tax treaties are raised ex officio

This is a peculiarity among international treaties in French judicial practice. Many treaties are not raised ex officio, because the *Conseil d'Etat* distinguishes between the scope of the law and the violation of a higher rule of law. The idea is that judges cannot decently apply a law to a situation that is obviously outside the scope of this law. Therefore the scope of the law is raised ex officio. But it is up to the plaintiff to claim that a law or regulation or decision violates a higher rule of law. Courts are not supposed to find ex officio all the reasons why an act might be invalid. This theory is applied to domestic law: the violation of a statute by a decree will not be raised ex officio.

Applied to treaties, this theory means that the violation of treaties by French legislation is not usually raised ex officio. This applies even to multilateral treaties such as the European convention for the protection of human rights and fundamental freedoms. It also applies to EC law, the relationship between domestic law and EC law being treated in the same way as the relationship between a French decree and a French statute.

However, tax treaties are raised ex officio because, if they deny French tax jurisdiction, the relevant income falls outside the scope of French tax law. It is a matter of jurisdiction, not violation. The relevant domestic tax law is not invalid, but it cannot be applied to a specific bilateral situation. This logic regarding tax treaties has been expressed in the wording of the *Schneider Electric* decision of 28 June 2002.

The distinction between scope and invalidity might be blurred by the use of the concept of inapplicability: according to common judicial techniques, a court will "set aside" or declare "inapplicable" a provision that cannot be applied because it is contrary to a higher rule of law, such as a statute or the EC Treaty. However, there are different reasons for inapplicability: the scope of the law is one thing, the violation of a higher rule of law is another. Tax treaties are different because they allocate tax jurisdiction.

#### 4.2.2. Are tax treaties treated differently from EC law?

As seen above, tax treaties are raised ex officio whereas EC law is not (with the slight nuance that domestic law must be interpreted in a way that is compatible with EC law, which practically means that the national judge must look at EC law anyway even if the parties to the case do not mention it; but this is interpretation, not inapplicability and this problem of interpretation versus invalidity also arises in domestic law).

One major difference is the relativity of tax treaties, whereas EC law applies to a whole region. In the *Lasteyrie du Saillant* case, which involved the freedom of establishment under Art. 43 of the EC Treaty, the *Conseil d'Etat* referred the case to the ECJ, then quashed the French decree of 6 July 1999 for failing to exclude from the exit tax Member States and the use of the freedom of establishment. This means that French legislation is invalid if it does not provide for a European exception when necessary.

But if Mr de Lasteyrie du Saillant had claimed the benefit of a bilateral tax treaty in his *recours pour excès de pouvoir* to get the exit tax decree quashed, he would have had no chance of success. If a domestic tax regulation must be set aside because of a bilateral tax treaty, this does not mean this regulation is invalid. This regulation will remain perfectly valid in all other situations, it will just not be applied in a specific bilateral situation. This logic was not followed in the *Lasteyrie du Saillant* case because EC law has become the norm for a large European area.

#### 4.2.3. The status of tax treaties vs. other treaties in case of conflict

In case of conflict between treaties, present case law states that administrative courts do not have jurisdiction to decide whether a treaty is invalid because it violates another treaty (*Conseil d'Etat*, 18 December 1998, *SARL du parc d'activités de Blotzheim*, Lebon p. 484). The reason is that this issue relates to the decision to sign a treaty, which is part of higher diplomatic policy. This is part of a jurisprudence stating that higher diplomacy and the constitutional relationship between branches of

government (such as the dissolution of the National Assembly, a House of Parliament) are outside the jurisdiction of administrative courts as *actes de gouvernement*.

This solution has been applied to EC law, the *Conseil d'Etat* refusing to check whether the Schengen Convention is compatible with the EC Treaty (30 July 2003, n° 237649, *Association Gurekiri*).

In case of conflict between tax treaties and other treaties or EC law, this logic should apply. An isolated decision has accepted to check whether the France-UK tax treaty is compatible with the freedom to provide services under Art. 49 of the EC Treaty (*Conseil d'Etat*, 30 March 2005, *Villatte*, RJF 7/05 n° 751). But this decision, which rejected the claim, cannot be seen as reversing precedents of higher standing.

For the time being, potential conflict between tax treaties and other treaties can be resolved by compatible interpretation and combination of treaties, although this exercise may have limits.

### 4.3. Tax treaties and domestic law

#### 4.3.1. Superiority over domestic law is clear

With France applying monist doctrine, treaties are part of domestic law after ratification. Article 55 of the French Constitution stipulates that international treaties, after ratification and publication, are superior to French legislation.

Administrative courts will set aside all statutes that are contrary to a treaty, even if the statute was enacted after the treaty (*Conseil d'Etat*, 20 October 1989, *Nicolo*, Lebon p. 190). So there is no treaty override.

#### 4.3.2. Is interpretation different?

##### 4.3.2.1. Interpretation of domestic law

Interpretation of domestic law is a case-by-case exercise that is not easy to summarize. To be short, *Conseil d'Etat* practice in legal interpretation follows four principles:

1. First, literal interpretation is a priority.
2. Second, the *Conseil d'Etat* will look at *travaux préparatoires* if the text is unclear.
3. Third, the *Conseil d'Etat* can deviate from literal interpretation if the literal meaning of the text seems to be absurd with regard to the coherence and purpose of the legislation that is being interpreted.  
There is a degree of court discretion in this approach. The *Conseil d'Etat* will weigh a balance of public and private interests when deciding whether to follow the literal or purposive interpretation. On the one hand, legal certainty might favour a literal interpretation, because individuals or operators have made decisions following the letter of the law. On the other hand, literal interpretation may badly damage the purpose of the law or lead to absurd or unfair consequences.
4. Fourth, the necessity to respect higher legal norms may lead to "neutralizing interpretation". The legislation or regulation will be interpreted in a way that is compatible with a higher rule of law, domestic or international. This can lead to constructive interpretation in order to "neutralize" what might otherwise appear as a violation of the higher norm.

##### 4.3.2.2. Special interpretation rules for tax treaties

The interpretation of treaties is governed by specific rules.

General interpretation rules are found in the Vienna Convention on the law of treaties of 23 May 1969. France is not a signatory to this convention, but Arts. 31 and 32 dealing with treaty interpretation are accepted as the codification of international custom. The *commissaires du gouvernement* before the *Conseil d'Etat* rely on these articles in their opinions on tax treaty cases, and the wording of the *Heskes* case shows that the *Conseil d'Etat* has accepted to follow a discussion based on the various principles

of interpretation laid down in Art. 31 (*Conseil d'Etat*, 17 December 2003, *Heskes*, RJF 3/04 n° 249).

This case dealt with the claim by a retired UNESCO employee to an exemption of his UNESCO pension from French income tax. He claimed (unsuccessfully) the benefit of an exemption that he tried to find in the France-UNESCO headquarters treaty. The court decision follows his discussion of the means of interpretation of Art. 31, with a marked reservation regarding the use of subsequent practice by the tax administration.

This acceptance of the Vienna principles is made easier by the perception that these principles bear some resemblance to domestic interpretation principles (e.g. priority of literal interpretation in Art. 31, criteria for looking at preparatory work in Art. 32).

Tax treaties often have a specific interpretation rule when they mirror Art. 3(2) of the OECD Model Tax Convention, providing for the use of domestic definitions when a term is not defined in the treaty.

#### **4.3.2.3. Interpretation practice is very literal; more than in domestic law**

This difference has various reasons.

Basically, the main reason is the allocation of tax jurisdiction achieved in tax treaties, which requires legal certainty and a respect for the compromise reached by the two tax administrations.

Interpretation according to object and purpose suggested by Art. 31 of the Vienna Convention reaches limits: once it is agreed that tax treaties aim at the avoidance of double taxation, or sometimes at the prevention of tax evasion, the specific reasons for the allocation of taxing rights on this or that category of income are not always very clear.

Preparatory work on tax treaties is usually not accessible.

Some other means of interpretation are viewed with some reluctance. The ratification law is unilateral. Subsequent administrative practice, suggested by Art. 31(3) of the Vienna Convention, is viewed with reluctance by an administrative judge who is accustomed to deciding whether administrative policies are in line with the law. In the case of tax treaties, courts must decide whether administrative practice is a correct interpretation and application of the treaty, which makes it difficult to rely on this practice as a reference for interpretation.

Some examples may show this predominance of literal interpretation.

## Examples

In a case decided by the *Conseil d'Etat* on 6 May 1996, *Quartz d'Alsace* (RJF 6/ 96 n° 731), the issue involved Art. 11(3) of the France-Switzerland Treaty of 9 September 1966. This clause extended the benefit of the French *avoir fiscal* to Swiss residents if they were individuals or companies. In the case, dividends were paid by a French company to a Swiss entity not qualified as a legal person. The court of appeals had extended the benefit of *avoir fiscal* to this entity, using Art. 3(1)(d) of the Treaty stating that the term "persons" includes individuals, companies and any other body of persons. The *Conseil d'Etat* quashed this decision, stating that Art. 11(3) was clear and did not require a combination with the definition of the term "persons", which was not at stake in Art. 11. Basically, the court of appeals had corrected what was felt as an omission in Art. 11 (3). But who knows why the drafters of the treaty decided to extend *avoir fiscal* to Swiss individuals and companies but not to other groups of persons?

In a case decided by the *Conseil d'Etat* on 25 February 2004, *Hallminster Ltd* (RJF 5/04 n° 463), the issue was the France-UK Treaty of 22 May 1968, which is significantly different from OECD Models, the main problem being the unusual wording of the relationship between Art. 6 on business profits and treaty articles dealing with other categories of income. A UK company had realized capital gains on the sale of a Bordeaux winery. There was disagreement on the application of Art. 13(1) on capital gains (which designated the place of the immovable property for the taxation of capital gains on immovable property) or Art. 6 on business profits (which used the PE test). The treaty clearly separates Art. 5 (immovable property) from Art. 6 (business profits): Article 5(4) clarifies that this article applies even to immovable property owned by a business, and Art. 6(5) excludes other items of income by giving a closed list of treaty articles not affected by Art. 6, Art. 5 being in that list. But there is no such separation between Art. 6 (business profits) and Art. 13 (capital gains): Article 13 is silent on the topic and is not mentioned in the list of Art. 6(5). By a literal interpretation of Arts. 13 and 6(5), the *Conseil d'Etat* decided that capital gains on immovable property owned by a business should be taxed according to the PE test. The result of this analysis is that current income from immovable property will always be taxed according to the location of the property, whereas capital gains on the sale of immovable property belonging to a business will follow the PE test. This discrepancy in the tax treatment of income from immovable property of business may seem puzzling, but it is difficult to assess what the motives of treaty negotiators might have been.

In the *Natexis Banques Populaires* case of 26 July 2006, the tax sparing clause under Art. 22 of the France-Brazil Treaty of 10 September 1971 provided for a French tax credit for Brazilian withholding tax on dividends and interest, which was deemed to be levied at a 20% rate, higher than the maximum allowed treaty rate. A French guideline of 8 December 1972 stated that the tax credit applied even in the absence of Brazilian taxation. This interpretation was reversed by a later guideline of 5 December 1997. The *Conseil d'Etat* approved the later interpretation, in view of the combined provisions of Art. 22(2)(d), which grants the 20% rate, and Art. 22(2)(c), which provides for French tax credits for income that has borne Brazilian tax. In spite of the earlier interpretation by the French tax administration, which gave a wide meaning to the tax sparing clause, the *Conseil d'Etat* held that the wording of the tax sparing clause did not deviate clearly enough from the general principle stated in Art. 22(2)(c). In his opinion, the *commissaire du gouvernement* refused to rely on some arguments put forward by the bank or the tax administration. He set aside the *travaux préparatoires* of the ratification law as being unilateral. He set aside the 1972 guideline as being unilateral and posterior to the treaty. He finally set aside French instructions to the treaty negotiators as being unilateral.

#### 4.3.2.4. The OECD Model and Commentaries

One peculiarity of the interpretation of tax treaties is the existence of an international organization that drafts a model tax treaty and issues extensive commentaries on the meaning of the model provisions. Most other treaties do not raise this issue.

Courts need to strike a balance between legal principles, which might downplay the significance of the OECD Model and Commentaries, and a pragmatic approach, recognizing that these documents are a background for negotiations, reflect an agreement between various tax administrations and can be a guidance for tax practitioners.

It is difficult to find an ideal solution. The ambulatory use of commentaries suggested by the OECD in the introduction to these commentaries does not fit very well into the means of interpretation suggested by the Vienna Convention: the OECD is an international organization and the commentaries relate to a mere model, not a real treaty. But a legalistic solution rejecting the use of later commentaries is not perfect. It can lead to the problem of "frozen commentaries": when a tax treaty is old, the commentaries of that time might not give guidance for issues that have arisen due to changes in technology or business practice. It can also lead to the problem of "frozen case law" if a treaty provision is interpreted by a tax court in a case involving Treaty A signed before a new commentary and the same issue arises later on a similar provision in a later Treaty B signed after the new commentary: will there be two different interpretations of the same wording or will the court stick to the first interpretation in spite of the new commentary which is nevertheless prior to Treaty B? This issue can be identified when looking at the *Andritz* decision rendered by the *Conseil d'Etat* on 30 December 2003 (RJF 3/04 n° 238), regarding the relationship between Art. 9 of the OECD Model and thin capitalization rules.

What is the practice of the *Conseil d'Etat* regarding the OECD Model and Commentaries? There is a clear-cut distinction between prior and later commentaries.

Later commentaries are not admissible as a relevant instrument for interpretation. This solution is explicitly written in the *Andritz* decision of 30 December 2003 on thin capitalization, in which the *Conseil d'Etat* rejects the argument that thin capitalization tax adjustments are allowed by Art. 9 of treaties following the OECD Model. To support this idea, the French tax administration relied on the 1986 OECD report on thin capitalization inspiring a 1992 addition to the commentary under Art. 9(1). The *Andritz* decision rejects this reference to OECD commentaries because the France-Austria Treaty was signed and amended before these commentaries.

However, later commentaries can have persuasive value, especially regarding treaty provisions that allocate the right to tax specific categories of income. A clear example of OECD influence is the *Interhome AG* decision of 20 June 2003 (RJF 10/03 n° 1147), regarding the criteria of the dependent agent as a PE. The wording of the decision, compared to the opinion of the *commissaire du gouvernement*, who refers frequently to later OECD commentaries, reveals a willingness to look at these commentaries and agree with them. Later OECD commentaries on the notion of permanent establishment may have a special persuasive value, because they can give practical guidance on a concept that is crucial to the correct allocation of taxing rights and requires some clarification for taxpayers. The persuasive value of later OECD commentaries stating that usual national anti-avoidance provisions are compatible with the Model Treaty may be significantly lower, because OECD commentaries reflect the common thinking of national tax administrations who have a stake in these provisions.

Prior commentaries are seen as an admissible instrument for interpretation. The exact place of commentaries in the means of interpretation suggested by the Vienna Convention can be debated. It does not seem to be the context, because Art. 31(2) of the Vienna Convention, defining context, refers to the whole treaty and other agreements between the parties, which is a narrow bilateral approach. Prior commentaries could be related to purpose, assimilated to *travaux préparatoires* or more generally

accepted as a tool for clarifying the intention of the parties to the treaty when they chose to mirror the OECD Model.

The most significant case in which the *Conseil d'Etat* looked at a prior commentary is related to Art. 3(2) of OECD-type treaties, which states that terms not defined in the treaty will be interpreted under domestic law, "unless the context otherwise requires". In the *Golay Buchel* decision of 27 July 2001 (RJF 11/01 n° 1428), the *Conseil d'Etat* dealt with Art. 12 of the France-Switzerland Treaty of 9 September 1966 allowing (at that time) withholding tax on interest by the source State. The issue was the taxation of interest for late payment of a commercial debt owed by a French company to a Swiss company, withheld by the French tax administration. For the definition of interest, Art. 12 of the Treaty mirrored the 1963 OECD draft convention, including in the definition "income from debt-claims of every kind". The *Conseil d'Etat* decided that this expression was not defined in the Treaty and referred to the national meaning under Art. 3(2). The case was resolved according to French case law establishing that interest for late payment is not a financial gain, but belongs to the same category as the main income, such as wages, business income (*Conseil d'Etat*, 4 December 1992, *Brossard*, RJF 1/93 n° 3). But, before coming to this conclusion, the *Golay Buchel* decision mentions that no element of context requires an interpretation that would be different from domestic law. As indicated in the opinion of the *commissure du gouvernement*, the *Conseil d'Etat* researched the commentaries of the 1963 OECD draft convention to check if the wide notion of "income from debt-claims of every kind" might have been commented as including interests for late payment. The answer was that there was no relevant commentary on this issue. This decision implies that the 1963 commentary could have prevented the application of domestic law under Art. 3(2).

### **4.3.3. Is burden of proof different?**

#### **4.3.3.1. Domestic law is complex**

The general tax code and the tax procedures code do not fully regulate the burden of proof but deal only with some specific situations. In between, case law is very pragmatic. Recent case law expands a neutral burden of proof, departing from a previous case law that tried to codify burden of proof for most situations. For instance, previous case law distinguished the scope of a tax, for which the tax administration should justify taxation, from exemptions, which the taxpayer should justify he deserved. This system created problems in some situations, for instance, non-profit entities that are outside the scope of income tax but benefit from a VAT exemption. The same issues relate sometimes to scope, sometimes to exemptions.

Present case law is summarized by the *Conseil d'Etat* in the *Lebreton* decision of 20 June 2003 (RJF 10/03 n° 1140). Each party to the case must justify his own assertions; evidence is required from the party that holds the information; courts should avoid requiring negative proof. For instance, taxpayers are required to justify expenses, but not to prove the absence of concealed revenues.

#### **4.3.3.2. Burden of proof is simpler for tax treaties**

Few tax treaty cases involve a lot of facts, except when residence is disputed. And when facts matter, the burden of proof has been simplified by the *Conseil d'Etat* in the *Diebold Courtage* decision of 13 October 1999 (RJF 12/99 n° 1492). This case deals with Art. 12 of the France-Netherlands Treaty of 16 March 1973, stating that there is no withholding tax on royalties paid to a resident of the other State. The French tax administration inflicted penalties on a French company for failing to apply withholding tax on royalties paid to a Dutch CV, which was transparent, legally and fiscally. The French tax administration argued that the CV was the recipient of the royalties but was not a Dutch resident because it was not liable to tax in the Netherlands. The *Conseil d'Etat*, although the case initially starts with a penalty, applies a neutral burden of proof for the applicability of the tax treaty and quashes the decision of the court of appeals that had decided that the tax administration should prove that the Treaty did not apply.

So the burden of proof is more clear-cut for tax treaties than for domestic law. The neutral burden of proof, with the basic principles laid down by the *Lebreton* jurisprudence, applies.

#### 4.3.4. The choice between domestic consistency and international consistency

##### 4.3.4.1. International consistency is desirable

The main object of tax treaties is to avoid double taxation. This object can be jeopardized by contradictory interpretations and applications of the treaty in the two signatory States, which may result in double taxation, or double non-taxation.

In this respect, tax treaties are different from other treaties. For instance, in an extradition treaty case, the *Conseil d'Etat* decided that international treaties should be interpreted so as to be compatible with the French Constitution (3 July 1996, *Koné*, Lebon p. 255). In that case, the *Conseil d'Etat* expanded the wording of the bilateral extradition treaty between France and Mali to ensure that extradition should be refused when it is requested for political purposes. This method of interpretation could lead to diverging applications of an extradition treaty between the two signatory States. But there is no major breach of the object of the treaty if one State applies an interpretation that grants more protection than the other State.

The desire to avoid conflicting interpretations explains the willingness by the *Conseil d'Etat* to adopt a pragmatic attitude towards the OECD Commentaries, even later commentaries. If the commentaries advise solutions that seem to be reasonable, why not use them as guidelines for allocating tax jurisdiction, knowing that many tax administrations and tax practitioners will rely on them?

The objective of international consistency also explains the willingness to take foreign law into account, in order to achieve the purpose of the tax treaty, i.e. the avoidance of double taxation.

In the *Diebold Courtage* decision of 13 October 1999, the *Conseil d'Etat* accepted to take foreign law into account for the application of a tax treaty. As stated above, the issue related to Art. 12 of the France-Netherlands Treaty of 16 March 1973, which provided that there was no withholding tax on royalties paid to a resident of the other State. In that case, royalties were paid by a French company to a Dutch CV, which was transparent in Dutch law, both legally and fiscally. In the view of the French tax administration, the CV was the recipient of the payment, because it should be assimilated to a French *société de personnes*, treated as a legal person and considered as liable to tax although tax is collected from the partners. But the CV was not a Dutch resident, because it was not liable to tax in the Netherlands. Therefore, according to that view, the royalty was not paid to a Dutch resident and Art. 12 did not apply.

The *Conseil d'Etat* did not follow that line of reasoning, which would result in the systematic denial of the treaty benefit in the presence of conflicting views on partnerships. The Court did not try to assimilate a Dutch CV to a French entity, but accepted to take into account the real status of the Dutch entity according to its national law. Because of the transparency of the CV in Dutch law, the royalty was seen as paid directly to the partners who, in that case, were all Dutch residents. So the treaty benefit applied because of the residence of the partners.

In this logic, the *Conseil d'Etat* applied French law first (i.e. French tax treaty law). But foreign law was taken into account at a later stage, to determine foreign residence and the real beneficiary of a payment.

This distinction between the application of domestic tax law and the use of foreign law for the application of national criteria is shown in another case: *Conseil d'Etat* 27 May 2002, *Superseal Corporation*, RJF 8-9/02 n° 900. This case dealt with the dissolution of a Canadian company, which was fully owned by a Canadian parent company. The former subsidiary had immovable property in France. The issue was whether this Canadian dissolution/absorption of a fully owned subsidiary could be analysed as a transfer of assets giving rise to the taxation of capital gains under French domestic tax law, which was applicable under the France-Canada tax treaty. The taxpayer brought to court written expert statements on Ontario company law and Canadian tax law in order to show that the dissolution was neutral. The French tax administration dismissed these arguments as irrelevant. The *Conseil d'Etat* decided that Ontario company law should be taken into account, but held that, under that law, the assets of the two companies were separate before dissolution, with the consequence that dissolution led to a transfer of assets for the

purpose of French tax legislation on capital gains. The reference to Canadian tax law granting tax neutrality to the dissolution was seen as irrelevant, since the applicable tax law was French tax law.

In the pursuit of international consistency, the knowledge of the tax treaty case law of other States would be useful. Unfortunately, court practice shows that foreign tax treaty court decisions are seldom looked at. The main reason is that the *Conseil d'Etat* is not aware of them, because the parties to the case do not refer to them and the usual tools of court research do not mention them. There is a language problem, because French courts use mostly legal literature written in French. The use of foreign-language materials would need to be a special precaution linked to international cases. And there is a relevance problem, since tax treaties have different wordings and foreign court decisions might often be rendered on treaty provisions that do not match the clause that is applicable in the national case. Practically, the main occurrence of references to a foreign case is the reference by the *commissaire du gouvernement* on the *Schneider CFC* case to the *Bricom Holdings* decision of 25 June 1997 by the London High Court.

#### 4.3.4.2. But domestic consistency and rule of law must be considered

International consistency cannot be the only objective that courts should try to achieve. Courts must take into account consistency with domestic law, consistency with the national treaty network and the rule of law.

Domestic consistency is favoured by the very existence of Art. 3(2) of OECD-type treaties, which refers to domestic definitions of treaty terms. More generally, courts might be tempted, for the sake of domestic consistency, to avoid puzzling differences in the interpretation of treaty terms and domestic terms that are similar or very close.

For instance, the *Banque Française de l'Orient* case (13 October 1999, RJF 12/99 n° 1587) confronted the *Conseil d'Etat* with two issues regarding the connection of treaty dividends with related French concepts. The issue was income from transfer pricing between a French subsidiary and a Dutch parent company. Article 10 of the France-Netherlands Treaty of 16 March 1973 allowed withholding tax on dividends. Was the income from transfer pricing received by the Dutch parent company a French-source dividend?

The *Conseil d'Etat* decided that the treaty did not give a definition of dividends, but a list of financial instruments that did not qualify as a synthetic definition of dividends (it is a view linked to the preference for synthetic definitions in French legislation, but para. 23 of the OECD Commentaries on Art. 10 of the Model Convention suggests that the definition of dividends in the Model is not a complete one). Therefore the *Conseil d'Etat* applied the narrow definition of dividends in French tax law, which mirrors French company law.

Had the *Conseil d'Etat* decided to accept that the term "dividends" was defined in the treaty, the next issue would have been the meaning of "income from shares". As in the later *Golay Bucket* case on interests, the *Conseil d'Etat* would probably, as the *commissaire du gouvernement* suggested, have decided that this expression was not defined in the treaty, which justified the use of domestic law. The expression "income from shares" bears a clear resemblance to the expression "income from participations" used in the French participation exemption regime. French case law already decided that income from transfer pricing from a subsidiary to a parent company was not "income from participations" (*Conseil d'Etat*, 6 June 1984, *Compagnie financière de Suez*, RJF 8-9/84 n°940). It would have been difficult to explain to French taxpayers that "income from shares" for treaty purposes could be different from "income from participations" under the French participation exemption regime.

Consistency with the national treaty network is another constraint, which might conflict with the desire to be consistent with the treaty case law of the other contracting State. France has signed more than 110 treaties on income taxes, and many of these treaties share the same idiosyncrasies. What if, on the same treaty provision of the France-Italy and France-Spain treaties, an Italian court chooses interpretation A and a Spanish court chooses interpretation B? If French courts want to be consistent with the case law of each bilateral partner, that would mean different interpretations of the same clause of two French treaties.

Even without inventing such an extreme example, the existence of the national treaty network means that national courts will try to find precedents in national case law regarding similar treaties, which is easier to find than the domestic case law of the other contracting State.

Finally, the respect for the rule of law makes it difficult to give systematic legal value to administrative agreements and practice. From a practical point of view, it might seem sensible to uphold administrative practices that lead to coherent solutions avoiding both double taxation and double non-taxation. But unless treaty provisions give binding value to administrative agreements, courts cannot abstain from verifying the conformity of administrative solutions with the treaty, when a dissatisfied taxpayer challenges administrative practice, even if this practice is bilateral.

One example of this problem is the *Wildenstein* case decided by the *Conseil d'Etat* on 13 May 1983 (RJF 7/83 n° 848). Article 3 of the France-US Treaty of 28 July 1967, which defined residents, gave a list of criteria for the resolution of conflicts of residence and provided for a mutual agreement if these criteria did not designate a single residence State. In the *Wildenstein* case, there was a mutual agreement between France and the US in favour of French residence. But the taxpayer challenged this solution before French courts, and he won. The *Conseil d'Etat* decided that the mutual agreement could have no legal effect on the taxpayer or the courts, because the conflict between tax jurisdictions could be resolved by application of a prior treaty criterion (center of vital interests). Therefore there was no need for a mutual agreement. In the case, residence was decided to be in the US, because personal relations were mixed, but economic relations were mainly with the US.

Another example is the *Malet* case decided by the *Conseil d'Etat* on 26 February 1992 (RJF 4/92 n° 534). This case dealt with director's fees originating in the US, earned by a French resident. There was no specific article on director's fees in the relevant France-US Treaty of 28 July 1967. The US tax administration held the view that the relevant category for this type of income was "independent services", which led to taxation in France for Mr Malet. The French tax administration agreed and taxed Mr Malet. The taxpayer challenged this implicit agreement before French courts, and the *Conseil d'Etat* decided that director's fees did not belong to "independent services" and that this income had to be dealt with under the "other income" article of the treaty, which designated the source State. French taxation was judged illegal, although the French tax administration insisted that double non-taxation was wrong.

One of the main issues courts are therefore confronted with is the tension between the need to decide in application of the rule of law and the need to protect the purpose of tax treaties by pursuing international coherence in order to prevent double taxation and, possibly, double non-taxation. In this exercise, the attention that could be given to the coherence of solutions chosen on each side of a bilateral treaty might not be enough, because of the lack of coordination between national courts. In this context, multilateral thinking by an international organization such as the OECD is clearly useful, whatever the reservations about the legal status of the OECD Model and Commentaries.

## Chapter 5 – European Court of Justice

### 5.1. Introduction

According to the settled case law of the European Court of Justice ("ECJ"), direct taxation falls in principle within the competence of the Member States. <sup>[2]</sup> The competence of the Member States includes the right to determine the criteria for taxation on income and wealth with a view to eliminating double taxation. For this purpose Member States can act on a unilateral basis or by means of international agreements. In fact, Member States have concluded many bilateral conventions based on the model conventions drawn up by the Organisation for Economic Cooperation and Development ("OECD"). <sup>[3]</sup>

There is no doubt that bilateral tax treaties play the predominant role for the avoidance of double taxation. However, there are some initiatives at Community level in this regard.

Article 293 EC Treaty recognizes the avoidance of double taxation as an objective of the Treaty. This provision, however, does not empower the Community to adopt measures eliminating double taxation but merely invites the Member States to do so. Apart from Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, <sup>[4]</sup> no unifying or harmonizing measure for the elimination of double taxation had yet been adopted by the Member States nor at Community level. <sup>[5]</sup>

Although the Member States are the main actors in the field of the abolition of double taxation, the Community is - according to Art. 94 EC Treaty - competent for the harmonization of the national tax provisions affecting the functioning of the Common Market. On this basis, the Community has already taken some steps in order to prevent double taxation under specific circumstances. The EC Parent-Subsidiary Directive, <sup>[6]</sup> for example, delimits the power to tax dividends distributed by a resident subsidiary to its foreign parent company with the view to preventing double taxation at the level of the parent company.

The main issue of this chapter is: "The Court of Justice applying EU law with respect to tax treaties".

In the preliminary ruling procedure the Court is only entitled to interpret Community law. Bilateral tax treaties are treated like national law and the Court therefore has no jurisdiction to interpret them.

There are three basic principles that can be deduced from the Court's case law with regard to tax treaties:

1. Member States are free to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation.
2. Member States must exercise their competence in the field of direct taxation consistently with Community law. <sup>[7]</sup> When concluding a double taxation convention, they must not infringe the basic freedoms guaranteed by the Treaty.
3. In order to establish discrimination contrary to a basic freedom the transnational situation has to be compared with an internal situation taking into account a tax treaty governing the transnational situation.

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<sup>2</sup> Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, para. 19, and Case C-319/02 *Manninen* [2004] ECR I-7477, para. 19.

<sup>3</sup> Case C-336/96 *Gilly* [1998] ECR I-2793, para. 24.

<sup>4</sup> OJ 1990 L 225, p. 10.

<sup>5</sup> Case C-336/96 *Gilly*, op. cit., para. 23 and Case C-376/03 D [2005] ECR I-5821, para. 50. The Court seems to apply Art. 293 only to multilateral treaties and not to BITs.

<sup>6</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990 L 225, p. 6), as amended by Council Directive 2003/123/EC of 22 December 2003 (OJ 2004 L 7 2004, p. 41)

<sup>7</sup> Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651, para. 19, and Case C-319/02 *Manninen* [2004] ECR I-7477, para. 19.

To illustrate these three principles through some cases, I begin with principles (1) and (2):

## 5.2. Free allocation of the power to tax and respect of the basic freedoms

### 5.2.1. *Gilly* case <sup>[8]</sup>

The *Gilly* case concerns the liberty to determine the connecting factors for the purposes of allocating powers of taxation. The Court ruled that even nationality can be such a connecting factor. The OECD Model Convention provides for reasonable allocation criteria. In *Gilly*, the Court also emphasized that Community law does not prohibit unfavourable consequences resulting from the differences between the tax scales of the Member States concerned.

The facts underlying *Gilly* can be summarized as follows: Mr and Mrs Gilly reside in France, near the German border. Mr Gilly, a French national, teaches in a State school in France. Mrs Gilly, who is a German national having also acquired French nationality by marriage, teaches in a State school in Germany, in the frontier area.

Due to the French-German DTC and in accordance with the OECD Model Convention, the income of Mrs Gilly is subject to tax in Germany as the paying State and in France as the State of residence. To avoid double taxation she received a tax credit in France in respect of the tax paid in Germany. However, the credit did not correspond to the - higher - amount of tax actually paid in Germany, but took as a reference the lower amount of tax Mrs Gilly would have to pay on the relevant income in France.

In resolving the case, the Court emphasized Principle number 1: the Member States are competent to determine the criteria for taxation with a view to eliminating double taxation - by means, inter alia, of international agreements - and have concluded many bilateral conventions. Taking into account that competence, as well as the absence of harmonizing measures, Member States may even explicitly use nationality as a connecting factor for the purpose of allocating jurisdiction. Although the DTC uses the criterion of nationality as such for the allocating fiscal jurisdiction, "such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty". <sup>[9]</sup>

It appears that only unreasonable or arbitrary allocations might cause problems under Community law. In order to evaluate whether States might overstep their freedom to allocate tax jurisdiction, the Court takes inspiration from the OECD Model Conventions and the Commentaries thereto: It is not unreasonable for Member States to base their allocation agreements on international practice and the Model Convention drawn up by the OECD, which in particular provides for recourse to the paying State principle.

According to the commentary on that article, that principle is justified by "the rules of international courtesy and mutual respect between sovereign States" and "is contained in so many of the existing conventions between OECD member countries that it can be said to be already internationally accepted". <sup>[10]</sup>

The question is not whether those Model Conventions, let alone the Commentaries, are law or reflect customary international law; rather, the Court rightly uses them as some soft standard when evaluating whether Member States might have overstepped their broad liberty to allocate tax powers as between themselves by acting in an unreasonable or arbitrary fashion. The Court needs neither special competence nor empowerment of any kind to take inspiration from the Model Conventions of the OECD. With regard to the German-French DTC, the Court held that the object of such a convention is simply to prevent double taxation. It is not to ensure that the tax to which the taxpayer is subject in one State is

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<sup>8</sup> Case C-336/96 *Gilly* [1998] ECR I-2793.  
<sup>9</sup> *Gilly*, op. cit., para. 30.  
<sup>10</sup> Id. para. 31.

no higher than that to which he or she would be subject in the other. <sup>[11]</sup> The Court clearly attributed the unfavourable consequences entailed by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, to the differences between the tax scales of the Member States concerned. <sup>[12]</sup> Determination of tax scales, however, is a matter for the Member States.

### 5.2.2. *De Groot* case <sup>[13]</sup>

In *de Groot*, the ECJ based its decision on full allocation of losses to the State of residence; it did not resolve the case on the basis of the concept of proportional allocation of deductible losses among source States. Moreover, it made clear that a double taxation convention does not justify or undo restrictions of fundamental freedoms resulting from the proportionality or pro rata parte method. <sup>[14]</sup> Thus, the Court rejected the solution underlying the Dutch legislation that has been supported in academic writings, e. g. by Terra/Wattel.

The facts underlying *de Groot* were as follows: Mr de Groot, a resident of the Netherlands, received in a fiscal year income as employee of companies in the Netherlands and several other Member States. After being divorced, he had to pay maintenance payments to his ex-wife. The Dutch tax authorities granted the deduction of these payments only in part in applying a so-called proportionality factor. This method led to an apportionment of the losses to be offset corresponding to the proportion of the domestic income only. In the other Member States, Mr de Groot had, however, no right to deduct the losses at all as he was not a resident of those States. The application of the proportionality factor by the Netherlands, however, was in accordance with the relevant DTCs.

Clearly, Mr de Groot suffered a real disadvantage as a result of the application of the proportionality factor since he derived from his maintenance payments - and from the tax-free allowance - a lesser tax advantage than he would have received had he received his entire income for 1994 in the Netherlands.

The Court clarified that a disadvantage caused by the application by the Member State of residence of its rules on the avoidance of double taxation is liable to discourage a national of that State from leaving it in order to take up paid employment, within the meaning of the Treaty, in the territory of another Member State.

Distinguishing *de Groot* from *Gilly*, the Court explained that

Contrary to what the Netherlands Government maintains when it relies on *Gilly*, the disadvantage suffered by Mr de Groot is attributable neither to the disparities between the tax systems of the Member States of residence and employment nor to the tax systems of the various States in which Mr de Groot was employed. <sup>[15]</sup>

The tax disadvantage suffered by Mr de Groot was in no way the result of the difference between the tax rates of the State of residence and those of the States of employment. Rather, Mr de Groot was deprived in his State of residence of part of the reductions provided for residents of that State by its legislation because he exercised his right to freedom of movement. Mrs Gilly, on the contrary, had enjoyed full national treatment in her State of residence.

As regards the failure by the tax regimes in the States of employment to take into account Mr de Groot's personal and family circumstances, the Court made clear that there was *no* provision for such an obligation in the DTCs with Germany, France and the United Kingdom. The proceedings were not

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<sup>11</sup> Id. para. 46.

<sup>12</sup> Id. para. 47.

<sup>13</sup> Case C-385/00 *de Groot* [2002] ECR I-11819.

<sup>14</sup> See also Case C-307/97 *Saint-Gobain* [1999] ECR I-6161, para. 56 et seq.

<sup>15</sup> *De Groot*, op. cit., para. 85.

concerned with the obligations of those other source or employment States. But if the DTCs with those other States had obliged them to take into account de Groot's personal and family circumstances, the restriction might not have been attributable to the Netherlands. The Netherlands could then have argued that their approach was a reasonable allocation of taxing powers through DTCs.

In the absence of proportional allocation through DTCs, the Court could recall older cases according to which it is a matter for the State of *residence*, in principle, to grant taxpayers all the tax allowances relating to their personal and family circumstances. The Court also uses the practical argument that the State of residence is "best placed to assess the taxpayer's personal ability to pay tax, since that is where his personal and financial interests are centred." <sup>[16]</sup>

The Court added that it was irrelevant that the Netherlands applied the proportionality factor in accordance with the provisions of the DTCs with Germany and France, in relation to the income derived and taxed in those Member States.

Thus, Member States are free to allocate tax power (principle (1) but thereby they must comply with Community law, and, "more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty." <sup>[17]</sup> As a result, the Court held that

[... ] rules such as those at issue in the main proceedings therefore constitute an obstacle to freedom of movement for workers which is, in principle, prohibited by Article 48 of the Treaty. <sup>[18]</sup>

The rationale is very simple: Member States are free to grant reductions or not, but if they do so, they must not discriminate against persons making use of their basic freedoms. Clearly, the prohibition of discrimination is no "punishment" (Wattel) of a state granting (only) partial relief to persons exercising their basic freedoms. Obviously, the Netherlands would also have lost their case had they given no tax relief at all to Mr de Groot. And the liberty to deny tax relief - purely internal and fundamental freedom - in all cases is irrelevant in the framework of a discrimination claim. <sup>[19]</sup>

Terra and Wattel call the *de Groot* case "a Chance Missed" and criticise it as follows: The Court "tried to adapt reality to its initial misunderstanding of it." They contend that instead of requiring the Netherlands to grant 100% of the benefit of the Netherlands tax allowances - even though the Netherlands taxed only 40% of Mr de Groot's income - all the other source States should also have entitled him pro rata parte to personal benefits. <sup>[20]</sup>

However, (i) that was not the matter in dispute before the Court and (ii) the basis for such claim against non-resident States could only be national treatment. And this would require (a) that residents and non-residents such as Mr de Groot were in the same situation with regard to personal benefits and (b) that source States would apply the pro rata parte method to their own nationals. Even under the hypothesis that the two latter conditions were met, some practical problems may arise under the Terra/Wattel approach: Taxpayers would have to declare their worldwide income in any State where they require pro rata parte benefits and all those States would need all the information required to assess the taxpayer's overall ability to pay, taking account of the personal and family circumstances. <sup>[21]</sup>

The pro rata approach has a good point, however: in a globalized world, there will often be no one single State constituting the economic centre of the taxpayer's activities. As a result, it may sometimes seem a

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<sup>16</sup> Id., para. 90.

<sup>17</sup> Id., para. 94.

<sup>18</sup> Id., para. 95.

<sup>19</sup> Confusing Terra and Wattel, see *European Tax Law* (2005) p. 99.

<sup>20</sup> Terra and Wattel, Id., pp. 96 et seq.

<sup>21</sup> Case C-376/03 D [2005] ECR I-5821, para. 27 with references.

bit arbitrary to allocate all allowances to one single "resident" State, even if taxpayers may earn there only a fraction of their worldwide income.

In any case, which approach is more reasonable and more practical is not a matter for the Court to decide. Introducing the pro rata approach is a matter for the States, acting through DTCs, or for legislators.

### 5.2.3. *N* case <sup>[22]</sup>

In *N*, the Court recognized the preservation of the allocation of the power to tax as a justification for infringements of the basic freedoms. Moreover, the Court held that inspiration by the OECD Model Conventions is reasonable; however, deviations can be tolerable and do not necessarily lead to unreasonable allocations.

Mr *N*. challenged the Netherlands exit tax regulation. The national Dutch law provided for the assessment of the tax on profits from substantial shareholdings when residence is moved to another Member State. Emigration from the Netherlands was treated as equivalent to the disposal of shares. Accordingly, tax on the increase in value of the shares was assessed at the time of emigration, albeit tax collection was then deferred for 10 years or until the date of actual disposal.

To be clear, in this case there was no tax collection at exit, but even the tax assessment is a burden and therefore a restriction of the freedom of establishment. But, referring to the *Lasteyrie* case, the Court recalled that national measures that are liable to hinder the exercise of fundamental freedoms or make them less attractive may be allowed if they pursue a legitimate objective, are appropriate to ensuring the attainment of that objective and do not go beyond what is necessary. <sup>[23]</sup> In *Marks & Spencer*, <sup>[24]</sup> the Court explicitly recognized the allocation of fiscal jurisdiction as a legitimate objective and potential justification for infringements, but the concept also underlies its earlier case law. In the *N* case, tax assessment at exit served the legitimate objective to allocate the power to tax increases of value in company holdings between Member States, on the basis of the territoriality principle. According to the Netherlands government, that legislation is also designed to prevent double taxation.

When allocating fiscal jurisdiction, the Court recalled, it is not unreasonable for Member States to find "inspiration" in international practice and, particularly, the Model Conventions drawn up by the OECD. <sup>[25]</sup>

In *N*, the ECJ clarified that "inspiration" does not mean 100% observance. Thus, the Court saw no problem in a slight deviation from the OECD Model: The Model Convention allocates the power to tax gains from the alienation of property to the State of residence exclusively, whereas the applicable DTC provided for a transitional period of five years during which it conferred the power to tax those gains on the exit State, namely State of *former* residence. Thus, (slight?) deviations from the Model Convention do not necessarily lead to unreasonable allocations that then may violate the basic freedoms. The *N* case thus makes even clearer that the Court, of course, does not apply the Model Conventions as law. They may only provide some orientation when assessing potential limits of the Member States broad freedom to allocate taxing powers as between themselves. Logically, deviations do not violate Community law.

## 5.3. Comparison of transnational and internal situation: Taking tax treaties into account

### 5.3.1. *Bouanich* case <sup>[26]</sup>

In *Bouanich*, the Court supported an overall as opposed to a country-per-country approach: when comparing transnational and internal situations, advantages resulting from a DTC need to be taken into account.

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<sup>22</sup> Case C-470/04 *N* [2006] not yet reported.  
<sup>23</sup> Case C-470/04 *N* [2006] not yet reported, para. 40.  
<sup>24</sup> Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, para. 45.  
<sup>25</sup> Case C-470/04 *N* [2006] not yet reported, para. 45.  
<sup>26</sup> Case C-265/04 *Bouanich* [2006] ECR I-923.

The *Bouanich* case concerned the Swedish legislation on the taxation of proceeds of sale that is applicable when a company resident in Sweden repurchases shares from its own shareholders. At issue was the question of whether the provisions on the free movement of capital preclude a difference in treatment between shareholders domiciled or permanently resident in Sweden and those shareholders who are not domiciled or permanently resident in Sweden, in so far as the first group are permitted to deduct their acquisition costs from the taxable amount, whereas that possibility is denied to the second group. In this regard, the Court had to answer the question of whether a difference in treatment may be compensated for by more favourable provisions resulting from a double taxation agreement that is in force between Sweden and the shareholder's State of residence. More precisely, the Court had to examine whether the Franco-Swedish agreement must be taken into account in determining whether the Swedish tax legislation is consistent with free movement of capital.

Relying on *Saint-Gobain*, the Commission pleaded that compliance with Community law cannot be dependent on the content of a double taxation agreement concluded between two Member States. The Court had a different approach:

Since the tax system under the Franco-Swedish agreement, as interpreted in the light of the commentaries on the OECD Model Tax Convention, forms part of the legal background to the main proceedings and has been presented as such by the national court, the Court of Justice must take it into account in order to give an interpretation of Community law that is relevant to the national court.

[27]

Consequently, it had to be established whether that agreement removes the restriction on fundamental freedom that has been found to exist.

With regard to tax treatment under the Franco-Swedish agreement, the Court recalled

[t]hat a non-resident shareholder such as Ms Bouanich is permitted, under that agreement, as interpreted in the light of the commentaries on the OECD Model Tax Convention, to deduct the nominal value of the shares from the taxable amount payable on the occasion of a repurchase of those shares. The remaining amount is then taxed at the rate of 15% [28] only.

In view of the fact that resident shareholders are taxed at the [higher] rate of 30% on share repurchase payments after deduction of the cost of acquisition, it must be ascertained whether those shareholders are treated more favourably than non-resident shareholders. In order to do this, it is necessary to know the cost of acquisition of those shares as well as their nominal value. [29]

These are questions of fact and therefore a matter for the national courts. Thus, the national court had to determine, under *Bouanich*, whether the fact that non-resident shareholders are permitted to deduct the nominal value and are liable to a maximum tax rate of 15% amounts to treatment that is no less favourable than that afforded to resident shareholders, who have the right to deduct the cost of acquisition and are then taxed at a higher rate of 30%.

Thus, DTCs cannot justify discriminations. But in order to establish whether there is less favourable treatment, the concrete situation needs to be taken into account. Thereby, advantages resulting from DTCs may compensate disadvantages that might otherwise constitute discriminations.

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27 Id. para. 51.  
28 Id. para. 52.  
29 Id. para. 53.

A-G Geelhoed in his *Denkavit Opinion* <sup>[30]</sup> gave two reasons for such an overall approach. His first reason is most closely related to principle number 1: Member States have freedom to apportion between themselves not only tax jurisdiction but also priority to taxation. <sup>[31]</sup> And,

second, if the effect of the DTC in an individual case were not taken into account, this would ignore the economic reality of that taxable subject's activity and incentives in a cross border context. Put otherwise, it could distort the real effect on that taxpayer of the combination of home and source State obligations. <sup>[32]</sup>

According to A-G Geelhoed, "the combination of home state and source State obligations under the free movement provisions should properly be seen as a whole, or as achieving a type of equilibrium." <sup>[33]</sup>

The Court thus looks at the concrete situation underlying the case to be decided. This makes sense because only in this way is it possible to establish whether there are, at all, incentives against cross-border economic activity.

### 5.3.2. D case

In *D*, the Court made clear that nationals of Member States falling under a DTC are not to be regarded as being in the same situation as nationals of Member States not covered.

Mr D resided in Germany; nevertheless, he was liable to wealth tax in the Netherlands where he owned real property. Dutch law provided that resident taxpayers were entitled to an allowance applied to their net worldwide assets while non-resident taxpayers were taxed on their net assets in the Netherlands without the right to an allowance.

Mr D was of the view that the unequal treatment of resident and non-resident taxpayers was contrary to the treaty rules on free movement of capital.

Secondly, he argued that he was treated less favourably than Belgium residents subject to wealth tax in the Netherlands. Those taxpayers, benefiting from the Belgium-Netherlands DTC, had the right to the allowance.

After rejecting non-resident D's claim for equal treatment with resident taxpayers, the Court examined whether D had to be granted most-favoured treatment. The underlying question was whether the basic freedoms require that favourable DTC treatment granted to citizens of the State party must be extended to nationals of other Member States. In order to answer that question the Court had to compare the situation of a person resident in a State not party to a specific DTC and that of a person covered by that convention. Normally, the scope of a bilateral tax convention is limited to the natural or legal persons referred to in it. However, as the Court recalled, "there are situations where the benefits under a bilateral convention may be extended to a resident of a Member State which does not have the status of party to that convention." <sup>[34]</sup> Thus, in *Saint-Gobain*, the Court had held that

[... ]in the case of a double taxation convention concluded between a Member State and a non-member country, the national treatment principle requires the Member State which is party to the convention to grant to permanent establishments of non-resident companies the benefits provided for by that convention on the same conditions as those which apply to resident companies. <sup>[35]</sup>

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<sup>30</sup> Opinion of A-G Geelhoed Case C-170/05 *Denkavit International*, not yet reported.

<sup>31</sup> Id. para. 34.

<sup>32</sup> Id. para. 36.

<sup>33</sup> Id. para. 37.

<sup>34</sup> Case C-376/03 D [2005] ECR I-5821, para. 55.

<sup>35</sup> Id. para. 56 referring to *Saint-Gobain*, para. 59.

In the *Saint-Gobain* situation, the Court had regarded the non-resident taxable person having a permanent establishment in a Member State as being in a situation equivalent to that of a taxable person resident in that State. <sup>[36]</sup> Now, the Court had to consider, whether in the concrete situation of D - meaning with regard to wealth tax in the Netherlands - a taxable person, such as Mr D., resident in Germany and a taxable person resident in Belgium are in the same situation. Two short paragraphs sufficed the Court to reject that proposition. First, the Court emphasized principle number 1: States here made use of their power to allocate powers of taxation as between themselves. Thereby

[ ... ]the fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands. A rule such as that laid down in the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance. <sup>[37]</sup>

Thus, different treatment of EU citizens of different Member States resulting from DTCs, as such, is no discrimination prohibited by Community law - DTC plus fundamental freedoms do *not* produce most-favoured nation treatment.

The differences to the *Saint-Gobain* case, where the Court had granted most-favoured treatment, are first, in *Saint-Gobain* an EU citizen claimed most-favoured nation/equal treatment with a citizen of a third State falling under a DTC; second, the comparable situation of permanent establishments and subsidiaries under the circumstances of the case mattered in *Saint-Gobain*.

Two questions remain after D: (1) does any clause of a DTC, by the very fact of being included in the DTC, necessarily allocate taxing powers and therefore, in principle, comply with Community law? (2) Are member states at liberty to introduce all kinds of different treatments through DTCs, which would violate the basic freedoms if enacted unilaterally?

## 5.4. Concluding remarks

Summarizing the findings of the Court, one can see that the ECJ attaches great significance to DTCs. Their provisions generally reflect the allocation of powers of taxation, which Member States are competent to determine, when exercising their jurisdiction to tax. However, DTCs, just like national laws, must not violate the fundamental freedoms.

When comparing transnational and internal situations, the Court does not only consider the domestic tax law, but includes the consequences of DTCs into its comparison. Negative consequences from national law may be compensated by DTCs.

The Court particularly recognizes that a DTC constitutes an entire system of mutual concessions. Consequently, nationals of another Member State cannot invoke singled out favourable provisions of a DTC (no most-favoured-nation treatment). Also, different treatment resulting from DTCs, as such, does not constitute discrimination.

With regard to future developments one might raise the old question: Does Community law prohibit double taxation?

Article 293 EC Treaty has no direct effect. Whilst abolition of double taxation is an objective of the Treaty, individuals cannot derive rights there from. Surely, double taxation works as a restriction within the Common Market. But, in order to prohibit double taxation, Community law would have to determine

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<sup>36</sup> Id. para. 57.  
<sup>37</sup> Id. para. 61 et seq.

the addressee of such a hypothetical obligation to abolish double taxation. This is so because making responsible, for undoing double tax burdens, the first of the two or more States brought before the Court is no satisfactory solution. Granting priority to the tax claims of one Member State over tax claims of another Member State, however, would imply allocating the taxing powers between Member States. This exceeds the competencies of the Court of Justice.

Advocate-General Geelhoed goes even further by introducing the term of "quasi-restrictions" for, as he formulates it, distortions resulting from the co-existence of discrete tax systems in a particular direct taxation sector. According to A-G Geelhoed

[ ... ]the causes and character of these quasi-restrictions mean that they may only be eliminated through the intervention of the Community legislator, in the absence of which intervention they should be held to fall outside the scope of the Treaty free movement provisions. <sup>[38]</sup>

A-G Geelhoed goes further by taking away those "quasi-restrictions" from the scope of application of the Treaty's free movement provision, whereas the Court acknowledges restrictions which might, however, be justified by the need to preserve the allocation of fiscal jurisdictions.

Nevertheless, given that Member States are free to allocate their taxing powers, the ECJ could rule at most that all States concerned are jointly and severally liable for situations of double taxation. But this does not seem a realistic scenario. What remains is therefore only the further elaboration of bilateral - or perhaps sometime in the future, a multilateral - double taxation convention.

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38 Opinion of A-G Geelhoed, Case C-513/03 *Kerckhaert and Morres* [2006] not yet reported, para. 38 with references to his other opinions.

## Chapter 6 – EC Treaty freedoms, tax treaties and national courts

### 6.1. Overview of and comments on the ECJ case law on tax treaties and EC law

#### 6.1.1. Introduction

In this chapter, 13 ECJ cases on tax treaties will be quoted in chronological order and commented on from both an EC law point of view and an international tax law point of view. As will be seen, bilateral tax treaties between two Member States in principle are not treated differently by the Court from national law, albeit that the Court adopts an *overall* approach, meaning that what would from a one-jurisdictional point of view be a prohibited discrimination, may be allowed if the effect of a tax treaty is to undo that discrimination or to compensate for it in the other jurisdiction. As will be seen as well, the ECJ does not limit itself to interpreting EC law, but also embarks upon tax treaty interpretation, unfortunately not always very successfully, and largely *ultra vires*, as only national courts are competent to interpret tax treaties.

#### 6.1.2. *Avoir fiscal*: EC Treaty freedoms not dependent on tax treaty negotiations

The first case in which the ECJ was called upon to consider the relationship between the (scope of the) EC Treaty freedoms and the effect of bilateral tax treaties was Case C-270/83, *Commission v. France* ("*Avoir fiscal*"). The French government argued, *inter alia*, that it could not be required to extend its imputation credit for underlying corporation tax (*avoir fiscal*) to branches of non-resident companies holding shares in French quoted companies without first having negotiated, with the residence State of that company, similar benefits for its own residents. The Court, however, considered that:

26. [...] the rights conferred by article 52 of the treaty are unconditional and a member state cannot make respect for them subject to the contents of an agreement concluded with another member state. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other member states.

In hindsight, this decision looks pretty obvious: national treatment of residents of other Member States cannot be made dependent on the question of whether one gets something in return for it, especially not as the other Member State involved is required just as well to grant national treatment unconditionally, so that reciprocity is, in that sense, secured automatically. <sup>[2]</sup>

#### 6.1.3. *Bachmann*: Tax treaties not relevant as outside the scope of negative integration

The next case to touch on tax treaties was Case C-204/90, *Bachmann*. The taxpayer, a German administrator temporarily seconded and resident in Belgium, pointed out to the Court that although Belgium might under its national law have a point in refusing him deduction of pension and annuity contributions paid to a German insurer (as Belgium would not be able to tax the corresponding future benefits), Belgium had concluded a tax treaty with Germany, reciprocally relinquishing taxing rights as regards pension and annuity benefits in favour of the (then) residence State of the taxpayer, irrespective

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<sup>2</sup> The author observes that this ruling did not mean that France had to extend its imputation credit to all non-resident EC shareholders in French companies, but merely that if France taxed the non-resident shareholder for the French dividend received, it had to tax that non-resident taxpayer in the same manner (thus crediting the underlying corporation tax) as a resident taxpayer receiving the same dividend.

of whether the contributions had been deducted and, if so, in which jurisdiction. The Court did not take account of the tax treaty, as it considered this a matter of positive harmonization outside its competence:

26. It is true that bilateral conventions exist between certain Member States, allowing the deduction for tax purposes of contributions paid in a contracting State other than that in which the advantage is granted, and recognizing the power of a single State to tax sums payable by insurers under the contracts concluded with them. However, such a solution is possible only by means of such conventions or by the adoption by the Council of the necessary coordination or harmonization measures.

This standoffish approach as regards tax treaties was completely abandoned in later cases, such as *Wielockx*, *Gilly* and *Bouanich* (see below), but probably because of the ECJ's modest success rate in interpreting tax treaties (see below) it seems to revive again in recent case law, such as particularly *D. v. Inspecteur* and *Kerckhaert-Morres* (see below).

Meanwhile, in Mr Bachmann's case, the Court drew the incorrect conclusion that Belgium could refuse deduction on the justification grounds of fiscal cohesion - within one taxing jurisdiction - between deduction of contributions and taxation of the corresponding benefits. The Belgian measure was clearly disproportionately restrictive in respect of securing territorial fiscal cohesion, as nothing prevented Belgium from granting Mr Bachmann his deduction as if he had paid contributions to a Belgian insurer, but taxing him (recapturing the deduction) later, at the moment he would leave the Belgian taxing jurisdiction (and the insurer would be out of the Belgian jurisdiction as well). That would have been a less restrictive but still quite effective cohesion measure.

#### **6.1.4. *Wielockx*: Tax treaties relevant; macro cohesion; unsuccessful interpretation**

Case C-80/94, *Wielockx*, prominently featured tax treaty issues. The Netherlands government, relying on the *Bachmann* case, argued that Mr Wielockx, a self-employed physiotherapist, resident in Belgium and practising in the Netherlands, could not be allowed a reduction of his taxable profits in order to form a tax-free old-age reserve, as the Netherlands would, for lack of jurisdiction, be unable to tax him once the tax-free reserve would later be transformed into an old-age annuity and commence paying. Although the Court rightly rejected this fiscal cohesion argument, it did so for erroneous reasons advanced by its Advocate-General Léger, based on a misinterpretation of the Belgium-Netherlands tax treaty and of tax treaties in general. But apparently the Court wanted to respond to the criticism with which its *Bachmann* judgment had met from the international tax literature, which had argued that the Court should have taken into account the effect of tax treaties on the cohesion between deductibility and later taxation:

24. As the Advocate General observed in point 54 of his Opinion, the effect of double-taxation conventions which, like the one referred to above, follow the OECD model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States.

25. Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue.

This reasoning is incorrect, as the old-age reserve (part of business capital) was, unlike the ECJ supposed, *not* covered by Art. 18 (pensions) of the Treaty and, in any case, the reasoning is conspicuously erroneous in itself, as Mr Wielockx evidently would have been in no need of EC law if the Netherlands had already, as the Court supposed, relinquished its taxing right under the bilateral treaty (at "another level"). The very fact that Mr Wielockx could *not* rely on the - directly effective - tax treaty implied that the benefits were *not* allotted by the tax treaty to Belgium and that the Netherlands had *not* given anything away in respect of the old-age reserve. Moreover, tax treaties do not address deductions for old-age provisions.

As in *Bachmann*, the correct decision would have been to consider the refusal of the deduction as disproportionate to secure cohesion and therefore to allow Mr Wielockx to have his base reduction as if he were a resident, but allowing the Netherlands to recapture that reduction in case of impending loss of taxing power (i.e. on the occasion of Mr Wielockx' retirement from practice or on any other moment of cessation of exposure to Netherlands taxing jurisdiction).

### **6.1.5. *Les époux Gilly*: OECD distributive rules and relief mechanisms "not unreasonable"; no full credit required under EC law**

Case 336/96, *Gilly*, is the Court's most elaborate judgment on the EC law limits to Member States' sovereignty in concluding (OECD Model-like) tax treaties. It concerned the French resident Gilly couple. Mrs Gilly was employed as a civil servant in Germany and complained that she and her husband lost part of their French personal allowances as a result of the relief mechanism for double taxation in the Franco-German tax treaty, and that in general she had to pay a higher tax on her income than if she had earned the same income in France. The Court unfortunately did not quite catch the personal allowances argument (it did not realize that France allocated its personal allowances proportionally to both domestic and exempted foreign source income for purposes of relief from double taxation), but rightly held (i) that it is up to the Member States to determine their nexus of taxation and to establish both distributive rules for the division of their taxing power and mechanisms for relief of (remaining) double taxation, and (ii) that a higher tax rate in the State to which the wages are allocated is not a discrimination or restriction (caused by only one jurisdiction), but a disparity of tax systems which falls outside the scope of the Treaty Freedoms and may only be remedied by harmonization measures of the Member States. The *Gilly* judgment leaves the general impression that conforming to the OECD Model Convention will in general protect Member States from interference in (the division of) their taxing jurisdictions by the ECJ on the basis of incompatibility with the EC Treaty Freedoms:

24. The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation - by means, *inter alia*, of international agreements - and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organisation for Economic Cooperation and Development ("OECD").

25. That is the context in which the Convention concluded between the French Republic and the Federal Republic of Germany applies a number of connecting factors for the purpose of allocating jurisdiction between the contracting parties as to the taxation of income from dependent work.

[...]

30. [...] It flows, in the absence of any unifying or harmonising measures adopted in the Community context under, in particular, the second indent of Article 220 of the Treaty, from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation.

31. Nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD, [...].

[...]

34. Nor is it established in the present case that the choice of the paying State as the State competent to tax income earned in the public sector can of itself be to the disadvantage of the taxpayers concerned. As has been pointed out by the governments of the Member States which have submitted observations and by the Commission, whether the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor but by the level of taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation.

[...]

41. The purpose of the tax credit mechanism set up by Article 20(2)(a)(cc) of the Convention, which is based on the arrangements envisaged for that purpose in the OECD model convention, is to avoid the double taxation of French residents in receipt, in Germany, of profits or other income taxable in both Germany and France.

[...]

46. [...] it must be stressed, [...], that the object of a convention such as that in issue is simply to prevent the same income from being taxed in each of the two States. It is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other.

47. However, it is common ground that any unfavourable consequences entailed in the present case by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the Member States concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the Member States.

48. Furthermore, as has been observed by the French, Belgian, Danish, Finnish, Swedish and United Kingdom Governments, if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation.

The most striking feature of the *Gilly* judgment is the ECJ's very detailed, very extensive (paras. 26-29, 31-35, 42-46) and insouciant interpretation of the applicable bilateral tax treaty, even referring to a commentary on an OECD Model tax treaty (without checking for conformity and anteriority, however), which for many national courts not even counts as soft law or doctrine, especially not if the commentary post-dates the treaty to be applied, or if that commentary has been changed since the conclusion of the treaty or if the treaty does not conform *verbatim* to the OECD Model. This is striking, because the ECJ is not competent to interpret bilateral treaties between Member States. The competence attribution system of the EC Treaty is clear as to the limits of ECJ competence (see Arts. 220-243 of the EC Treaty). The only authority the ECJ could possibly acquire in the interpretation of a bilateral tax treaty comes under Art. 239 of the EC Treaty, in the very rare case where (i) there is a dispute between the Contracting States as regards the interpretation of that tax treaty, and (ii) that dispute relates to the subject matter of the EC Treaty, and (iii) the tax treaty contains an arbitration clause (or the Contracting States separately agreed to an understanding) conferring judicial competence on the ECJ (such as apparently is the case of the tax treaty between Germany and Austria as regards transfer pricing disputes leading to double taxation and insoluble under the treaty clause on mutual agreement).

Another point worth observing is that the ECJ seemed to think that allocation of taxing power entails exclusive allocation of income to one taxing jurisdiction: the taxpayer is either lucky (ends up in the lower tax rate jurisdiction) or unlucky (ends up in the higher rate jurisdiction). After application of the Treaty, Mrs Gilly's German wages were apparently considered to be taxed only in Germany. That is not the case, however. Generally, the cross-border income is fully taxed in both the residence and the source State, and only after calculating and levying domestic tax on the worldwide income will the residence State allow its residents a reduction of the tax debt so calculated in order to take into account that the source State taxes the income as well. This means, *inter alia*, that progression effects occur and that *pro rata parte* reduction of the benefit of personal deductions occurs. Moreover, if the residence State applies a credit system for double taxation relief, considerable amounts of additional residence State tax may strike the foreign source income. It is therefore a shared competence, not an exclusive one. It cannot be upheld, therefore, that distributive and relief rules in tax treaties lead to either source State jurisdiction or home State jurisdiction and that any disadvantageous effect (allocation to the higher rate State) is thus just a disparity. In the later *De Groot* case (see below), the Court realized this.

Despite this incompleteness, the *Gilly* judgment may be considered as a fundamental one as regards tax treaties and unilateral relief for double taxation, because (i) it recognizes the freedom of Member States to define, share, allocate and divide their taxing jurisdiction (albeit "with a view to eliminating double taxation") and to define their elimination mechanisms, and (ii) its paragraph 48 sweepingly states that a Member State cannot be required to credit (refund) any foreign tax which it does not levy itself on the foreign source income concerned, because that would in effect partly prevent that State (the residence State) from taxing other (domestic source) income and would thus encroach unjustifiably upon its sovereignty. This means that an ordinary credit suffices; the EC treaty freedoms do not call for a full credit, not even if extended in internal situations (e.g. where domestic wages tax withheld proves to be higher than the ultimate domestic income tax liability of the taxpayer).

Given the fact that Member States are free to define and divide their taxing jurisdiction, the Court's observation (para. 31) that it is "not unreasonable" for them to do so on the basis of the OECD Model, is gladly understood, but does not seem to add more than reminiscence of that Tom Jones classic: "*It's not unusual to be loved by anyone ...*"

#### **6.1.6. *Saint-Gobain*: National treatment leading to extension of tax treaties with third States to non-residents**

Case C-307/97, *Saint-Gobain*, concerned a classical triangular situation and therefore application of three tax treaties at the same time, although the Court apparently did not realize that. It focused on only one of the three tax treaties involved. The French resident company Saint-Gobain had a branch in Germany to which US and Swiss sourced group dividends pertained. Germany's tax treaties with the US and Switzerland provided for an exemption of group dividends originating in the jurisdiction of the tax treaty partner. As the branch was not a resident of Germany and tax treaties are limited in personal scope to residents of one of the Contracting States, (the German branch of) Saint-Gobain was not eligible for the German/third State treaty benefits. The Court, however, required Germany to grant national treatment to Saint-Gobain ('s branch) as if it were a German resident:

54. Finally, as justification for not allowing the tax concessions in question, the German Government maintains that the conclusion of bilateral treaties with a non-member country does not come within the sphere of Community competence. Taxation of income and profits falls within the competence of the Member States, which are therefore at liberty to conclude bilateral double-taxation treaties with non-member countries. In the absence of Community harmonisation in this area, the question whether, in the case of dividends, the tax exemption for international groups should be granted to permanent establishments under a tax treaty concluded with a non-member country is not governed

by Community law. To extend to other situations the tax advantages provided for by treaties concluded with non-member countries would not be compatible with the division of competences under Community law.

55. The Swedish Government observes that double-taxation treaties are based on the principle of reciprocity and that the balance inherent in such treaties would be disturbed if the benefit of their provisions was extended to companies established in Member States which were not parties to them.

56. [...] the Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves [...].

57. As far as the exercise of the power of taxation so allocated is concerned, the Member States nevertheless may not disregard Community rules. According to the settled case-law of the Court, although direct taxation is a matter for the Member States, they must nevertheless exercise their taxation powers consistently with Community law (see *ICI*, cited above, paragraph 19, and the case-law cited there).

58. In the case of a double-taxation treaty concluded between a Member State and a non-member country, the national treatment principle requires the Member State which is party to the treaty to grant to permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies.

59. As the Advocate General points out in point 81 of his Opinion, the obligations which Community law imposes on the Federal Republic of Germany do not affect in any way those resulting from its agreements with the United States of America and the Swiss Confederation. The balance and the reciprocity of the treaties concluded by the Federal Republic of Germany with those two countries would not be called into question by a unilateral extension, (...), of the category of recipients in Germany of the tax advantage provided for by those treaties, in this case corporation tax relief for international groups, since such an extension would not in any way affect the rights of the non-member countries which are parties to the treaties and would not impose any new obligation on them.

60. [...].

61. The Swedish Government, in its written observations, argued that in certain extreme situations extending the scope of bilateral double-taxation treaties could lead to no tax yield being produced at all.

62. As the Advocate General points out in point 88 of his Opinion, such an argument is not relevant in the case referred since it has not been argued that there was a risk that profits would not be taxed in any country.

It would seem that no one pointed out to the Court that Saint-Gobain's head office, being a resident of France, could also rely on the tax treaties between France and the source States, nor that a reduction of the branch's tax liability in Germany might not benefit Saint-Gobain at all if the tax treaty between France and Germany were to contain a credit system for double tax relief. The simple application of the national treatment rule to branches of EU non-resident taxpayers has the same effect, in situations as the one in issue, as extending the scope of the third State tax treaty to certain non-residents of Germany, and therefore of simultaneous and cumulative treaty application (both the France-US treaty - for the head office - and the Germany-US treaty - for the branch - must be applied, on top of the French-German treaty).

As the ECJ required the branch State to apply its treaty with the US (more precise: to extend unilaterally the same benefits to the branch as residents would obtain under that treaty), the Netherlands' *Hoge Raad*

has drawn the conclusion from the *Saint-Gobain* case, in a triangular case before it, <sup>[3]</sup> that the branch State is the State first called and responsible to credit third State withholding tax, and that the home State, if it exempts the branch profits, does not have to credit such third State tax, because crediting it against the head office's corporation tax would, under an exemption system, lead to the home State having to refund tax on other (domestic) income. This reasoning would seem to imply that if the home State does not *exempt* the branch profits to which the third State dividends pertain, but applies an (ordinary) *credit* system for double tax relief (resulting in the taxing away of the credits the branch State is to extend in order to conform to the *Saint-Gobain* judgment), the home State must also credit the third State withholding tax. However, one might just as well reason - *vice versa* - that if the head office State uses a credit system for double tax relief, the branch State cannot be required to grant national treatment (cannot be expected to conform to the *Saint-Gobain* judgment), as national treatment of the branch in those circumstances would not benefit the taxpayer in any way. Indeed, the head office would just pay extra in its State what its branch would pay less in the branch State. The EC Treaty Freedoms do not have the purpose of such a mere shift of tax revenue from one Member State to another without benefiting the taxpayer in any way. One might therefore argue that the branch State can only be required to credit the part of the third State withholding tax that cannot be credited in the head office State for lack of tax exposure there (excess foreign tax credit). Whichever of the two approaches one takes, the two Member States involved will have to take into account the tax (treaty) position of the taxpayer in the other Member State, which - to put it mildly - will not simplify tax treaty application, especially not as there are no priority rules or rules of sequence as regards the application of the three tax treaties concerned. A circular "après vous" effect may occur.

The *Saint-Gobain* judgment also makes a distinction between the *allocation* of taxing power (which is up to the Member States), and the *exercise* of the taxing power "so allocated" (which is limited by Community law). This distinction is puzzling. One way of exercising one's taxing power is by allocating (first assuming and then limiting) it. The underlying presupposition may be that mere allocation of taxing powers cannot be discriminatory or restrictive as it only implies choosing a (one) jurisdiction. I am not convinced that presupposition is correct as long as "allocation of taxing powers" has not been defined, and since, as observed, allocation of taxing power is only rarely exclusive (shared power). The approach taken in this respect by the ECJ here seems to be based on an international private law way of thinking (choice of - only - *one* national legal system to govern the case).

#### **6.1.7. X. and Y. vs. Riksskatteverket: Interpretation of a non-applicable tax treaty**

Case C-436/00, *X. and Y. vs. Riksskatteverket*, concerned a Swedish capital gains tax on the transfer of shares in a Swedish company, closely held by two Swedish individuals, to another Swedish company, which was a subsidiary of a Belgian company, which was, in its turn, controlled by the same two individuals. Had the transfer been to a wholly Swedish owned company, then no capital gains tax would have been levied (a transfer at cost and a roll-over of unrealized capital gain would have been allowed). The measure was aimed against circumvention of the Swedish capital gains tax by Swedish individuals first transferring their shares at cost to a controlled (indirectly) foreign company without paying tax and then emigrating to a State not levying a capital gains tax or granting a step up in fiscal value upon immigration, after which the shares in the foreign company would be sold or that company would be dissolved. The Court unfortunately first reiterated its erroneous *Wielockx* judgment (again not seeing that if Sweden had really relinquished its taxing rights, the individual shareholders could simply have relied on the tax treaty and would have been in no need of EC law), and then unfortunately went on to interpret Art. 13 of the Swedish-Belgian tax treaty:

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<sup>3</sup> Hoge Road 8 February 2002, case no. 36 155, published in *BNB2002/184*

54. The effect of double taxation conventions such as the Belgo-Swedish Convention, and, in particular, its Article 13(4), which is, in fact, identical to the same article of the OECD model convention, is that, as a general rule, a State taxes all gains on shares received by transferors resident on its territory, but, conversely, does not impose tax on gains made by transferors residing in the territory of the other Contracting State, regardless of whether the transferor has benefited from deferral of tax at the time of a previous transfer of the shares concerned.

55. The hypothetical risk of the transferor's moving definitively out of the country in the case of type A share transfers, which the national provision at issue seeks to deal with by refusing deferral of taxation, is thus covered by Article 13(4) of the Belgo-Swedish Convention on a basis of reciprocity, insofar as, in that event, only the Contracting State to which the transferor has moved his residence has authority to tax the gains concerned.

56. Moreover, Article 13(5) of the Belgo-Swedish Convention provides for a reciprocal system which specifically apportions the rights to tax of the Kingdoms of Belgium and Sweden as regards taxation of gains on disposal of shares. That provision seeks to deal with the situation covered by the national provision at issue here, namely, in relation to a share transfer, the risk of a transferor's moving definitively to the other Contracting State. In that connection, Article 13(5) of the Belgo-Swedish Convention provides essentially that, in the event of a transfer of shares in a company resident in its territory by its own nationals, the Contracting State concerned loses only its right to tax share transfers which take place more than five years after the definitive departure for the other Contracting State of the transferor.

57. In any event, refusal of deferral of taxation on type A and type B share transfers, as provided for by the national provision at issue here, is not necessary and proportionate to the objective it pursues.

This ultra vires interpretation makes no sense, as the tax treaty was simply not applicable. Indeed, the case concerned two Swedish resident transferors, transferring shares in a Swedish resident company to another Swedish resident. Therefore, the case was entirely internally Swedish and there was no question of any treaty being applicable. Even if the shares in the Swedish company had been transferred directly to the controlled Belgian company, the Treaty would still not have been applicable. The cited Art. 13(4) and (5) of the Swedish-Belgian tax treaty only apply if, unlike the Swedish individuals and their company, the transferring shareholder and the company whose shares are being transferred are *not* resident in the same State. If the shareholders would emigrate and subsequently sell their shares in the Belgian company, the tax treaty would still not be applicable, as in that case both the company and the shareholder would be non-Swedish and anyway the shareholders would probably not emigrate to Belgium, but further south, and they would probably not sell the shares, but dissolve the Belgian company (the controlling company was probably only in Belgium because in Belgium it was possible to dissolve a company and to receive its profit reserves as a liquidation payment without paying Belgian income tax). Therefore, whatever any treaty provided for, was irrelevant, in any case at the time of the transfer of shares at issue. What Sweden did was simply taxing the real but as yet unrealized capital gains on the occasion of any transformation of domestic shares into foreign shares, because Sweden applied a trailing tax (of ten years) which only caught emigrants taking with them shares in *Swedish* companies.

[4] It was therefore crucial in the Swedish system, in order to retain the justified Swedish tax claim on the Swedish sourced unrealized capital gains, to catch transformations of shares in Swedish companies into shares in foreign companies. Such taxation cannot be considered to be a treaty override (as the treaty was not even potentially applicable at that moment), and even if it could, EC law does not prohibit treaty overrides, as the Member States remain free to define their taxing jurisdictions and to negotiate (or not to

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4 See Wiman, B., "Pending Cases Filed by Swedish Courts", in Michael Lang (ed.), *Direct taxation: Recent ECJ Developments*, Vienna: Linde Verlag, 2003, p. 194

negotiate, or to terminate, or to override) allocation rules, as long as they do not discriminate or have a good justification for doing so.

The Court was correct in the quoted para. 57 and should have limited itself to that consideration: whether or not any treaty was applicable, Sweden made a distinction on the basis of the residence of the acquiring company and had no good excuse for that. Although there was a real threat of circumvention of capital gains tax, the Swedish measure to curb it was disproportionate. Sweden taxed the transferring shareholders too early: both before they emigrated (maybe they were not even planning to emigrate, although that did not seem very likely) *and* before they (ultimately) disposed of their (indirect) shares in the original Swedish company. In any case, nothing prevented Sweden from applying the same trailing tax for emigrants holding Swedish shares also to emigrants holding foreign shares (and to require security, as the ECJ itself suggested! The later *N. v. Inspector* case - see 6.1.13. below - shows that the ECJ later changed its mind on the permissibility of such security requirement). It should be observed that the very fact that the ECJ itself suggested a conservatory exit tax with provision of security (which is closer to a treaty override than the actual Swedish system), seems to demonstrate that pre-empting treaty application or even treaty overriding do not in themselves fall foul of the EC Treaty Freedoms.

### 6.1.8. *De Groot*: Denial of national treatment; the "always somewhere" principle

In Case C-385/00, *De Groot*, the Court for the first time used what the author calls [5] - for want of a better name - the "*always somewhere*" principle in direct tax matters: taxpayers making use of the Treaty Freedoms should not lose any tax benefits as compared to those not using them, and should therefore always be enabled to use their personal and family deductions (or loss relief [6] or cost deduction [7]) somewhere in the EC, either in the source State or in the home State. If these States do not achieve this result of their own motion, either bilaterally or unilaterally, then the Court will make one of them responsible.

The preliminary questions in the *De Groot* case concerned the *pro rata parte* effect of double tax relief mechanisms and made the Court see what had escaped its attention in the *Gilly* case: both under an exemption and under a credit system, the home State will grant no more tax reduction to prevent double taxation than its domestic tax attributable to the foreign source income. Under both systems, such attributable domestic tax will be calculated *pro rata parte*: if 60% of the income is foreign source, then no more than 60% of the home State tax on the worldwide income will be waived. One of the effects of this *pro rata parte* method is that also 60% of the personal and family deductions of the taxpayer will be attributed to the foreign source income (to be taken into account by that source State which, after all, also taxes that income).

Astonishingly, the Court denied taxpayers their right to national treatment in the source State (which can therefore discriminate non-resident workers as it pleases as regards person-related tax reductions), and instead forced the home State to grant the taxpayer the full benefit of home State personal allowances, although that State taxed only 40% of the income. The Court further allowed the Member States involved to deviate from the EC Treaty rules on freedom of movement (as applied by the Court) if the source State voluntarily grants the national treatment which according to the Court it is not required to extend. Therefore, if the source State chooses not to discriminate non-resident workers or self-employed persons, the home State is "released" from having to compensate for such discrimination. The Court considered (*emphasis added*):

99. The Member States are of course free, in the absence of unifying or harmonising measures adopted in the Community, to alter, by way of bilateral or multilateral agreements for the avoidance

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5 Annotation to the *Marks & Spencer* case C-444/03, in *BNB* 2006/72

6 See the later *Marks & Spencer* case C-446/03

7 See the later *Bosal* case C-168/01

of double taxation, that correlation between the total income of residents and residents' general personal and family circumstances to be taken into account by the State of residence. The State of residence can therefore be released by way of an international agreement from its obligation to take into account in full the personal and family situation of taxpayers residing in its territory who work partially abroad.

100. The State of residence may also be released from that obligation if it finds that, even in the absence of a convention, one or more of the States of employment, with respect to the income taxed by them, grant advantages based on the personal and family circumstances of taxpayers who do not reside in the territory of those States but receive taxable income there.

101. However, *the mechanisms used to eliminate double taxation* or the national tax systems which have the effect of eliminating or alleviating double taxation *must permit the taxpayers in the States concerned to be certain that, as the end result, all their personal and family circumstances will be duly taken into account, irrespective of how those Member States have allocated that obligation amongst themselves*, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws.

102. In this case, it is clear that Netherlands law and the conventions concluded with Germany, France and the United Kingdom do not ensure that result. The State of residence is partially released from its obligation to take into account the taxpayers' personal and family circumstances without the States of employment undertaking to bear the tax consequences of taking such circumstances into account or having them imposed on them by virtue of the conventions for the avoidance of double taxation concluded with the State of residence. The situation is different only as regards the Convention with Germany, in the sole case that 90% of the income is received in the State of employment, which is not the case in the main proceedings.

103. [...] with respect to the argument put forward by the Belgian Government that it would be disproportionate to place on the State of residence the burden of granting all the allowances which resident taxpayers who have received income in other Member States may claim, even where that income has been taxed in those other Member States without the taxpayer's personal and family circumstances being taken into account, it is settled case-law that a loss of tax revenue can never be relied upon to justify a restriction on the exercise of a fundamental freedom (Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 28, and *Saint-Gobain*, paragraph 51).

But the Belgian government was entirely right, and the Court's reaction to its argument was quite irrelevant: *loss of tax revenue* was not the issue, but *division* of tax revenue in accordance with the Treaty Freedoms. The Belgian argument was that it is difficult to see (any legal basis) why the home State should be made responsible for taking away the illegal consequences of the source State's violation of the free movement of workers: the source State should have granted national treatment, and there would have been no problem. The Court's denial of the national treatment principle in this case is all the more striking as in *Saint-Gobain* it decided that the national treatment rule even requires Member States to grant third State tax treaty benefits to non-residents (see 5.1.6. above).

It should be observed, meanwhile, that the Court looked at Mr De Groot's *overall* tax position, including the effects of the application of the three tax treaties involved, requiring that "as the end result" all of Mr De Groot's personal and family circumstances would be "duly" taken into account, "irrespective" of how the Member States involved allocated their taxing powers. The *De Groot* case thus for the first time suggests that certain prohibited discriminations and restrictions may be excused if the other jurisdiction involved takes away the negative effects of that discrimination, placing the taxpayer "as the end result" in a like position as a taxpayer in a comparable purely internal situation. It is submitted that this is a laudable approach, but that it was quite uncalled for in the *De Groot* case, as simple application of the

most basic EC Treaty rule (national treatment of non-residents) would already have solved the problem completely and better. Instead, all 25 Member States are now stuck with an incomplete, unbalanced and discriminatory (mis)allocation of personal allowances of cross-border workers and entrepreneurs.

Here are just two examples out of many to illustrate this: (i) if Mr De Groot had earned not 60% but his entire income in the three source States involved, the ECJ's case law would have given him nothing: no allowances anywhere, as in none of the source States did he pass the *Schumacher* threshold (90% or more of one's income), and in his home State he would only have had exempted foreign-source income; (ii) if his home State had chosen for *afiat tax* policy (one flat and low income tax rate compensated for by the total absence of any personal allowances or other base reductions), where at the same time the source State(s) applied a policy of taking into account, tax-wise, all kinds of personal and special circumstances (leading to a high progressive rates compensated for by an abundance of allowances, credits and base reductions), Mr De Groot would have received no allowance whatsoever (as his home State would not grant any to anyone), although he would not have benefited from the corresponding low flat rate, but would instead have paid the high progressive rates of the source State(s) corresponding with the high source State credits and deductions he did *not* receive because the source State was allowed to deny national treatment.

### 6.1.9. *Océ-van der Grinten*: Further overall instead of one-jurisdictional approach

Case C-58/01, *Océ-van der Grinten*, provided further evidence that the ECJ looks at the overall position of taxpayers and not merely at the (possibly discriminatory) position in just one State. One of the questions referred in *Océ-van der Grinten* concerned the UK 5% withholding tax under the UK-Netherlands tax treaty on the UK payment of half of its imputation credit to Netherlands corporate shareholders in UK companies. The Court interpreted the UK-Netherlands tax treaty on this issue as follows (*emphasis added*):

87. In the context of the convention at issue in the main proceedings, the 5% charge was established directly in conjunction with payment of a tax credit which was introduced in order to mitigate the economic double taxation of dividends paid by a subsidiary established in the United Kingdom to its parent company established in the Netherlands. That charge, which amounts to a withholding tax within the meaning of Article 5(1) of the Directive in so far as it is imposed on the dividends, was not, as the Italian Government has pointed out, set at a rate such as to cancel out the effects of that lessening of the economic double taxation of dividends. *In any event, any tax paid in the United Kingdom in respect of the dividends remains deductible from the tax due in the Netherlands, pursuant to Article 22(2)(c) of the convention at issue in the main proceedings.*

Unfortunately, that was not the case, however, as the UK dividend was exempt in the hands of the Dutch parent company, resulting in no UK tax being deductible from any such non-existent Netherlands tax. The Court should have known, as it had decided the *Bosal* case (C-168/01), precisely on the Netherlands participation exemption, only one week earlier.

Nevertheless, the judgment again shows an *overall* approach: even if the UK tax would be at odds with EC law, those odds would apparently be forgiven if the Netherlands were to credit the restrictive UK tax, so that *overall* no unfavourable tax effect would remain for the taxpayer <sup>[8]</sup> (apart from a cash flow disadvantage, which seems to be acceptable, as the later *Marks & Spencer II* case (C-446/03) shows (see below)).

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<sup>8</sup> This overall approach has been confirmed more or less explicitly in the post-seminar case C-170/05, *Denkavit Internationaal BV and Denkavit France Sàrl*: "47 [...] the combined application of the Franco-Netherlands Convention and the relevant Netherlands legislation does not serve to overcome the effects of the restriction on freedom of establishment which was held to exist [in France; *author*]."

### 6.1.10. *D. vs. Inspector of taxes*: No "most-favoured" tax treaty treatment

Case C-376/03, *D. vs. Inspector of taxes*, featured different treatment, not of residents and non-residents, but of two different non-residents. The case concerned the Netherlands-Belgian tax treaty (granting Netherlands personal wealth tax allowances to Belgian residents owning Netherlands property) and the Netherlands-Germany tax treaty (not granting such allowances to German residents owning Netherlands property). Mr D., a resident of Germany, owned 10% of his net wealth in the Netherlands and 90% in Germany, but was not paying any net wealth tax in Germany as Germany had abandoned such tax. He claimed the same personal allowances as under the Netherlands-Belgian tax treaty would be granted to a Belgian resident. For tax treaty application purposes, however, the Court did not consider a resident of one treaty partner to be in the same position as a resident of another treaty partner. It moreover, in principle, considered all elements of a tax treaty as inseparable from the remainder of that treaty, all of them contributing to its overall balance:

53. The main proceedings do not [...] relate to the consequences of allocating powers of taxation in relation to nationals or residents of Member States that are party to a convention, but are concerned with drawing a comparison between the situation of a person resident in a State not party to such a convention and that of a person covered by the convention.

54. The scope of a bilateral tax convention is limited to the natural or legal persons referred to in it.

55. However, there are situations where the benefits under a bilateral convention may be extended to a resident of a Member State which does not have the status of party to that convention.

56. The Court has thus held that, in the case of a double taxation convention concluded between a Member State and a non-member country, the national treatment principle requires the Member State which is party to the convention to grant to permanent establishments of non-resident companies the benefits provided for by that convention on the same conditions as those which apply to resident companies (see *Saint-Gobain ZN*, cited above, paragraph 59).

57. In such a case, the non-resident taxable person having a permanent establishment in a Member State is regarded as being in a situation equivalent to that of a taxable person resident in that State.

58. However, the second question asked by the national court is based on the premise that a non-resident such as Mr D. is not in a situation comparable to that of a resident of the Netherlands. The question is designed to ascertain whether Mr D.'s situation can be compared to that of another non-resident who receives special treatment under a double taxation convention.

59. Similar treatment with regard to wealth tax in the Netherlands of a taxable person, such as Mr D., resident in Germany and a taxable person resident in Belgium presupposes that those two taxable persons are regarded as being in the same situation.

60. It is to be remembered that, in order to avoid the same income and assets being taxed in both the Netherlands and Belgium, Article 24 of the Belgium-Netherlands Convention allocates powers of taxation between those two Member States and Article 25(3) lays down a rule under which natural persons resident in one of those two States is entitled in the other to the personal allowances which are granted by it to its own residents.

61. The fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands.

62. A rule such as that laid down in Article 25(3) of the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance.

63. Having regard to the foregoing considerations, the answer to the second question asked must be that Articles 56 EC and 58 EC do not preclude a rule laid down by a bilateral convention for the avoidance of double taxation such as the rule at issue in the main proceedings from not being extended, in a situation and in circumstances such as those in the main proceedings, to residents of a Member State which is not party to that convention.

The differences with *Saint-Gobain* are that (i) the comparison is not between a resident and a non-resident, but between two non-residents from different jurisdictions with different tax systems, leading to different tax treaty negotiation results with the Netherlands, and (ii) that these differences are a consequence of differences between national tax systems and are therefore disparities, not to be remedied by the ECJ's negative integration, but by harmonization.

The *D.* judgment does not imply that Member States are now at liberty to include discriminations in their tax treaties they would not be permitted to enact unilaterally. To the author's knowledge, no such discriminatory provisions exist in tax treaties. The author at least knows of no tax treaty between two Member States A and B providing that they will both grant certain benefits to each other's residents *and* to residents of (only) Member State C. Such provisions do not occur, because both Member State A and Member State B will probably feel that Member State C must first join in the *reciprocal* granting of benefits.

#### **6.1.11. *Bouanich*: Taking bilateral tax treaties into account on the same footing as national law; more overall approach**

One of the questions referred by the national (Swedish) Court in case C-265/04, *Bouanich*, was whether, for discrimination assessment purposes, one should only look at national law or also at the effects of the applicable tax treaty. The case concerned a repurchase of its own shares by a company, the proceeds of which were characterized as a capital gain for resident shareholders, but as a dividend for non-resident shareholders. This different characterization resulted in differences both in base calculation and rate of taxation. The Court considered (*emphasis added*):

48. [...] it is necessary to consider whether the Franco-Swedish agreement must be taken into account in determining whether tax legislation is consistent with Community rules on the free movement of capital. If that is the case, *it falls then to be established whether that agreement removes the restriction on fundamental freedom that has been found to exist.*

[...]

51. Since the tax system under the Franco-Swedish agreement, as interpreted in the light of the commentaries on the OECD Model Tax Convention, forms part of the legal background to the main proceedings and has been presented as such by the national court, the Court of Justice must take it into account in order to give an interpretation of Community law that is relevant to the national court. It is not for the Court to interpret national law or to assess its application in the present case (see, *inter alia*, Case C-435/93 Dietz [1996] ECR I-5223, paragraph 39, and Case C-136/95 Thibault [1998] ECR I-2011, paragraph 21).

52. With regard to tax treatment under the Franco-Swedish agreement, it should be recalled that a non-resident shareholder such as Ms Bouanich is permitted, under that agreement, as interpreted in the light of the commentaries on the OECD Model Tax Convention, to deduct the nominal value of the shares from the taxable amount payable on the occasion of a repurchase of those shares. The remaining amount is then taxed at the rate of 15%.

53. In view of the fact that resident shareholders are taxed at the rate of 30% on share repurchase payments after deduction of the cost of acquisition, it must be ascertained whether those

shareholders are treated more favourably than non-resident shareholders. In order to do this, it is necessary to know the cost of acquisition of those shares as well as their nominal value.

54. In that regard, it must be recalled that the assessment and finding of the facts in a case are not matters for the Court of Justice but for the national court (see Case 36/79 Denkavit [1979] ECR 3439, paragraph 12; Joined Cases C-175/98 and C-177/98 Lirussi and Bizzaro [1999] ECR 1-6881, paragraph 37; and Case C-318/98 Fornasar and Others [2000] ECR 1-4785, paragraph 31).

55. It is therefore a matter for the national court to determine in the proceedings before it whether the fact that non-resident shareholders are permitted to deduct the nominal value and are liable to a maximum tax rate of 15% amounts to treatment that is no less favourable than that afforded to resident shareholders, who have the right to deduct the cost of acquisition and are taxed at a rate of 30%.

56. The answer to the second question must therefore be that Articles 56 EC and 58 EC must be interpreted as precluding *national legislation which derives from a double taxation agreement*, such as the Franco-Swedish agreement, which fixes a lower ceiling on the taxation of dividends for non-resident shareholders than for resident shareholders, and, by interpreting that agreement in the light of the OECD's commentaries on its applicable model convention, permits the nominal value of such shares to be deducted from the share repurchase payment, except where, under such national legislation, non-resident shareholders are not treated less favourably than resident shareholders. It is for the national court to determine whether that is the case in the specific circumstances of the main proceedings.

This judgment, particularly the italicized words in para. 56, suggest that the ECJ views bilateral tax treaties as domestic law, which must be interpreted as such (i.e. by the national Court; this author fully agrees), and which form part of the (national) legal environment to be tested under the Treaty Freedoms. Their effect on the *overall* tax position of the taxpayer invoking EC law must therefore be fully taken into account. If they overrule or undo internal law that would, but for the treaty, have discriminatory or otherwise restrictive effects, they can save such internal law from incompatibility with EC law. <sup>[9]</sup> This approach makes sense: Sweden was applying its internal law as limited by it by concluding the tax treaty. The fact that the undoing of, or compensating for, initially discriminatory internal measures may take time and red tape (e.g. a refund procedure) is apparently accepted by the Court, as is also shown by the *Océ-Van der Grinten* case cited above (UK withholding tax later to be credited in the Netherlands) and by the *Marks & Spencer II* case, C-446/03 (a cash-flow disadvantage because of territorial compartmentalization of losses and profits, causing considerable timing differences in loss relief).

### **6.1.12. Van Hilten-Van der Heijden: Acceptance of the (direct) credit method? Reverse discrimination; referral to a non-representative, even non-existent OECD Commentary**

Case C-513/03, *Van Hilten-Van der Heijden*, concerned a Netherlands national who left the Netherlands in 1988 to live first in Belgium, later (1991) in Switzerland. She died in 1997. Because she had retained Netherlands nationality and had been a Netherlands resident less than ten years ago, her heirs were taxed by the Netherlands as if she had still been a Netherlands resident, i.e. for her worldwide estate, with an ordinary credit for possible locus State tax to prevent international double taxation. Had Mrs Van Hilten possessed any other nationality in otherwise exactly the same position, her heirs would have been taxed not on the worldwide estate, but only for Netherlands-located real estate. Questions were referred as to the compatibility of this Netherlands trailing tax with the free movement of capital, especially as regards third States. The ECJ held that the free capital movement was not restricted, as emigrating nationals were

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<sup>9</sup> See the previous note.

not taxed more unfavourably than resident nationals, nor were non-nationals taxed more unfavourably than nationals. The fact that both nationals who emigrated more than ten years ago and nationals who had never been resident were taxed more favourably was considered irrelevant, as these distinctions between nationals could not restrict the capital movement of nationals of other Member States. The fact that emigrating non-nationals were also taxed more favourably was considered justified by the Court on the basis of the Commentary to the 1982 OECD Model inheritance tax treaty. It would further seem that the Court accepted as compatible with the EC Treaty freedoms the ordinary credit system for prevention of international double taxation:

47. As regards the differences in treatment between residents who are nationals of the Member State concerned and those who are nationals of other Member States resulting from national legislation such as that in question in the main proceedings, it must be observed that such distinctions, for the purposes of allocating powers of taxation, cannot be regarded as constituting discrimination prohibited by Article 73b of the Treaty. They flow, in the absence of any unifying or harmonising measures adopted in the Community context, from the Member States' power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation [...].

48. Moreover, the Court has already had occasion to decide that, for the purposes of the allocation of powers of taxation, it is not unreasonable for the Member States to find inspiration in international practice and, particularly, the model conventions drawn up by the Organisation for Economic Cooperation and Development (OECD) (see Gilly, paragraph 31). As the Netherlands Government observed, the legislation in question in the main proceedings complies with the commentaries in the Model Double Taxation Convention concerning Inheritances and Gifts (Report of the Fiscal Affairs Committee of the OECD, 1982). It is clear from the commentaries on Articles 4, 7, 9A and 9B of that model that that type of legislation is justified by the concern to prevent a form of tax evasion whereby a national of a State, in contemplation of his death, transfers his residence to another State where the tax is lower. The commentaries state that double taxation is avoided by a system of tax credits and that, since prevention of tax evasion is justified only if the death occurs only a short time after the transfer of residence, the maximum permitted period is 10 years. The same commentaries state also that the scope can be extended to cover not only nationals of the State concerned but also residents who are not nationals of that State.

[...]

51. The reply to the questions referred must therefore be that Article 73b of the Treaty is to be interpreted as meaning that it does not preclude legislation of a Member State, such as that in question in the main proceedings, by which the estate of a national of that Member State who dies within 10 years of ceasing to reside in that Member State is to be taxed as if that national had continued to reside in that State, while enjoying relief in respect of inheritance taxes levied by other States.

Unfortunately, the cited 1982 OECD Model inheritance tax convention does not represent international practice, in any case not in 1951, when the Netherlands-Switzerland inheritance tax treaty was concluded. Even today, there is still very little uniform or coordinated bilateral practice as regards international double inheritance tax. The Netherlands has concluded only seven inheritance tax treaties (against some 78 treaties on income and wealth taxes), three of which (including the one with Switzerland 1951) were concluded long before the OECD published any model (1966). Therefore, even if it is assumed that for the competent national Court the commentary of the OECD fiscal committee (which is a club of tax representatives of governments) to a non-binding model has any interpretational value under the Vienna Convention on the Law of Treaties other than that of other learned writing, it is evident that the

commentary to the much later model (1982) cited by the Court, has very little interpretational merit as regards a treaty concluded 31 years prior.

It is also surprising that the Court finds authority in this Commentary for its finding that the direct nationality discrimination at issue "is justified by the concern to prevent a form of tax evasion." In the first place, according to the Court, direct nationality discrimination can only be justified by reasons explicitly stated in the EC Treaty, amongst which prevention of tax avoidance does not feature. In the second place, there was not even a hint (it had not even been put forward by the Netherlands government/tax administration) that Mrs Van Hilten, who had been away from the Netherlands almost ten years when she died, had in any way sought to avoid inheritance tax by moving to Belgium and later to Switzerland. In the third place, in constant case law the Court has been prohibiting Member States to maintain such general (unspecific) restrictive anti-abuse measures, because the extreme overkill in them is manifestly disproportionate to the purpose of combating "wholly artificial arrangements." In the fourth - and most important place - the "concern to prevent abuse" is manifestly unable to justify the direct discrimination in this regard between nationals and non-nationals, since the exact same risk of tax avoidance through emigration exists as regards non-nationals who were resident in the Netherlands as with regard to nationals. The only foot-holding grounds for the judgment thus seems to be the argument that EC law does not oppose reverse discrimination.

What may be much more important is that *Van Hilten* seems to imply acceptance of the ordinary credit method for the prevention of international double taxation. Unlike the *Eurowings Luftverkehrs* case (C-294/97) suggested, home States would seem to be at liberty to levy additional tax on top of the tax already levied in the source State, in order to undo any relative tax advantages of going abroad, the reason being that taking away the advantage of a lower tax burden abroad is not resulting in a higher tax burden than the tax burden that would have been suffered if the taxpayer had stayed at home: the cross-border situation is thus not treated unfavourable as compared to the internal situation.

It is difficult to reconcile this implication of acceptance of the (protective and inconsistent) ordinary credit system, however, with the later *Cadbury Schweppes* case (C-196/04), in which the Court held the UK CFC legislation to be incompatible with the EC Treaty Freedoms, unless specifically targeted at "wholly artificial arrangements". Indeed, CFC legislation is designed to bolster the credit for underlying tax system and to take away the benefit of a lower tax rate abroad. The only explanation this author can think of to reconcile *Van Hilten* and *Cadbury* is that the first concerned current *legal* international double taxation (same inheritance; same taxpayer), whereas the latter concerned current *economical* international double taxation of (non)distributed foreign company profits in the hands of the controlling shareholder of that company. That is no difference of principle, however.

### **6.1.13. *N. vs. Inspecteur*. Preserving the allocation of taxing power; again, interpretation of Article 13(5) OECD Model**

Case C-470/04, *N. vs. Inspecteur*, concerned the Netherlands exit tax on the unrealized increase in value of shares in closely held companies. The exit taxation consisted of a conservatory assessment and the obligations to file and to provide security for payment in case the shares would be sold within ten (under treaties, five) years after emigration. This was found to be in principle a prohibited discrimination of the border-crosser as compared to the internal remover. The Netherlands government, however, had released or waived the security requirement after the ECJ's judgment in case C-9/02 *Hughes de Lasteyrie du Saillant*. Under these circumstances, and unlike the French conservatory exit tax in *De Lasteyrie*, the Netherlands conservatory exit tax was accepted by the Court for reasons of preservation of the allocation of the power to tax, provided that (i) automatic extension of payment without security requirement was available, and (ii) post-emigrational decreases in value would be taken into account. The author fully agrees, except for the latter condition (post-emigrational change in value seems a matter for the new residence State). In its finding, the Court made a rather novel interpretation of Art. 13(5) of the

Netherlands-UK tax treaty (or rather, of the most recent - and therefore again posterior - and non-binding OECD Model and Commentary), without paying visible attention to the actual Treaty:

41. Concerning first the condition in relation to the satisfaction of an objective in the public interest, and the possibility of attaining it through the tax system in question, the national court observes that, having regard to the original circumstances of their adoption, the national provisions at issue in the main proceedings are designed, in particular, to allocate between Member States, on the basis of the territoriality principle, the power to tax increases of value in company holdings. According to the Netherlands Government, that legislation is also designed to prevent double taxation.

42. This Court finds that preserving the allocation of the power to tax between Member States is a legitimate objective recognised by the Court of Justice (see, to that effect, *Marks & Spencer*, paragraph 45). [...].

43. [...]

44. [...] the Court has already held that, in the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation [...].

45. In this area, it is not unreasonable for the Member States to find inspiration in international practice and, particularly, the model conventions drawn up by the Organisation for Economic Cooperation and Development (OECD) [...].

46. Thus, gains realised on the disposal of assets are taxed, in accordance with Article 13(5) of the OECD Model Tax Convention on Income and on Capital, and in particular in accordance with its 2005 version, in the contracting State of which the person making the disposal is a resident. As the Advocate General has observed in paragraphs 96 and 97 of her Opinion, it is in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions in question provide for the charging of tax on increases in value recorded in the Netherlands, the amount of which has been determined at the time the taxpayer concerned emigrated and payment of which has been suspended until the actual disposal of the securities.

As noted, the author almost fully agrees with the outcome of the case, but again, like with regard to *X and Y vs. Rikskatteverket* cited above, it must be observed that the tax treaty was not applicable, so that its interpretation - and especially the posterior 2005 OECD Commentary - was irrelevant, as the exit tax was levied *before* N. became a resident of the UK, and therefore *before* the UK-Netherlands tax treaty would be applicable. That is the whole point of such exit taxes: *not* to be dependent on treaty allocation rules, but to help oneself, just in case, and therefore to be *ahead* of possible treaty applicability; to catch them *before* one's legitimate but latent tax claim evaporates as a result of a change of jurisdiction and corresponding tax treaty protection. Tax treaties simply do not address exit taxes, although it is possible that in certain circumstances a national court may consider such a tax, depending on its form, aim, and effect, as incompatible with the good faith and permanency of commitments requirements of the Vienna Convention on the Law of Treaties. Neither do tax treaties regulate so-called multiple residence taxation, such as in the case of an increase in share value which partly or wholly occurred while the shareholder was resident of one State, but which is realized while residing in another.

Nor does the treaty-posterior 2005 Commentary to the OECD Model cited by the Court even deal with this issue. Again, as in *X & Y*, the tax treaty was not relevant, not even if the exit tax might be regarded as a one-sided pre-emptive treaty override, as treaty overrides, from an EC law point of view, are justified if their possible restrictive effects can be justified under the ECJ accepted mandatory requirements of public

interest, such as curbing abuse, fiscal coherence, preservation of taxing power allocation or effective fiscal supervision.

Finally, one may even doubt the applicability of the EC Treaty in Mr N's case in the first place. As the ECJ noted, Mr N's closely held company was not established in the Netherlands for tax purposes, but on Curaçao (Netherlands Antilles), which is not part of the EC. Apparently it sufficed the Court that the company had been incorporated under Netherlands Law, even where that was the only nexus to the Netherlands jurisdiction. For tax purposes, the Kingdom Tax Act allocated *all* taxing powers as regards the company to the Netherlands Antilles.

#### **6.1.14. Kerckhaert-Morres: Disparities are not discriminations; EC law does not designate culprits of international double taxation; the ECJ refrains from unsolicited tax treaty evaluation**

In the most recent case C-513/04, *Kerckhaert-Morres*, the Court accepted that there is no legal basis in EC law to designate one jurisdiction as being responsible for the undoing of disadvantageous effects of dislocations (fragmentation of a taxpayer's income over different unharmonized taxing jurisdictions). One might even infer from the judgment that the Court accepted that EC law contains no - at least no directly applicable - obligation to prevent legal double taxation as long as both States involved do not discriminate. The judgment thus suggests a reconsideration of the "always somewhere" approach previously applied in *De Groot*, *Bosal* and *Marks & Spencer II*, which sure enough has no visible basis in EC law, as mutual recognition in direct tax matters is impossible for lack of a clue who is to recognize whose taxation. This sets direct tax cases apart from cases of diploma requirements, product safety requirements, phyto-sanitary checks, etc. In such cases, there is a clear product or service and a clear origin State and a clear destination State, and it is difficult to see why the destination State should be allowed to merely repeat restrictive requirements that have already properly been met in the origin State.

*Kerckhaert-Morres* concerned French source dividends (including an *avoir fiscal* - imputation credit - paid out by France) received by a Belgian couple. Belgium taxed both domestic and foreign source dividends indiscriminately at a flat income tax rate of 25%, without credits, and therefore without crediting the 15% French withholding tax. The opinion and the judgment are unspecific about this, but apparently, Belgium levied on domestic dividends a final (uncreditable) withholding tax. Thus, both the French withholding tax and the Belgian income tax (final withholding tax) on the same dividend income persisted in the hands of the same taxpayer (legal international double taxation). We must assume that France did not discriminate either (that it withheld the same source tax on domestic dividend payments). If I understand the judgment correctly, Belgium could not be required to credit the French withholding tax, as it did not credit any Belgian withholding tax either, and France could not be required to credit (refund) the French withholding tax, as unlike residents, the couple were not subjected to the French income tax, against which the French source tax would be creditable. The double tax effect was thus a consequence of the coexistence of two in themselves non-discriminatory - but unharmonized - national tax systems: France charged a *creditable* withholding tax and Belgium did not. The fact that the tax treaty between France and Belgium provided for the mutual crediting of withholding taxes (but to no avail of the couple, as apparently Belgium under national law had abandoned all crediting of withholding taxes), did not change this finding, as the referring national court did not ask for any ECJ ruling on the interaction between EC law, the applicable tax treaty provision, and Belgium's apparent domestic overriding or pre-empting of the latter:

20. In circumstances such as those of the present case, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty.

21. It must be recalled, in that regard, that conventions preventing double taxation such as those envisaged in Article 293 EC are designed to eliminate or mitigate the negative effects on the functioning of the internal market resulting from the coexistence of national tax systems referred to in the preceding paragraph.

22. Community law, in its current state and in a situation such as that in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community. Apart from [the Parent-subsidiary and Interest savings Directives and the Transfer pricing arbitration convention; PJW], no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level.

23. Consequently, it is for the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings by applying, in particular, the apportionment criteria followed in international tax practice. The purpose of the France-Belgium Convention is essentially to apportion fiscal sovereignty between the French Republic and the Kingdom of Belgium in those situations. However, that convention is not at issue in the preliminary reference at hand.

24. In the light of all those considerations, the answer to the question referred must be that Article 73b(l) of the Treaty does not preclude legislation of a Member State, such as Belgian tax legislation, which, in the context of tax on income, makes dividends from shares in companies established in the territory of that State and dividends from shares in companies established in another Member State subject to the same uniform rate of taxation, without providing for the possibility of setting off tax levied by deduction at source in that other Member State.

It must be admitted that it would have been awkward to require Belgium to credit the French tax, as the couple were better off than if they had received domestic dividends, since the *avoir fiscal* paid out to them by France was considerably higher than the French dividend tax withheld. On Belgian domestic dividends, no *avoir fiscal* would have been available. Although the Advocate-General had pointed this out, it was apparently of no importance to the Court for its decision.

Nevertheless, it is unsatisfactory that the manipulation of the mechanics of national tax law pre-empts a finding of discrimination: if Belgium had applied in economic terms the exact same system (a 25% tax burden on individual dividend income), but with slightly different mechanics (a 25% withholding tax, not final, but creditable against an exactly matching 25% liability under the final income tax), it would have had the exact same financial outcome for taxpayers, but unlike the *Kerckhaet* mechanics, it would certainly have been considered discriminatory if the French source tax were not credited (as the *Manninen* case, C-319/02, shows). Skilled lawmakers can thus pre-empt EC law.

The judgment not only suggests that the Treaty Freedoms offer no remedy against double taxation ensuing from a Member State's (indiscriminate) choice not to relieve its residents from possible legal double taxation, it also suggests that the Court is wisely staying away from tax treaty interpretation if no guidance on that matter is provided by the referring national tax court and no question is asked on the bearing of the tax treaty on the EC law issue referred. Thus, it would seem that the Court - via *Wielockx*, *Gilly*, and *Bouanich* - has come full circle from *Bachmann*.

## 6.2. Conclusions drawn from the case law

At first, the ECJ largely seemed to ignore tax treaties when testing national tax arrangements under the EC Treaty Freedoms (*Avoir fiscal*; *Bachmann*), probably for three reasons:

1. the fact that another Member State agrees to a tax arrangement which contravenes EC law, cannot justify that contravention;

2. the Treaty Freedoms are unconditional and therefore independent of tax treaties or any other bilateral reciprocity other than Community loyalty, and
3. tax treaties are coordinating if not harmonizing measures, which is a form of positive integration and therefore outside the Court's law-creating task and competence.

However, the Court later changed its mind, taking into account the effects of - and interpreting - tax treaties, probably because it realized that:

- a) the trade-off in tax treaties may have consequences for the territorial fiscal cohesion between tax reductions/latencies and the corresponding benefits (*Wielockx; X & Y v. Riksskatteverket; N. v. Inspecteur*);
- b) tax treaties may compensate for or undo unilateral restrictive measures, and only the overall ("end result") tax position of the taxpayer in a cross-border situation is the economic reality to be compared with the strictly internal situation (*Océ-Van der Grinten, De Groot, Bouanich*, and, post-seminar: *Denkavit*); and
- c) limitation of treaty benefits to only residents may well constitute a violation of the national treatment requirement, especially as regards branches of non-residents (*Saint-Gobain*).

The Court is not competent, however, to interpret bilateral tax treaties, and it was not very successful at it (especially not in *Wielockx, X and Y vs. Riksskatteverket*, and *Océ-Van der Grinten*). Maybe for that reason the Court of late shows more judicial restraint in venturing into tax treaty interpretation, leaving the evaluation of their actual effect on taxpayer positions to the competent national court (*Bouanich, Kerckhaert-Morres*), and in *Kerckhaert-Morres* even leaving the impression that it has come full circle from *Bachmann*.

The *Gilly* case clarified that the Member States remain free to define, share, allocate and divide their taxing jurisdiction(s) ("with a view to eliminating double taxation") and to design their own double tax relief mechanisms. The *Saint-Gobain* case, however, added that the *exercise* of the taxing powers "so allocated" remains subject to ECJ scrutiny under the EC Treaty Freedoms, without clearing up, however, how to distinguish allocating taxing powers from exercising them.

These and other cases, such as *Van Hilten-Van der Heijden* and *N. vs. Inspecteur*, also suggest that conforming to the OECD Model Double Tax Convention - or at least to "international practice" - is not only "not unreasonable," but will generally protect Member States from interference in (the division of) their taxing jurisdictions by the ECJ on the basis of alleged incompatibility with the EC Treaty Freedoms.

The Court often relied on Commentaries to OECD Model treaties, but without checking:

1. whether the Model referred to represented international practice (*quod non*, in *Van Hilten*);
2. whether the Model referred to conformed *verbatim* to the actual treaty to be applied;
3. whether the Model relied on existed at all at the time of the conclusion of the tax treaty (*quod non*, in *Van Hilten*);
4. whether, provided the Model already existed, the Commentaries relied on were changed after the conclusion of the tax treaty; and
5. which interpretational value, if any, the Commentaries relied on possessed under (i) the domestic law system in which the tax treaty had been implemented by way of a national law, and (ii) the Vienna Treaty on the Law of Treaties.

These matters were better left to the competent national courts, as the ECJ indeed did in *Kerckhaert-Morres*.

From an EC law point of view, tax treaties are like national law (*Bouanich*), to be taken into account in order to establish the overall (international) tax position of the taxpayer for comparison purposes. Tax treaties may thus undo or compensate for and therefore excuse discriminatory rules of one Contracting State, e.g. if restrictive refusal of tax benefits by one State is compensated for by extension of similar benefits by the other Contracting State, or if a restrictive withholding tax of one State is credited by the other State (*De Groot, Océ-Van der Grinten*, and - post-seminar -*Denkavit Internationaal BV*).

The Court not only seems to adhere to an overall approach, but also to a parallel "always somewhere" approach, meaning that in principle the Court does not accept that taxpayers, because of going abroad or because of earning foreign source income, lose part of their possibilities to deduct expenses, to obtain loss relief, to obtain personal tax reductions, to deduct pension contributions, etc. Within this approach, the Court does not seem to care very much whether the State which it makes responsible for undoing the disadvantageous effects of the border crossing is the right or the wrong jurisdiction, thereby making political choices of allocation it is in the author's view not competent to make (*De Groot, Bosal, Marks & Spencer*).

The Court's case law further seems to imply that:

- a) the (direct) ordinary credit method for double taxation relief is acceptable under the EC Treaty Freedoms, despite its clearly home market protective and inconsistent effects (*Van Hilten*);
- b) Member States applying a direct credit cannot, under the EC Treaty Freedoms, be required to grant full (as opposed to ordinary) credit for foreign tax if that would mean having to refund domestic tax on domestic other income (*Gilly*), not even if domestic tax (withholding or corporate) is fully credited and therefore refunded if exceeding the income tax liability of the taxpayer, and
- c) Member States cannot be required, under the EC Treaty Freedoms, to provide relief for legal international double taxation as long as they do not fiscally discriminate between domestic income and foreign source income (*Kerckhaert-Morres*).

### 6.3. Some general observations on the interaction between national courts and the ECJ in tax matters

An important difference between the ECJ and national courts is that national courts are competent and called to interpret and apply national law, bilateral tax treaties *and* EC law whereas the ECJ's competence and task is limited to EC law and general principles of law, such as fundamental rights and the principles of legitimate expectations and legal certainty. The ECJ, therefore, tends to show tunnel vision: it considers EC law to be important, at least more important than other law. It would seem to be less receptive to other relevant angles (such as interstate budgetary equity, consistency, reliability and predictability of case law, budgetary certainty in times of stability pacts, democratic justification for budgetary and therefore taxation consequences, etc.) than the interests of the internal market and a level playing field.

One excrement of this is the ECJ's case law on State liability for (in hindsight of the ECJ) incorrect application of EC law by national highest Courts (Case C-224/01, *Köbler*), although at the same time the ECJ itself makes ultra vires and serious mistakes in the interpretation and application of tax treaties (see 6.1. above) and of EC law (such as the discriminatory denial of national treatment in *De Groot*, the unjustified discrimination between residents and non-residents in *Schumacher* and the ultra vires allocation or even creation of jurisdiction in *Marks & Spencer II* and *N. vs. Inspecteur*) in inconsistent case law which offers little reliable guidance for national courts, budget legislators, taxpayers or tax administrations, and apparently on the basis of double standards, as the ECJ does not hold the Community liable for the budgetary and taxpayer equity consequences of the ECJ & s mistakes. [10]

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<sup>10</sup> See Wattel, P.J., "Köbler, CILFIT and Welthgrove; we can't go on meeting like this", 41 *CMLRev.* 1 (February 2004) pp. 177-190

Another important difference is that between direct taxes and indirect taxes under EC law. Direct taxes have hardly been harmonized and direct taxing power is neither defined nor allocated at EC level. From an EC law point of view, direct taxes are governed almost exclusively by primary EC law (the EC Treaty and general principles of law), i.e. by negative integration. The interaction between EC law and direct tax law (and therefore with tax treaties, as tax treaties deal only with direct taxes) therefore mostly concerns fundamental questions such as discrimination, mandatory requirements of general interest, sovereignty, competence, and allocation and division of powers. Indirect taxes, by contrast, are governed by secondary EC law, as they have been uniformized (customs duties) or harmonized (excises, VAT) at EC level. They are governed by positive integration. The interaction between EC law and indirect tax law therefore mostly concerns (very) detailed and technical questions on discrepancies between very specialized EC Directives and Regulations and equally specialized national implementation measures. Because of that, application of EC law in indirect tax matters basically only concerns implementation problems. It is tax law, really, as it concerns application of tax rules.

The application of EC law in direct tax matters, by contrast, is less tax law than general EC law and international public law, to be applied to a very large and sophisticated (partly OECD) body of national and bilateral tax law which is infinitely more precise and concrete than the vague and sweeping general principles in the EC Treaty Freedom provisions. To give but one example: one cannot sweepingly state that the Treaty Freedoms must be interpreted as meaning that a border-crosser may never lose any tax benefits because of the border crossing and leave it at that, since that border crossing makes the taxpayer change or double taxing jurisdictions, with different or maybe no comparable tax benefits, and therefore immediately giving rise to both very technical and very political questions, such as which of the two jurisdictions should extend which benefit in which detailed manner. Overall or per country? Only within the same tax year or with carry back and carry forward? Exemption or credit? *Pro rata parte* Full or ordinary credit? Are mere timing differences acceptable? Are procedural differences acceptable? Are cash flow differences acceptable? Etc. etc.

The ECJ is in a very difficult position here: the consequences of applying general EC rules and principles in direct tax and tax treaty matters can only be understood on the basis of a thorough and detailed knowledge of both the (political) principles and the sometimes very complex mechanics of national and bilateral tax systems (and of the expected aggressive and immediate reaction of international tax advisers to any loophole created), but involving itself in these principles and mechanics without the competent guidance of the referring national court exposes the ECJ to the pertinent criticism of going beyond its authority and of either not understanding what it is doing, or of reinventing (or irregularizing) an until then perfectly round wheel, using unusual and impracticably imprecise concepts (e.g. "fiscal cohesion", "fiscal principle of territoriality", "preserving the (balanced? <sup>[11]</sup>) allocation of the power to impose tax").

National courts should therefore - much more than they have been doing until now - (i) explain the fiscal, political and economic environment of, and the mechanics behind, their preliminary questions in direct tax matters, (ii) propose a reasoned answer to their own questions, and (iii) explain the consequences to be expected, both of following that answer and of not following it.

## 6.4. Three issues for national courts applying EC law and tax treaties

### 6.4.1. Conflict rules

Obviously, it is best to avoid having to establish a conflict of law. Therefore, national courts are in the first place required to interpret and apply tax treaties as much as possible without leading to a conflict with EC law, i.e. as much as possible in line with EC law (reconciliatory interpretation). <sup>[12]</sup>

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<sup>11</sup> In *Marks & Spencer* the Court referred to "a *balanced* allocation of taxing power" as a justification for fiscal restrictions on EC Treaty Freedoms; in *N. vs. Inspecteur*, although referring to *M & S* as a precedent in this respect, the ECJ omitted the word "balanced", possibly because it realized that whether or not the bilateral division of taxing power is balanced or not, only regards the two Member States involved.

<sup>12</sup> See e.g., case C-106/89, *Marleasing*

But if a conflict is unavoidable, conflict rules are needed. Courts in monistic constitutional systems can give priority to directly effective tax treaty provisions over incompatible national law provisions if their constitution so provides. Courts in dualistic systems can only apply national law, which means that the tax treaty needs to have been implemented correctly into national law provisions before it can have effect. However, if a conflict with EC law arises, whether primary or secondary EC law, the difference between monistic and dualistic constitutional systems in principle becomes irrelevant. From an EC law point of view, national constitutional law is just national law and therefore subordinate to EC law, and bilateral tax treaties between Member States or with third States have no higher or other status than national (constitutional) law either, which means that EC law, whether primary or secondary, always takes precedence, <sup>[13]</sup> also over national constitutions and bilateral or multilateral treaties (provided the relevant EC law provision has direct effect). The reason is obvious: we cannot have an internal market with a level playing field if the Common Market rules could simply be sabotaged by concluding a bilateral treaty or invoking the national constitution. What Member States cannot do on their own (subordinating EC law to domestic law), they cannot do bilaterally either (see cases C-286/86, *Gérard Déserbais*, and C-235/87, *Annuziata Mateucci*). To make sure, also in relation to third States, the EC institutions had a consideration included in the preamble of the second Vienna Convention on the Law of Treaties (1986), stipulating that the VCLT will not in any way be construed as affecting relations between an international organization and its Member States that are governed by regulations of that organization.

As far as the writer is aware, there is only one exception to this priority rule in Member States such as Germany, where the *Bundesverfassungsgericht* held, in its *So lange* judgments, that it reserves the right not to give priority to EC law if EC law does not offer equivalent protection of fundamental rights as the German constitution does; but this is a rather theoretical exception, especially since the Treaties of Nice and Amsterdam, and particularly in tax matters.

Obviously, EC law itself may switch itself off, thus giving priority to either domestic law or bilateral treaty law, or both. It does so, for instance, in Art. 1(2) of the EC Parent-Subsidiary Directive (giving room to domestic or treaty-based anti-abuse provisions), but not unconditionally, as this provision will not justify national measures that also deviate from the EC Treaty. Another example is Art. 7(2) of the same Directive, giving precedence to domestic or treaty-based provisions designed to prevent economic double taxation of dividends through indirect credits. A third example is Art. 11 of the Mutual Assistance Directive in tax assessment matters, providing that the Directive shall not preclude application of any other acts of law providing for wider exchange of tax information than provided for in the Directive.

Tax treaties between a Member State and a third State are respected by the EC Treaty (and therefore have priority even over primary EC law) if they predate 1958 or the date of accession of the Member State involved; but if there is any conflict, that Member State has an obligation to renegotiate the treaty to align it with its EC obligations. Treaties with third States concluded after accession to the EC may not contravene EC law, as the Court made very clear in the *Open Skies* cases (C-471-476/98) against six Member States on discriminatory aviation agreements with the US, and to a certain extent also in the *Saint-Gobain* case on the US-German tax treaty cited above. This last fact may mean that a Member State could be required to refund US or Japanese withholding tax that was levied by the US or Japan on the basis of a discriminatory LOB (limitation on benefits) provision in the tax treaty to which that Member State should not have consented because it offends the national treatment requirement.

It would seem wise, therefore, for Member States to try to include in tax treaties with third States a provision which generally gives precedence to EC law and domestic implementation of EC law over the tax treaty, but the third State involved may not be wildly enthusiastic about such provision. Also, in intra-EC situations such a provision might be helpful, e.g. where an EC Directive (such as the Savings-Interest Directive) requires Member States to levy a withholding tax at a rate which is higher than the tax

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<sup>13</sup> Cases 26/62 *Van Gend & Loos* and 6/64 *Costa/ENEL*

treaty allows. Even after proper implementation of the Directive into domestic law, this withholding tax obligation will have no effect in a monistic jurisdiction such as the Netherlands, since (i) the tax treaty trumps domestic law, and (ii) a Directive has no inverse vertical direct effect <sup>[14]</sup> (it cannot be relied on by the State as against the taxpayer). In such a situation, the tax treaty needs to be renegotiated if no automatic priority for EC Directives was included in it.

We in the domestic courts are in the business of judicial protection. Therefore, I will not go into the fascinating public international law aspects of a conflict between EC law and a bilateral tax treaty (the *horizontal* relation, between the two States involved, comprising issues such as interstate liability, *exceptio non adimpleti contractus*, termination of treaties, etc.). I will instead focus on the taxpayer's position, i.e. on the *vertical* relation between an EU citizen or company and the EC residence or source State taxing it.

### 6.4.2. Some substantive issues

The taxpayer seems to be in a no-lose situation within the interaction of EC law, tax treaties and national tax law. If an EC directive and national law or a tax treaty are in conflict, taxpayers can choose whichever rule suits them best, since the direct effect of an EC directive works only one way (against the Member State that failed to implement it properly). Although primary EC law (the EC Treaty) prevails in case of conflict with domestic law or a tax treaty, the taxpayer is still mostly in a winning position, as the EC Treaty hardly contains any obligations; it rather endows taxpayers with rights.

The case law of the ECJ and of the EFTA Court suggests that EC (EEA) law may preclude Member States from having the division of taxing powers they agreed to in their tax treaties. In its *Fokus Bank* case E-1/04, the EFTA Court (dealing with preliminary questions originating in Norway, Liechtenstein and Iceland as to the interpretation of the EEA Treaty, but under an obligation to adjudicate in conformity with ECJ case law) held that EEA States cannot withhold tax on outbound dividends if they do not withhold the exact same tax on internal dividends, not even if the treaty with the home State provides for a credit for the source tax in the home State. The *Verkooijen* and *Manninen* cases of the ECJ imply that EC (and EEA) States must credit foreign withholding tax in the exact same manner and amount as comparable domestic withholding tax, no matter whether there is a tax treaty and, if so, no matter what it says. <sup>[15]</sup>

The *Fokus Bank* case, however, was probably decided incorrectly in this respect, as it makes no sense to force the source State to refrain from withholding tax if that will not benefit the taxpayer in any way, but will only have the effect of benefiting the treasury of the home State of the shareholder, which will merely credit less foreign source tax. As was shown above, the *De Groot* case explicitly considered one State relieved from its EC obligations if the other State takes away the disadvantageous effects. Conversely, in *De Groot* the ECJ allowed the source State to discriminate foreign workers, compensating for that by making the home State fully responsible for the taxpayer's personal allowances. The same approach in *Océ-Van der Grinten* suggests that the EFTA Court should not have ignored the credit effects in the other State, but should have considered the *overall* (international) tax position of the taxpayer. Also, other cases cited above, such as *Gilly*, *Van Hilten*, *N. vs. Inspecteur* and *Kerckhaert-Morres*, suggest that the Member States can have any division of tax jurisdiction they choose, as long as they either (i) both refrain from discrimination, or (ii) make sure that a discrimination in one jurisdiction is compensated for in the other jurisdiction.

In the pending case C-170/05, *Denkavit Internationaal BV*, France will therefore probably have to refrain from its source tax on outbound dividends, as (i) it levies no such source tax in domestic parent/subsidiary situations, and (ii) there is no credit available in the parent company State because that State exempts foreign subsidiary dividends in the hands of the parent company (which brings the Netherlands parent in

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<sup>14</sup> See cases C-80/86, *Kolpinghuis* and C-91/92, *Faccini Dori*

<sup>15</sup> Preliminary questions on the comparability of foreign and domestic withholding taxes have been asked by the Netherlands *Hoge Road* in case C-194/06, *Orange European Smallcap Fund*, suggesting that in the cross-border situation, the levying and crediting of such taxes are part of the division of taxing jurisdiction, whereas in the internal situation, they are just for practicability and anti-fraud reasons.

the exact same position as a French parent enjoying the same exemption, which was the reason for not levying the source tax in internal French situation in the first place).

This means that the *Avoir Fiscal* case cited above is partially repealed or at least refined: Member States *can* make observation of the Treaty Freedoms dependent on the content of a bilateral tax treaty, if that treaty has the effect of the other State undoing, by way of credit, the discriminatory source tax.

It will be interesting to see the Court's decision in case C-298/05, *Columbus Container Services*, featuring a German treaty override (swapping exemption for ordinary credit) in case of low-taxed passive foreign investment. In the writer's opinion, it is of no concern whether or not a Member State's national law implies a tax treaty override, as long as that national law does not imply discriminatory taxation of non-residents or of foreign source income.

Another interesting question of tax treaty compatibility is the question not yet answered by the ECJ in case C-152/03, *Ritter-Coulais*: What if a tax treaty allocates (negative) income from real estate exclusively to the location State, leading to a loss of the possibility to offset that negative income against positive employment income in the other State? This is clearly an impediment to cross-border movement, but it is also clearly a consequence of a non-discriminatory division of taxing power between the two States involved. More generally, exclusive allocation rules, however non-discriminatory, tend to fragmentize the tax base over different jurisdictions, causing three effects for individuals: (i) no horizontal levelling out of positive and negative income in different jurisdictions; (ii) re-allocation of personal (non-income related) deductions, and (iii) loss of rate progression. An answer to issue (i) may be provided by three pending cases on the exclusive allocation of (negative) branch profits to the branch State in tax treaties concluded by Germany with two other Member States and with a third State (Cases C-293/06, *Deutsche Shell*, C-414/06, *M+T*, and C-415/06, *SEW GmbH*). The recent *Kerckhaert-Morres* case suggests that the Court will accept non-discriminatory dislocation effects of parallel taxing jurisdictions, but on the other hand both *De Groot* and *Marks & Spencer* suggest that it will not accept a loss of offsetting possibilities which would have existed if the taxpayer had performed its business in only one jurisdiction.

As regards the national court's application of anti-abuse measures or doctrines as regards tax treaties in situations within the scope of the EC Treaty Freedoms, the writer submits that the possibilities for Member States under EC law for combating abuse of their tax treaties should be exactly the same as for combating abuse of the EC's own resources and rules: the criteria for application of anti-abuse doctrines should be exactly the same, irrespective of whether abuse of EC resources and of EC regulations is at issue (see the *Emsland-Stärke* Case, C-110/99, on EC export restitutions), or domestic resources are at stake (see the *Halifax* case, C-255/02, on indirect taxes, and the *Cadbury Schweppes* case, C-196/04, on direct taxes). It is not certain, due to the different framing, whether the criteria applied in these three cases fully match.

### 6.4.3. Some procedural issues

If the "always somewhere" approach prevails (see the *De Groot*, *Bosal* and *M&S* cases cited in 5.1. and 5.4.2. above), we (the national courts) will have to look at the legal position in the other State, such as A-G Geelhoed also wants the Member States to do in transfer price adjustment situations (see his opinion in the *Thin Cap GLO* case C-524/04). The writer agrees that *Fokus Bank* (see 6.4.2. above) was decided wrongly and that one must take an overall view on the question of whether there is - at the end of the day - a tax restriction in the cross-border situation as compared to the internal situation. This means that we have to study foreign tax law in languages we do not understand, and need detailed information from the other States. This may cause considerable procedural and language problems.

Some examples may illustrate this:

### Examples

1. After the *De Groot* case, I handled a case before the Netherlands *Hoge Raad* concerning a Dutchman deriving Italian source income and litigating on the double tax relief mechanism. I therefore needed to establish whether Italy extended any personal allowances to him. Now if one reads Italian, one may consult the International Bureau of Fiscal Documentation's source materials. But to be sure that all relevant texts were found and that one understands them correctly, one had better also ask a practising Italian judge, lawyer or tax inspector. My legal secretary phoned Andrea Parolini (a partner of the Milan law firm organizing this seminar) whom he knew from a mutual LL.M. course and asked him to select and send the relevant Italian statute texts (highlighting the relevant sentences) as applicable in the relevant year, which Andrea most kindly did. I incorporated the relevant texts in my opinion for the Netherlands *Hoge Raad* and both parties (the taxpayer and the tax administration) were given the opportunity to react to my findings based on that foreign law. This is definitely not speeding up procedures, and I would have been at a total loss if I had not been able to rudimentarily read Italian, or if the other State's language would have been Slovenian or Finnish. A national tax judge can hardly, whenever there is a need, call on his colleagues abroad to translate local Statute law that might be relevant, particularly as national courts, unlike the ECJ, have not even one single translator on their payrolls.
2. The ECJ's VAT and customs duties case law on absolutely prohibited goods, such as hard drugs and counterfeit money (see cases such as *Einberger*, *Mol*, and *Witzemann*), requires national courts to find out whether the goods or services involved are absolutely prohibited throughout the EC, and whether such total prohibition is actually enforced. With 25 (shortly, 27) Member States, that is simply impossible for a national court. In a case before the *Hoge Raad* I handled, concerning *paddos* (psychotropic mushrooms), I proposed to circumvent the problem by referring to a UN Convention on psychotropic substances, to which all of the then 15 Member States had acceded, advising the *Hoge Raad* to start from the reasonable assumption that all Member States had loyally implemented that Convention and were regularly enforcing their implementing laws, which the *Hoge Raad* did.
3. In his opinion in case C-524/04, *Thin Cap GLO*, the A.-G. Geelhoed goes even further: he wants the UK to ascertain that the other State makes a corresponding adjustment under the applicable tax treaty before applying its transfer pricing rules or refusing interest deduction, and to refrain of such correction if the other State does not oblige. I think this is a fallacy. As long as the UK applies its thin-cap and transfer pricing rules indiscriminately also in internal situations, which it at least formally does, I do not believe there is any such obligation. Even if the UK were to apply its transfer pricing and thin-cap rules only in cross-border situations (which would make sense, as only in cross-border situations jurisdictional base erosion is possible), there is no legal basis whatsoever in EC law to determine which State's income characterization or transfer pricing rules are better. We may agree - we all do, I trust - that the ensuing double taxation should be taken away, but EC law offers no answer to the question which of the two States should subordinate itself to the particular arm's length views of the other State.

Without a common judiciary expert center somewhere in the European Union, it is difficult or impossible for national courts to apply the "always somewhere" principle, or to establish whether or not a differential tax treatment is warranted because it will be compensated for in the other State. Perhaps the EC Commission, the International Bureau of Fiscal Documentation (IBFD) and - if such were to exist - an EU-wide organization of national tax courts should some day get together to set up such expert center.

More generally, it is impossible for national courts to seriously follow the ECJ's *CILFIT* instruction for preliminary questions. <sup>[16]</sup> With 25 (shortly 27) States and 22 official languages (including Finnish, Gaelic and, soon, Bulgarian), it is totally unrealistic to require a national court to compare all official languages and to ask itself whether the interpretation of some EC text would be evident or not to his Greek, Portuguese, Slovenian and Polish colleagues. According to *CILFIT*, they would have to refer practically every case involving national tax law and the EC Treaty Freedoms to the ECJ, in particular every case involving a tax treaty. A more substantive point is that it is of little help to refer cases to the ECJ if it does not answer the question asked (as in the *Bosal* and *Ritter* cases), or reframes them or makes assumptions of fact to make the answer useless (see the *Arsenal* case C-206/01), or simply gives erroneous answers (see 6.1. above).

It should lastly be noted that although the ECJ is not competent to interpret tax treaties, it might be a blessing if it *would* be competent to do so, *and* national courts could ask preliminary questions on such interpretation, *and* the ECJ would have the capacity to give an answer within the year. In such a format, we would finally have a supranational Court securing uniform application of tax treaties in both Contracting States.

## 6.5. A manual for national courts

1. Before deciding whether there is a discrimination or restriction, first take into account not only the effect of application of the tax treaty in the State of litigation (*Bouanich*), but also the effects of (i) application of national tax law in the other State involved (*De Groot*), and (ii) the actual effect of that tax treaty in the other State (*Océ-Van der Grinten*, and, post-seminar: *Denkavit*); more generally: always take the overall tax position of a cross-border taxpayer or cross-border income into account before comparing with the internal situation. Therefore:
2. Ignore the one-jurisdictional approach in the *Fokus Bank* judgment of the EFTA Court (*De Groot, Océ*), unless the ECJ confirms it for intra-EC situations.
3. When applying EC law, treat tax treaties as much as possible as if they were (specifications of the reach of) national law (*Bouanich*).
4. If you refer preliminary questions:
  - i. explain in detail how national tax law, a possibly applicable tax treaty, and, as far as possible, the other State's national tax law affects the taxpayer's tax position;
  - ii. include a reasoned draft answer to the preliminary questions; and
  - iii. explain the interstate and taxpayer equity effects and other significant consequences of divergent approaches the ECJ may be expected to consider.
5. If the ECJ embarks upon tax treaty interpretation, ignore it, and replace it by your own interpretation: the national court is the only court competent, responsible and accountable for tax treaty interpretation. Realize, however, that there is great merit in uniform tax treaty interpretation in both Contracting States, and that if the ECJ interpretation is reasonable and it is to be expected that tax courts in the other Contracting State will conform to it (especially if it conforms to the temporally correct OECD Commentary and the treaty verbally conforms to the anterior Model), it may be wise to conform.
6. Although the interpretational value (if any) of the Commentary to the OECD Model is unclear under the Vienna Convention on the Law of Treaties - and in many Member States later commentaries

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<sup>16</sup> Case 283/81, *CILFIT*

than those present when the tax treaty was concluded are ignored - conforming to the OECD Model Double Tax Convention and its Commentaries (or at least to "international practice") will in general avoid an ECJ finding of incompatibility, as allocation and division of taxing power is up to the Member States and conforming to OECD views is "not unreasonable" under the EC Treaty Freedoms, as long as no substantive discrimination of the cross-border situation arises.

7. Grant EU non-residents which are liable to tax within your jurisdiction as if they were residents (such as especially branches of EU non-resident companies) the same tax reliefs and benefits as residents are entitled to under tax treaties with EU Member States or with third States (*Saint-Gobain*), unless the same or a similar relief or benefit has already been granted in the other Contracting State, or unless such granting does not benefit the taxpayer, as it will lead only to less double tax relief credit in their home State.
8. Do not take *CILFIT* too seriously and especially not literally.
9. Do not hold your State liable for misinterpretation of EC law where, for the same kind of mistake, the ECJ would not hold the Community liable under the exact same conditions.
10. Apply exactly the same concept of abuse when judging justifications for national restrictive tax measures as the ECJ applies when judging measures curbing abuse of EC rules and EC resources (as in *Emsland-Stärke*).
11. Find yourself a pen-friend (e-mail-friend, telephone-friend) in the judiciary of every other Member State whom you can rely on to provide you with (and whom you can reciprocally provide with) accurate information on how tax law and the applicable tax treaty is applied in the other State. Always allow the parties before you to comment on any such information gathered *ex officio*.
12. Do not extend full credit for foreign taxes if national law or the tax treaty provides for no more than ordinary credit, not even if internally withholding taxes or imputation taxes are refunded if exceeding final income tax liability.

## Chapter 7 – Use of foreign court decisions in interpreting tax treaties

*"As respects decisions of foreign courts, the persuasive value of a particular court's decision must depend upon its reputation and its status, the extent to which its decisions are binding upon courts of co-ordinate and inferior jurisdiction in its own country and the coverage of the national law reporting system."* [2]

### 7.1. Introduction

The OECD and various authors have often expressed the desirability of a uniform interpretation of tax treaty provisions, many of which now, with the widespread use of the OECD Model, fall into a common pattern. [3] The argument for a consistent interpretation of a bilateral tax treaty provision is much stronger in relation to the two Contracting States than the argument, which is more theoretical, that all similar tax treaty provisions should be interpreted in all countries in the same way. If courts of various countries all apply the same rules of treaty interpretation and apply them to the treaties themselves, it is likely that they will come to agreement on the interpretation of similar treaty provisions. [4] However, the same rules are not always applied. One of the important issues, of course, is the proper role to be played by the Commentaries on the OECD Model. [5] Although the Commentaries existing at the time the bilateral tax treaty was concluded, particularly between two member Countries of the OECD, may properly be used as part of the "legal context" [6] to indicate the common intention of the two Contracting States concerning the interpretation and application of that particular convention, later Commentaries cannot play the same role.

[7]

The differences in the weight given to existing and later Commentaries are not always recognized. Further, although the internationally accepted rules for the interpretation of tax treaties contained in Arts. 31-33 of the Vienna Convention on the Law of Treaties (hereinafter "Vienna Convention") have had widespread acceptance, these rules are by no means universally followed. [8] The purpose of this chapter to this volume is to consider what weight should be given to decisions of foreign courts in interpreting particular provisions of tax treaties that may be the same or similar to the provisions that were before the foreign court. [9]

Foreign court decisions are, of course, not the only materials that may be considered to be relevant. Also relevant and perhaps much more relevant are the Commentaries to the OECD and the UN models, previous decisions of the courts of the same country dealing with the same treaty and, of course, the

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2 Lord Diplock in *Fothergill v Monarch Airlines Ltd.* [1981] A.C. 251 p. 284.

3 Paras. 5 and 29 to 29.3 of the "Introduction to the OECD Model", Vogel, K. et al., *On Double Taxation Conventions*, London, The Hague, Boston: Kluwer, 1996, 3rd ed., Sec. 73 et seq.; "Introduction" and Baker P., *Double Taxation Conventions and International Law*, London: Sweet & Maxwell, 1994, 2nd ed., at C-29.

4 In the context of tax treaties, because of the constantly evolving OECD Commentaries, "similar treaty provisions" refers to provisions of treaties concluded in the context of similar existing Commentaries.

5 In this chapter, I deal with the OECD Model Convention and Commentaries. If a bilateral treaty or parts thereof is or are based on the UN Model or some other model, the commentaries on that model will be relevant, and the issues concerning their role will be similar.

6 "Legal context" is a term used in Canada to describe the relevant circumstances existing when a statute is enacted that may inform or assist the court as to how the legislature intended the statute be interpreted. The expression is also found in para. 12 of the OECD Commentary on Art. 1. This method of interpretation of statutes by reference to legal context was extended to a tax treaty by reference to the OECD Commentaries that existed when the treaty was concluded by the Supreme Court of Canada in *The Queen v Crown Forest Industries Ltd.* 95 DTC 5389.

7 See Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IFA, Canadian Branch, and IBFD Publications BV, 2005, p. 31 et seq. and p. 110 et seq.

8 E.g. the US has not acceded to the Vienna Convention.

9 Compare the German *Bundesfinanzhof* decision of 9 October 1985, I.R. 128/80 (1985) 145 BFHE 341, the UK High Court decision in *IRC v Commerzbank, A.G.* [1990] S.T.C. 285, and the US Court of Claims decision in *Great West Life Assurance v U.S.*, 678 F.2d 180 (1982) where the courts came to different conclusions on what, essentially, was the same tax treaty point. This is not unique to tax treaties as was shown in *Ulster-Swift Ltd. v Taunton Meat Haulage Ltd.* [1997] 3 All E.R. 641, which referred to 30 decisions of Continental European courts leading to 12 different interpretations of the *Convention on the Contract for the International Carriage of Goods by Road*.

views of respected authors. Previous decisions of the courts of the same country dealing with other tax treaties and views of respected authors may also have been influenced by statements in the OECD Commentaries that were current at the time the treaty dealt with in the earlier case was concluded or in respect of views of authors, current at the time when the author was writing, but those Commentaries may not have been published before the particular tax treaty under consideration was concluded and are not part of the legal context of the particular treaty. Therefore, not only should care be taken in following court decisions in the same country dealing with other tax treaties to ensure that a court does not indirectly and inadvertently adopt later commentary and give it the same weight as existing commentary but also similar care should be taken in dealing with decisions of a foreign court or views expressed by authors which were formulated based on such later commentary.

## 7.2. OECD Model and Commentary

The OECD Commentaries have been widely recognized as helpful aids to the interpretation of treaty provisions based on the OECD Model wording. <sup>[10]</sup> There are, however, a number of unresolved issues concerning the use of the Commentaries. One issue is whether the Commentaries should be used as part of the general rule of interpretation as described in Art. 31 of the Vienna Convention or as supplementary means of interpretation within Art. 32. There is no consensus on this issue. One argument that the Commentaries are to be used as part of the general rule is that they form part of the context as narrowly defined by Art. 31(2), namely,

[... ] an agreement relating to the treaty which was made between all parties in connection with the conclusion of the treaty or an instrument that 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.

When both Contracting States are members of the OECD it may appear to be easier to make this connection than it would be if only one or neither party to the treaty is a member. This argument, however, is not entirely convincing because whether, in fact, there was such an agreement may depend upon what was actually agreed or represented during the negotiation of the particular treaty but, the records relating to the tax treaty negotiations are rarely, if ever, available to taxpayers or to courts.

As the OECD has made clear, the Commentaries are not legally binding <sup>[11]</sup> and thus it cannot be assumed that they were agreed and accepted by the treaty negotiators in connection with the conclusion of the particular treaty with the intention that they would have the effect of making them binding in international law in respect of that particular treaty. <sup>[12]</sup> It has been argued that they can nevertheless be used as supplementary means of interpretation to which recourse may be made under Art. 32 of the Vienna Convention if the text of the treaty leaves the meaning ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable. However, the Commentaries are not preparatory work (*travaux préparatoires*) of any particular tax treaty and Art. 32 has a limited role to play in treaty interpretation.

A third - and perhaps the better position - would be that the Model and the Commentaries existing when the particular treaty was concluded should be given substantial weight in interpreting a treaty provision which is based on the OECD Model without regard to the particular "pigeon holes" of Arts. 31 and 32 of

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<sup>10</sup> See paras. 15 and 29-29.3 of the *Introduction to the OECD Model Convention*.

<sup>11</sup> See Ward et al., *op. cit.* [note 7](#), p. 6 et seq.

<sup>12</sup> The OECD has stated that the OECD Commentaries are not legally binding in para. 29 of the *Introduction to the Model* and para. 32 of the *OECD Triangular Case Report*. See also Art. 5(b) of the *Convention on the Organization for Economic Co-operation and Development*, and Rule 18(b) of the *OECD Rules of Procedure* which make it clear that the OECD Commentaries, which are supported by a Council Recommendation (and not a Decision) are not intended to be binding. For a contrary view, see Engelin, F., *Interpretation of Tax Treaties Under International Law*, Amsterdam: IBFD Publications BV, 2005.

the Vienna Convention. <sup>[13]</sup> This presumes that the Commentaries existing when the particular tax treaty was concluded inform the interpretation of the treaty as understood or intended by the treaty negotiators.

Another unresolved issue is whether, and if so, how amendments made by the OECD to the Commentaries subsequent to the negotiation and conclusion of a particular treaty should properly be taken into account in interpreting the treaty that adopts the text of the OECD Model. The OECD Committee on Fiscal Affairs considers that pre-existing tax treaties should "as far as possible" be interpreted in the spirit of revised Commentaries, even in cases where the provisions of those tax treaties do not coincide with the more precise wording of the Model Convention as the Committee is of the view that the revised Commentaries are "relevant" in interpreting and applying previously concluded treaties.

<sup>[14]</sup> It is difficult, however, to justify the use of revised commentary within Art. 32 of the Vienna Convention as the revised Commentary could hardly be considered to be preparatory work in respect of the particular treaty, nor part of the circumstances of its conclusion. If the Commentaries made prior to the conclusion of a particular treaty are to be used as "legal context" to indicate the shared intentions of the treaty negotiators or as supplementary means of interpretation, this would seem to rule out the similar use of subsequent Commentaries.

It has been argued that the part of the general rule of interpretation expressed in para. 3(a) of Art. 31, which authorizes the taking into account together with the context of "any subsequent agreement between the parties regarding the interpretation of the treaty and the application of its provisions", applies to the use of later Commentaries. Whether or not the Commentaries constitute a "subsequent agreement", they clearly do not constitute such an agreement between any of the member Countries of the OECD which is intended as binding. If the two Contracting States to the particular treaty are both represented on the Committee on Fiscal Affairs of the OECD, then, although it may be stretching a point, a revised commentary to which neither of the two parties enters any observation could possibly be regarded as no more than a non-binding understanding similar to the effect of a non-binding Memorandum of Understanding ("MOU") in international law. <sup>[15]</sup> In dealing with Art. 31(3)(a) of the Vienna Convention, the Commentaries to Arts. 31-33 of the Vienna Convention indicate that this part of the general rule of interpretation refers to agreements which the parties intend to be binding:

An agreement as to the interpretation of a provision reached after the conclusion of the treaty represents an authentic interpretation by the parties which *must* be read into the treaty for purposes of its interpretation. <sup>[16]</sup> [emphasis added] <sup>[17]</sup>

At best, subsequent Commentaries - which are genuinely interpretive and are not disguised attempts to amend the Model, to fill gaps or to reverse prior interpretations - can be informative and used in a way similar to the use of published works of experts, but should not be confused with the different role that is played by Commentaries that were published before a particular treaty was concluded.

Lastly, in some instances the OECD Commentaries are far more detailed and contain interpretive rules that are not actually reflected in a reading of the text of the Model treaty itself. The question, therefore, can be raised as to what reliance is to be placed upon those statements made in the Commentaries that are not simply interpretive, but rather actually enlarge on the wording of the particular provisions of the Model or may be viewed as attempts to fill gaps in the Model. Here, the OECD has recognized the lesser influence of such Commentaries as it has said that rulings handed down by the courts are to be

<sup>13</sup> The application of principles of logic and good sense used by national courts to interpret statutes is permitted in international law in interpreting treaties, although not referred to in Art. 31 or 32 of the Vienna Convention, see Ward et al. op. cit. [note 7](#), p. 27 et seq. This also seems to be the position adopted by the American Law Institute, see *Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties*, Philadelphia: American Law Institute, 1992, p. 53.

<sup>14</sup> Paras. 33, 35 and 36 of the Introduction to the OECD Model.

<sup>15</sup> See the discussion of non-binding MOUs by Aust, A., *Modern Treaty Law and Practice*, Cambridge: Cambridge University Press, 2000, p. 26 et. seq.

<sup>16</sup> Para. 14 of the Commentaries to draft Arts. 27-30 of the Vienna Convention. Arts. 31-33 were very slightly amended from draft Arts. 27-30.

<sup>17</sup> The word "must" underlies the binding nature of the agreement.

respected which interpret the literal provisions of the treaties in issue and conflict with Commentaries that enlarge on the wording of the Model. [18] In fact, because of the primacy of the text of the particular treaty in the interpretive process as codified in Art. 31 of the Vienna Convention, and explained in the Vienna Convention Commentaries, it is difficult to see an important - or any - role for such Commentaries.

The principal purpose of this chapter is not to consider the several issues involved in the use of the OECD Commentaries in interpreting particular conventions, but rather to consider the use to be made of decisions of foreign courts in interpreting particular tax treaties. Such foreign court decisions may, or may not, reflect the OECD Commentaries, but courts, as the Introduction to the Model notes, are making more frequent references to the Commentaries and therefore it is increasingly likely that foreign court decisions have been influenced by the Commentaries. In considering foreign court decisions, and the weight to be given to them by the domestic court, issues such as the level of the court that rendered the decision, the binding nature of such court decision in the foreign country, the role that the OECD Commentaries may have played in reaching that decision [19], and which Commentaries were used, as well as the style of the judgment and convincing nature of the logic or reasoning, or lack thereof in the foreign court decision itself or of the Advocate-General (or similar official), if it is apparent that the court followed the reasoning in the opinion of the Advocate-General (or official), should all be evaluated by the domestic court. As discussed below, domestic courts do not always appear to evaluate foreign court decisions with those considerations in mind but there are some cases where courts simply gave no weight to foreign court decisions dealing with other treaties.

### 7.3. The principle of stare decisis in common law countries

Common law jurisdictions recognize the principle of stare decisis. [20] Basically, in those jurisdictions that apply the doctrine of stare decisis, the *ratio decidendi* of a previous case in an appellate court or a higher court is recognized as having become part of the law and should be followed in that court and lower courts in all subsequent decisions.

The principle of stare decisis is, of course, essential in a juridical system that recognizes the power of the courts to make, or as some legal scholars put it, to declare, [21] from time to time, what is the law on particular points that have never previously been written down as they are in systems of law based on a civil code. Not only does the stare decisis principle apply to statements of the law, it also applies to interpretations of statutory [22] and, it is suggested, treaty provisions which have been incorporated into internal or municipal law.

Apart from the rare cases where the House of Lords, the Supreme Court of the United States or the Supreme Court of Canada do not apply the *ratio decidendi* of an earlier case decided in those courts, it is recognized that precedent is binding and not merely persuasive because stare decisis is, generally speaking, a hard and fast rule in England and in the other countries deriving their law from English law. [23]

### 7.4. Precedent in civil law countries

The practical use of precedent in civil law is illustrated in the discussion below in relation to three of the major civil law countries: France, Germany and Italy.

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18 See para. 32 of the OECD *Triangular Cases Report*. The Commentaries to Arts. 31-33 of the Vienna Convention stress the textual basis for the interpretation of treaties, and therefore would seem to rule out reliance on those parts of the OECD Commentaries which go beyond a mere interpretation of the text of the Model.

19 If the domestic court (as seems to be the case in the US, Canada, Australia and perhaps France, Sweden and the Czech Republic) restricts its consideration of the OECD Commentaries to those current when the treaty in question was concluded, this point should be considered. If, however, the domestic court considers later Commentaries to be equally relevant, this point may not be so relevant. As to the positions of various courts on this issue, see Ward et al., *note 7* pp. 95-104. For a case that seems to give subsequent Commentaries weight equivalent to law, see the decision of the Swiss Federal Court in *A Holding ApS v Federal Tax Administration* 8 ITLR 536 (2005), where the court, perhaps in obiter dictum, considered later OECD Commentaries to be amendments of the "rules" which member Countries (and presumably courts) must follow in interpreting and applying previously concluded treaties.

20 *Halsbury's Laws of England*, 4th ed., vol. 26, para. 573 p. 292.

21 *Blackstone's Commentaries* 13th ed., vol. i, pp. 88-9, *Willis v Baddeley* [1982] 2 Q.B. 324 p. 326. This theory that common law judges "declare" rather than "make" the law has been criticized: Cross, R., *Precedent in English Law*, Oxford: Clarendon Press, 1961, p. 21 et seq.

22 *London Transport Executive v Betts* [1959] A.C. 211 p. 232 per Lord Reid.

23 Cross, *note 21*, p. 4. It has however been recognized that in a federal state, the multiplicity of jurisdictions which produces a multiplicity of law reports and, of course, creates separate appellate courts at state or provincial levels weakens the application of the doctrine of stare decisis: Cross, *note 21*, p. 13.

### 7.4.1. France

In France, the civil and penal codes are, theoretically at least, considered to be complete in the sense they are supposed to cover every situation with which the courts are concerned. Even here, there is a body of case law that deals with the construction of the codes and the solution to problems on which they are silent, and the *droit administratif* of the *Conseil d'Etat* is mainly based on precedent. However, a significant difference between English, American, Canadian and Australian law on the one hand and French case law on the other is that a French judge does not regard himself absolutely bound by the decision of any court in a previous case. He attempts rather to ascertain the trend of recent decisions (*la jurisprudence*) on particular points. It has been said:

The practice of the courts does not become a source of law until definitely fixed by the repetition of precedents which are on agreement on a single point. [24]

The legal history in civil law countries has led to a constitutional rule supporting the separation of powers reserving to the legislature the power to enact or establish the laws and avoiding any judicial responsibility for their development. [25] As Benjamin Watt has explained:

Article 5 [of the French *Civil Code*] dictates that a judge is prohibited from deciding cases before him by laying down general rules. He is, therefore, required to dispose of the case by reference to *enacted* rules, not by reference to prior decisions. He knows no authority other than enacted law. In the event that he does refer to prior decisions, this consideration may not in itself determine the outcome of the case.

The theory of the supremacy of enacted law embodied in Article 5 implies that the judge may be considered *incapable* of creating legal rules. In principle, his decisions are of referential value only and do not bind his successors. [26]

The theory and practice in France, however, are not always coincidental as it is not uncommon for French courts to make reference to earlier judicial decisions and in practice to decide a case in conformity with earlier decisions to the extent to which they are similar, i.e. in conformity with *la jurisprudence* (case law), particularly decisions delivered by *La Cour de Cassation*. The law of 15 May 1991 recognizes this trend and enables inferior courts to request the opinion of *La Cour de Cassation* when they encounter new questions of serious difficulty. But this Law includes the fundamental caveat that the advice given by *La Cour de Cassation* does not bind the requesting court.

### 7.4.2. Germany

The German Constitution states in Art. 20, chap. 3 the following (translation into English):

(1) The legislative power is bound by the Constitution, the executive and judicial power are bound by statute and law.

As judicial power is bound by statute and law, the courts must follow the law and are not allowed to create law. Otherwise, the principle of separation of powers would be violated. The Constitutional Court

<sup>24</sup> Lambert, "Case Method in Canada", 39 *Yale L.J.*, 1 (1929) p. 14, quoted by Cross, [note 21](#), p. 11. As a civil law jurisdiction, the principle of stare decisis is not part of the law of Québec. The Québec courts are not bound by a judgment even of the Supreme Court of Canada if they are of the opinion it is incorrect: *Bellefleur v Lavallée* [1957] R. L. 193 (Que. C.A.). See, however *Daoust, Lalonde & Cie v Ferland* [1932] S.C.R. 343 where the point is made that the Supreme Court of Canada applies stare decisis to appeals from Québec.

<sup>25</sup> See Watt, B., "Why French Law Rejects Judicial Precedent", 25 *International Business Lawyer* 1 (January 1997), p. 18.

<sup>26</sup> *Id.* p. 19.

(*Bundesverfassungsgericht*) could be called and the decision based on "created law" would be declared void.

In practice, however, it is recognized that the application, interpretation and supplementation of statutes is not the creation of law. The Constitutional Court has decided, for example, that it is a fundamental duty of judges to fill gaps in statutes. [27] Especially in tax law, the Constitutional Court has decided that generating principles through courts is a matter of legal security and equality. [28]

As is the case in France and Italy, courts are not bound by decisions of other courts. However, when decisions in courts on the interpretation of statutes establish certain doctrines and consistently adhere to them, a so-called "*herrschende Rechtsprechung*" (unofficial translation into English: "ruling opinion") comes into existence and this tends to be followed by other courts. A reason for this is that an appeal against a decision not following the ruling opinion has a great probability of success. On the other hand, ruling opinions can be specified or changed from time to time.

German legal history reflected the view that a judge's power to make the law needed to be curbed so that although, in theory, the judge was supposed to bridge gaps left in the statute to provide a "logical consistency" to the legal system, the judge in doing this was left with as little discretion as possible. [29] The more modern view, however, is that German courts are not restricted to merely interpreting the law but can develop the law within the limits set by Art. 20, Chap. 3 of the German Constitution. Although a decision of a German court normally has relevance only for the individual parties to the case, in interpreting or developing the law the court maintains that the decision corresponds to the law and implicitly, therefore, claims that any similar case should be adjudicated in a similar manner.

As a consequence of this, a lower court usually respects the published "precedents" of the highest courts and the highest-ranking court itself usually observes its own prior decisions, sometimes with potentially necessary modifications. Thus, many "precedents" after a reasonable period of time are treated in a practical sense as if they were part of the law. But from a theoretical point of view, the limits set by the Constitution must be observed so that precedents can only have actual effectiveness but not legal validity as they are not a "source of law" themselves, but merely a helpful analysis of the law and therefore binding but only to the extent that they are considered to correctly interpret or develop the law. The German judge, therefore, is required to take responsibility for the evaluation of the case and, at most, it is arguable that the prior decision is supported by a presumption of correctness which can be rebutted by the subsequent judge in charge of the actual case.

Further, only rules rendered by the highest German courts are considered to be "factually binding guidelines" supported by a presumption of correctness. [30] When these decisions of the highest German courts are rendered that deal with a situation in which, within the statutory law, several solutions appear to be equally correct, the decision, it is thought, should be binding on subsequent judges since certainty of the law and equal treatment should take precedence over the individual analysis of the subsequent judge. In Germany, however, a decision can rank only as a true "source of law" if it becomes part of the customary law, a threshold level which is very high as in general the ruling view is that it must reach a level where it is reflected in a continuous practice without notable exception. This conviction has to be shared amongst the general population not only amongst jurists and other legally trained people, but also in a way that shows the decision is considered a binding norm.

### 7.4.3. Italy

As in France, in Italy, court decisions are not regarded as sources of law. [31] Therefore, in principle, the *ratio decidendi* of a court decision is not binding on any other court irrespective of the hierarchy of

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27 VBerfGE 13, 164.

28 BVerfGE 31, 287; 49, 318; 69, 203.

29 Larenz/Canaris, *Methodenlehre der Rechtswissenschaft*, 3. Aufl. 1995, p. 189.

30 Id. p. 257. The risk of annulment by an appellate court of lower court decisions that ignore the presumption of effectiveness is considered high.

31 Colesanti, *Giurisprudenza*, in Nss. Dig. it. IV (Turin, 1977) 1104; Mengoni, *Diritto vivente*, in Ius, (1988) 14.

the court delivering the previous decision. However, in practice under the Italian legal system, court decisions do play an important role since they show the application to the facts of a specific case of the impersonal or abstract rule contained in the civil code or other written law. Therefore, it is generally viewed that, in particular, the decisions of the *Corte di Cassazione* (Italian Supreme Court), even if not formally mentioned amongst the sources of law, play a substantial role in creating the law. The *Corte di Cassazione* does not concern itself with the merits of disputes but only with questions of law and can quash the decision and remand the case to the lower court stating the legal principle to which the lower court must conform the decision and those legal principles are binding on the judge to which the case is remanded, but not binding on other judges. [32] However, the legal maxims or principles of the *Corte di Cassazione* have, in practice, a broader effect since they are widely followed by the judges and lawyers and generally regarded as *diritto vivente* (living law) where there has developed a uniformity of judicial applications, that is to say a large or prevalent view. [33]

The *Ufficio del Massimario* (Office of the Maxims) in Rome collects all the maxims of the *Corte di Cassazione* and publishes them both in a journal and on an online basis and, therefore, provides the necessary textual basis to determine what is included in *diritto vivente* which one expects the judges of the *Corte di Cassazione* to follow in order to give a uniform interpretation of the laws, but which, however, are not binding on the *Corte di Cassazione* or on judges of lower courts. [34] Judges of lower courts, however, are expected when they deviate from the precedents of the *Corte di Cassazione* to expressly show the reasons for their choice with complete, consistent and convincing arguments. [35] Therefore, although not legally binding, judicial precedents do have a practical, constant and prime point of reference for Italian lawyers. Scholars generally maintain that Italian judges and lawyers work using and citing precedents rather than the law. [36]

## 7.5. Differences in the style of writing court judgments

In common law countries, appellate courts customarily sit with a panel of judges. It is not unusual for judges to issue separate opinions or reasons for judgment, including, when the panel members do not agree, dissenting opinions or reasons. [37] The writing of separate opinions or reasons provides the reader, including other courts (particularly courts accustomed to the Anglo-American tradition of judicial writing) with a clearer understanding of the issues, the process of logic and analysis and the differences of view amongst the judges on the panel, than does the Continental style of rendering a single judgment, without any dissent. [38] It is suggested that decisions of appellate courts in common law countries have, therefore, greater persuasive value in other Anglo-American courts as they tend to show more of the process of reasoning, the differences of opinion and the *ratio decidendi* of the majority of the judges on the panel.

Professor Markesinis has written a very interesting (but colourful) article pointing out other stylistic differences between Anglo-American on the one hand and German, French and Italian judges on the other in the way they write their reasons for judgment. [39] Markesinis contrasts the style of writing of judgments or opinions in the Anglo-American tradition with the style adopted by German judges, which, he says, quoting Cardozo, "seem to march at times to pitiless conclusions under the prod of a remorseless logic which is supposed to leave no alternative".

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32 Sec. 101 of the Italian Constitution states that judges are *only* subject to the law.

33 Zagrebelsky, "La Dottrina del diritto vivente", *Giur. cost.*, (1986) p. 1148.

34 See Art. 65 of Royal Decree no. 12 of 1941.

35 *Cassazione*, no. 7428 of 3 December, 1983, *Impianti Sportivi v Viel*, in *Mass. Giur. lav.*, 1984, 66 and Andrioli, *Appunti di diritto processuale civile*, Naples, 1964, 174.

36 BIN, *Il precedente giudiziario*, Padua, 1995, p. 61; Galgano, "L'interpretazione del precedente giudiziario", in *Contratto e impresa*, 1985, p. 701; Inzitari, "Obbligatorietà e persuasività del precedente giudiziario", in *Contratto e impresa*, 1988, p. 530; Galgano, "Giurisdizione e giurisprudenza in materia civile", in *Contratto e impresa*, 1985, p. 41; BIN, "Precedente giudiziario, ratio decidendi e obiter dictum; due sentenze in tema di diffamazione", in *Riv. trim. proc. civ.*, 1988, p. 1004.

37 The members of the Judicial Committee of the Privy Council did not, as a practice, write separate reasons for judgment.

38 Although the opinion of the Advocate-General in civil law countries may display the process of logic and analysis that he or she used in forming the opinion, it is often unclear to what extent this process has been adopted by the court in arriving at its decision.

39 Markesinis, B.S., "A Matter of Style", (1994) 110 L.Q.R. 607. Prof. Markesinis is a professor of European Private Law, University College, London and professor of Anglo-American Private Law, University of Leiden.

In commenting on the judgments in the French *Cour de Cassation* he says, "those judges are trained to keep their thoughts to themselves". In commenting on judgments of the Italian Supreme Court he says that clear and thought-provoking style "is absent from the judges of the Italian Supreme Court which are uniformly abstract (to the extent that one can ascribe uniformity to a nation as endearingly individualistic as Italy)". [40] In his view, the judgments of common law judges "can be stylistically attractive and, probably, more informative of what is really going through the judge's mind when he is trying a case". Without making any assertion that one language has greater beauty or expressive power than another, in considering the effectiveness of judicial styles he finds clarity of thought in the totally untechnical language used by Anglo-American judges as compared with the style used by German judges, which is more steeped in legal jargon, although, in the examples cited, he notes that both courts arrive at the same ultimate result. Markesinis states:

Common law judicial style has many attractions that could be fruitfully studied by foreign students and, perhaps, for different reasons, imitated by foreign practitioners. The flip side of this coin is that, to foreignize, the German judgment ... can be too abstract, too theoretical, and too preoccupied with fitting concrete problems into a conceptual system. Many of these (real or perceived) weaknesses could be reduced if the authors of German judgments targeted a wider audience than they currently do, paid more attention to the distinctive features of previous decisions (using them as building blocks for the constant development of the law rather than as illustrations of a certain position) and placed their cases more overtly in the socio-economic context of which they belong. [41]

Although critical of the style of writing by German judges, Markesinis expresses the view that judgments written by English judges would benefit from the practice of German judges of paying closer attention to informed commentary of authors, including academics. [42] He cites Lord Justice Stewyn in *White v Jones* [43] complaining of counsel's failure to cite relevant academic views and stressing that "it is arguments that influence decisions rather than the reading of pages upon pages from judgments". Markesinis has also expressed criticism of the current attitude of American courts towards foreign law. [44] In his article, Markesinis compares the US Supreme Court's practice in dealing with (non-tax) issues, including constitutional questions, of ignoring foreign legal thinking, which he compares unfavourably with the more willing consideration of foreign court decisions in the UK, particularly in the Privy Council and the House of Lords, the Canadian Supreme Court, the South African Constitutional Court and the Israeli Supreme Court, particularly in matters involving human rights. [45]

## 7.6. References by domestic courts to decisions of foreign courts in interpreting tax treaties

In dealing with tax treaties, Philip Baker takes the approach that courts should examine and follow decisions of authorities of the other States in interpreting tax treaties "unless they are convinced that the other decisions are incorrect". [46] That perhaps puts the onus too high and the wrong way around, particularly in respect of decisions of courts in third States. I would suggest that they should follow such decisions not only if they are convinced that the decisions are correct, but also if they are not dependent

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40 Id. pp. 608-9.

41 Id. p. 617.

42 This criticism of English judges cannot be extended to Canada as Canadian judicial decisions, including those of the Supreme Court, are replete with citations of books and articles written by publicists, academics and also legal practitioners.

43 [1993] 3 WLR 730 at p. 751.

44 Sir Basil Markesinis, "Rational Self-Sufficiency or Intellectual Arrogance? The Current Attitude of American Courts Towards Foreign Law", *Cambridge Law Journal*

(2006) p. 301.

45 See also the discussion of the current trends in the US Supreme Court not to refer to foreign judicial reasoning particularly in constitutional cases: Ernest & Young, "The Supreme Court, 2004 Term: Comment: Foreign Law and the Denominator Problem", 119 *Harvard Law Review* 148 (2005).

46 Baker, note 3 at C-28.

on factors extraneous to the particular tax treaty being considered by the court, such as later OECD Commentaries.

Baker states that there is no clear legal basis for such a reference to decisions of other jurisdictions and nowhere in the Vienna Convention is such a reference sanctioned. [47] He is of the view that there seems to be a good, logical and jurisprudential argument for according weight to interpretations of similar treaty provisions in other countries. As he analyses it, the taxing authorities in each of the two Contracting States that have entered into a tax treaty should, as far as possible, apply the same interpretation to the words of the treaty so that the treaty does not mean two different things in the two Contracting States. This is certainly true for the two Contracting States, but much less true in respect of third States. [48] Baker expands his view stating that if one Contracting State has treaties with many other Contracting States which contain the same terminology, "it seems to be correct that the interpretation concerning the treaty with state Y should also apply to those treaties [with states Z, P and Q]".

Attractive as this logic may be, it seems odd that the courts of one Contracting State should feel constrained to follow the court decisions of a third State, whether one with which it has a tax treaty or not, in interpreting a tax treaty between that State and another State. [49] Because tax treaties are usually bilateral treaties between two Contracting States, there is a much less strong argument for a universal interpretation of treaty terms than there is in the case with a multinational treaty. [50] Because tax treaties concluded by a State can be presumed to have been negotiated based on the interpretations in the then-current OECD Model (or UN Model or that State's own Model), which have been described by courts as "legal context" or simply "context" (but not "context" as defined by Art. 31(2) of the Vienna Convention), there may be little justification for interpreting them all in the same way if the Commentaries expressed different interpretations of the Model when the treaties were negotiated and concluded or other evidence indicates a different interpretation was intended.

David Rosenbloom has taken a different position from Baker. He has pointed out that since understandings are reached during bilateral negotiations, "[t]hose responsible for interpreting [a treaty] are charged with ascertaining and implementing the treaty bargain, not developing an approach that will reduce all treaties to common themes". [51] Further, there does not appear to be a very strong argument

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47 Baker might, however, have noted that Sec. 38(l)(d) of the *Statute of the International Court of Justice* directs the court to decide cases in accordance with international law and apply, *inter alia*, judicial decisions as subsidiary means for the determination of rules of law. See the discussion of this provision in Shabtai Rosenne, *Practice and Methods of International Law*, London/Rome/New York: Oceana Publications, Inc., 1984, p. 83. Baker might also have noted the common practice of national or municipal courts of referring to foreign court decisions in dealing with multinational treaties in order to find a common interpretation of those treaties.

48 Any attempt to seek a common interpretation should, as Baker acknowledges, be subject to the provisions of Art. 3(2) of the OECD Model.

49 Vogel, note 3 at Secs. 74-76, "Introduction", advocates that courts and administrative bodies take into consideration and *evaluate* not only relevant decisions in the other Contracting State but also "if necessary" those of third States. However, he acknowledges that such decisions cannot be considered to be binding.

50 In the case of multinational treaties, UK courts have illustrated how difficult it is to find an international consensus on the interpretation of such treaties: *Ulster Swift Ltd. v Taunton Meat Haulage Ltd.*, note 9, and *Fothergill v Monarch Airlines Ltd.*, note 2.

However, an international consensus was developed respecting the relationship between the *jus cogens* principle of international law against the official practice of torture and the international law principle of sovereign immunity in the House of Lords' recent decision in *Jones v Ministry of Interior for the Kingdom of Saudi Arabia et al* [2006] UKHL 26 and a decision of the Ontario Court of Appeal in *Bouzari v Islamic Republic of Iran* (2004) 71 OR (3d) 675. In the House of Lords decision, Lord Bingham of Cornhill referred to decisions of courts in Germany, the US, Canada and Ireland, and the International Criminal Tribunal for the former Yugoslavia, all of which had come to the same conclusion.

Another example is cases dealing with the *Convention for the Unification of Certain Rules Relating to the International Carriage by Air* illustrated by a decision of the Ontario Superior Court of Justice, *Connaught Laboratories Ltd. v British Airways* (2002) 61 OR (3d) 204 dealing with the question whether damage to cargo was as a result of mere negligence or whether it amounted to "recklessness" within the meaning of Art. 25 of the Convention. In the course of his reasons for judgment, the judge referred to an article of Professor Bin Cheng, "Wilful Misconduct: from Warsaw to the Hague and from Brussels to Paris" (*Annals of Air and Space Law*, vol. II (Toronto: Carswell, 1977)) where Cheng, referring to a decision of the Belgium *Cour de Cassation*, accepts the following statement: "The interpretation of an international convention the purpose of which is the unification of the law cannot be done by reference to the domestic law of one of the contracting States. If the treaty text calls for interpretation, this ought to be done on the basis of elements that pertain to the treaty, notably, its object, its purpose and its context as well as its preparatory work and genesis. The purpose of drawing up an international convention designed to become a species of international legislation would be wholly frustrated if the courts of each State were to interpret it in accordance with concepts that are specific to their own legal system." In the course of the decision, the Ontario Court referred to and rejected a dissenting judgment in *Saba v Compagnie Nationale Air France* 78 F. 3d 664 (DC Cir. 1996) and the dissenting opinion of Kirby, J.A. in *SS Pharmaceutical Co. v Qantas* [1991] 1 LLR 288 (Aust. CA) and accepted and followed *Goldman v Thai Airways International Ltd.* [1983] All ER 693 (C.A.), *Lacroix Baartmans, Callens and Van Tichelen v Swiss Air* (1974), 28 RFDA 75 (Federal Suisse Tribunal) and *Piamba Cortes v American Airlines Inc.* (1977) F. 3d 1272 CA 11 (Fla.) 1999. Under the same Convention in another line of cases, an issue has been raised as to whether deep-vein thrombosis that sometimes occurs when passengers take long air flights is caused by an "accident" within the meaning of the Convention. An example here is the decision of *McDonald v Korean Air* [2002] OJ No. 3655, a decision of the Ontario Superior Court of Justice in which reference was made to the decision of Justice O'Connor in *Air France v Saks* 105 S Ct 1338 (1985) (USSC) who found "when the injury results from the passenger's own internal reactions to the usual normal expected operation of the aircraft, it has not been caused by an accident". The Court also referred to *Sherer v Pan American* 54 AD (2d) 636, a decision of the New York Supreme Court, Appellate Division, to the same effect and adopted the same test.

51 *Proceedings of the New York University Fortieth Annual Institute on Federal Taxation* (New York, Matthew Bender, 1982). David Rosenbloom is a former International Tax Counsel of the United States Treasury.

for the courts of one State to follow an interpretive decision of similar treaty provisions by the court of another State when that decision in the other State is not rendered by its highest court and is not binding on the courts of that State under the principle of stare decisis or some other similar principle or practice in that State. Added to this may be the apparent unconvincing style of the logic and even, in some cases, an absence of logic and reasoning in the judicial decisions of some foreign courts when seen through the eyes of the domestic court because of the paucity of logic exhibited in the reasons for judgment, or because of the absence of references to juridical writings or other precedents in other cases. Further complicating matters are, of course, issues of translation of language and, quite often, less than perfect national reporting systems for the judgments of courts.

Finally, of course, there is no assurance that the foreign court has in fact got it right. [52] It is quite natural, therefore, where courts have referred to the decisions of foreign courts to look to decisions of the courts of the other Contracting State interpreting the same tax treaty, most frequently when the language of those decisions is the same as the language of the court quoting or following such decisions. The record shows, however, that courts have not limited themselves to references to treaty decisions in the treaty partner State, but this has happened frequently with the Canada-US treaties of 1942 and 1980. For example, the Tax Appeal Board and the Tax Court of Canada have quoted decisions of the US Tax Court and, in the US, the Ninth Circuit Court of Appeals has quoted a decision of the Canadian court in interpreting the same treaty. [53] In Canada, the Tax Court also referred to a UK tax treaty case as support for using the OECD Commentaries to interpret the Canada-UK Treaty. [54] Canadian courts have not, however, limited themselves to seeking guidance only from decisions of courts in treaty partner States. For example, the Canadian Federal Court of Appeal [55] referred to the three US cases [56] to interpret the Canada-China Treaty and in another case [57] relied on a UK decision [58] in dealing with the Canada-US Treaty of 1942.

The Australian High Court has done the same thing. It quoted cases from the United Kingdom [59] and Canada. [60] in an appeal involving the interpretation of the Australia-Switzerland Treaty. [61] The same court referred to a Canadian Supreme Court case that dealt with the Canada-Ireland Treaty, [62] a Rhodesian case that dealt with the UK-Sweden Treaty (which extended to Rhodesia) [63] and a South African case that dealt with the Switzerland-South Africa Treaty, [64] all in a case involving the Australia-UK Treaty. [65] The Australian Administrative Appeals Tribunal referred to and followed a Canadian case [66] in dealing with the Australia-US Treaty. [67] In New Zealand, there is a (rare) example of the citation of a civil law decision by a common law judge who cited a decision of the German *Bundesfinanzhof* [68] in a case involving the treaty between New Zealand and the United Kingdom. [69] In none of these cases where domestic courts considered decisions of third country courts was there the kind of detailed analysis of the basis for the foreign court decision that I have suggested should be done, notwithstanding that in

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[52] This is discussed in OECD publication *Tax Treaty Override*, para. 4(a).

[53] *Number 630 v MNR* 59 D.T.C. 300 and *Donroy Ltd. v U.S.* 301 F. 2d 200 (1962). See also for Canada, *Canadian Pacific Ltd. v The Queen* 76 D.T.C. 6120 (FCTD) p. 6135: "While it is true that this Court has the right to interpret the *Canada-United States Tax Convention and Protocol* itself and is in no way bound by the interpretation given to it by the United States Treasury, the result would be unfortunate if it were interpreted differently in the two countries when this would lead to double taxation". See also *CIR v JFP Energy Inc.* (1990), 14 TRNZ 617 at p. 623 for a similar reference by the New Zealand Court of Appeal to the interpretation of the treaty by the US Treasury. Even between Canada and the US, however, common interpretation is not always achieved. The Second Circuit Court of Appeals decided a case under the Canada-US Treaty in a way that did not accord with Canadian jurisprudence: *U.S. v A.L. Burbank & Co. Ltd.* 525 F. 2d. 9 (1975).

[54] *Hinkley v MNR* 91 DTC 1336.

[55] *Quig Gang KLi v The Queen* 94 DTC 6059.

[56] *Quidwai v Commr.* (1984) 47 TCM 962; *Siddiqui v Commr.* (1978), 70 TC 553; and *Budhwani v Commr.* (1978), 70 TC 287.

[57] *The Queen v Bank of Nova Scotia* 81 DTC 5115.

[58] *Grieg v Ashton* [1956] 1 WLR 1056, a case decided under the UK-US Treaty.

[59] *Ostime v Australian Mutual Provident Society* [1960] AC 459, and *Sun Life Assurance Co. of Canada v Pearson* (1986), 59 TC 250.

[60] *MNR v Tara Exploration and Development Co. Ltd.* (1972), 28 DLR (3d) 135.

[61] *Thiel v F.C.T.* (1990), 90 A.T.C. 4717.

[62] *MNR v Tara Exploration and Development Co. Ltd.* (1972), 28 D.L.R. (3d) 135, [1974] SCR 1057.

[63] *C of T v Aktiebolaget Tetra Pak* [1966 (4)] 198.

[64] *Secretary for Inland Revenue v Downing* (1975) (4) S.A. 518 (A), 37 SATC 249.

[65] *Unisys Corp. v FC of T* 5 ITLR 658.

[66] *Utah Mines Ltd. v The Queen* [1992] 1 CTC 306 (FCA).

[67] *Case 38/95.95 ATC* 341 (1995).

[68] BFH decision of January 13, 1970.

[69] *CIR v United Dominions Trust Ltd.* [1973] 1 NZTC 61,028.

Australia, the Australian Federal Court [70] has held that the Commentaries are only applicable to treaties subsequently concluded and, in Canada, the Supreme Court [71] and the Federal Court of Appeal [72] have confined themselves to existing commentaries. [73]

Quite apart from citing foreign cases, a Canadian court has even allowed the opinion of a foreign tax official to be filed as part of the evidence in a case involving the interpretation of the tax treaty between Canada and the tax official's country. [74] Canada has also allowed the other Contracting State (the United States) to intervene before the court and present arguments in a case involving the Canada-US Income Tax Convention. [75]

The question of how far a court should look for relevant foreign decisions was squarely faced by the Federal Court in Australia in a 1997 case involving the Australia-Netherlands Treaty. [76] In the reasons for judgment, the court expressed the view that not only would decisions of the Dutch *Hoge Road* dealing with the Australia-Netherlands Treaty be relevant, but also decisions of "an appropriate Dutch court" interpreting any treaty with identical or similar language would be relevant, reversing the view of the judge who heard the case at first instance. [77] In *The Queen v Crown Forest Industries Limited*, [78] the Supreme Court of Canada referred to decisions of the Supreme Court of the United States to show that, as in Canada where a treaty is to be given a liberal interpretation, the same principles of interpretation of treaty interpretation are applied in the United States. The court also referred to the Australian High Court decision in *Thiel v FC of T*, [79] a decision relating to the Australia-Switzerland Treaty.

In the *Gladden Estate* case, [80] the Canadian Federal Court referred to two US cases in interpreting the 1942 Canada-US Treaty as supporting the principle that a tax convention, unlike a taxing statute, should have a liberal interpretation "in the interests of the comity of nations" thereby seeking to apply common interpretive techniques. The Tax Court of Canada also referred to - but did not seem to accept or reject a US decision, *Consolidated Premium Iron Ores Ltd. v CIR* [81] - in a case under the Canada-US Treaty involving the question whether a Canadian corporation had a permanent establishment in the United States for tax treaty purposes. [82] The Tax Court of Canada also has referred to a US Tax Court case [83] in dealing with the residence tie-breaker rules in the Canada-Korea Treaty. [84]

The *BFH* in Germany, in dealing with the US-Germany Treaty, refused to give weight to a US Court of Claims decision [85] as it was of the view that the case was insufficient to provide evidence of the treaty practices of the United States. A *BFH* decision under the Germany-Switzerland Treaty noted and followed a decision of the Swiss Federal Court [86] concerning the definition of "frontier workers". [87] The *BFH* also followed a Swiss case [88] in a case decided under the 1935 Germany-Sweden Treaty for Administrative and Legal Assistance for the Enforcement of Tax Claims. [89] These two last-mentioned *BFH* decisions probably illustrate the propensity of courts to look to foreign court decisions in the same language.

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70 *FC of T v Lamesa Holdings B.V.* (1997) 36 ATR 589. See also the reasons for judgment of Dawson J. in *Thiel v FC of T* (1990) ATR 531 (H.C.).

71 *The Queen v Crown Forest Industries Ltd.*, note 6.

72 *MNR v Dudney* 2000 DTC 6169. See also, *MNR v Cudd Pressure Control Inc.* 98 DTC 6630.

73 Although the Tax Court of Canada has not been consistent, in the most recent decision, it also confined itself to existing commentaries: *MIL (Investments) SA v The Queen* 2006 DTC 3307.

74 *Hunter Douglas Ltd. v The Queen* 79 DTC 5340 at p. 5344.

75 *The Queen v Crown Forest Industries Ltd.*, note 6.

76 *FC of T v Lamesa Holdings BV* (1997) 36 ATR 589.

77 The Federal Court Trial Division of Canada in *MCA Television Limited v The Queen* 94 DTC 6375 refused to consider excerpts from a report of the US Department of State and a report of the Senate Foreign Relations Committee concerning a Protocol amendment to the Canada-US Treaty, not because in principle the court would not look at such material, but rather on the basis that the material was not helpful to the point being argued.

78 Note 6.

79 90 ATC 4717 at 4722.

80 *Gladden Estate v The Queen* 85 DTC 5188 (FC TO).

81 Reported in Canada at 57 DTC 1146.

82 *Fiebert v MNR* 86 DTC 1017.

83 *Podd v Commissioner* (1998) 1 ITLR 539.

84 *Yoon v The Queen* 2005 DTC 1109.

85 *Great West Life Assurance Company v US, Court of Claims No. 114-79T.*

86 55 SA 5585; 1986/87.

87 *BFH* decision, 16 March 1994; 1(b) 186/93.

88 *Bundesgericht*, 23 December 1970.

89 *BFH* 20 February 1979; vii 16/78.

In Luxembourg, the *Tribunal Administratif*, upheld on appeal by the *Cour Administratif*,<sup>[90]</sup> declined to follow two decisions of the French *Conseil d'Etat*<sup>[91]</sup> in a case under the Luxembourg-France Treaty of 1958. The *Conseil d'Etat* decisions had held that rents from immovable property could be taxed as industrial and commercial profits under tax treaties. The Luxembourg Court declined to follow the French decisions with the result that the Luxembourg company was not taxed at all.

In an impressive tour de force, the Supreme Court of India, in dealing with the question that arose under the India-Mauritius Treaty whether anti-abuse rules should be applied to Mauritius conduit corporations and holding that they should not, referred to a host of foreign court decisions from Australia, Canada, the United States and the United Kingdom<sup>[92]</sup> (all English language cases), many of which were not tax treaty cases and many were distinguished or not followed.<sup>[93]</sup> The court also discussed the different possible views of appropriate tax treaty policies that could lead to different interpretations. Of the cases noted, the *Johansson* case was said to be "easily distinguishable" because under the US-Switzerland Treaty, the United States was authorized to apply its own definition of undefined terms and held that the appellant's claim to residence in Switzerland was not concluded by the mere conclusion of the Swiss tax authorities. The Canadian *Gladden Estate* case was cited for the proposition that tax treaties should have a liberal interpretation contrary to ordinary taxing statutes, with a view to implementing the true intentions of the parties. The Australian *Lamesa* case was quoted for the proposition that even though the item of income might not be subject to tax in the country of residence, "that of itself cannot effect the interpretation of the tax treaty. The *Chong* case was cited for a similar holding by the Federal Court of Australia. The *Hausmann* case was cited as a Canadian judgment that threw light on the principle that the benefits of a tax treaty would be available even if the other Contracting State in which the "particular head of income is to be taxed" chooses not to impose tax on it. The UK *F.G. Films* case was said to be "pressed into service as an example of the mask of corporate entity being lifted and account being taken of what lies behind in order to prevent 'fraud'".

The Supreme Court in its decision said that that case only emphasizes the doctrine of piercing the veil of incorporation and that there is no doubt where necessary, the courts are empowered to lift the veil when applying domestic law. The UK cases of *Fischer's Executors* and *the Duke of Westminster* were cited for the proposition that taxpayers are entitled to arrange their affairs in such manner as not to attract taxes or to lower taxes that would otherwise be payable. The *McDowall* case had been cited by counsel for the proposition that *Fischer's Executors* and *the Duke of Westminster* have been "exorcised in the country of their origin" as evidenced by the *Ramsey* case, the *Burmah Oil* case and *Furniss v Dawson*.

The Supreme Court, however, did not agree that *the Duke of Westminster* case had been exorcised but rather "continues to be alive and kicking in England" and for that purpose referred to the *Westmoreland* decision. The US *Gregory v Helvering*, *Helvering v St. Louis Trust* and the *Perry R. Bas* cases were cited as authority for the proposition that the motive of tax avoidance is irrelevant in considering the legal efficacy of a particular transaction. The *Barber-Green* case was cited for the proposition that a corporation will not be denied tax benefits merely because it was purposely created to obtain those benefits. The *Snook* case was cited for the proposition that a sham properly understood means acts done or documents executed which are intended by the parties to give third parties and the court the appearance of creating legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create.

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<sup>90</sup> Decision 3 December 2001, Case No. 12831 upheld 23 April 2002, No. 14442C.

<sup>91</sup> Decision dated 22 May 1992, No. 63266, RFJ 7/92, No. 960 and Decision dated 18 March 1994, No. 79971, 8th and 9th subsections, RFJ 5/94, No. 530.

<sup>92</sup> *Barber-Green Americas Inc. v CIR* 35 TC 365 (1996); *Commissioner of Taxation v Lamesa Holdings B.V.* (1997) 77 F.C.R. 597; *Cox and Kings Ltd.* [2002] All E.R. (D) 433; *Craven v White* [1988] S.T.C. 476; 1989 A.C. 398; *Estate of Michelle Hausmann v The Queen* [1998] 4 C.T.C. 2232; *F.G. Films Ltd.* [1953] 1 All E.R. 615; *Furniss v Dawson* [1984] S.T.C. 153; [1984] A.C. 474; *Gregory v Helvering* 293 U.S. 465 (1935); *Helvering v St. Louis Trust Company* 296 U.S. 48; *I.R.C. v Burmah Oil Co. Ltd.* [1982] S.T.C. 30; *I.R.C. v Challenge Corp. Ltd.* [1986] S.T.C. 548; [1987] A.C. 155; *I. R.C. v Duke of Westminster* [1936] A.C. 1; *I.R.C. v Fischer's Executors* [1926] A.C. 395; *Gladden Estate v The Queen* 85 D.T.C. 5188; *Johansson v U.S.* 336 F. 2d 809 (1964); *MacNiven v Westmoreland Investments Ltd.* [2003] 1 A.C. 311; *Perry R. Bas v C.I.R.* U.S. 50 T.C. 595 (1968); *Ramsey (W.T.) Ltd. v I.R.C.* [1982] A.C. 300; *Russell v Scott* [1948] A.C. 422; *Snook v London and West Riding Investments Ltd.* [1967] 2 Q.B. 786; *Stoneleigh Finance Ltd. v Phillips* [1965] 1 All E.R. 513; *Yorkshire Railway Wagon Co. v Maclure* (1882) 21 Ch. D. 309.

<sup>93</sup> *Azadi Bacho Andolan v Union of India* (2003) 6 I.T.L.R. 233.

In the UK, the court found a decision <sup>[94]</sup> of the US Court of Claims of no real assistance. <sup>[95]</sup> In another UK case under the UK-Germany Treaty, the Chancery Division <sup>[96]</sup> referred to a decision of the Bundesfinanzhof <sup>[97]</sup> in dealing with a German silent partnership under a different tax treaty. The Chancery Division was cautious about relying on this decision stating:

The decision of the *Bundesfinanzhof* case and the views of Professor Vogel are of some help but they cannot by themselves be determinant. They do, however, reflect what must, to my mind, be decisive, that the purposive argument for construing the Convention in as symmetrical a way as possible, unless the language is clearly against such a construction. The perfect symmetry (or meshing together) may be an unattainable ideal, so long as domestic tax systems vary so much, but that is not to my mind a reason for rejecting as much symmetry as can reasonably be achieved....

In the Court of Appeal, <sup>[98]</sup> the *Bundesfinanzhof* decision was rejected by Peter Gibson, L.J. for the following reasons:

The judge [in the court below] found of some help a decision of the *Bundesfinanzhof* (1982) BFH 22 HFR 301. That included the comment: "What was meant by dividends was explained at other places in the Treaty (for dividends in Article 10(6) DTT). It is true that income from the holding as a sleeping partner was not explicitly mentioned in Art 28(1) DTT; but it fell within the provision of the concept of dividend contained in Article 10(6) DTT, whereby the expression 'dividends' comprised not only income from shares and limited companies, but continued typically to encompass holdings in a trade as a sleeping partner within the meaning of German law." That was a decision on a differently worded article in a different context in a different double taxation convention (between Germany and Switzerland) and it is open to question how much assistance can be obtained from other conventions, the more so when they are conventions to which the UK is not a party... <sup>[99]</sup>

Recently, Her Majesty's Revenue and Customs ("HMRC") in the UK issued a draft guidance concerning the application of the Court of Appeal decision in *Indofood International Finance Ltd. v. JP Morgan Chase Bank NA* <sup>[100]</sup> stating (in para. 9) that the decision, as far as it relates to tax treaties "is now part of UK law". HMRC also stated that it is "obliged to follow" this decision. *Indofood*, however, involved the question which had to be determined by English courts as to the decision that would be given by an Indonesian Court under the Netherlands-Indonesia Treaty concluded in 2002 and brought into force in 2005 in respect of a similar question considered by the Indian Supreme Court in the *Andolan* case. <sup>[101]</sup>

In coming to a conclusion opposite to that which had been arrived at by the Indian court, the Court of Appeal noted that the Indonesian internal law contained substance-over-form rules and the court relied heavily upon the 2003 OECD anti-abuse Commentary on Art. 1 and the views of Professor Baker also formulated in part based on that commentary which arguably had more relevance to the recently brought into force treaty than to earlier treaties.

It is interesting to speculate as to whether or not HMRC got it right. One of the concurring decisions in the UK Court of Appeal in *Indofood* was that of Peter Gibson L.J. who in the *Memec* case <sup>[102]</sup> had found

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<sup>94</sup> *Great West Life Assurance Co. v U.S.* 49 AFTR 2d 1386 (1982).

<sup>95</sup> *IRC v Commerzbank AG* [1990] STC 285.

<sup>96</sup> *Memec plc v IRC* [1996] STC 1316.

<sup>97</sup> (1982) BFH 22 HFR 301.

<sup>98</sup> (1998) 1 I.T.L.R. 3.

<sup>99</sup> The Finnish Supreme Administrative Court in *Re A. Oyj Abp* (2002) 4 ITLR 1009 has also found that a reference to a decision of a French court in *Re SA Remy-Cointreau* (1999) 1 ITLR 833 dealing with a similar treaty issue that was made by the taxpayer in argument could not be accepted as the court said that "directly relevant guidance on the case at hand cannot be derived from judgements of courts of other countries."

<sup>100</sup> [2006] STC 1195.

<sup>101</sup> Note 93.

<sup>102</sup> Note 98.

a decision of the German *Bundesfinanzhof* not to be of any help as it was "a decision on a differently worded article in a different context in a different double taxation convention ... and it is open to question how much assistance can be obtained from other conventions, the more so when they are conventions to which the UK is not a party ...." [103]

There are also a number of decisions in the United States. As has already been mentioned, the US Court of Appeals for the 9th District, in deciding a case under the 1942 Canada-US Treaty, referred to and adopted the reasoning in a Canadian Tax Appeal Board decision, [104] which in turn had relied on a US Tax Court decision [105] indicating a consistent interpretation of the Treaty in both countries. [106] The US Court of Appeals for the District of Columbia Circuit also referred to the same Tax Court decision [107] for the proposition that Canadian authorities have a similar interpretation of the Canada-US Treaty. The US Tax Court in dealing with an interpretation of the 1942 Canada-US Treaty referred to a Canadian Supreme Court decision [108] and additional Canadian cases [109] in considering the claim of a taxpayer to be exempt from US tax on salary earned while in Canada "on a temporary visit" within the meaning of the Treaty. [110] The US Court of Appeals for the 9th District, [111] in dealing with the Switzerland-US Treaty and the exchange of information provision, looked to the definition of "a business secret" in the decision of the Swiss court, [112] although this was not actually a tax treaty case in Switzerland.

In another case in the US Tax Court dealing with the US-Japan Treaty, [113] the court looked at a German court decision affirmed by the *Bundesfinanzhof* [114] in respect of the Germany-Netherlands Treaty. In dealing with the case, the Tax Court said:

While the result reached in the German case is consistent with that which we reach herein, we think that its utility herein is limited to the clearly distinguishable facts.

## 7.7. Summary and conclusions

There is substantial - but certainly not universal - scepticism, reluctance and sometimes opposition by courts of various countries to the relevance of OECD Commentaries published after the conclusion of the negotiations of a particular tax treaty in interpreting and applying that treaty. This is particularly the case in respect of those parts of the Commentaries that can be viewed as attempts to alter or change, to fill gaps in, or to reverse the meaning of the Model Convention and therefore indirectly of tax treaties negotiated based upon the OECD Model. A survey of those cases where courts have looked to foreign court decisions for help or guidance in dealing with tax treaty questions shows that courts have not always been as careful in excluding the effect of subsequent Commentaries as they have been when faced directly with the issue of their relevance. Therefore, there are cases where foreign court decisions have been quoted, referred to or even treated as helpful where there has been no apparent analysis of the question of whether and to what extent the foreign court decision might have been affected by a later Commentary that would not have been directly applied by the particular court in dealing with the tax treaty in issue.

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[103] Also, in the UK in *NEC Semi-Conductors et al. v IRC* [2004] STC 489, a decision involving the UK-Japan Treaty and the US-Switzerland Treaty, the judge at first instance commented on the helpful references made by counsel in argument to decisions of courts at the highest levels in the Netherlands and Sweden and a case pending in the *Conseil d'Etat* in France in dealing with the non-discrimination provisions. On appeal, however, [2006] S.T.C. 606, the court did not refer to any foreign court decisions but nonetheless agreed with the judge at first instance.

[104] *No. 630 v MNR* (1959) 59 DTC 300.

[105] *W.C. Johnston v CIR* (1955) 24 T.C. 920.

[106] *Donroy Ltd. v U.S.* (1962) 301 F. 2d 200.

[107] *No. 630 v MNR*, note 103.

[108] *MNR v Steckel* 74 DTC 6268.

[109] *The Queen v Hunt* 77 DTC 5404; *Wyatt v MNR* 75 DTC 72; *Shihadeh v MNR* 75 DTC 74; *The Queen v Reeder* 75 DTC 5160; and also a contrary decision, *Erickson v MNR* 80 DTC 1118.

[110] *Riley v U.S.* 74 TC 414.

[111] *United States v Vetco Inc. et al.* 691 F. 2d 1281 (1981).

[112] *Swiss Federal Attorney v A 98 BGE IV 209* (September 7, 1972).

[113] *The Taisei Fire and Marine Insurance Co. Ltd. v Commissioner* 104 TC 535 (1995).

[114] German Tax Court at Bremen, FG 14/73, 10 EFG 467049 (1973), affirmed IR 152/ 73, BStBl II (24) 626-629 (1975).

Where a court refers to decisions of courts of the treaty partner state interpreting or applying the same treaty, differences in the Commentaries are less likely to arise, but if the treaty partner's court has applied later OECD Commentaries in interpreting and applying the tax treaty and the particular court of the other State would not have applied such later Commentaries, again the issue of the relevance of later Commentaries is squarely raised although very seldom considered.

The survey has also shown that it is much more likely that courts will refer to foreign court decisions where the decisions are rendered in the same language. There is less evidence that the weight that may be given to a foreign court decision may in large part depend upon the judicial style of writing of the foreign jurist, the binding effect of the decision in a foreign country and, of course the display, if any, of the judicial reasoning supporting the decision of the foreign court. This however may be because of the reticence of judges to be critical of their brothers in other countries.

The general rule of interpretation in the Vienna Convention requires emphasis to be placed upon the text of the tax treaty as the primary basis for its interpretation. Where the text may be ambiguous or obscure, what was said in the OECD Commentaries current when the treaty was concluded (which forms part of the legal context of the particular treaty) is an important tool to inform the interpretation of the treaty provision based upon the presumed common understanding of the two treaty partners. Later Commentaries cannot perform this function but, because they are formulated by tax treaty experts, albeit representing tax collectors on the OECD Committee of Fiscal Affairs, they can, with care, be used in a way similar to the use of opinions by authors, including academics. However, like the opinions of authors and academics, where the opinions and commentaries are not fair interpretations of tax treaties, where they fill gaps in the Model and in the tax treaties, or where they depart from the text of the tax treaty or reverse the meaning that can be presumed to have been understood by reference to the Commentaries current when the treaty was concluded, those Commentaries and opinions by authors and academics should probably be given a lesser interpretive weight, if any.

The task, of the court - in using foreign court decisions in the tax treaty interpretive process - should include a winnowing out of the effects of these later commentary changes in selecting and giving weight to the decisions of foreign courts.

## Chapter 8 – Court decisions and the Commentary to the OECD Model Convention

### 8.1. Introduction

This chapter addresses the relationship between court decisions and the Commentary included in the OECD Model Convention. That relationship has two aspects:

- the influence that the OECD Commentary has on court decisions;
- the influence of court decisions on the development of the Commentary.

### 8.2. Influence of the OECD Commentary on court decisions

Any discussion of the influence of the OECD Commentary on court decisions dealing with the interpretation of tax treaties must address two different questions: whether and on what basis national courts *should* refer to the OECD Commentary and whether and on what basis national courts *do* refer to the Commentary.

On the first question, a useful starting point is the view of one of the original drafters of the OECD Commentary, Prof. Jan van den Tempel. As the Chairman of the Fiscal Committee of the OEEC [and, after 1961, of the OECD], Prof. van den Temple participated actively in the work leading to the 1963 OECD Draft Convention. In a 1967 article, he expressed the following view:

"[It] is to be expected that the interpretation by national administrations *or by national judges* of provisions in bilateral treaties which have been taken from the OECD draft, will be influenced by the commentary, because it can be assumed that the parties to a treaty, which follow OECD text, have understood that text according to the meaning expressed in the commentary, which they have also adopted in the drafting of the OECD text. Such interpretation will contribute to the development of a body of international concepts and rules independent from national law" <sup>[2]</sup> [emphasis added]

This accurate prediction shows that the drafters of the Commentary considered that the use of the Commentary by courts as an interpretative tool would be both logical and desirable.

The reason that the 1963 OECD Draft Convention was presented as a "draft convention", and not as the "model convention" that it became in 1977, was that the OEEC Fiscal Committee initially considered that the development of model provisions would be a step in the direction of a multilateral convention. As explained in the first report of the Fiscal Committee:

"14. The task entrusted to the Committee is necessarily a long-term work and concrete results can only be obtained gradually. On various questions, final agreement depends on the solutions to be adopted for connected problems. The Fiscal Committee proposes to establish a series of articles which, taken together, will finally cover all the problems which the bilateral double taxation Conventions are designed to solve and will thus constitute a Model Bilateral Convention acceptable to all Member countries. It would then be possible to envisage going further towards harmonisation by replacing the existing bilateral Conventions between the Member countries of the O.E.E.C. by a

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<sup>2</sup> A.J. van den Tempel, *Relief from Double Taxation*, Amsterdam: IBFD, 1967.

single Multilateral Convention. It is naturally impossible, at this stage, to foresee how long it will take to implement such a Convention.

15. In the Committee's opinion, a Multilateral Convention would not prevent Member countries which felt a need for more detailed provisions, owing to the existence of particular conditions, from implementing them in the form of protocols, for example. [...]

16. The Fiscal Committee wishes to recall here that the International Chamber of Commerce, at its 15th Congress in Tokyo in May 1955, adopted a Resolution inviting the O.E.E.C. to undertake an investigation of the possibility of concluding, between the Member countries, a Multilateral Convention which would have the great advantage of securing uniformity of principles and practice in double taxation matters in a vast area of world trade." [3]

It is quite common to have a commentary on a multilateral convention and this probably explains why the O.E.E.C. felt it necessary to include a detailed commentary on the provisions that it put forward in 1958. There is no doubt that a commentary prepared when drafting a multilateral convention is extremely relevant to its interpretation. For that reason, it was only natural for the drafters of the 1963 Draft Convention to conclude that the commentary that they prepared when drafting model provisions to be included in bilateral treaties would be equally relevant to the interpretation of these bilateral treaties.

While the ultimate step of a multilateral convention proved elusive, there is no doubt that the work of the drafters of the OECD Draft Convention has been very useful. The OECD, the IBFD and the UN have made rough estimates of the number of treaties that are currently in force and these estimates suggest that there are now around 2,550 bilateral tax treaties. The fact that these treaties are almost always based on the OECD Model Convention shows the great influence that the OECD Model (and the UN Model, which is derived from it [4]) has had on the development of the network of tax treaties. Similarly, the influence of the Commentary on what van den Temple described as "the development of a body of international concepts and rules independent from national law" has been very important.

Many commentators have discussed the legal basis on which it can be concluded that the Commentary of the OECD Model Tax Convention is relevant in interpreting bilateral treaty provisions. [5] Without going into the details of the various positions, most if not all the commentators basically agree that the Commentary may be used as a tool for the interpretation of bilateral provisions, even if no general agreement on the appropriate legal basis under which this can be done and therefore, on the weight to be given to the Commentary. These issues are dealt with exhaustively in a recent book on tax treaty interpretation by David Ward and the International Tax Group that puts the emphasis on the role of the Commentary to the OECD Model Convention. [6]

David Ward also published a recent article on the same topic. [7] Comments on that article have been published by Prof. Frank Engelen [8] and Prof. Maarten Ellis. [9] These three articles discuss the role of the Commentary in the interpretation of tax treaties, focussing primarily on a very interesting argument that

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3 *The Elimination of Double Taxation*, Report of the Fiscal Committee of the O.E.E.C., Paris, 1958.

4 This is explicitly acknowledged in paras 8 and 37 of the Introduction to the *United Nations Model Double Taxation Convention between Developed and Developing Countries*, New York, 2001.

5 Ex multis H.J. Ault, "The role of the OECD commentaries in the interpretation of tax treaties", in *Interfax*, 1994, issue 4, p. 144; K. Vogel and R. Prokisch, "General Report", in International Fiscal Association, *Cahiers de droit fiscal international*, Interpretation of double taxation conventions, vol. LXXVIIa, Deventer, The Netherlands: Kluwer, 1993, pp. 55-85; K. van Raad, "Interpretation and Application of Tax Treaties by Tax Courts", 36 *European Taxation* 1 (1996), p. 4; M. Lang, "Later Commentaries of the OECD Committee on Fiscal Affairs not to Affect the Interpretation of Previously Concluded Tax Treaties", 25 *Intertax* 1 (1997) p. 7; K. Vogel, "The influence of the OECD Commentaries on Treaty Interpretation", 54 *Bulletin for International Fiscal Documentation* 12 (2000) p. 614; M. Lang, "Die Bedeutung des Musterabkommens und des Kommentars des OECD-Steuerausschusses für die Auslegung von Doppelbesteuerungsabkommen", in AAVV: *Aktuelle Entwicklungen im Internationalen Steuerrecht*, Wien, 1994; Michael Edwardes-Ker, *Tax Treaty Interpretation*, Dublin: In-Depth Publishing, 1995 (looseleaf); Korn/Debatin, *Doppelbesteuerung. Kommentar* (looseleaf), München: Systematik m.nos. 131-135, 1981; Jean-Marc Rivier, *Droit Fiscal Suisse, Le Droit Fiscal International*, Neuchatel 1983, p. 101; E.B. Switzer, "Exchange of Information Articles", 26 *Canadian Tax Journal* 306 (1978) p. 313.

6 D. Ward et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model Convention*, Amsterdam: IBFD Publications BV, 2005.

7 D. Ward, "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process", 60 *Bulletin for Fiscal Documentation* 3 (2006) p. 97.

8 F. Engelen, "Some Observations on the Legal Status of the Commentaries on the OECD Model", 60 *Bulletin for Fiscal Documentation* 3 (2006) p. 205.

9 M. Ellis, "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process - Response to David Ward", 60 *Bulletin for Fiscal Documentation* 3 (2006) p. 103.

has been brought forward for the first time by Prof. Frank Engelen <sup>[10]</sup> and according to which there might be, under certain circumstances, a possibility to consider that the Commentary is a binding instrument as a consequence of the international public law concepts of estoppel and acquiescence. <sup>[11]</sup>

The theory put forward by Prof. Engelen is interesting and may eventually be presented to a court. Without commenting on its merits, I would suggest that OECD member countries would probably be surprised to hear that the Commentary could constitute a binding statement as regards the interpretation of their treaties. The analysis of the wording used in the Recommendation adopted by the OECD Council with respect to the OECD Model Convention <sup>[12]</sup> shows that while the OECD recommended to the Governments of the OECD Member countries "that their tax administrations follow the Commentaries on the Articles of the Model Tax Convention, as modified from time to time, when applying and interpreting the provisions of their bilateral conventions that are based on these Articles", there did not seem to be an expectation that these countries would be bound by the Commentaries. The Recommendation was drafted very carefully to be directed at tax administrations and does not refer to national courts.

I believe that Prof. Engelen's argument could, however, be right if one could otherwise establish that Member countries has acquiesced to the OECD Commentary. Austria's practice of asking its treaty partners to confirm that the treaty will be interpreted in accordance with the OECD Commentary could constitute such evidence. <sup>[13]</sup>

Regardless of the legal arguments, however, I would suggest that it would be very risky for the tax administration of an OECD Member country to challenge in court the position of a taxpayer who would be relying on a clear statement included in the Commentary, unless that country had made an observation on the relevant part of the Commentary. In such a case, I would expect that the national court would take the position that the taxpayer is entitled to rely on an interpretation that the ambassador of the relevant country has approved at the OECD Council and that - as a consequence of the Recommendation of the OECD Council - should be followed by the tax administration.

This leads me to the issue of the relative weight to be given to the part of the Commentary that existed at the time of the signature of a particular treaty and to the part of the Commentary that is subsequent to that signature. As a starting point, I would refer to the conclusion that emerged from the discussion of that issue at the OECD-IFA seminar that took place during the 2001 IFA Congress in San Francisco <sup>[14]</sup>: for me, that conclusion was that recourse to a subsequent Commentary would always be possible but that the right question was how much weight should be given to such subsequent Commentary.

As already mentioned, there are various legal arguments that may be used to support the use of the Commentary as a tool for the interpretation of the provisions of a bilateral treaty <sup>[15]</sup>:

- ordinary meaning under Article 31.1 Vienna Convention on the Law of Treaties;
- special meaning under Article 31.4 Vienna Convention on the Law of Treaties;
- part of the context of the treaty;
- an instrument related to the treaty under Article 31 (2) (b) VCLT;

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<sup>10</sup> Such possibility has been envisaged for the first time by F. Engelen, *Interpretation of Tax Treaties under International Law*, Amsterdam: IBFD Publications BV, 2004, p. 463.

<sup>11</sup> On the concepts of estoppel by acquiescence in public international law cfr. I. Sinclair, "Estoppel and Acquiescence", in V. Lowe and M. Fitzmaurice, *Fifty years of the International Court of Justice - Essays in honour of Sir Robert Jennings*, Cambridge: Cambridge University Press, 1996, p. 104.

<sup>12</sup> Recommendation C(97)195/Final adopted by the OECD Council on 23 October 1997 (the text of that recommendation is reproduced at the end of the condensed version of the OECD Model Tax Convention).

<sup>13</sup> See, for instance, the memorandum of understanding to the 1996 Austria-US tax convention, according to which "It is understood that provisions of the Treaty that are drafted according to the corresponding provisions of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital shall generally be expected to have the same meaning as expressed in the OECD Commentary thereon. The understanding in the preceding sentence will not apply with respect to the following [...]".

<sup>14</sup> Seminar B of the 2001 IFA Congress: *The OECD Model Convention - 2001 and beyond*. Chair: John F. Avery Jones; Panelists: Michael Lang (Austria), Philippe Martin (France), Jacques Sasseville (OECD), Richard J. Vann (Australia), Mike Waters (UK). The proceedings are available on the IFA website [www.ifa.nl](http://www.ifa.nl).

<sup>15</sup> These various arguments have been put forward in some of the articles referred to in [notes 5 and 6](#).

- supplementary means of interpretation Article 32 VCLT;
- international consensus expressed in the OECD Recommendation;
- OECD recommendation would constitute a legal duty to interpret tax treaties according to the Commentary;
- public international law: estoppel, acquiescence and reasonable expectations which may justify not only looking at the Commentary but giving it a mandatory character.

In 1995, the OECD carried out some work on this issue. The conclusion reached was that in the large majority of OECD Member countries, courts would be expected to pay attention to the Commentary in interpreting provisions based on the OECD Model Tax Convention.

I personally have a lot of sympathy for the argument, which was initially put forward by Prof. Hugh Ault in an article published in 1994, <sup>[16]</sup> according to which the Commentary could be said to provide a "special meaning" of treaty terms for purposes of the rule found in Article 31.4 VCLT. Because of the influence of the OECD Model Tax Convention, the wording of tax treaties is fairly uniform and is also, for many countries, quite different from that of domestic laws. The style of drafting is also entirely different.

The reality is that the OECD Model is always used or referred to during tax treaty negotiations (directly or through the UN Model). Confirmation of this - if confirmation is needed - may be found in the US Technical Explanations, which mention expressly the relevance of the OECD Model in the negotiation process. For instance, the Technical Explanations to the US-Australia tax treaty signed in 1982 affirm openly that the treaty was negotiated on the basis of the OECD Model. <sup>[17]</sup> When treaty negotiators simply adopt the wording of the provisions of the OECD Model, one could reasonably expect them to intend that this wording be given the meaning that has according to the Commentary.

One possible difficulty however, is that Art. 31.4 VCLT makes reference to a special meaning given to a "term". To what extent can one consider that a whole provision of a treaty is a "term" for purposes of Art. 31.4 VCLT? I would suggest that this issue should be addressed pragmatically and that the word "term" should not be restricted to a single word.

I do not believe that courts agonize as to whether the Commentary becomes relevant by virtue of Art. 31.2, Art. 31.4 or Art. 32 VCLT. As David Ward has suggested, the answer might even lie outside these provisions since the Vienna Convention on the Law of Treaties is not intended to be exhaustive as to what may be used as an aid to the interpretation of a bilateral treaty.

Overall, the Commentary is and should be an important source of tax treaty interpretation for courts. I think that the statement laid down in a decision dated 17 January 2006 of the Administrative Court of Appeal of Luxembourg (case 20316/C) accurately describes the relevance of the Commentary:

[Translation]"...the fact remains that the provisions of a double taxation treaty copied from the OECD Model Convention should be applied in light of the relevant official comments made by OECD bodies since the main purpose of the said Model is to enable the problems which arise most commonly in the field of international juridical double taxation to be resolved in a uniform fashion".

The OECD has itself commented on the use of the Commentary by the courts. In paragraph 29.3 of the Introduction of the OECD Model, it is stated that:

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<sup>16</sup> H.J. Ault, "The role of the OECD commentaries in the interpretation of tax treaties", *Intertax* 4, (1994) p. 144.

<sup>17</sup> According to the Technical Explanations: "This Convention, signed at Sydney, Australia on August 6, 1982, was negotiated on the basis of the U.S. Model Convention [...] and the Model Double Taxation Convention on Income and Capital published by the Organization for Economic Cooperation and Development (OECD) in January 1977. The technical explanation is an official guide to the Convention. [...]". The Technical Explanations to more recent treaties concluded by the United States indicate that the negotiations "also took into account" the OECD Model.

Bilateral tax treaties are receiving more and more judicial attention as well. The courts are increasingly using the Commentaries in reaching their decisions. Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge's deliberations. The Committee expects this trend to continue as the world-wide network of tax treaties continues to grow and as the Commentaries gain even more widespread acceptance as an important interpretative reference.

This paragraph merely takes account of the fact that national courts are increasingly using the Commentary in reaching their decisions. I wish to stress, however, that for the OECD, national courts are not the prime audience at which the Commentary is directed. The statistics put forward in earlier chapters of this volume show that there are very few tax treaty disputes that reach the stage where a judge must decide on an interpretation of a treaty provision (this is particularly evident in countries such as the United Kingdom). The first role of the OECD Commentary is to prevent disputes from going to courts. There are many examples of interpretations that the OECD adopted and that were widely applied by tax administrations to their existing treaties: this is what happened in the case of the Commentary changes dealing with the tax treaty treatment of software payments, of various e-commerce payments, of employee stock-options etc. These interpretations are used by tax administrations to prevent and to solve disputes in those areas, including through the mutual agreement procedure.

The emergence of arbitration as a means to ensure that tax treaty disputes are solved consistently by the two countries involved is likely to increase reliance on the Commentary as an interpretation tool. Where the tax administrations of the two States that have concluded a tax treaty adopt conflicting interpretations of a treaty provision, the mutual agreement procedure, supplemented by an arbitration process to ensure that there are no unresolved issues, is inherently preferable to recourse to domestic tribunals. This is because the outcome of the mutual agreement procedure is binding on the tax administrations of both States and not only of one country.

The arbitration process <sup>[18]</sup> that has recently been endorsed by the OECD recognizes the role of the OECD Commentary as a guide to the interpretation of tax treaties. According to the mechanism suggested by the OECD for the implementation of arbitration:

14. Applicable Legal Principles. The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the treaty and, subject to these provisions, of those of the domestic laws of the Contracting States. Issues of treaty interpretation will be decided by the arbitrators in light of the principles of interpretation incorporated in Articles 31 to 34 of the *Vienna Convention on the Law of Treaties, having regard to the Commentaries of the OECD Model Tax Convention as periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction to the OECD Model Tax Convention...*[emphasis added]

A similar approach has been followed by the United States and Germany with respect to the arbitration provision included in Article 22 of the protocol that they concluded on 1 June 2006:

i) In making its determination, the arbitration board will apply, as necessary and in descending order of priority:

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<sup>18</sup> The OECD Committee on Fiscal Affairs has recently endorsed arbitration as a way to improve the mutual agreement procedure: see [www.oecd.org/document/40/0,2340,en\\_2649\\_37427\\_38057000\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/document/40/0,2340,en_2649_37427_38057000_1_1_1_37427,00.html)

- aa) the provisions of the Convention;
- bb) any agreed commentaries or explanations of the Contracting States concerning the Convention;
- cc) the laws of the Contracting States to the extent they are not inconsistent with each other; and
- dd) any OECD Commentary, Guidelines or Reports regarding relevant analogous portions of the OECD Model Tax Convention [emphasis added]

### 8.3. Influence of court decisions on OECD Commentary

There is no need to state before an Italian audience that decisions of national courts sometimes influence the drafting of the Commentary. Tax treaty specialists are aware that the decision rendered by the Italian Supreme Court (Corte di Cassazione) in the *Philip Morris* case <sup>[19]</sup> has triggered recent amendments to the Commentary on Article 5 (these were included in the 2005 update to the OECD Model Tax Convention).

This is not an isolated example. The drafting of the Commentary has long been influenced by interpretations put forward by courts. The following are two previous examples:

- Paragraph 10 of the Commentary on Article 5 affirms: "Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines". This clarification - added in the 1977 Model Double Tax Convention - finds its origin in a 1906 Swiss tax case on intercantonal allocation of profits; <sup>[20]</sup>
- Paragraph 11 of the Commentary on Article 3 stipulates the following: "However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly". This clarification finds its origin in a decision by the Canadian Supreme Court <sup>[21]</sup> which had to determine whether a domestic law change to the meaning of "interest" that was subsequent to the entry into force of a tax treaty could be taken into account for the purposes of a provision similar to paragraph 2 of Article 3 of the OECD Model Tax Convention.

These examples show that where important treaty interpretations are put forward by national courts, the OECD considers that it is its role to discuss them, and after discussion between representatives of a large number of countries, to determine whether these interpretations are correct with respect to the wording of the OECD Model Tax Convention. The aim of the changes to the Commentary that are then adopted is to reduce the risk of diverging interpretations between countries that would trigger cross-border disputes and risks of double taxation or non-taxation.

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<sup>19</sup> Decisions of the Tax Chamber of the Supreme Court of Italy: No. 3367 and No. 3368 of 20 December 2001 (released on 7 March 2002), No. 7682 of 20 December 2001 (released on 25 May 2002) and No. 10925 of 20 December 2001 (released on 25 July 2002). See 4 *International Tax Law Reports*, 2002, at 903. The decision has been commented by several scholars: P. Tognolo, "Philip Morris Case: The Position of the Italian Court of Cassation on PE Matters", *Tax Planning International Review* 6 (2002) p. 14; M. Gazzo, "Permanent Establishment through Related Corporations: New Case Law in Italy and its Impact on Multinational Flows", *Bulletin* 6 (2003) p. 257. The case has also been discussed at a seminar held on 27 August 2002 in the course of the 56th Congress of the International Fiscal Association ("IFA") in Oslo (a summary of the proceedings has been published by R. Goulder, "IFA Panelists Slam Italian High Court Ruling on Permanent Establishment", 27 *Tax Notes International* 10 (2002) p. 1152.

<sup>20</sup> Supreme Court judgment of 25 March 1906, BGE 29 I 8. As stated by X. Oberson, "Swiss National Report", in International Fiscal Association, *Cahiers de droit fiscal international*, Taxation of income derived from electronic commerce, vol. LXXXVIa, The Hague, London, Boston: Kluwer Law international, 2001, p. 695. In such decision, "...the Swiss Supreme Court ruled that vending machines (Automaten), which distributed goods against payment at the place of location, must be characterized as PEs of an enterprise whose registered office was in another canton".

<sup>21</sup> Supreme Court of Canada, *The Queen v. Melford Developments Inc.* (1982), 139 D.L.R. (3d) 577. For a comment to the decision see J.S. Hausman, "Interpreting Tax Treaties - A Canadian Perspective", *Bulletin for Fiscal Documentation* 3 (2001) p. 93.

## Chapter 9 – Austria

### 9.1. The nature of rules governing tax litigations

#### 9.1.1. Tax law procedures versus other kind of procedures

Since 1 January 2003 a new nationwide and independent administrative authority was set up in Austria. The Independent Tax Tribunal <sup>[2]</sup> superseded the *Finanzlandesdirektionen* (FLD). With this reform, an amplified equalization of the legal protection standard to those of the Independent Administrative Tribunal and the fiscal jurisdiction in other EU Member States was obtained. For the first time an appellate instance was established for tax law procedures with features similar to those of courts.

In Austria tax law cases are subject to an autonomous procedure. The rules are laid down in the Federal Fiscal Code (FFC). <sup>[3]</sup> The main principles in the procedure are the ex officio principle, the principle of free consideration of evidence, the principle of unrestricted evidence, the taxpayer's duty to cooperate and the right to be heard.

The period of time for an appeal is one month. <sup>[4]</sup> The appeal has to be filed with the tax authority that issued the assessment notice, which are usually the tax authorities. But the appeal can be filed as well with the authority of second instance responsible for the decision of the appeal, <sup>[5]</sup> which is the Independent Tax Tribunal. <sup>[6]</sup> According to Sec. 276 (1) FFC the authorities of first instance have the possibility to decide on the appeal. Since the tax procedures are mass-procedures, the assessment notices are not always issued error-free; therefore, the aim and purpose of this regulation is to give the tax authorities that issued the assessment notice the possibility to decide again and correct their own errors. However, the authority can, as well, reject the appeal. The decision of the authority of first instance can be appealed to the authorities of second instance within one month. <sup>[7]</sup> The authority of second instance - the Independent Tax Tribunal - is competent only for tax matters, crimes regarding fiscal offences and customs matters. The members of the Tribunal are independent and not bound by instructions. The organs of the Tribunal are Senates, which consist of four members: a president, one full-time member and two part-time members, who are delegated from compulsory professional associations, with an exception for the compulsory professional associations for legal advisers. <sup>[8]</sup> The vote of the president is decisive in cases of equal votes. The whole Senate decides only in exceptional cases and normally the referee decides in the name of the Senate. The president has to appoint the referee out of a maximum of seven full-time members who are assigned to the Senate or may, as well, appoint him/herself as referee. <sup>[9]</sup>

Oral proceedings are possible before the Independent Tax Tribunal. According to the prevailing opinion in legal literature, the Independent Tax Tribunal is a court according to Art. 234 EC Treaty <sup>[10]</sup> and Art. 6 (1) Human Rights Convention. <sup>[11]</sup> As it is not a court of last instance, in case of doubts it may refer the questions for preliminary ruling to the ECJ but is not obliged to do so. As the Independent Tax Tribunal is an authority of last instance, however, a complaint against a decision of the Independent Tax Tribunal can

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<sup>2</sup> *Unabhängiger Finanzsenat* (UVS).

<sup>3</sup> *Bundesabgabenordnung*.

<sup>4</sup> Sec. 245 (1) FFC.

<sup>5</sup> Sec. 249 (1) FFC.

<sup>6</sup> *Unabhängiger Finanzsenat* (UVS).

<sup>7</sup> Sec. 276 (2) FFC.

<sup>8</sup> Holoubek, "Der Unabhängige Finanzsenat im System oberster Kollegialbehörden", in Holoubek/Lang (ed.), *Das Verfahren vor dem Unabhängigen Finanzsenat*, Vienna: Linde Verlag, 2003, p. 15 (p. 17).

<sup>9</sup> Sec. 270 (5) FFC.

<sup>10</sup> Wegener, in Callies/Ruffert (ed.), *Kommentar zum EU-Vertrag und EG-Vertrag*, Luchterhand: Neuwied, 1999, m.no. 11 et seq; see Holoubek, "Vorlageberechtigung und Vorlageverpflichtung", in Holoubek/Lang (ed.) *Das EuGH-Verfahren in Steuersachen*, Vienna: Linde, 2000, p. 45 (pp. 56 et seq); Lang, "Die Bedeutung des Vorabentscheidungsverfahrens für das Abgabenverfahren", in Holoubek/Lang (ed.), *Das EuGH-Verfahren in Steuersachen*, Vienna: Linde, 2000, p. 99 (pp. 101 et seq).

<sup>11</sup> Frowein/Peukert, *EMRK-Kommentar*, 2nd ed., Engel: Kehl am Rhein, 1996, m.no. 56 et seq.

be filed to the Administrative or the Constitutional Supreme Courts within six weeks. The complaint has to be signed by a lawyer; in tax cases it can be signed as well by an auditor.

The Administrative Supreme Court may repeal the assessment notice upon request of the taxpayer based on unlawful content, infringement of fundamental process regulations or incompetence of the appellate authority. <sup>[12]</sup>

The Supreme Court, however, does not conduct a re-examination of the facts and circumstances. It is, in fact, bound by the investigations of the appellate authority and may only review the facts and circumstances if the authority caused an infringement of the fundamental process regulation. The Administrative Supreme Court may only quash the assessment notice but is not authorized to decide the case itself. Consequently, the appeal is again outstanding and the appellate authority - the Independent Tax Tribunal - has to re-decide the case, but this time it is bound by the legal opinion of the Administrative Supreme Court. The taxpayer is allowed to present new facts and circumstances and may request new evidence. As the Administrative Supreme Court is a court of last instance, it is obliged to ask the ECJ for preliminary rulings, according to Art. 234 EC Treaty, in the case of doubt on how the EC Treaty is to be interpreted.

Taxpayers may also at the same time file a complaint to the Constitutional Supreme Court if the assessment notice infringes their constitutional rights or unlawful regulations, unconstitutional law or unlawful treaties are applied. <sup>[13]</sup> The Constitutional Supreme Court has the right to quash the complaint if there is slight chance of success or the clarification of constitutional questions cannot be expected. Most of the complaints in the field of tax law are therefore quashed by the Constitutional Supreme Court. As it is a court of last instance, it is obliged to ask the ECJ for preliminary rulings, according to Art. 234 EC Treaty, in the case of doubt on how the EC Treaty is to be interpreted.

Furthermore, the taxpayer has two possibilities to speed up the procedure. If the authority of first instance does not decide within six months, taxpayers have the possibility to file a request in which they ask for the transfer of the competence to the authorities of second instance - the Independent Tax Tribunal. <sup>[14]</sup> The Independent Tax Tribunal assigns the authority of first instance to decide within three months. In the case of special circumstances the term can be prolonged. If the term has expired, the Independent Tax Tribunal must decide by itself. <sup>[15]</sup> If the Independent Tax Tribunal itself is competent and does not decide within six months, it is possible to file a complaint to the Administrative Supreme Court. <sup>[16]</sup> The Administrative Supreme Court assigns the Independent Tax Tribunal to decide within three months, which may be prolonged only once. If the term is expired, the Administrative Supreme Court has to decide by itself as the authority of second instance; meaning that in this case, the Administrative Supreme Court may as well be assigned to investigate into the facts and circumstances.

The Administrative Supreme Court is composed of full-time judges who are appointed by the federal president on the proposal of the federal government. A precondition for becoming a judge of the Administrative Supreme Court is that the prospective judge is a graduate from a university in law and has a minimum of ten years of practice.

A peculiarity of the Austrian tax law procedure is that the Independent Tax Tribunal is not identical to the administrative procedure and its tribunals. The decisive differentiating factor is in its autonomy. <sup>[17]</sup> In particular, the main crucial differences are the capability of the Ministry of Finance to influence the appointment of the members of the Independent Tax Tribunal and the absence of a fixed allocation of

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<sup>12</sup> Sec. 42 (2) VwGG.

<sup>13</sup> Art. 144 (1) B-VG.

<sup>14</sup> Sec. 311 (2) FFC *Devolutionsantrag*.

<sup>15</sup> Sec. 311 (4) FFC.

<sup>16</sup> Art. 132 B-VG in conjunction with Sec. 27 VwGG.

<sup>17</sup> See Graf, "Der UFS im Vergleich zu den UVS und zum UBAS am Beispiel des Kriteriums der Unabhängigkeit", in Holoubek/Lang (ed.), *Das Verfahren vor dem Unabhängigen Finanzsenat*, Vienna: Linde Verlag, 2003, p. 37 (p. 39).

duties. Nevertheless, the Independent Tax Tribunal does not flinch from establishing its own views on the interpretation of laws, which are occasionally contrary to decrees of the Ministry of Finance. <sup>[18]</sup>

Unfortunately, the written decisions of the Administrative Supreme Court are rather short and, from the perspective of the reader, the main reasoning for the decision is often missing. The decision indicates first which legal provisions are concerned in the judgment. Subsequently, the names of the judges who participated in the case, as well as the initial letter of the plaintiff and the name of the lawyer are mentioned. Furthermore, the tax and assessment years concerned are mentioned before the main part the judgment is provided. The facts and circumstances, as well as the arguments of the plaintiff and the authorities, are indicated in the main part of the decision, before the Court gives its reasoning. The judgment, as well as the decision as to the costs, is provided in the final part.

As will be described in more detail under 9.2.3. below, the Administrative Supreme Court refers in many of its decisions to Austrian literature. In almost all these cases, the Court refers to Austrian literature to emphasize its decisions but only seldom to foreign literature or to dissenting opinions in legal literature.

All of the decisions of the Administrative Supreme Court can be found in an online-databank and are free of charge. <sup>[19]</sup> The decisions of the Independent Tax Tribunal can be found on its website <sup>[20]</sup> or under the FINDOK <sup>[21]</sup> online search, and are also provided free of charge.

### 9.1.2. Burden of proof

The underlying principle in tax law procedures under the Austrian FFC is that the authorities have to identify the underlying facts and circumstances of the case at issue by virtue of office (*ex officio*). <sup>[22]</sup> The authorities may thereby request the taxpayer to cooperate. <sup>[23]</sup> The obligation *ex officio* and the cooperation are within a relationship of dependency. <sup>[24]</sup> Only if the facts and circumstances can be identified with the cooperation of the taxpayer is there a legal obligation for the taxpayer to cooperate. A requirement for the obligation to cooperate is that the possibilities of the authorities to investigate are limited. <sup>[25]</sup> Therefore, primarily, the authorities are only obliged to investigate to the extent it is reasonable.

<sup>[26]</sup> This principle consists as well under the administrative law procedure and is provided in Sec. 39 (2) General Administrative Procedure (hereinafter "GAP"). The authority shall proceed *ex officio*. The Administrative Supreme Court interpreted this provision in a similar manner than Sec. 115(1) FFC. <sup>[27]</sup>

The obligation of the taxpayer to cooperate is in practice often seen as burden of proof. In principle, the authorities have to bear the burden of proof <sup>[28]</sup> and, consequently, the authorities have to bear the risk of non-proved facts and circumstances. The general rule can be modified if taxpayers do not fulfil their obligation to cooperate. Consequently, non-cooperation leads to a shift of the burden of proof towards the taxpayer. The Administrative Supreme Court has argued that in cases in which the taxpayer allege facts and circumstances that are exceptional according to the overall picture of the economic reality, the burden of proof is shifted to the taxpayer. <sup>[29]</sup> It shall not be the obligation of the authorities to order an

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<sup>18</sup> See Lang, *Unabhängiger Finanzsenat an der kurzen Leine?*, *Die Presse*, 1 September 2006, Rubrik: Rechtspanorama.

<sup>19</sup> [www.ris.bka.gv.at/vwgh/](http://www.ris.bka.gv.at/vwgh/)

<sup>20</sup> [www.ufs.bmf.gv.at/](http://www.ufs.bmf.gv.at/)

<sup>21</sup> [www.findok.bmf.gv.at/findok/welcome.do](http://www.findok.bmf.gv.at/findok/welcome.do)

<sup>22</sup> Sec. 115(1) FFC.

<sup>23</sup> Sec. 119(1) FFC.

<sup>24</sup> See Schuch, *"Amtswezigkeit und Mitwirkungspflicht - innerstaatlich, europarechtlich und abkommensrechtliche Grenzen für Dokumentationspflicht im Konzern"*, in Tanzer (ed.), *Die BAO im 21. Jahrhundert - Festschrift für Gerold Stoll zum 80. Geburtstag*, Vienna: Orac, 2005, p. 113 (p. 117).

<sup>25</sup> Administrative Supreme Court 10 October 1996, 94/15/0093; 30 May 1995, 91/13/0076; Administrative Supreme Court 22 March 1995, 93/13/0076; Administrative Supreme Court 27 July 1994, 92/13/0140; Administrative Supreme Court 27 July 1994, 92/13/0140; Administrative Supreme Court 21 January 1993, 92/15/0002; Administrative Supreme Court 19 May 1992, 91/14/0089-0091; Administrative Supreme Court 22 January 1992, 90/13/0200.

<sup>26</sup> Administrative Supreme Court 30 May 1972, 1912/71; Administrative Supreme Court 30 October 1996, 95/13/0122; Administrative Supreme Court 15 December 1995, 92/17/0171; Administrative Supreme Court 30 May 1972, 1912/71; see Heinrich, *"Untersuchungsgrundsatz und Mitwirkungspflichten im Abgabenverfahren"*, in Holoubek/Lang (ed.), *Allgemeine Grundsätze des Verwaltungs- und Abgabenverfahrens*, Vienna: Linde Verlag, 2006, p. 145 (p. 149 et seq).

<sup>27</sup> See Wiederin, *"Untersuchungsgrundsatz und Mitwirkungspflichten im Verwaltungsverfahren"*, in Holoubek/Lang (ed.), *Allgemeine Grundsätze des Verwaltungs- und Abgabenverfahrens*, Vienna: Linde Verlag, 2006, p. 125 (p. 129).

<sup>28</sup> Administrative Supreme Court 23 January 1976, 824/75.

<sup>29</sup> Administrative Supreme Court 15 September 1988, 87/160165.

inquiry for facts that are not very likely to exist according to the underlying circumstances. [30] If the facts and circumstances cannot be identified completely, the authorities are obliged to estimate. [31]

### 9.1.3. Rules on evidence

Under tax law procedures everything that is adequate to determine the underlying facts and circumstances and that is appropriate according to the single case is of relevance as evidence. [32] The same principle is valid for administrative law procedures. [33] Therefore, in general, no limitations on evidence exist, as well as no ranking. The Federal Fiscal Code explicitly regulates instruments, witnesses, authorized experts and inspections of the authorities.

It is up to the free conviction of the authority to ascertain whether or not the facts and circumstances are proven. If no conviction of the authority can be ascertained, the more reliable evidence is valid. In tax law procedures a likelihood of slightly more than 50% is sufficient - in both directions. [34] In criminal proceedings for fiscal offences the situation is different because of the principle "*in dubio pro reo*". In these proceedings, facts and circumstances that are more in favour of the suspected person have to be assumed. [35]

### 9.1.4. Special rules applicable to international (tax) law cases

Regarding the obligation of the taxpayer to cooperate (described above for national law purposes under 9.1.2.), this obligation is different in a cross-border situation. If foreign facts and circumstances are involved, the weighting between the authorities and the taxpayer are shifted towards the taxpayer. In these cases the taxpayer has an advanced obligation to cooperate. [36] However, there is no explicit legal basis for the advanced obligation to cooperate. This principle was developed by the courts. [37] According to the Administrative Supreme Court, the taxpayer only has the obligation to cooperate if the facts and circumstances cannot be identified. [38] The dimension of the taxpayers' obligation is therefore dependent on the possibilities of the authorities. In cross-border situations these possibilities might be lower than in domestic situations. [39] But this has to be decided on a case-by-case basis. Particularly within the European Union, the Directives on Mutual Assistance for the Exchange of Information [40] and for the Recovery of Claims [41] provide for an adequate instrument. [42] The Administrative Supreme Court has not yet explicitly clarified its position. [43] In a case concerning a German letterbox company the Court once ruled that with German administrative assistance in force, consequently, the authorities can only in a very limited way be released from their obligation *ex officio*. [44] Only one, in a different case involving Liechtenstein, the Court repeated its line of reasoning. The Court concluded that since no administrative assistance in the exchange of information and the collection of taxes exists with Liechtenstein, the taxpayer has an advanced obligation to cooperate. From the court cases the conclusion can be drawn that a general advanced obligation to cooperate in cross-border situations has rather to be negated. [45]

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30 Administrative Supreme Court 22 June 1967, 153/65.

31 Sec. 184 FFC.

32 Sec. 166 FFC.

33 Sec. 45 (2) GAP.

34 Kotschnigg, "Praxisfragen aus dem Grenzbereich von Abgaben- und Finanzstrafverfahren", *SWK* 2002, p. 969 (p. 973).

35 Tanzer, "Der Grundsatz der freien Beweiswürdigung im Abgabenverfahren", in Holoubek/Lang (ed.), *Allgemeine Grundsätze des Verwaltungs- und Abgabenverfahrens*, Vienna: Linde Verlag, 2006, p. 385 (p. 399).

36 Administrative Supreme Court 25 May 1993, 93/14/0019; Administrative Supreme Court 21 November 1985, 85/16/0092; Administrative Supreme Court 6 March 1985, 84/13/0235; Administrative Supreme Court 17 September 1974, 1613/73.

37 See e.g. Administrative Supreme Court 29 May 2001, 96/14/0069; Administrative Supreme Court 12 September 2001, 2000/13/0031.

38 Administrative Supreme Court 16 September 1986, 86/14/0020.

39 See Administrative Supreme Court 26 July 2007, 95/14/0145.

40 Council Directive of 19 December 1977, 77/799/EEC.

41 Council Directive of 15 March 1976, 76/308/EEC.

42 See Administrative Supreme Court 22 March 1995, 93/13/0076; see Ritz, "Ausländische Besteuerungsnachweise - Mitwirkungspflicht bei abgabenrechtlich nicht bedeutsamen Umständen?", *SWI* 2003, p. 109 (p. 113) with further references.

43 See Heinrich, in Holoubek/Lang (ed.), *Allgemeine Grundsätze*, p. 159.

44 Administrative Supreme Court 22 March 1995, 93/13/0076.

45 See Schuch, in Tanzer (ed.), *BAO*, p. 119.

However, in a case concerning customs law, the Administrative Supreme Court concluded that if the taxpayer demands a preferential treatment, the beneficiary has to prove that the legal requirements are fulfilled. [46] Similarly, the Court argued in a case concerning the administrative law procedure by stating that even though under Sec. 39 (2) GAP the authorities shall proceed ex officio, the burden of proof is shifted to the taxpayer if a preferential tax treatment upon request is concerned. An explicit regulation is not covered by the GAP and the Court has not provided a dogmatic reasoning. [47]

According to *Loukota*, taxpayers have to provide sufficient documents if their demands are for the application of the exemption method under DTC Law. [48] This view has been heavily criticized in Austrian legal literature. [49] It is only a matter of the way a law has been written, either in a broad manner with several exemptions or already limited and without any exemptions. Under the first option the burden of proof would be shifted to the taxpayer whereas under the second option this would not be the case. Consequently, the exemption method under DTC cannot lead to an advanced obligation of the taxpayer to cooperate. The argument of the Court brought forward in the case mentioned above concerning the administrative law procedure rather cannot be considered in the case of the application of the exemption method under DTCs because a request of the taxpayer is not required.

The Administrative Supreme Court argues very similarly concerning the administrative law procedure [50] and it can therefore be concluded that in the tax law procedure, as well as in the administrative law procedure, the obligation of advanced cooperation is interpreted alike by the Court.

Whether the advanced obligation to cooperate in cross-border situation is in line with the EC Treaty cannot yet be clearly answered. In some decisions the ECJ mentioned that the Mutual Assistance Directives provide Member States the possibility to cooperate, but the Court also mentioned that a duty of information may nevertheless be imposed on the taxpayer. [51] It is crucial, however, that the principle of proportionality be observed. It must be ensured that those requirements do not exceed what is necessary in order to attain the objective of securing the information sought. [52]

## 9.2. International tax treaty case law

### 9.2.1. Interpretation

The Vienna Convention on the Law of Treaties (VCLT) came into effect in Austria on 27 January 1980. [53] Articles 31 and 32 of the VCLT contain general rules of interpretation for international treaties and are applied in Austria for the interpretation of international law agreements and treaties. [54]

The Austrian Administrative Supreme Court has explicitly referred to the VCLT in several decisions. The Court argued that Art. 31 VCLT would be undermined if it would not be possible for States to apply their domestic anti-avoidance provisions if there are no special provisions in the DTC. [55] In another decision with reference to the VCLT, the Court concluded that the Austrian municipal tax is part of the payroll taxes and consequently falls within the scope of Art. 2 of the DTC. [56] However, in another case the Court

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46 Administrative Supreme Court 27 September 1990, 90/16/0088 with further references.

47 See Wiederin, in Holoubek/Lang (ed.), *Allgemeine Grundsätze*, p. 132.

48 Loukota, "Ausländische Besteuerungsnachweise", *SWI* 2000, p. 113 (p. 118).

49 See Lang, *SWI* 2000, p. 217 with further references.

50 See Wiederin in Holoubek/Lang (ed.), *Allgemeine Grundsätze*, pp. 129 et seq.

51 ECJ 28 January 1992, C-204/90, *Bachmann* [1992] ECR I-249, m.no. 20; ECJ 28 October 1999, C-55/98, *Vestergaard* [1999] ECR I-7641, m.no. 26; see also ECJ 3 October 2002, C-136/00, *Danner*, [2002] ECR I-8147, m.no. 49; Advocate-General Poiras Maduro 7 April 2005, C-446/03, *Marks & Spencer* [2005] ECR I-0000, m.no. 81.

52 Id. Advocate-General Poiras Maduro.

53 Vogel/Prokisch, "General Report: Interpretation of double taxation conventions", in IFA (ed.) *Cahiers de droit fiscal international* LXXVIIIa, p. 55 (p. 66).

54 For the interpretation of double tax treaties see: id. Vogel/Prokisch, *IFA Cahiers* LXXVIIIa, p. 66; Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen* 2nd ed., Vienna: Linde Verlag, 2002, m.no. 83 et seq. and Lang, *Hybride Finanzierungen im Internationalen Steuerrecht*, Vienna: Orac, 1991, p. 21 et seq.; for the agreement between the European Union and Switzerland see Oberson, "Agreement between Switzerland and the European Union on the Taxation of Savings - A Balanced 'Compromis Helvétique'", *Bulletin for International Taxation* 3 (2005) p. 108 (p. 109); Danon, "Cross-border Dividends from the Perspective of Switzerland as the Source State - Selected Issues under Article 15 of the Swiss-EU Savings Agreement", 33 *Intertax* 11 (2005) p. 503 (p. 505); Hiny, "Überblick über das Zinsbesteuerungsabkommen zwischen der Schweiz und der EU", *Ecolex* (2006), p. 353 (p. 354).

55 Administrative Supreme Court 26 July 2000, 97/14/0070; Administrative Supreme Court 9 December 2004, 2002/14/0074; the same result is reached by the Administrative Supreme Court in its decision from 10 October 2005, 2001/13/0018 without explicit reference to the VCLT.

56 Administrative Supreme Court 3 August 2000, 99/15/0265; Administrative Supreme Court 28 March 2001, 2000/13/0134.

argued that results of mutual agreements of two tax authorities are not binding for the Court even though the VCLT in Art 31 (3) (b) refers to the subsequent practice in the application of the treaty. <sup>[57]</sup>

### 9.2.2. Relevance of the Commentaries on the Articles of the OECD MC

The Austrian Administrative Supreme Court has referred to the OECD Model Convention (MC) in several decisions. <sup>[58]</sup> In its decisions the Court concluded that in so far as the Contracting States adopt the provisions of the OECD MC, the corresponding provisions in the bilateral agreement shall have the same content as in the OECD MC. Furthermore, the commentary which is effective at the time the treaty was concluded shall have a special meaning for interpretation purposes. <sup>[59]</sup>

### 9.2.3. Other commentaries

The Administrative Supreme Court referred to the protocol to the DTC between Austria and Germany to conclude that neither from the treaty itself nor from the protocol, can a definition to draw the borderline between income from independent personal services and dependent personal service be derived. <sup>[60]</sup> The Court undoubtedly takes protocols to DTCs into consideration for interpretation purposes.

The Court also refers to the results of mutual agreements procedures when interpreting treaties but at the same time the Court emphasises that they are not legally binding. <sup>[61]</sup> The result of the mutual agreement procedure is implemented in Austria as a ministerial order and is therefore only an instruction for the administration. The Court only considers the result of the mutual agreement procedure if it is an appropriate result according to the interpretation of the provision. <sup>[62]</sup> Even if the result of the mutual agreement procedure is implemented in the form of a decree, it is not legally binding. <sup>[63]</sup> Consequently, it is irrelevant in which form the result of the mutual agreement is implemented; it is never legally binding for the Court.

### 9.2.4. Article 3(2) OECD MC

Without explicitly mentioning Art. 3(2) OECD MC, the Austrian Administrative Supreme Court referred to the domestic legal definition of an employment status to answer the question whether the income from a music teacher subject to unlimited tax liability in Austria who lectures in Switzerland is characterized as independent personal service or income from employment under the treaty. Even though the Court did not explicitly mention that the domestic legal definition was used for the treaty definition, one might get the impression from reading the decisions that the same main characteristics - the business risk - under national law were used under tax treaty law. <sup>[64]</sup> In a later decision, the Court is more explicit. It concluded that no definition could be derived from either the DTC or the protocol and consequently, the national law definition was applied. <sup>[65]</sup> Interestingly, the Court, by referring to national literature, ruled that the reference to domestic law has to be interpreted dynamically. <sup>[66]</sup> The Court argued that no equivalent to Art. 3(2) OECD MC existed under the treaty with Germany. Therefore, the Court concluded that the decision at issue is no departure from its earlier decisions in which it was concluded that the reference to the national law has to be interpreted statically. <sup>[67]</sup> In the negative, Contracting States could unilaterally modify international law treaties. <sup>[68]</sup>

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<sup>57</sup> Administrative Supreme Court 30 March 2006, 2002/15/0098 with further references.

<sup>58</sup> Administrative Supreme Court 21 May 1997, 96/14/0084.

<sup>59</sup> Administrative Supreme Court 31 July 1996, 92/13/0172.

<sup>60</sup> Administrative Supreme Court 30 March 2006, 2002/15/0098.

<sup>61</sup> Administrative Supreme Court 30 November 1962, 364/61; Administrative Supreme Court 30 March 2006, 2002/15/0098.

<sup>62</sup> Administrative Supreme Court 30 November 1962, 364/61.

<sup>63</sup> Administrative Supreme Court 27 August 1991, 90/14/0237.

<sup>64</sup> Administrative Supreme Court 24 June 2004, 2001/15/0113.

<sup>65</sup> Administrative Supreme Court 30 March 2006, 2002/15/0098.

<sup>66</sup> Administrative Supreme Court 30 March 2006, 2002/15/0098.

<sup>67</sup> Administrative Supreme Court 20 September 2001, 2000/15/0116; see as well Administrative Supreme Court 21 May 1997, 96/14/0084, Administrative Supreme Court 27 August 1991, 90/14/0237; Administrative Supreme Court 27 August 1991, 90/14/0237.

<sup>68</sup> Administrative Supreme Court 27 August 1991, 90/14/0237.

In a number of decisions, the Administrative Supreme Court referred explicitly to tax literature, albeit, admittedly, mainly to Austrian tax literature and not to international tax literature. Examples in which it referred to national literature include the rationale that the term "fixed base" under Art. 14 has the same meaning as the term "permanent establishment" under Art. 7 OECD MC, [69] to define the term "fixed place of business" under Art 5. OECD MC, [70] to emphasize the legitimacy of dynamic interpretation or to conclude the direct application of double tax treaties in Austria. [71]

Furthermore, the Court has referred to Austrian literature

- to argue that a mutual agreement is not binding for the Court; [72]
- for the definition of capital income; [73]
- to conclude that domestic anti-avoidance provisions can be applied if there are no specific rules in the treaties; [74]
- to argue that the OECD commentary in the version applicable at the time the treaty was concluded shall have a special meaning for interpretation purposes; [75]
- to define the centre of vital interest; [76]
- to conclude that double tax treaties only restrict and do not create new taxing rights for the Contracting States; [77]
- to determine how the proviso safeguarding progression has to be applied; [78]
- to determine how the term "remunerations paid in respect of services rendered to that State" under Art. 19 (1) OECD MC has to be interpreted; [79]
- to conclude that under the 183-day-rule in Art. 15 OECD MC the 183 days have to be calculated within a 12-month period, [80]
- to come to the conclusion that the Austrian municipal tax is part of the payroll taxes and consequently falls within the scope of Art. 2 of the DTC; [81] and
- to argue that under the DTC with Japan the foreign tax can only be credited in the year in which the Japanese tax was levied and consequently cannot be carried forward to a subsequent year if in the year at issue no taxes are levied in Austria due to the set off of losses. [82]

The Independent Tax Tribunal also referred several times to legal literature to conclude that through Art. 24(1) OECD MC, Sec. 1(4) IITA (which is the implementation of the *Schumacker* case) [83] is applicable not only to EC and EEA nationals but also to nationals of third countries. [84] Consequently, through the DTC the benefits of the *Schumacher* case are extended to nationals of third countries.

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[69] Administrative Supreme Court 15 February 2006, 2001/13/0319; Administrative Supreme Court 21 May 1997, 96/14/0084.  
[70] Administrative Supreme Court 21 May 1997, 96/14/0084.  
[71] Administrative Supreme Court 30 March 2006, 2002/15/0098.  
[72] Administrative Supreme Court 30 March 2006, 2002/15/0098.  
[73] Administrative Supreme Court 25 November 2002, 99/14/0099.  
[74] Administrative Supreme Court 26 July 2000, 97/14/0070; Administrative Supreme Court 9 December 2004, 2002/14/0074.  
[75] Administrative Supreme Court 31 July 1996, 92/13/0172.  
[76] Administrative Supreme Court 26 July 2007, 95/14/0145.  
[77] Administrative Supreme Court 29 September 2001, 99/14/0217.  
[78] Administrative Supreme Court 23 October 1997, 96/15/0234.  
[79] Administrative Supreme Court 4 November 1998, 93/13/0201.  
[80] Administrative Supreme Court 24 February 1998, 95/13/0137.  
[81] Administrative Supreme Court 15 December 1999, 98/13/0021.  
[82] Administrative Supreme Court 20 April 1999, 99/14/0012; see Administrative Supreme Court 15 April 1997, 93/14/0135.  
[83] ECJ 14 February 1995, C-279/93, *Schumacker* [1995] ECR I-225.  
[84] Independent Tax Tribunal 2 February 2006, RV/1792-W/05.

### 9.2.5. Foreign tax law

As an auxiliary argument, the Administrative Supreme Court referred to the tax consequences in Germany to decide whether the respective income is characterized as income from dependent or independent personal services and consequently, whether or not Austria has taxing rights. [85] The Court's rationale was very result-orientated and it used the argument to avoid double non-taxation in its favour. In a case concerning the treaty with Switzerland, the Court explicitly referred to the Swiss national law, in which the term "*Verwaltungsrat*" is defined, and argued that this definition has no impact on the interpretation of the treaty term. [86]

### 9.2.6. Foreign court decisions and foreign tax practice

The Administrative Supreme Court has referred to the German Federal Fiscal Court to define the term "fixed place of business" under Art 5. OECD MC. [87] In another decision, it referred again to the same German Court for the argument that under a DTC, different legal consequences can be achieved depending upon under which basket the income is received and the method of determining profits. [88] In another decision, the Court has also referred, indirectly, to the German Federal Fiscal Court by citing tax literature and the cases referred to therein. [89]

In cases concerning the double tax treaty with Switzerland, the Court ignored the view of the Swiss authorities on the interpretation of the term "frontier workers" [90] and of the term "*Verwaltungsrat*". [91] According to the Court, the view of the foreign authorities is not relevant. [92]

## 9.3. Article 234 EC Treaty

### 9.3.1. Cases involving application of EC law and not referred to the ECJ

The Austrian Administrative Supreme Court has referred around 50 cases for preliminary rulings to the ECJ under Art. 234 EC Treaty and in approximately 160 other cases with a connection to European tax law the Court decided on its own. [93] This shows that European law became part of the day-to-day business of the Court. [94] Unfortunately, no cases involving questions on the compatibility of DTC provisions with the EC Treaty have yet been referred to the ECJ. From other case law, however, it can be seen that in some cases, the Administrative Supreme Court, by following the rationale in the *C.I.L.F.I.T.* case, [95] decided not to refer questions to the ECJ under Art. 243 EC Treaty. For each of the three reasons mentioned in the *C.I.L.F.I.T.* case, examples can be found in the case law of the Administrative Supreme Court. [96] Questions were not referred to the ECJ if cases were involved in which:

1. EC law was not yet applicable in Austria; [97]
2. questions were raised which were materially identical with questions that were already subject of a preliminary ruling in a similar case; [98] and

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85 Administrative Supreme Court 30 March 2006, 2002/15/0098.

86 Administrative Supreme Court 31 July 1996, 92/13/0172.

87 Administrative Supreme Court 21 May 1997, 96/14/0084.

88 Administrative Supreme Court 25 November 2002, 99/14/0099.

89 Administrative Supreme Court 9 December 2004, 2002/14/0074.

90 Administrative Supreme Court 30 November 1962, 0364/61.

91 Administrative Supreme Court 31 July 1996, 92/13/0172; Administrative Supreme Court 26 July 2000, 97/14/0070.

92 See Lang, "*Die Erbringung von ausländischen Besteuerungsnachweisen durch den Steuerpflichtigen*", *SWI* 2000, p. 210 (p. 213).

93 See [www.vwgh.gv.at/Rechtsprechung/Dokumentation für Europarecht](http://www.vwgh.gv.at/Rechtsprechung/Dokumentation_für_Europarecht).

94 See Handstanger, "*Die Bedeutung des Vorabentscheidungsverfahrens für das verwaltungsgerichtliche Verfahren*", in Holoubek/Lang (ed.), *Das EuGH-Verfahren in Steuersachen*, Vienna: Linde Verlag (2000) pp. 83 et seq.

95 ECJ 6 October 1982, 283/81, *C.I.L.F.I.T.* [1982] ECR 03415.

96 See Handstanger, in Holoubek/Lang, *EuGH-Verfahren in Steuersachen*, pp. 95 et seq.

97 Administrative Supreme Court 15 November 1995, 95/13/0101; Administrative Supreme Court 27 January 1999, 98/16/0228.

98 Administrative Supreme Court 19 February 1998, 97/16/0405.

3. the Court had already dealt with the point of law in question, even though the questions at issue were not strictly identical. <sup>[99]</sup>

Of particular interest is a case referred not by the Administrative Supreme Court to the ECJ but by the Independent Tax Tribunal concerning the same facts of a case previously decided by the Administrative Supreme Court and in which the ECJ judged contrary to the decision of the Administrative Supreme Court. The case concerned the interpretation of Arts. 13 and 16 of the Protocol on the Privileges and Immunities of the European Communities. <sup>[100]</sup> The ECJ stated that

[...] for the purposes of applying Articles 13 and 16 of the Protocol on the Privileges and Immunities of the European Communities, the decision of a Community institution defining the status of one of its servants and determining his conditions of employment is binding on national judicial and administrative authorities, so that they cannot make an independent classification of the employment relationship in question." <sup>[101]</sup>

Another case decided by the Independent Tax Tribunal concerned an Austrian domestic provision granting a tax exemption for income received by persons subject to unlimited tax liability who are sent abroad for more than one month for construction and assembling activities. <sup>[102]</sup> The exemption is only granted if the person is employed by an Austrian employer or by an Austrian PE of a foreign company. On the basis of the "*acte-clair*" doctrine, the Tribunal decided that this provision infringes the free movement of workers.

<sup>[103]</sup>

### 9.3.2. Referral ex officio

The *ultra petita* principle is inherent in the Austrian domestic procedural rules. According to Sec. 41(1) VwGG, the Administrative Supreme Court may only decide on the facts and circumstances investigated by the authorities and only within the framework of asserted complaints. In the ECJ case *Peterbroeck and others*, <sup>[104]</sup> and in *Van Schijndel and others*, <sup>[105]</sup> the ECJ explicitly mentioned that Community law precludes application of a domestic procedural rule whose effect is to prevent the national court from considering on its own motion whether a measure of domestic law is compatible with a provision of Community law when the latter provision has not been invoked by the litigant. Also, in *Upjohn*, <sup>[106]</sup> the Court decided that national procedure for judicial review of decisions of national authorities must enable the court or tribunal to apply the relevant principles and rules of Community law when reviewing its legality. In Austrian legal literature, <sup>[107]</sup> arguments in favour of the ECJ cases can be found but admittedly no definitive answer can yet be given.

### 9.3.3. Double tax treaty cases involving application of EC law and not referred to the ECJ

The Administrative Supreme Court had to decide in two cases (in September and October 2001) <sup>[108]</sup> on the deductibility of foreign PE losses of a person subject to unlimited tax liability in Austria in a situation in which a DTC with the exemption method was concluded with the foreign PE State. Until September 2001, the Austrian Supreme Court followed the thesis developed by the *Reichsfinanzhof* in the 1930s, deciding

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<sup>99</sup> Administrative Supreme Court 25 June 1996, 96/09/0088.

<sup>100</sup> 67/444/EEC.

<sup>101</sup> ECJ 8 September 2005, C-288/04, *AB* [2005] ECR I-0000, para. 40.

<sup>102</sup> Sec. 3 (1) (10) IITA.

<sup>103</sup> Independent Tax Tribunal 5 October 2005, RV/0016-F/04.

<sup>104</sup> ECJ 14 December 1995, C-312/93, *Peterbroeck and others* [1995] ECR I-04599, m.no. 21.

<sup>105</sup> ECJ 14 December 1995, C-430/93 and C-431/93, *van Schijndel and others* [1995] ECR I-04705, m.no. 15.

<sup>106</sup> ECJ 21 January 1999, C-120/97, *Upjohn* [1999] ECR I-00223, m.no. 36.

<sup>107</sup> Sterner, "*Beschwerdepunkte und Beschwerdegründe unter Berücksichtigung gemeinschaftsrechtlicher Einflüsse*", in Holoubek/Lang (ed.), *Das verwaltungsgerichtliche Verfahren in Steuersachen*, Vienna: Linde Verlag (1999) pp. 61 et seq.

<sup>108</sup> Administrative Supreme Court 25 September 2001, 99/14/0217; Administrative Supreme Court 25 October 2001, 99/15/0149.

that under a double tax treaty with an exemption method foreign PE losses do not have to be deducted from the tax base but must be taken into consideration under the proviso safeguarding progression. <sup>[109]</sup> With its decision from September 2001, the Court made a U-turn and decided to the contrary. The Court explicitly mentioned that double tax treaties can only restrict but do not create new taxing rights. This leads to the result that in a situation without a double tax treaty, the taxpayer cannot be better off as in a situation with a double tax treaty. Without a double tax treaty the taxpayer would not be hindered in its resident State to take into account the foreign losses according to the principle of worldwide taxation. To avoid double utilization of losses, the Austrian domestic law was changed and the foreign PE losses are recaptured in the year in which the foreign losses can be set off against foreign PE profits. <sup>[110]</sup> The Court based its arguments solely on the respective DTC. This case law is an example of a reversal by the Court. But it argued that since the accession of Austria to the European Union on the 1 January 1995, the legal situation, especially with regard to Art. 43 EC Treaty, is different and, consequently, the Court did not have to decide in an amplified senate.

The Austrian Supreme Court was criticized in legal literature that it did not base its argument on the EC Treaty. <sup>[111]</sup> The Court would have had to either ask the ECJ for a preliminary ruling on the question whether or not the foreign PE losses have to be deducted from the tax base even if a DTC with an exemption method is concluded under Art 43 EC Treaty or, with regard to third States, under Art. 56 EC Treaty, or had to decide by itself on the basis of the "*acte-clair*" doctrine. But as the Court decided on the basis of the DTC, there was no need for it to address the compatibility of the domestic rule with the EC Treaty.

The Austrian Supreme Court failed to ask the ECJ for a preliminary ruling but the German Federal Finance Court identified the EC law issues and requested the ECJ for a preliminary ruling in two cases. On 28 July 2006, the first case was referred to the ECJ concerning the compatibility of exemption with progression with the freedom of establishment and the free movement of capital. The Court asked whether it is compatible with Arts. 43 and 56 EC Treaty if a German company is not entitled to set off losses of its Luxembourg PE pursuant to the Luxembourg-Germany tax treaty, under which the profits attributable to a Luxemburg PE are exempt in Germany. The second case referred by the German Federal Finance Court to the ECJ for a preliminary ruling on 22 August 2006 concerns the same question but with regard to third countries. The answers of the ECJ probably might not have an impact on the Austrian domestic law and the interpretation of double tax treaty law because Austria probably even went further, as it is required to do under the EC Treaty. The Austrian legislator was, however, generous and enacted a new domestic law that is applicable to foreign PE losses irrespective where the PE is situated.

As these two German cases show, the German Court has doubts whether the German provision is an infringement of the freedom of establishment and the free movement of capital. Hence the Austrian Administrative Supreme Court probably was wrong to decide its cases not with an amplified senate by arguing that the legal basis has changed and consequently no reversal exists. Rather, the Court should have taken the EC Treaty into account and answered the question whether or not, under the EC Treaty, the Austrian provision is an infringement of the fundamental freedoms and, in the affirmative, whether or not it can be justified. If the prior Austrian domestic provision would have been an infringement of the EC Treaty - but could have been justified - the Court would not have been forced to reverse from its former judgments. With respect to third countries, these questions are even more difficult to answer since no profound case law of the ECJ yet exists on the scope of this freedom, vis-à-vis third countries. Consequently, the judgment of the ECJ on the two German cases must be awaited in order to conclude whether or not the Administrative Supreme Court reversed itself from its former case law and would have had to decide in an amplified senate.

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<sup>109</sup> See Zorn in Lang et al. "*Konsequenzen der neuen Judikatur des Verwaltungsgerichtshofs zu den Auslandsverlusten - Podiumsdiskussion*", SWI 2002, p. 428.

<sup>110</sup> Sec. 2(8) IITA.

<sup>111</sup> Lang et. al. op. cit. "*Konsequenzen der neuen Judikatur des Verwaltungsgerichtshofs zu den Auslandsverlusten - Podiumsdiskussion*", SWI 2002, p. 428.

In another decision of the Administrative Supreme Court, the complainant argued that he was hindered in his free movement of establishment and the free movement of capital if foreign withholding taxes are not refunded in the case the profit is nil according to the offset of losses, whereas under a pure national situation a refund would be granted. <sup>[112]</sup> Due to a lack of determining the relevant facts and circumstances, the Court did not examine this question. Nevertheless, the Court indicated that according to Art. 23 (1) (2) of the treaty between Austria and Belgium, the credit of the source taxes has to be granted on the taxes on the same income, irrespective if the withholding taxes and the taxes in the home State at the same income are levied in the same year. It should be noted, however, that this article deviates from Art. 23 OECD MC in its wording. If the Court would have decided the question whether or not the Austrian domestic law is in line with the EC Treaty by itself or would have referred this question for a preliminary ruling to the ECJ, cannot be answered from this decision.

The same is true in a case in which the Administrative Supreme Court was faced with the question whether the limitation to deduct losses for persons subject to limited tax liability is in line with the fundamental freedoms under the EC Treaty. <sup>[113]</sup> The Court decided a similar case in February 2006. <sup>[114]</sup> The main difference to the earlier case law was that the DTC with Netherlands was concerned in which a corresponding provision to Art. 24 (3) OECD Model Convention is contained, whereas in the former case the old DTC with Germany, which did not contain a non-discrimination provision for PEs, was concerned. Under the non-discrimination provision for PEs, the PE has to be treated equally with that of a domestic entity. Domestic entities are not limited in carrying forward their losses, whereas PEs may only carry forward those losses that exceed the worldwide income of the foreign person maintaining the PE. Under the condition that the double utilization of losses is avoided, the Court concluded that the Austrian domestic provision under Sec. 102(2)(2) IITA infringes the non-discrimination provision under the DTC. The Netherlands applied the credit method in the case at issue and, consequently, a double utilization of losses did not take place. As the domestic law provision already infringes the DTC non-discrimination provision, the Court argued that there is no need for further recourse to Art. 43 of the EC Treaty. The Court was criticized in legal literature on its assumption that only if a double utilization of losses is impossible, the Austrian PE has to be granted equal treatment to domestic entities. The non-discrimination rule under the DTC only addresses the PE State regardless of the consequences in the resident State of the person maintaining the PE. <sup>[115]</sup>

How the Court will decide cases in which a DTC contains a non-discrimination provision for PEs, but the double utilization of losses will not be avoided, remains to be seen. According to the arguments of the Court, the non-discrimination provision under the DTC would not apply. Consequently, the Court would have to make recourse to EC law. In the *Marks & Spencer* case, the ECJ stated that "... relating to the danger that losses would be used twice, it must be accepted that Member States must be able to prevent that from occurring." <sup>[116]</sup> Admittedly, in the case at issue, the source State and not the resident State as under the *Marks & Spencer* decision is concerned - which may change the line taking into account the principle of worldwide taxation that most European States use for persons subject to unlimited tax liability and the principle of territoriality that most of the European States use for persons subject to limited tax liability.

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<sup>112</sup> Administrative Supreme Court 21 October 2004, 2001/13/0017.

<sup>113</sup> Administrative Supreme Court 18 November 2003, 99/14/0011.

<sup>114</sup> Administrative Supreme Court 16 February 2006, 2005/14/0036.

<sup>115</sup> See Schneeweiss, "Betriebsstättendiskriminierungsverbot: Kein Verlustvortrag für beschränkt Steuerpflichtige bei doppelter Verlustverwertung", SWI 2006, p. 312.

<sup>116</sup> ECJ 13 December 2005, C-446/03, *Marks & Spencer* [2005] ECR I-0000, para. 47.

## Chapter 10 – France

### 10.1. The nature of rules governing tax litigation

#### 10.1.1. Tax law procedure versus other kind of procedure

##### 10.1.1.1. The procedure before the courts

###### 10.1.1.1.1. *Pre-trial procedure*

The French tax procedure encourages the tax authorities and the taxpayers to settle disputes out of court. The largest part of the *Livre des procédures fiscales* (the tax procedure code, "TPC") sets rules for appeals within the tax authorities and for review of the case by special committees before the dispute is even heard by the courts. Furthermore, tax cases are specific in that taxpayers are not allowed to petition the courts directly. Whether the dispute concerns tax deficiencies determined by the tax authorities or the refund of excessive or illegal tax liabilities, taxpayers must lodge an appeal (*reclamation*) with the tax authorities before bringing their cases to the courts. <sup>[2]</sup> This administrative appeal sets the limits of the claim brought by the taxpayer who will not be allowed to assert new requests before the court. <sup>[3]</sup>

###### 10.1.1.1.2. *The tax judiciary*

France does not have a single judicial forum in which tax disputes are tried. Both administrative and civil courts can have jurisdiction over a tax case, depending on the subject matter and the tax at stake. This duality of jurisdiction, which dates back from the French Revolution, <sup>[4]</sup> allocates cases involving direct taxes and value added tax to the administrative courts, and cases involving transfer duties, stamp duties, indirect contributions and wealth tax to the judicial courts. <sup>[5]</sup> In addition to these rules, the civil courts have the authority to hear tax controversies involving private law issues, such as property rights or civil rights; they also have extensive jurisdiction over cases dealing with the collection (*contentieux du recouvrement*) of taxes as opposed to their assessment (*contentieux d'assiette*). These allocation rules are sometimes arcane to the layperson and even tax practitioners can face serious difficulties in assessing the correct venue for filing their suit, which is all the more unfortunate as this defence can be raised by any of the parties at anytime, even on appeal, and improper venue is a ground for dismissing the suit. <sup>[6]</sup>

The *Tribunal administratif* is the administrative court of first instance; appeals against decisions rendered by a *Tribunal administratif* are lodged before a *Cour administrative d'appel* (administrative court of appeals); the *Conseil d'Etat* functions as a court of last resort for administrative matters. The judicial courts' organization mirrors that of their administrative counterparts, with the *Tribunal de grande instance* as the court of first instance, the *Cour d'appel* as the court of appeals, and the *Cour de cassation* as supreme court. When a conflict between the rulings or the attributions of administrative and civil courts arises, the *Tribunal des Conflits*, which comprises an equal number of members of the *Conseil d'Etat* and the *Cour de cassation*, settles which court should handle the matter or renders a final judgment itself. It is also worth noting that civil and administrative courts are not competent to hear constitutional challenges against statutes - in tax as in all other matters, the *Conseil constitutionnel* (Constitutional council) holds exclusive power to review the constitutionality of statutes.

Within one jurisdiction, there is no specific tax court, even though tax cases are usually allocated to specific sections of each court, the competence of which, however, is not limited to taxation. As a result,

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<sup>2</sup> Sec. R. 190-1 of the TPC.

<sup>3</sup> Sec. R. 200-2 of the TPC.

<sup>4</sup> Law of August 16 and 24, 1790 and law of September 7 and 11, 1790.

<sup>5</sup> Sec.L. 199 of the TPC.

<sup>6</sup> *Conseil d'Etat*, 4 October 1967, no. 60808, *Trani*, Lebon, 352.

even though all of the judges who handle tax cases have expertise in the tax legislation, their skills are not limited to tax laws, and tax cases generally represent a limited percentage of their dockets.

#### 10.1.1.1.3. Procedure before the courts

To a very large extent, the French tax procedure is based on the rules applicable to ordinary administrative and civil litigations, and the TPC provides a general remand to the rules applicable to hearings before the administrative courts, with a limited number of exceptions. <sup>[7]</sup> Before the civil courts, the general rules also apply, but a set of specific tax rules also come into play. <sup>[8]</sup> In setting up these rules, the code envisions user-friendly procedures that aim at encouraging taxpayers to litigate without some of the hassle, expenses and technical traps that are frequent with the civil courts. Key in this respect is the written procedure that governs tax controversies, and which emphasizes the role of the judge in the administration of the case; another notable feature of the tax procedure is that tax cases are not decided by jury but by bench trials. Also consistent with this purpose, taxpayers can appear *pro se* <sup>[9]</sup> (representation by an *avoué*, however, is required before the court of appeals).

#### 10.1.1.2. The courts' decisions

##### 10.1.1.2.1. Structure of the courts' decisions

Even though the legal terminology used by civil and administrative courts may vary, the structure of their decisions tends to follow a similar mould. The statutes and regulations which provide the legal basis of the ruling are mentioned first (*visa*), then are stated the facts on which the court relies to reach its decision, followed by the arguments and claims of the parties. The decision then briefly discusses the merits of these arguments and reaches a conclusion, which gives the support for the ruling. Consistent with the practice of French courts, tax rulings are generally carefully drafted but extremely concise and avoid the lengthy discussion of the parties' arguments, reference to precedents and obiter dicta that are familiar to common law courts.

Also contrary to what is customary in common law countries, the court opinion is deemed shared by all the judges who belong to the court. Consequently, the ruling is generally not signed by or attributed to a single judge, no concurring or dissenting opinions are expressed and no detail on the votes of the judges is released. Even more striking to the common law observer is the fact that these decisions do not - or only very infrequently - mention precedents. This position is consistent with the rule prohibiting *stare decisis* (*arrêts de règlement*); <sup>[10]</sup> this is not to say that lower courts do not pay attention to the supreme courts' rulings, but they tend to avoid mentioning them in their own opinions. Similarly, judges usually refrain from quoting directly from scholars or commentators.

Because they are so terse, these decisions can prove difficult to understand and one may fail to grasp fully the legal context of the case, the reasoning of the court or the significance of the ruling by mere reading. More readily understandable are the opinions delivered, after the case has been submitted by the parties, by the *Commissaire du gouvernement* or by the *Avocat général* before, respectively, the *Conseil d'Etat* (or lower administrative courts) and the *Cour de cassation* (or civil court of appeals). In substance, these two magistrates make a report on the case in the form of an opinion, in which they describe in greater detail the factual and legal context of the case, the arguments of the parties, the applicable statutes, the precedents, relevant literature, and submit their own findings and conclusions to their fellow judges. Even though these opinions carry considerable weight, they are not binding on the court.

##### 10.1.1.2.2. Influence of tax literature/administrative practice

The tax decisions' structure and the absence of references to the works of legal scholars could deceive the casual observer into believing that French courts do not take account of sources other than the law

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<sup>7</sup> Sec. R. 200-1 of the TPC.  
<sup>8</sup> Administrative guidelines 13 O 4, no. 3, 10 August 1998; Secs. R. 202-1 et seq. of the TPC.  
<sup>9</sup> Sec. R. 202-2 of the TPC.  
<sup>10</sup> Secs. 5 and 1351 of the French Civil Code.

itself. Of course, this is not the case, as witnessed by the numerous references to tax literature made by the *Commissaires du gouvernement* and *Avocat généraux* in their opinions. It remains difficult, however, to assess the real significance of the tax literature on judges.

In spite of their practical importance, the guidelines published by the tax authorities are not a source of law in France and they are not binding on taxpayers. They are, however, binding on the tax authorities if certain conditions are met. <sup>[11]</sup>

#### 10.1.1.2.3. Availability of tax decisions

Decisions of the *Cour de cassation*, *Conseil d'Etat* and most of those rendered by courts of lower instance are available free of charge on the Internet at [www.legifrance.gouv.fr](http://www.legifrance.gouv.fr). Unfortunately, because they are the personal property of the author, the opinions given by the *Commissaires du gouvernement* and by the *Avocats généraux* are not as readily available; most opinions relating to significant tax cases decided by the *Conseil d'Etat*, however, are published by court reporters and tax publications. <sup>[12]</sup>

### 10.1.2. Burden of proof

#### 10.1.2.1. Principle

The rules of evidence in tax cases are complex, sometimes arcane, but the common thread that runs through them is that the party which brings forth an allegation or contests an assertion bears the burden of proving - or at least of presenting prima facie evidence of - what such party puts forward: "*actori incombatur probatio*." Contrary to, for instance, the US federal tax procedure, French tax courts do not conceptually distinguish between the burden of production and the burden of persuasion; this posture is consistent with the fact that, in the absence of a jury, French tax courts are both judges and ultimate fact finders.

For instance, if the tax authorities contend that the taxpayer is a member of a silent partnership, they must produce evidence that such a partnership exists; <sup>[13]</sup> by contrast, if it is the taxpayer who makes this claim, he/she bears the burden of providing the items of proof that substantiates it. <sup>[14]</sup> Of course, if the statement made by a party is undisputed, the judge will take it as true without further requirements. <sup>[15]</sup> The waters are muddied a bit in respect of certain basic factual issues, for which the TPC allocates the initial burden of proof specifically to the tax authorities or to the taxpayer, and to certain examination procedures, which carry special rules of evidence.

#### 10.1.2.2. The initial burden of proof

##### 10.1.2.2.1. Initial burden of proof lying with the tax authorities

The tax authorities bear the burden of proving that they have satisfied all the procedural rules set forth by the tax code during the audit, which include the fact that they have sent an audit notice (*avis de vérification*), and, as the case may be, a deficiency notice. In a similar vein, if the taxpayer raises this issue, the tax authorities must prove that the tax auditor was competent for carrying out the audit.

In disputes over the existence of a taxable activity <sup>[16]</sup> or over the applicable tax regime, <sup>[17]</sup> the tax authorities must also introduce evidence in support of their assertions.

There is no principle of tax law that the tax authorities' determinations in a statutory notice of deficiency are presumptively correct. If the tax authorities intend to challenge the characterization of an act or activity taken by the taxpayer, and if the latter has maintained the required records, the tax authorities have the

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<sup>11</sup> Sec. L. 80 A of the TPC.

<sup>12</sup> E.g., the *Bulletin des Conclusions Fiscales* published monthly by Editions Francis Lefebvre.

<sup>13</sup> *Conseil d'Etat*, 22 October 1984, no. 44593, RTF 12/84 no. 1468; *Conseil d'Etat*, 8 July 1985 no. 40016, 40017 and 40018, RJF 10/85 no. 1331; *Conseil d'Etat*, 8 October 1986, no. 46527, RJF 12/86 no. 1105; *Cour administrative d'appel* of Lyon, 3 April 1996, no. 94-1414 through 94-1417, *Cappeau*, RJF 7/96 no. 894.

<sup>14</sup> *Cour administrative d'appel* of Paris, 14 May 2002, no. 98-3192, RJF 6/03 no. 742.

<sup>15</sup> *Conseil d'Etat*, 26 June 1982, no. 25426.

<sup>16</sup> *Conseil d'Etat*, *Section*, 6 July 1990, no. 92330, *Baptiste*, RJF 8-9/90 no. 103; *Conseil d'Etat*, 10 July 1985, no. 40789, RJF 10/85 no. 1278; *Conseil d'Etat*, 20 March 1991, no. 73199, *SCA d'élevage du Château de Vèrigny*, RJF 5/91 no. 575.

<sup>17</sup> *Conseil d'Etat*, 19 October 1977, no. 997, RJF 11/77 no. 598; *Conseil d'Etat*, 23 June 1982, no. 25317, RJF 8-9/82 no. 798; *Conseil d'Etat*, 24 March 1976, no. 92875, RJF 5/76 no. 230; Administrative guidelines 5 G-1144, no. 24 through 26, 15 September 2000.

burden of proof. [18] They must also establish that the taxpayer has recorded assets at an inflated value [19] or that rent payments received are insufficient. [20]

As to penalty matters, the tax authorities have an initial burden of proof; in particular, they are responsible for establishing that the conditions for imposing bad faith penalties are met. [21]

#### 10.1.2.2.2. Initial burden of proof lying with the taxpayer

For the tax authorities to have the burden of proof in a tax case, certain conditions must first be met by the taxpayer. Specifically, taxpayers must prove that (i) they have complied with all the formalities required of them by the tax code and that (i) all the items in their records are substantiated.

Taxpayers must show to the satisfaction of the courts that they have complied with the requirements for which they are responsible, such as the due and timely filing of their tax returns. Taxpayers who claim they have made an option for a specific tax regime also have the onus of establishing the correct exercise of the option. [22]

The substantiation requirement means that the taxpayer must establish any claimed item (generally a deduction or an expense). The requirement is actually twofold: the taxpayer must show that the item is true (the expense was really paid) and legitimate (the expense was incurred in furtherance of business' interest).

#### 10.1.2.3. Burden of proof governed by the examination procedure

Various types of examinations can be used by the tax authorities to audit or correct a taxpayer's situation and can shift the burden of proof to one party or the other.

##### 10.1.2.3.1. The contradictory examination procedure

In most cases, the contradictory examination procedure (*procédure de redressement contradictoire*) [23] will apply: the auditor will issue a notice of deficiency (*proposition de rectification*) and will offer the taxpayer with an opportunity to rebut the proposed adjustment. In this posture, the burden of proof will be with the tax authorities. Even where certain matters in issue are submitted to a special committee (*commission départementale*), which is competent to review factual questions (e.g. fair market value of a building), the tax authorities have to bring forward evidence substantiating their allegations. However, if the taxpayer's books and records are seriously flawed, and if the committee sides with the tax authorities, the burden of proof is shifted to the taxpayer. [24]

##### 10.1.2.3.2. The abuse of law procedure

A special procedure may be used where the tax auditor suspects an abuse of law (*abus de droit*). [25] In this case, if either of the parties lodges an appeal with the abuse of law committee (*comité consultatif pour la répression des abus de droit*), and if the tax authorities prevail in their contention, the taxpayer will carry the burden of proof at trial.

##### 10.1.2.3.3. Summary procedures

The failure by the taxpayer to comply with certain tax rules (e.g. omission to file a tax return or refusal to allow the tax auditor to review the books and records in a field examination) will permit the tax authorities to conduct a non-contradictory assessment of the tax liability (*taxation d'office*) owed by the taxpayer, who will then have the burden of proving that the amount assessed by the tax authorities is excessive. [26]

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18 *Conseil d'Etat*, 28 May 2004, no. 250817, *Sté Magneti Marelli France*, RJF 8-9/04 no. 916; *Conseil d'Etat*, 15 May 1985, no. 43728, RJF 7/85 no. 1035.

19 *Conseil d'Etat*, 28 October 1985, no. 40574, RJF 12/85 no. 1499; *Min. Resp. Coupelle*, JO *Sénat*, 20 July 1961, no. 1827, 914.

20 *Min. Resp. Coupelle*, JO *Sénat*, 20 July 1961, no. 1827, 914.

21 Sec. L. 195 A of the TPC; *Conseil d'Etat*, 9 January 1985, no. 40589, RJF 3/85 no. 369; *Conseil d'Etat*, 3 June 1987, no. 62061, RJF 7/87 no. 753; *Conseil d'Etat*, 2 April 1990 no. 41626, RJF 5/90 no. 602.

22 *Conseil d'Etat*, 1 April 1987, no. 60501, RTF 5/87 no. 525; *Conseil d'Etat*, 9 October 1991, no. 80461, RJF 11/91 no. 1349.

23 Sec. L. 55 of the TPC.

24 Sec.L. 192 of the TPC.

25 Sec.L. 64 of the TPC.

26 Secs. L. 74 and L 193 of the TPC.

#### 10.1.2.4. Objective proof

The objective proof rule (*régime de la preuve objective*) simply means that the court will consider the allegations and evidence brought forward by each party without putting the burden of proof on a single one.

For instance, the depreciation rate of an asset, which, in principle, is determined by the customs of the particular industry in which this asset is used, will be set by the court on the basis of the elements on these customs produced by the taxpayer and by the tax authorities. [27]

#### 10.1.3. Rules on evidence

In general, to substantiate their assertions, the parties are allowed to bring forward all the sorts of evidence permitted by the general procedural rules, even though documentary evidence is frequently favoured over other types of evidence.

##### 10.1.3.1. Documentary evidence

Evidence introduced by the parties to a tax disputes must be consistent with the written procedure, [28] which obviously makes documentary evidence particularly suitable to the proceeding. To be admissible, however, documents must meet certain standards, mostly in order to ensure that they have not been prepared by the taxpayer solely as a defence in view of a tax audit, and that they are a fair reflection of the truth.

First, the documents introduced by a party must have been established before the audit or the dispute: [29] affidavits submitted by taxpayers and signed by their customers after a court of first instance has ruled on the matter carry an obvious risk of bias and will not be taken into consideration by the court of appeals. [30]

Second, in general, evidentiary documents must result from the confrontation of contradictory interests to allay the risk of collusion. This means that the cross-checking of the item produced by a party (generally the taxpayer) as evidence with other documents from a third party must be available and that the interests of this third party must be not aligned with those of the taxpayer. [31] An invoice, which should be reflected in the records of the taxpayer's client or supplier to substantiate the deduction or profit, satisfies this rule, whereas an internal memorandum prepared by an employee of the company is less likely to be regarded as credible evidence.

Documentary evidence is not subject to any form of authentication. In principle, the best evidence rule does not apply and the courts will admit photocopies as evidence, unless there is a specific reason that requires original documents to be produced. [32]

In general, the documents presented as evidence must be specific to the taxpayer: general reports or monographs on the business in which the taxpayer is engaged may provide useful information, but have no evidentiary authority. For instance, a study prepared by the tax authorities on the average margin rates in a specific industry is not admissible as evidence. [33]

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27 *Conseil d'Etat, Plén.*, 25 November 1981, no. 11383, RJF 1/82 no. 18; *Conseil d'Etat*, 14 April 1982, no. 27228, RJF 6/82 no. 572; *Conseil d'Etat*, 5 June 1985, no. 34792, RJF 8-9/85 no. 1151.

28 Sec. R. 202-2 of the TPC.

29 *Conseil d'Etat*, 13 July 1967, no. 44452.

30 *Conseil d'Etat*, 13 July 1961, no. 41540.

31 Administrative guidelines 13 0 1221, no. 1, 30 April 1996. *Commissaire du gouvernement* Mandelkern's opinion, *Conseil d'Etat*, 24 April 1974, no. 8405.

32 *Cour de cassation, com.*, 17 October 1995, no. 1754 D, *Grappe*, RJF 1/96, no. 137.

33 *Conseil d'Etat*, 14 June 1982, no. 16671.

### 10.1.3.2. Non-documentary evidence

#### 10.1.3.2.1. Taxpayers' own admission

The tax authorities can discharge their burden of proof by introducing the taxpayer's own admission as evidence; for instance, if taxpayers admit in their pleadings that they have purchased or sold goods without invoices. [34]

#### 10.1.3.2.2. Oaths

A statement made under oath can be admitted as evidence (*serment décisoire*) in certain branches of law, [35] but they are not admitted in tax cases. [36]

#### 10.1.3.2.3. Testimonials

As noted above, tax controversies are decided by the written procedure, which excludes, in principle, the use of testimonial evidence. [37] There exist some exceptions, however. First, taxpayers and the tax authorities are allowed to introduce testimonials in the form of written affidavits if they satisfy the requirements set forth by the law. [38] Second, the TPC allows for a limited number of exceptions to the prohibition of oral witnesses in special circumstances (specifically, to challenge the notices drawn up by indirect taxes officers, in the context of public sales, or in respect of liabilities for estate tax purposes). [39]

#### 10.1.3.2.4. Expert witnesses

The purpose of expert witnesses, as envisioned by the TPC, is to assist the trier of fact to decide a factual matter in issue, such as the determination of the surface of the taxpayer's professional premises [40] or the market value of a building. [41] By contrast, legal issues must be decided by the court and cannot be submitted to an expert witness.

The expert witness can be called by the court, notwithstanding the parties' opposition. [42] The parties may also file a written application with the court to request the appointment of an expert witness. This application, which must set forth the motives and the issues to be reviewed by the expert witness, is not binding on the court, however. If a single expert is called, the choice of the expert will be made by the President of the court. If three experts are called, each of the parties will have the right to choose one. [43]

The court will stay the proceeding and render a preliminary ruling in which it will set out the assignment of the expert witness. The expert witness will draw up a report which will be submitted to the court and notified to the parties.

The court decides the party that will bear the expert witness' fees and expenses. In general, those costs are supported by the party who succumbs in respect of the facts decided by the expertise. [44]

### 10.1.4. Special rules applicable to international (tax) law cases

There are few procedural rules specific to tax cases arising in an international context. Most of them tend to shift the burden of proof to the taxpayer where the tax authorities would lack sufficient jurisdiction to collect evidence of tax fraud or tax avoidance abroad by a French taxpayer. Other rules deal with the application of tax treaties.

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34 *Conseil d'Etat*, 22 March 1985, no. 37652, RJF 6/85 no. 953; *Conseil d'Etat*, 24 November 1986, no. 47531, RJF 1/87 no. 97; *Conseil d'Etat*, 12 December 1990, no. 112316-61643, *Dumas*, RJF 2/91 no. 217.

35 Secs. 1357 and 2275 of the French Civil Code.

36 Administrative guidelines 13 0 122, no. 9, 30 April 1996.

37 Administrative guidelines 13 0 1224, no. 1, 30 April 1996; *Conseil d'Etat*, 1 June 1922, *Grosjean*, RO 4838.

38 *Cour de cassation, com.*, 5 January 1988, *Consorts Evrard*.

39 Administrative guidelines 13 0 1224, no. 4, 30 April 1996.

40 *Conseil d'Etat*, 10 December 1984, no. 45625, RTF 2/85 no. 318.

41 *Conseil d'Etat*, 15 February 1984, no. 31918, RJF 4/84 no. 545.

42 *Conseil d'Etat*, 23 February 1895, no. 79348, *Communauté des Frères de Sainte-Marie-de-Thonon*, RO 6234.

43 Sec. R. 200-9 of the TPC.

44 *Conseil d'Etat*, 17 July 1867, no. 40067, *Compagnie du Chemin de fer de Paris à Lyon et à la Méditerranée*, RO 1909.

#### 10.1.4.1. Rules shifting the burden of proof

Several rules shift the burden of proof to the taxpayer in international settings by creating presumptions of tax avoidance or of collusion of interests between the taxpayer and another party. The purpose of these rules is clearly to put the tax authorities on an equal footing with taxpayers whose operations outside France, especially in countries with secrecy laws, cannot easily be examined by the French authorities. The most common tools used by the tax authorities, which target "preferential tax regimes" (which often coincide with tax havens), are the following.

##### 10.1.4.1.1. Section 238 A of the FTC

Section 238 A of the *Code général des impôts* (French tax code, "FTC") puts on the taxpayer the burden of showing that interest accruing and royalty payments made to non-resident persons who benefit from a preferential tax regime are related to bona fide transactions and that the amount paid is not excessive.

##### 10.1.4.1.2. Section 57 of the FTC

Section 57 of the FTC permits the tax authorities to recast transactions between a French company and a related person on arm's length terms and to apportion gross income and deductions between them. In this context, two companies are regarded as "related" where one controls the other one or where they are both controlled by the same third party. Section 57 creates an un rebuttable presumption that "control" exists if the foreign entity benefits from a preferential tax regime within the meaning of Sec. 238 A of the FTC.

##### 10.1.4.1.3. Section 155 A of the FTC

Section 155 A of the FTC provides that the fees received by a person who is not resident in France in consideration for services performed in France by a French resident is taxable to the French person if (i) the French person directly or indirectly controls the foreign person which receives the fees, (ii) the French person cannot prove that the foreign person is mainly performing industrial or commercial activities other than the services at issue, or (iii) the foreign person benefits from a preferential tax regime.

#### 10.1.4.2. Tax treaties

##### 10.1.4.2.1. Courts must raise tax treaties upon their own motion

In general, French courts do not raise on their own motion the fact that a statutory provision is not consistent with an international treaty. <sup>[45]</sup> The rationale for this posture is twofold: treaties can contradict domestic law, and to point out this contradiction is to raise an error in law (*erreur de droit*), which is the responsibility of the parties.

By contrast, tax treaties are not regarded as contradicting domestic law but as being substituted to it in order to avoid double taxation. This substitution pertains to the determination of the scope of the law, which is the courts' responsibility and which accordingly leads the court to raise a contradiction with a tax treaty on its own motion. <sup>[46]</sup> This principle is also consistent with some very pragmatic concerns: while it is quite impossible for a judge to review each of the treaties entered into by France, and each of the pieces of EC law, to ensure that they do not contradict the French statute in issue, it is easy to determine which double taxation convention applies and which clauses of this treaty are relevant. <sup>[47]</sup>

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<sup>45</sup> *Conseil d'Etat*, Section, 11 January 1991, no. 90995, RJF 2/91 no. 219.

<sup>46</sup> See *Conseil d'Etat*, 19 December 1986, no. 54101, RJF 2/87 no. 176 (see also *Commissaire du gouvernement Fouquet's Opinion*, *Revue des Sociétés* 1/87, 80; *Commissaire du gouvernement Marie-Hélène Mitjaville's Opinion*, *Conseil d'Etat*, 8 July 2002, no. 225159, *Lecat*, *Bulletin des conclusions fiscales*, 11/2002, no. 133, 10; *Cour administrative d'appel of Lyon*, 27 June 1989, no. 1245, 1230, 1231, RJF 1/90, no. 73.

<sup>47</sup> Olléon, L., "Article 209 et conventions fiscales internationales: 'Après les ténèbres, la lumière'", *RJF* 10/02, 755.

#### 10.1.4.2.2. *Onus of proof*

In *Diebold Courtage*, [48] the *Conseil d'Etat* quashed the ruling of the court of appeals that had allocated to the tax authorities the onus to prove that a Dutch CV was not resident of the Netherlands for purposes of applying the France-Netherlands tax treaty. As suggested by *Commissaire du gouvernement* Bachelier, the court held that the fiscal residence under a treaty is an objective evidence: the judge will consider the elements put forward by each party to reach his own conclusion as to the residence of the taxpayer for purposes of applying the treaty.

#### 10.1.4.2.3. *Application of the treaty by the other party*

Article 55 of the Constitution subjects the prevalence of an international treaty over domestic statutes "to its application by the other party". Consequently, it must be ascertained whether the other contracting state applies the tax treaty before effect is given to its provisions by French courts; if this condition is not met, French law applies.

Fortunately, the instances in which this issue is raised are extremely rare. It is all the better since the *Conseil d'Etat* seems to be reluctant to acknowledge that the treaty is not applied by the other party. First, if there is a conflict of interpretation or if a provision is misconstrued by the courts of the other state, it cannot be considered that the other party refuses to apply the treaty. [49] Second, where the treaty rule is not different from the applicable domestic statute, there is no need to examine whether the other state fulfils its obligations under the treaty. [50] Third, the *Conseil d'Etat* refuses to ascertain whether the other contracting state applies the treaty: [51] this question is deemed to be political in nature rather than strictly legal, and is therefore passed on to the government. [52] By contrast, the *Cour de cassation* refrains from questioning the application of the treaty by the other party but also from referring the matter to the Minister of foreign affairs. [53]

### 10.2. International tax treaty case law

#### 10.2.1. Relevance of the Vienna Convention on the Laws of Treaties

##### 10.2.1.1. Status of the Vienna Convention on the Laws of Treaties in France

At the Vienna Conference on the Laws of Treaties, the French representatives expressed the view that a majority of States cannot bring into existence an international norm that would be binding on the international community irrespective of the position of individual States. France argued that the draft article on jus cogens would indeed permit new rules to emerge and be imposed on all States without any control. Consequently, France was the only State to vote against the Vienna Convention on the Law of Treaties ("VCLT") and refused to ratify it. The VCLT is therefore not binding on French courts.

##### 10.2.1.2. Application of the VCLT by French courts

Even though France has not incorporated the VCLT into domestic law, French courts in effect accept to apply most of its provisions: "it may be said that the VCLT principles of interpretation are applicable within the French system, even if they are formally deprived of legal efficiency." [54] As noted above, France refused to ratify the VCLT because of the jus cogens issue, but French courts appear to consider that Arts. 31 et seq. of the VCLT merely embody principles of customary international public law that they have no difficulty to apply. Of course, since the VCLT is not law, consistent with their practice, French courts refrain

48 *Conseil d'Etat*, 13 October 1999, no. 191191, *SA Diebold Courtage*, RJF 12/99, no. 1492.

49 *Conseil d'Etat*, 20 November 2002, no. 230530, *SA Etablissements Soulés et Cie*, RTF 2/03 no. 153, and *Commissaire du gouvernement* Goulard's Opinion, 111.

50 *Conseil d'Etat*, 16 February 1983, no. 28383, RTF 4/83 no. 496.

51 See Gutmann, D., "Tax treaty interpretation in France, the relevance of EC law", 4 *EC Tax Review* 10 (2001) p. 202.

52 *Conseil d'Etat*, 9 April 1999, *Chevroi*, AJDA 1999, 459.

53 *Cour de cassation*, *civ. lire*, *Ait Kaci*, Bull. civ. I no. 65.

54 Gutmann, op. cit. at 205. See also Martínez, J-C, "Théorie générale des conventions fiscales", *Jurisque Droit fiscal international*, fasc. 350, no. 78 et seq.; Gouthière, B. *Les impôts dans les affaires internationales*, no. 534.

from referring to it directly, even though cases are replete with instances in which the courts applied the Convention's principles implicitly.

In *Heskes*, [55] the Conseil d'Etat noted that the Agreement between France and UNESCO regarding the headquarters of UNESCO does not provide a definition of the terms "salaries and emoluments" and that, accordingly, these terms had to be interpreted in light "of their ordinary meaning", which echoes the principles laid down by Art. 31(1) of the VCLT. Similarly, the court researched whether the practice of the French tax authorities, after the adoption of the treaty, could, in accordance with Art. 31(3) (b) of the Convention, help in the elucidation of the construction of the treaty.

The *Commissaire du gouvernement*, who opine on treaty cases, quote more frankly from the Convention to support their argument and do not hesitate to acknowledge that French courts follow most of the international public law principles it codifies. [56]

However, the adhesion to the principle that a tax treaty should be construed "in the light of its object and purpose", in accordance with Art. 31(1) of the VCLT, receives much weaker support in the jurisprudence of the *Conseil d'Etat*. It has been argued that the courts have no leeway in interpreting a treaty provision that is not ambiguous, which leaves no room for considering the objective of the treaty; [57] numerous cases seem to support this position. [58] Criticizing this approach, *Commissaire du gouvernement* Austray adopted a radically opposite stance in his opinion in the *Schneider Electric* case, one of the leading cases in this area: according to him, the purpose and the objective the treaty should play a pre-eminent role, irrespective of whether the text is an *acte clair* or not. [59] At issue was whether a French company may, absent double taxation, avail itself of a tax treaty to be exempted from CFC taxation; double tax treaties, the tax authorities contended, aim at removing double taxation, hence they cannot be applied where there is no risk of double taxation. The *Conseil d'Etat* did not follow the tax authorities and its *Commissaire du gouvernement*, holding very clearly that "the objective of eliminating double taxation which is attributed to this tax treaty does not justify a misapplication of the provisions [of Art. 7 of the Franco-Swiss double taxation convention]." [60]

The standard for deviating from the provisions of the treaty and apply domestic anti-abuse statutes appears to be even higher: the *Conseil d'Etat* held that

[...]even assuming that it had been established that the objective of combating tax avoidance and evasion had been assigned to the France-Switzerland tax treaty, this objective may not, in the absence of express provision to that effect, derogate from the rules stated in the treaty.

French tax commentators seem to approve the *Conseil d'Etat's* reluctance to adopt a purposive construction of treaty provisions, which could compromise legal certainty or lead to judicial override. [61]

## 10.2.2. Relevance of the Commentaries on the Articles of the OECD MC

### 10.2.2.1. Legal status of the Commentaries in France

As mentioned above, the VCLT has no legal authority in France: therefore, the interplay between the OECD Commentaries and the VCLT has not stirred as much controversy among French commentators

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55 *Conseil d'Etat*, 17 December 2003, no. 239677, *Heskes*, RJF 2003/3 no. 249.

56 See e.g. *Commissaire du gouvernement* Abraham's Opinion, *Conseil d'Etat*, 29 June 1990, no. 78519, *GISTI*, RJF 9/90 no. 1096. For further illustrations in tax treaty cases, see *Commissaire du gouvernement* Vallée's Opinion, *Conseil d'Etat*, 17 December 2003, no. 239677, *Heskes*, RJF 3/04, no. 249; *Commissaire du gouvernement* Arrighi de Casanova's Opinion, *Conseil d'Etat*, 13 October 1999, no. 190083, *SA Banque française de l'Orient*, RJF 1999, no. 1587; *Commissaire du gouvernement* Austray's Opinion, *Conseil d'Etat, Assemblée*, 28 June 2002, no. 232276, *Sté Schneider Electric*, RJF 10/02, no. 1080.

57 Chahid-Nourai, N. and Couturier, P., "L'article 209 B du CGI est-il soluble dans le droit fiscal international? (à propos de l'arrêt CAA Paris, 30 janv. 2001, n° 96-1408, SA Schneider)", *Revue de Droit Fiscal* 8 (2001) p. 333.

58 E.g. *Conseil d'Etat*, 24 May 2000, no. 209699, *CRCAM Normand*, RJF 7-8/00 no. 974 and *Commissaire du gouvernement* Touvet's Opinion, BDCF 7-8/00, 61; *Conseil d'Etat*, 6 May 1996, no. 154217, *SA Quartz d'Alsace*, RJF 6/96 no. 731 and *Commissaire du gouvernement* Bachelier's Opinion, BDCF 3/96, 44.

59 "le texte d'un traité international, même lorsqu'il est clair, doit toujours être interprété compte tenu de son objet".

60 Translation: *International Tax Law Reports*, 2002, 1108.

61 Gouthière, B., *Les impôts dans les affaires internationales*, no. 536-5; Chahid-Nourai and Couturier, op. cit. at 333.

as it may have among scholars from other jurisdictions. [62] In particular, the question of whether it is necessary to fit the Commentaries into Arts. 31 and 32 of the VCLT to provide them with a legal authority in the interpretation process [63] has little practical importance given the status of the VCLT in France.

#### 10.2.2.2. Commentaries in force at the time the treaty was executed

Absence of a legal status does not mean that the Commentaries play no role in the construction of a treaty. It is well accepted that the Commentaries in force at the time the convention was negotiated form part of the "legal context" which the parties must have considered at that time, and therefore may be useful to infer their intent. [64] Indeed, it would be surprising that two Contracting States would choose the language used by the OECD Model without accepting the accompanying commentaries, at least when both States are members of the OECD and neither of them has registered a reservation on the particular provision under consideration. As one senior tax official, quoted by Gutmann, once put it, member States "are at least morally bound by the Commentaries". [65]

But the status of the Commentaries remains uncertain, which probably explains why the *Conseil d'Etat* rarely refers to them as a means of treaty interpretation directly in its decisions. The *Commissaire du gouvernement*, however, have acknowledged their influence on the Court's decision in multiple occasions, though not all of them embrace the idea of using the Commentaries warmly. [66] Because they have been drafted by a multilateral board of experts, and not by the negotiators of a bilateral treaty, they can serve at best as an important, though non-binding, tool for the interpretation of tax treaties. [67]

#### 10.2.2.3. Commentaries not yet in force at the time the treaty was executed

While they reluctantly accept to consider Commentaries adopted before the double taxation convention in issue was signed, French courts refuse altogether to take any account of Commentaries [68] or OECD reports [69] published after its adoption. The rationale is not specific to French courts: as expressed by a noted commentator, "subsequent Commentaries do not form part of the 'legal context' existing at the time of the conclusion of a bilateral treaty, and they cannot therefore guide one in ascertaining the intention of the treaty negotiators at the time of negotiation and conclusion of the treaty." [70] This approach, which is contrary to the view expressed in the Commentaries, [71] seems to be shared by most French commentators. [72]

### 10.2.3. Other commentaries/means of interpretation

#### 10.2.3.1. Parliamentary reports

Pursuant to Art. 53 of the French Constitution, "those [treaties] that commit the finances of the State [...] may be ratified or approved only by virtue of an Act of Parliament." The importance of tax treaties indirectly proclaimed by the Constitution and the role it confers to the Parliament in this respect do not necessarily translate in very significant debates among members of Parliament or in the preparation of elaborate reports by its committees.

62 See e.g. Ward, D., "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process", 60 *Bulletin for International Taxation* 3 (2006) p. 97; Engelen, F., "Some Observations on the legal status of the Commentaries on the OECD Model", 60 *Bulletin for International Taxation* 3 (2006) p. IBFD, March 200 p. 105.

63 Ward, D. "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process", 60 *Bulletin for International Taxation* 3 (2006) p. 98, quoting Ault, H., "The Role of the OECD Commentaries in the Interpretation of Tax treaties" in Alpert and van Raad, *Essays in International Taxation in Honour of Sidney I. Robert*, Deventer: Kluwer (1993).

64 *Commissaire du gouvernement* Goulard's Opinion, *Conseil d'Etat*, 27 July 2001, no. 215124, *SA Golay Buchel France*, RJF 11/01, no. 1428.

65 Gutmann, op. cit. at 209.

66 See e.g. *Commissaire du gouvernement* Arrighi de Casanova's Opinion, *Conseil d'Etat*, 13 October 1999, no. 190.083, *Banque française de l'Orient*, RJF 12/99 no. 1587: 'the argument that the negotiators took account of the official commentaries on the OECD Model is not necessarily irrelevant' [in the interpretative process].

67 *Commissaire du gouvernement* Austry's Opinion, CE 20 June 2003 no. 224407, *Sté Interhome AG*, RJF 10/03 no. 1147.

68 See e.g. *Commissaire du gouvernement* Arrighi de Casanova's Opinion, *Conseil d'Etat*, op. cit.; *Commissaire du gouvernement* Bachelier's Opinion, *Conseil d'Etat*, op. cit.

69 For an example in which the OECD Report on thin capitalization was found to be irrelevant: *Commissaire du gouvernement* Bachelier's Opinion, *Conseil d'Etat*, December 30, 2003, no. 233894, *SA Andritz*, RJF 2004 no. 238.

70 Ward, op. cit. at 101.

71 Commentaries to the OECD Model Convention, Introduction, no. 33 et seq.

72 Gouthière, op. cit.

The slight significance of the Parliament's reports on tax treaties probably accounts for their limited impact on French courts, which otherwise pay heed to the legislative history of statutes. French commentators tend not to mention or to downplay the impact of the legislative history of the treaties. [73]

It is therefore hardly surprising that this author is not aware of any instance in which French courts used the legislative history of the statute ratifying a tax treaty in the interpretative process. Strong arguments militate against using them in any case. In particular, reports prepared in connection with these statutes are drafted by committees made up of members of Parliament (usually with the tax authorities' help) and not by those who negotiated the draft treaty on behalf of France; therefore, they can only indirectly shed light on the negotiators' intentions.

Moreover, they may not necessarily reflect the expectations of the other party. This was recently illustrated with the renegotiation of the France-Switzerland treaty; the French negotiators insisted on revising the relief from double taxation article in a manner that allows France to tax any income in accordance with its domestic legislation, notwithstanding any provision of the treaty to the contrary, and then to credit the foreign tax against the French tax liability. The parliamentary reports prepared at the time the bill relating to this revision of the treaty was submitted to the Parliament clearly states that this new provision will allow France to apply Sec. 209 B of the FTC (the CFC statute) to Swiss entities. The Swiss tax authorities, however, have vehemently contested this interpretation, [74] which clearly shows that the legislative history of a tax treaty in Parliament provides no reliable indication of the contracting parties' mind.

#### 10.2.3.2. Minister of Foreign Affairs

The French Minister of Foreign Affairs used to play a significant role in the construction of international treaties. Traditionally, the *Conseil d'Etat* deferred to the rulings of this Minister, who was regarded as a *jurisconsulte* (legal adviser) whose opinion was binding on the courts. [75] The courts progressively freed themselves from this ministerial tutelage by increasingly using the *acte clair* doctrine, which allowed them to construe unambiguous provisions without submitting the matter to the government. [76]

The landmark *GISTI* case [77] completed this evolution and led the *Conseil d'Etat* to decide that administrative courts are fully entitled to interpret treaty provisions themselves. Civil courts similarly accept to interpret tax treaties without the assistance of the Minister of Foreign Affairs, except where it would raise "international public law issues". [78]

#### 10.2.3.3. Administrative guidelines

The French tax authorities' practice was to publish administrative guidelines for most tax treaties. However, in certain instances, only portions of a tax treaty have been commented (most notably, the tax authorities' commentaries to the Franco-US tax treaty are limited to the treatment of partnerships). [79]

In a rather odd move, the tax authorities have stated that the recently published commentary to the Franco-Algerian tax treaty applies to all provisions of other tax treaties with an identical wording. [80]

As such, these administrative guidelines have no normative authority and are not binding on the taxpayers or on the courts (even though they are binding on the tax authorities under certain conditions). In practice, however, since they codify the practice of the members of the tax administration, they have considerable power.

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73 E.g. Gouthière, op. cit.; Gutmann, op. cit. and Martinez, op. cit.

74 See the Swiss tax authorities' ruling of 9 June 1999.

75 See e.g. *Conseil d'Etat*, 19 December 1975 no. 84774, *Revue de Droit Fiscal* 76/27 no. 925, *Commissaire du gouvernement Fabre's Opinion*; *Conseil d'Etat*, 27 July 1984, no. 16649, RJF 10/84 no. 1247.

76 E.g. *Conseil d'Etat*, 9 November 1987, no. 51075, RJF 1/88, 65.

77 *Conseil d'Etat*, 29 June 1990, no. 78519, *GISTI*, RJF 9/90 no. 1096.

78 See *Cour de cassation, crim.* 28 July 1877.

79 Administrative guidelines BOI 14 B-3-99, 26 April 1999.

80 Administrative guidelines BOI 14 B-3-03, 22 May 2003.

#### 10.2.3.4. International custom

Custom is not regarded by most French scholars as an authoritative source of law in tax treaty contexts. [81] Yet, some commentators have claimed that there exists a general principle that a tax treaty cannot be the basis for a taxation that would not be permitted under domestic law alone (*principe de non-aggravation*). Even though this principle finds some support in certain decisions, [82] or administrative guidelines, [83] it is generally admitted that it has no authority and is not respected by the courts. [84], [85]

#### 10.2.4. Article 3(2) OECD MC issues

##### 10.2.4.1. Application of Article 3(2) by the French courts

In substance, Art. 3(2) directs the court to use the definitions provided by the treaty and, where terms are not defined in the treaty, to use the definitions provided by domestic law, except where the context provides otherwise. This principle is well-grounded in the case law of French courts, which tend to use it even where the treaty does not include a provision similar to Art. 3(2). [86] In *SPA Raffaella*, [87] for instance, in the absence of such a provision in the 1958 Franco-Italian double taxation convention, the court referred to the French classification rules to determine the nature of rent payments derived by an Italian company from French real estate.

This presentation, however, needs to be qualified: it has been argued that the *Conseil d'Etat* is reluctant to find definitions in a treaty and resorts to domestic definition more easily than Art. 3(2) of the Model contemplates. [88]

The *Banque française de l'Orient* case [89] illustrates this tendency: the *Conseil d'Etat* held that Art. 10 of the 1973 Franco-Dutch treaty does not define the term "dividends" but merely provides an "enumeration" of examples, which justified resorting to domestic categories. More subtly, in *Golay Buchel*, [90] it was found that the Franco-Swiss treaty did include a definition of interest income, which referred to "*revenus de créance de toute nature*" (income from debt-claims of every kind); however, those terms having no definition in the treaty, the court fell back on the French definition.

This approach probably derives from the court's line of reasoning in tax treaty cases. The judge first analyses the case under domestic law and, if double taxation arises, applies the treaty. In this process, however, the process of legal qualification under domestic law, which comes first in the analysis, tends to remain and to prevail over definitions found in the treaty, especially where they are loosely worded. In *Schneider Electric*, the leading case in this area, for instance, the court found that the income in issue was "profits" within the meaning of Sec. 209 B of the FTC and not "deemed dividends" as contended by the tax authorities. It then decided to apply Art. 7 (Business Profits) of the Franco-Swiss convention instead of Art. 10 ("Dividends") or Art. 23 ("Other Income").

Consistent with this approach, French courts do not seem to explicitly refer to the third option provided by Art. 3(2), namely departing from the meaning of a term under domestic law where the context so requires.

##### 10.2.4.2. Potential treaty override

The importance of domestic law definitions in the construction of double taxation treaties makes Art. 3(2) a potential Trojan horse for treaty override. In theory, since the *Sociétés Cafés Jacques Vabre* [91] and the

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81 E.g. Gouthière, op. cit.

82 *Conseil d'Etat*, 17 December 1984, no. 47293, *Revue de Droit Fiscal*, 11/85, no. 553, *Commissaire du gouvernement* Fouquet's Opinion referring to the "*principe général consacré par la coutume du droit fiscal international suivant lequel la convention ne peut aboutir à une aggravation de la situation du contribuable par rapport au droit interne*".

83 Min. Resp. Mariotte, JO *Assemblée Nationale*, 30 November 1960.

84 See *Commissaire du gouvernement* Mitjaville's Opinion, *Conseil d'Etat*, 8 July 2002, no. 225159, *Lecat*, BDCF, 11/2002, no. 133, 11.

85 Gouthière, op. cit.

86 Gutmann, op. cit. at 206.

87 *Conseil d'Etat*, 22 May 1992, no. 63266, *SPA Raffaella*, RJF 1992/7 no. 960.

88 See Gouthière, op. cit., no. 523 and 536.2.

89 *Conseil d'Etat*, 13 October 1999, no. 190083, *SA Banque française de l'Orient*, RJF 1999, no. 1587.

90 *Conseil d'Etat*, July 27, 2001, no. 215124, *SA Golay Buchel France*, RJF 11/01, no. 1428.

91 *Cour de cassation, Ch. mixte*, 24 May 1975, *Société des cafés Jacques Vabre*, D. 1975.497.

*Nicolo* [92] cases, treaty override is no longer permitted in France and the courts of both administrative and civil jurisdictions give full effect to tax treaties, setting aside contrary statutes.

However, applying international treaties with French definitions creates a risk of abuse on the part of the Parliament, which can tamper with the effect of tax treaties by changing the meaning of terms used in the French tax code. This danger, which was clearly perceived by some judges, [93] has recently materialized with the CFC legislation.

As mentioned above, in *Schneider Electric*, the *Conseil d'Etat* examined Sec. 209 B of the French tax code and found that its provisions "have as their objective to permit the taxation in France of the profits [*bénéfices*] arising from the business of a company established overseas and not - contrary to the submission of the minister - of the distribution of profits deemed to have been made by this foreign company to its shareholders residing in France."

Subsequently, taking note that Art. 7 of the Franco-Swiss tax treaty does not provide any definition of "profits," the court reasoned that, in accordance with Art. 3(2), the "profits" referred to in the treaty must be defined in accordance with the French tax code. Had the tax code defined the income taxed under Sec. 209 B as a dividend deemed to have been distributed by the subsidiary, it is very likely, in the light of this reasoning, that the *Conseil d'Etat* would have found that it was not governed by Art. 7 of the Franco-Swiss treaty and that the latter did not preclude the tax authorities from applying Sec. 209 B. The tax authorities seem to have embraced this approach fully since, in the 2005 Finance Law, Sec. 209 B of the FTC was revamped and now targets distributions deemed to have been made by the foreign subsidiary. [94]

## 10.2.5. Foreign evidence

### 10.2.5.1. Foreign evidence obtained through the exchange of information procedure

Most procedural issues arising in connection with foreign evidence relate to the exchange of information clause in tax treaties.

The procedural requirements regarding the form of the documents received from the competent authorities of another State, or the way they are provided to the French authorities, are minimal and have no bearing on their admissibility. [95] The taxpayers' guarantees are also limited: for instance, there is no requirement under French law that a taxpayer be advised that the French tax authorities have requested information concerning him or her from a foreign State, [96] even though certain courts have ruled otherwise. [97]

The main difficulty when it comes to documents obtained through the exchange of information procedure lies with the communication or non-communication of such information to the taxpayer. There is an obvious tension between the provisions of tax treaties, which tend to stress the requirement of secrecy and to preclude the communication of this information to the taxpayer, and the right to a fair trial which clearly requires that the taxpayer be presented with this information.

French courts are split in this respect, and tend to favour either of these approaches. The *Cour administrative d'appel* of Nancy held that the French tax authorities must provide the taxpayer, upon his demand, with the investigation report drawn up by foreign authorities. [98] The *Cour de cassation* consistently adopted a similar approach and ruled in *Lynch* [99] that the information obtained under Art. 26

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[92] *Conseil d'Etat*, 20 October 1989, no. 108243, *Nicolo*, RJF 11/89 no. 1266.

[93] According to *Commissaire du gouvernement* Austry, in his opinion in *Conseil d'Etat*, 30 December 2002, no. 236096, *Hanna*, RJF 2003/3, 195, "lorsque le choix fait par le législateur de taxer selon une certaine qualification, ici celle de distributions occultes qui ne constituent pas en droit interne des dividendes, conduit à permettre l'imposition en France de revenus appréhendés par un non-résident, il faudrait s'interroger sur la conformité de la législation qui permet une telle imposition au regard de la régie *pacta sunt servanda*."

[94] "Lorsqu'ils sont réalisés par une entité juridique, [les bénéfices] sont réputés constituer un revenu de capitaux mobiliers imposables de la personne morale établie en France."

[95] *Tribunal administratif* de Dijon, 14 May 1996, no. 92-2210, *Oldham*, RJF 1996/10 no. 1119.

[96] *Min. Resp. Cerisier-Ben Guiga*, JO Sénat, 11 June 1998, 1873.

[97] *Cour administrative d'appel* of Nancy, 9 July 1992, no. 320, *SA Wilvia International*, RJF 12/92 no. 1625.

[98] *Id.*

[99] *Cour de cassation, com.*, 20 October 1998, no. 1584 P, *Lynch*, RJF 1/99 no. 45.

of the 1967 tax treaty between France and the United States was to be communicated to the taxpayer; the court reasoned that if the documents could be furnished to a judge, it implied necessarily that the parties to the proceeding should have similar access to them. In stark contrast to this ruling, in *Rohart* [100] the *Conseil d'Etat* stressed that this provision required the information obtained through this channel to be kept confidential and not disclosed to the taxpayer. It has been argued that this very literal construction of the treaty was warranted by the terms of the 1967 Franco-US treaty, which departed slightly from those of the OECD Model: where the former precludes the communication of the information to any persons other than those "*chargées de l'assiette, du recouvrement, de l'administration, de la perception, des poursuites ou de la détermination des recours relatifs aux impôts faisant l'objet de la présente convention*" (responsible for the assessment or collection of tax), the OECD Model reads: "*concernées par*" (concerned with), which could encompass the taxpayer. [101], [102] The *Conseil d'Etat* kept to its hard line in the context of the France-Switzerland tax treaty, [103] in which the provisions relating to the exchange of information are close to those of the 1967 France-US treaty. [104] It is not absolutely clear whether the *Conseil d'Etat* would have acceded to the taxpayer's request to be provided with the documents had the provisions been similar to those of the OECD Model, in respect of which the Commentaries expressly state that the information may be communicated to the taxpayer, [105] as suggested by some commentators. [106]

This is not to say that the *Conseil d'Etat* unduly favours the secrecy imposed by the treaty at the expense of the taxpayers' rights. On the contrary, the judges try to balance the secrecy requirement with the right to a fair trial by forcing the tax authorities either to disclose the information or to abstain from using it. [107] Though logical, this line of reasoning leaves little choice to the tax authorities and could lead the exchange of information provisions to remain unapplied for fear of not being able to use the documents received. Interestingly enough, a court of first instance tried to reconcile both requirements by staying the proceeding before it for six months and by enjoining the tax authorities to obtain the US IRS's authorization to communicate the information to the taxpayer.

#### 10.2.5.2. Foreign evidence obtained through the exchange of information procedure

Written documents in a language other than French are not admissible as evidence, unless an official translation in French is also provided to the courts. [108]

### 10.2.6. Foreign tax law

#### 10.2.6.1. Foreign law as evidence

In principle, the burden of determining the rules applicable to the dispute lies with the courts, [109] which must therefore take account of the foreign law in the resolution of the case. [110] However, as noted by Gutmann, [111] this is far from being readily admitted by the tax authorities, which usually put the onus on the taxpayer. In particular, where a French resident contends that he/she is also resident of another State, the tax authorities will claim that the taxpayer must prove this allegation. This could rest on a now rather old decision in which the *Conseil d'Etat* ruled that an individual availing himself of the protection of the

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[100] *Conseil d'Etat*, 5 March 1993, no. 105069, *Rohart*, RJF 5/93 no. 674.

[101] See, Gouthière, op. cit.

[102] The English language versions of the 1967 Franco-US treaty (which reads "concerned with") and the OECD Model (which reads "involved in") do not seem to reflect this nuance.

[103] *Conseil d'Etat*, 30 June 1995, no. 140891, *Fontana*, RJF 8-9/95, no. 990.

[104] Art. 27 of the treaty reads: "*personnes qui s'occupent de la fixation ou de la perception des impôts*", which is probably more restrictive than "persons concerned with".

[105] Commentary on Art. 26, §12: "The information obtained may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes with respect to which information may be exchanged according to the first sentence of the paragraph. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses.

[106] Mignon, E., *Fiscalité Internationale: la transparence n'est pas le vide*, RJF 12/99, 931.

[107] Id.

[108] *Cour administrative d'appel* of Paris, 7 May 1997, no. 94-1144, *Bitton*, RTF 1/98 no. 68; *Conseil d'Etat*, 10 June 1998, no. 188942, *Bitton*, RTF 10/98 no. 1073.

[109] Art. 12 of the Civil Procedure Code: "*le juge tranche le litige conformément aux règles de droit qui lui sont applicables*".

[110] See *Cour de cassation*, civ. Ière, 13 November 2003, *Revue critique de Droit International Public* 2004.495.

[111] Gutmann, *Le juge fiscal et la loi étrangère*, L'année fiscale 2005, 205.

France-UK tax treaty had to prove that he was a resident of the UK (such condition was not met by the taxpayer by simply referring to the taxes paid in the UK). [112]

According to Gutmann, the burden of proof should rest on the tax authorities, since, in practice, they have the wherewithal to obtain the required information from their foreign counterparts: most notably, the OECD Model provides that

[...]the competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, [...], insofar as the taxation thereunder is not contrary to the Convention." [113]

Within the European Union, the Directive of April 2004 [114] similarly allows tax authorities of the Member States to exchange information.

In practice, it seems that the courts follow this approach; for instance, in a case where a trust set up under the laws of the US was in issue, the court found that the tax authorities had failed to meet their burden of proving that the beneficiary of the trust had rights in rem (*droits réels*) on the assets in trust, which shows that the proof of the foreign law, in the mind of the court, was on the tax authorities. [115]

But even without shifting the burden of proof entirely to the tax authorities, it should be possible for tax courts to make this determination themselves. [116] The *Diebold Courtage* case illustrates this pragmatic approach of a rather delicate question: in this case, the *Conseil d'Etat* referred to a letter from the Dutch authorities describing the status of "*commanditaire vennootschap*" (limited liability partnerships) under Dutch law to reach its decision. This does not mean, however, that the taxpayer has no role to play in this matter. In *Superseal*, the issue was the dissolution of a Canadian wholly owned subsidiary by its Canadian parent and its consequences in France, and the *Conseil d'Etat* asked the Canadian respondent to provide a legal analysis of the reorganization under Ontario law to assist in the resolution of the case. [117]

#### 10.2.6.2. French courts and foreign tax law

French courts will take limited notice of foreign tax law, except to determine whether a taxpayer is resident of the foreign State under the tax laws of that State. Otherwise, French courts will ignore foreign tax laws.

In *Société L'Oréal*, the *Cour administrative d'appel* of Paris decided that a "*stille Gesellschaft*" could not be regarded as a corporation under French law and the profits it distributes are not "dividends" for purposes of applying the French participation exemption regime. In reaching this decision, the court refused to consider the provisions of the German tax legislation and those of the France-Germany tax treaty, which subject the profits received by a "*stiller Gesellschafter*" to the regime applicable to dividends. [118] Similarly, in *Superseal*, the *Commissaire du gouvernement* stated that while the legal effects of the dissolution without liquidation of an Ontario company had to be determined in accordance with Ontario corporate law, the tax consequences of the transactions were governed by French tax law only and that the Ontario tax legislation was entirely irrespective in this respect.

#### 10.2.7. Foreign court decisions and foreign administrative practice

As noted above, French courts do not follow the doctrine of *stare decisis* (*arrêts de règlement*). Similarly, administrative guidelines published by the French tax authorities have no legal authority. Consequently,

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[112] *Conseil d'Etat*, 14 February 1979, no. 6961.

[113] Art. 26(1) of the OECD Model Convention.

[114] Council Directive 2004/56/EC of 21 April 2004 amending Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums.

[115] See Blanluet, G. and Le Gall, J-P., "*Le trust au pied du mur*", TGI Nanterre 4 May 2004, *Revue de Droit Fiscal* 29 (2005) p. 1230.

[116] The European Convention on Information on Foreign Law of 7 June 1968 provides a legal basis for requests for information on foreign law and practices.

[117] *Commissaire du gouvernement* Goulard's Opinion, *Conseil d'Etat*, 27 May 2002, no. 1259659, *Sté Superseal Corporation*, 40 *Revue de Droit Fiscal* 750 (2002) p. 1318.

[118] *Cour administrative d'appel* of Paris, 14 April 2005, no. 03-2347, *Sté L'Oréal*, 36 *Revue de Droit Fiscal* 552 (2006).

there is no reason why French courts should pay special heed to foreign courts' or tax authorities' decisions and, not surprisingly, they do not.

It is settled case law that the interpretation of tax treaties adopted by French courts is autonomous from the position taken by foreign administrations. <sup>[119]</sup> The epitome for the French courts' disdain of foreign practices is the *Malet* case, <sup>[120]</sup> in which the *Conseil d'Etat* ruled that director's fees received by a French director from a US company must be regarded as "other income" under the 1967 France-US tax treaty, albeit the IRS considered that the same are governed by the provisions applicable to income derived from professional services, which resulted - much to the taxpayer's satisfaction and the French tax authorities' dismay - in leaving the fees untaxed in both States. While acknowledging that autonomous interpretations may lead to double exemption, *Commissaire du gouvernement* Fouquet concluded that this situation is common in international cases.

What is true for foreign administrative practices is also true for decisions rendered by foreign jurisdictions. To say that the decisions of foreign courts are not controlling does not mean that French courts ignore them entirely. In a report on requests for a preliminary ruling of the European Court of Justice, the *Conseil d'Etat* mentioned the fact that "exceptionally and in very sensitive matters involving European law issues," the Court researched decisions rendered by courts of other EU Member States. <sup>[121]</sup> *Commissaires du gouvernement* also - but rather infrequently - refer to foreign cases: in the *Schneider Electric* case, Austria noted that the Court of Appeal of London had ruled that tax treaties provide no protection against the UK CFC legislation in its *Bricom Holdings* ruling. <sup>[122]</sup> Again, even though it is obviously difficult to provide a fully informed answer to this question, the scarcity of references to foreign courts' decisions probably reflects their very limited impact on the tax decisions rendered by French courts.

### 10.3. Article 234 EC treaty

#### 10.3.1. Cases involving application of EU law which have not been referred to the ECJ

French courts have submitted approximately 600 requests for a preliminary ruling to the European Court of Justice (ECJ) since its creation. <sup>[123]</sup> Few among them directly dealt with the application of tax treaties. This is not surprising given the paucity of cases raising tax treaty and Community law issues.

In *Société Ceia International*, <sup>[124]</sup> the *Tribunal administratif* of Cergy-Pontoise examined whether the French thin capitalization rules were in line with the freedom of establishment. The French tax authorities had disallowed the deduction of interest accrued by Ceia International, a French company, to its Italian parent; it was not disputed that the interest would have been fully deductible had the parent been resident of France. Not surprisingly, the court held that the statute created a discrimination and was in breach of Art. 43 of the EC Treaty. It is worth noting that, before doing so, the court pointed out that the France-Italy tax treaty included a provision that expressly allowed France to apply its thin capitalization rules. In spite of this reference, the court refused to give effect to this provision and ruled in favour of the taxpayer. This decision suggests that French courts recognize that a general rule of European law should prevail over a provision of a tax treaty, even if the latter is more specific than the former. Interestingly, the court did not find it necessary to refer the matter to the ECJ or to stay the proceeding, even though the *Lankhorst-Hohorst GmbH* case, in which the compatibility of the German thin capitalization rules with the EC Treaty were in issue, was being heard at the same time by the Court. The court did not even follow its

<sup>119</sup> See e.g. *Tribunal administratif* of Versailles, 23 January 2001, no. 94-5442, 97-3388, *Jurcik*, R/JF 10/01 no. 1290.

<sup>120</sup> *Conseil d'Etat*, 26 February 1992, no. 83461, *Malet*, *Revue de Droit Fiscal*, 1992/ 52 no. 2459.

<sup>121</sup> "Le Conseil d'Etat français et le renvoi préjudiciel à la Cour de justice des Communautés européennes: rapport", *Conseil d'Etat, Actes du Colloque sur le renvoi préjudiciel à la Cour de justice des Communautés européennes* (2002) p. 14.

<sup>122</sup> See also *Commissaire du gouvernement* Bachelier mentioning the Canadian Federal Court of Appeal's decision in the *Specialty Manufacturing Ltd* case in his opinion in the *SA Andritz* case.

<sup>123</sup> *Rapport, Conseil d'Etat*, 2006, 278; as at 31 December 2005, the ECJ had recorded 693 requests for a preliminary ruling referred by French courts (ECJ, Annual report, 2005).

<sup>124</sup> *Tribunal administratif* of Cergy-Pontoise, 11 July 2002, no. 99-35301, *Sté Ceia International*, R/JF 12/2002 no. 1364.

*Commissaire du gouvernement*, who had opined that the court should postpone its decision until the ECJ rendered its ruling in the *Lasteyrie du Saillant* case.

Another interesting example is provided by the *Denkavit France* case. <sup>[125]</sup> Denkavit France, a French company, declared a dividend to Denkavit International BV, its Dutch parent, which attracted a withholding tax in France (the distribution occurred prior to the entry into force of Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, which removed withholding taxes on distributions between subsidiary and parent companies in the European Union). Had the parent been subject to tax in France, the dividend would not have been subject to withholding tax and, more generally, would not have been taxable to the recipient by virtue of the French parent-subsidiary regime. This apparent discrimination is less blatant when the provisions of the tax treaty between France and the Netherlands comes into the picture since Art. 24 of the treaty provides that the amount withheld by the French subsidiary can be set off by the Dutch parent against its own tax in the Netherlands. Dutch parents are not put on an equal footing with French parents, however, when the amount of withholding tax levied exceeds the tax liability of the parent and provides no tax benefit in the Netherlands. The court of first instance held that the petitioner had been discriminated against and that the withholding tax had been levied in breach of the freedom of establishment; it did not find it necessary to obtain further clarification from the ECJ. On the appeal of this case, the court stated expressly that it was not necessary to refer the matter to the European judge, in spite of the *Commissaire du gouvernement's* opinion to that effect, and reversed the decision of first instance. <sup>[126]</sup>

### 10.3.2. Referral ex officio

The *Conseil d'Etat* has developed its own doctrine on the opportunity of referring cases to the ECJ. In this respect, the requests presented by the parties seem to carry little weight in the *Conseil d'Etat's* decision to refer the matter to the ECJ.

As at 31 December 2001, the *Conseil d'Etat* had referred 24 cases to the European Court of Justice, out of which five were in respect of tax matters. <sup>[127]</sup> The petitions expressly requesting the matter to be referred to the ECJ are extremely limited, but tend to grow. From January 1995 through October 2000, approximately 15 such requests had been identified by the *Conseil d'Etat*, out of which none concerned tax matters. According to the report, the submission of a petition in view of bringing the case to the ECJ "has no bearing whatsoever on the determination of whether the case shall be referred;" <sup>[128]</sup> indeed, as at the date of the report, the *Conseil d'Etat* had never referred a case to the ECJ upon the request presented by a party.

A further example of the non-interference of the parties' submissions in the decision to refer the case to the ECJ is provided by the *Denkavit France* case mentioned above, in which the taxpayer had asked the court to bring the matter to Luxembourg, which the Court of Appeals expressly refused to do.

Criteria for deciding on whether to remand a tax case to the ECJ or to apply EU law directly have been developed in a few recent cases.

The most salient case in this area is *Lasteyrie du Saillant*. <sup>[129]</sup> The *Conseil d'Etat* examined the French exit tax, which, until it was repealed, subjected taxpayers transferring their tax domicile outside France to immediate taxation on the built-in gain on certain securities they held. Based on *Commissaire du gouvernement* Goulard's opinion, the Court had no great trouble reaching the decision that the statute at hand was probably breaching the freedom of establishment. Several arguments led the Court to refrain from ruling immediately on the case, however, and to give the ECJ an opportunity to give its input. First,

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<sup>125</sup> *Conseil d'Etat*, 15 December 2004, no. 235069, *Sté Denkavit International BV et SARL Denkavit France*, RJF 2005/3 no. 233.

<sup>126</sup> *Cour administrative d'appel* of Nantes, 13 March 2001 no. 97-1922, *Sté Denkavit France et Sté Denkavit International BV*, *Revue de Droit Fiscal* 7/02 no. 121.

<sup>127</sup> "Le Conseil d'Etat français et le renvoi préjudiciel à la Cour de justice des Communautés européennes: rapport, Conseil d'Etat", *Actes du Colloque sur le renvoi préjudiciel à la Cour de justice des Communautés européennes*, 2002 p. 22.

<sup>128</sup> *Id.* p. 17.

<sup>129</sup> *Conseil d'Etat*, 14 December 2001, no. 211341, *Lasteyrie du Saillant*, RTF 2/02 no. 160.

the issue at stake was new: exit taxes had not yet been dealt with by the ECJ even though prior decisions in the tax field suggested that the ECJ would find the statute contrary to EC law. It is unlikely, however, that this issue alone would have prevented the *Conseil d'Etat* from ruling on the case. But, second, and probably more importantly, the justices were aware that exit taxes were not a Gallic peculiarity but were shared by other Member States. The interpretation by the European Court of exit taxes in the context of the freedom of establishment would have repercussions in other Member States, and most probably would force these other States to follow France in repealing their exit tax statutes. The third argument derives from the second: repealing exit taxes would encourage taxpayers to take advantage of the more favourable tax regimes in Europe, thereby reining back on national sovereignties, and eventually, the *Commissaire du gouvernement* hoped, prompt Member States to agree on further tax harmonization in the European Union.

Another important case provides further insight on the *Conseil d'Etat's* line of reasoning. In *Coréal Gestion*, <sup>[130]</sup> the *Conseil d'Etat* considered that the thin capitalization statute breached EC law, but that no guidance from the ECJ was needed to reach this conclusion. *Commissaire du gouvernement* Goulard explored this issue by distinguishing *Coréal Gestion* from *Lasteyrie du Saillant*. Clearly, the thin capitalization rules were discriminatory and no strong argument could be put forward to their support. From a policy standpoint, it was unlikely that the case could provide the ECJ with an opportunity to refine its jurisprudence, which seemed already strongly settled with the recent and topical *Lankhorst-Hohorst* ruling.

This analytical grid has been used in other instances. Most notably, in *Denkavit France*, *Commissaire du gouvernement* Donnat explicitly applied *Coréal Gestion* (or, rather, Goulard's opinion, since the discussion is not apparent in the court's decision) to opine that the matter should be remanded to the ECJ. One of the most significant arguments in this favour was the interplay between the tax treaty, which mitigated the potential tax disadvantage affecting the Dutch parent, and the freedom of establishment. While noting that early on the ECJ held that "rights conferred by article 52 of the treaty are unconditional and a member state cannot make respect for them subject to the contents of an agreement concluded with another member State. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other member states," Donnat suggested that the case at hand in *Denkavit France* was sufficiently different to warrant a specific examination by the ECJ.

### 10.3.3. Application of Article 234(3) by highest courts

This author is not aware of any case involving the application of tax treaties in which either the *Conseil d'Etat* or the *Cour de cassation* decided not to refer the matter to the ECJ on the basis of the *acte clair* theory.

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130 *Conseil d'Etat*, 30 December 2003, no. 249047, *SARL Coréal Gestion*, RTF 2004/3 no. 233.

## Chapter 11 – Germany

### 11.1. The nature of rules governing tax litigation

#### 11.1.1. Tax law procedure versus other kind of procedure

Germany is a federal State. In general, the federation (*Bund*) has the competence to legislate the tax laws, <sup>[2]</sup> whereas the states (*Länder*) have the competence to administer the tax laws and collect the tax revenue.

The federation and the states have their own tax administration: <sup>[3]</sup> At the federation the highest level is the Ministry of Finance, the middle level is the so-called *Oberfinanzdirektion* and on the lowest level is the customs office. At the states the highest level is the Ministry of Finance of the states, on the middle level is the *Oberfinanzdirektion* and on the lowest level is the local tax office (*Finanzamt*). The local tax offices assess the amount of tax and levy the taxes. The *Oberfinanzdirektion* is an administration that belongs both to the federation and the states.

The tax assessment has to be in accordance with the applicable laws; therefore, the tax administration has to inquire all the facts for the tax assessment (*Untersuchungsgrundsatz*) <sup>[4]</sup> and cannot limit its inquiry to the facts stated by the taxpayer in a tax return. The tax administration has to look for facts that lead to a higher tax obligation as well as for facts which lead to a lower tax obligation of the taxpayer. The taxpayer is obliged to cooperate with the tax administration and has to provide all the evidences requested by the tax administration and has to answer truthfully. <sup>[5]</sup>

Germany has established a system of specialized tax courts. <sup>[6]</sup> The tax courts of first instance (*Finanzgerichte*) decide upon questions of facts and of law. The *Bundesfinanzhof*, as the court of second instance and the highest tax court in Germany, only decides upon questions of law. <sup>[7]</sup> The judges are all specialized tax judges belonging to the judiciary. In order to become a judge at a tax court the judges must have passed the second state examination in law. <sup>[8]</sup> The judges thus have the same education as lawyers, whereas economists are not allowed to serve as a judge at a tax court. As a position at a tax court enjoys a very high reputation, <sup>[9]</sup> many judges have served in the tax administration or spent some years in private tax practice before being appointed to the tax court. Judges from the *Bundesfinanzhof* are normally selected from the tax courts, in rare cases they are appointed directly from the tax administration.

At the level of the tax court, a body of five judges consisting of three professional judges and two lay judges passes judgments. <sup>[10]</sup> Decisions of minor importance are passed by one judge alone. At the level of the *Bundesfinanzhof*, all judgments are rendered by a body of five professional judges. <sup>[11]</sup>

Judgments are structured as follows: <sup>[12]</sup> A judgment begins with the name of the parties, followed by the name of the court and the names of the participating judges. Afterwards, the central part of the judgment, the conclusion, is given. Then the facts are stated, followed by an explanation of why the judges believed the facts to be true and the legal reasoning. The last part of the judgment explains the appeal process

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<sup>2</sup> Art. 105 (2), Art. 106 GG.

<sup>3</sup> Art. 108 GG, Secs. 1 and 2 FVG. See Seer, in Tipke/Lang, *Steuerrecht*, Köln, 18th ed. 2005, Sec. 21 marg. note. 30 et seq.

<sup>4</sup> Sec. 88 AO. See Seer, id. Sec. 21 marg. note 3.

<sup>5</sup> Sec. 90 seq. AO.

<sup>6</sup> See Sec. 1 FGO: "Die Finanzgerichtsbarkeit wird durch unabhängige, von den Verwaltungsbehörden getrennte, besondere Verwaltungsgerichte ausgeübt".

<sup>7</sup> See Sec. 2 FGO: "Gerichte der Finanzgerichtsbarkeit sind in den Ländern die Finanzgerichte als obere Landesgerichte, im Bund der Bundesfinanzhof mit dem Sitz in München".

<sup>8</sup> The second state examination is equivalent to the bar examination in other countries.

<sup>9</sup> A judge at a tax court receives the same salary as a judge at an "Oberlandesgericht" (court of second instance in civil or penal procedure).

<sup>10</sup> Sec. 5 (3) FGO: "Die Senate entscheiden in der Besetzung mit drei Richtern und zwei ehrenamtlichen Richtern, soweit nicht ein Einzelrichter entscheidet".

<sup>11</sup> Sec. 10 (3) FGO: "Die Senate des Bundesfinanzhofes entscheiden in der Besetzung von fünf Richtern ....

<sup>12</sup> See Sec. 105 (2) FGO.

and also has the signature of the judges. The length of a judgment depends on the legal difficulties of the case, ranging from very short judgments of less than a page to very long judgments of more than 50 pages. Judgments are passed by a majority of the judges; dissenting opinions are not allowed.

The courts are not bound by the administrative practice and often decide in favour of the taxpayer. Concerning technical questions such as the lifespan of depreciable goods, the courts generally follow the expertise of the tax administration, unless the results are not reasonable.

The influence of the literature seems to be quite extensive. In most of the cases, the courts at least deal with the relevant literature and cite the literature in order to find support, or on many occasions the courts explain why they did not follow the opinion in the literature.

All relevant decisions of the courts are published and available to the public. The *Bundesfinanzhof* has its own reporter (the so-called "*Entscheidungen des Bundesfinanzhofes*") and the decisions not published in this reporter can be found in the journal *BFH/NV* (decisions of the *Bundesfinanzhof* that are not officially published). All the important decisions of the tax courts of first instance are published in a journal called "*Entscheidungen der Finanzgerichte*" (decisions of the tax courts). The *Bundesfinanzhof*, as well as most tax courts, also publish their decisions online. <sup>[13]</sup>

### 11.1.2. Burden of proof

If a taxpayer is not satisfied with the result of a tax assessment, they have the right to file an objection against the assessment. The tax administration then has to review the case. <sup>[14]</sup> If the tax administration does not change its opinion, the taxpayer can go to court. The taxpayer decides which part of the tax assessment shall be reviewed in court. The courts are not allowed to go beyond the taxpayer's claim (*ne ultra petitur*) and must not worsen the result of the assessment of the tax administration (*no reformatio in peius*). <sup>[15]</sup> The taxpayer and the tax administration are not allowed to dispose about the facts and the legal results. They cannot agree on the factual situation and on the interpretation of a tax law provision. The tax court has to inquire the facts (*Untersuchungsgrundsatz*) <sup>[16]</sup> and will decide about the legal consequences according to its point of view.

As regards the burden of proof, neither the taxpayer nor the tax administration is obliged to prove the facts. The tax court will inquire the facts on its own. The question of the burden of proof only arises when facts cannot be clarified and remain in doubt. If the facts of a provision which favours the tax administration (i.e. a provision that establishes or increases the tax liability) cannot be proven, the tax administration does not prevail and the taxpayer does not have to pay the taxes. On the other hand, if the facts of a provision that favours the taxpayer (e.g. a tax exemption or an accelerated depreciation) cannot be proven, the taxpayer loses and will have to pay the taxes. Although taxpayers do not have the obligation to prove the facts beneficial to themselves, it is in their interest to give evidence in these cases.

### 11.1.3. Rules on evidence

As noted above, the court inquires the facts of the case. Facts can be proven by the following evidence: exhibits or inspection of an object such as a house by the court itself, witnesses, experts, documentary material or the questioning of the parties. <sup>[17]</sup> Evidence must be relevant, meaning that it must have a tendency to make the fact at issue in the proceeding more or less probable than it would be without the evidence. The evidence must be at hand, which means that it must not be too complicated or too time-consuming to obtain. <sup>[18]</sup> Only the evidence that has been examined by the court can be taken into account for the judgment. <sup>[19]</sup>

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<sup>13</sup> See e.g. [www.bundesfinanzhof.de](http://www.bundesfinanzhof.de); [www.finanzgericht.niedersachsen.de/master/C3139311\\_L20\\_D0.html](http://www.finanzgericht.niedersachsen.de/master/C3139311_L20_D0.html); [www.fg-koeln.nrw.de/](http://www.fg-koeln.nrw.de/).

<sup>14</sup> See Sec. 347 seq. *AO*.

<sup>15</sup> See Seer op.cit. Sec. 22 marg. note 162.

<sup>16</sup> Sec. 76 (1) (1) *FGO*: "*Das Gericht erforscht den Sachverhalt von Amtswegen*". See Seer op.cit. Sec. 22 marg. note 160.

<sup>17</sup> See Sec. 81 *FGO*.

<sup>18</sup> See List in Hübschmann/Hepp/Spitaler, *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, Köln, loose-leaf, November 1994, Sec. 81 *FGO* marg. note 2.

<sup>19</sup> See List id. Sec. 81 *FGO* marg. note 4: *Grundsatz der Unmittelbarkeit*.

The parties can only suggest particular evidence. The court is not obliged to follow that suggestion. [20] The court can set a time limit for a party to provide evidence. After the time has elapsed, the court is no longer obliged to take the evidence into account, even if the evidence is relevant for the judgment. [21]

This procedure is similar to the procedure in general administrative law. However, the tax procedure is quite different compared to penal law and civil law. In penal law the accused does not have the power to withdraw a claim. Similar to penal law is the inquisitorial system of adjudication, in which judges undertake an active investigation of the suits by examining the evidence. Similar to civil procedure, taxpayers have the right to withdraw their claim and to decide the issue that should be dealt with in court. In contrast, the civil law procedure follows an adversarial system in which the claimant and the defendant have to deliver the facts and the evidence, and in which the judge has a much more passive role and only presides over the proceedings.

#### 11.1.4. Special rules applicable to international tax

Generally, there are no special rules available whenever the application of international tax law comes into play. According to the German point of view, [22] tax treaties never generate tax obligations for the taxpayers; they only limit the taxing right of the Contracting States. As the application of a tax treaty is favourable for the taxpayer, the burden of proof is on taxpayers that they fall within the ambit of a tax treaty provision. The only difference between the application of domestic tax law and the application of a tax treaty can be found in its different interpretation. Courts interpret tax treaties in accordance with the Vienna Convention on the Law of Treaties (see 11.2.1.). These interpretation rules differ in some cases from the interpretation applied in a pure domestic setting.

### 11.2. International tax treaty case law

#### 11.2.1. Relevance of VCLT

Germany is a signatory state to the VCLT. It ratified this convention in 1987. According to the German point of view, the rules of interpretation contained in the VCLT have achieved the status of customary international law. [23] In some cases, German tax courts explicitly rely on the VCLT for the interpretation of tax treaties, as, for example, in the following:

##### 11.2.1.1. FG Köln II K 223/85 [24]

In its judgment the tax court held that the interpretation rules contained in the VCLT are customary international law and are, therefore, directly applicable in German law. According to Art. 32 VCLT, only the preparatory work of the treaty and the circumstances of its conclusion constitute a supplementary means of interpretation. This means that the OECD Model Convention cannot be used for the interpretation of a treaty if the tax treaty is older than the OECD MC.

##### 11.2.1.2. BFH I R 20/87 [25]

The *Bundesfinanzhof* has stated that the interpretation rules of the VCLT cannot be applied to tax treaties that are concluded before the VCLT became effective. According to its Art. 4, the VCLT applies only to treaties that are concluded by States after the entry into force of the Convention.

20 Sec. 76 (1) (4) FGO: "Das Gericht ist an das Vorbringen und an die Beweisanträge der Parteien nicht gebunden".

21 Sec. 79 (3) FGO: "Das Gericht kann Erklärungen und Beweismittel, die erst nach Ablauf einer...Frist vorgebracht werden, zurückweisen und ohne weitere Ermittlungen entscheiden, wenn 1. ihre Zulassung nach der freien Überzeugung des Gerichts die Erledigung des Rechtsstreits verzögern würde und 2. der Beteiligte die Verspätung nicht genügend entschuldigt und 3. der Beteiligte über die Folgen einer Fristversäumung belehrt worden ist".

22 Vogel in Vogel/Lehner, *Doppelbesteuerungsabkommen*, München, 4th ed. 2003, Intro. marg. note 72; Locher, "Zur negativen Wirkung von Doppelbesteuerungsabkommen", in *Festgabe zum Schweizerischen Juristentag 1988*, p. 366.

23 Vogel op.cit. Intro. marg. note 45.

24 FG Köln, 16.12.1986, EFG 1987, 230.

25 BFH, 14.03.1989, BStBl. II 1989, 649.

## 11.2.2. Relevance of the Commentaries on the Articles of the OECD MC

German courts rely in many occasions on the OECD MC for the interpretation of a tax treaty term. The courts, however, do not clarify the relationship between the OECD MC and the VCLT. In the literature, the interpretation of a tax treaty term by the OECD MC is either regarded as the ordinary meaning in the sense of Art. 31(1) VCLT or as the special meaning in the sense of Art. 31(4) VCLT. <sup>[26]</sup> Apart from this academic dispute of the right categorization, it is undisputed that the treaty partners by employing a term used in the OECD MC wanted to give it the meaning contained in the commentary of the OECD MC, unless they have made a reservation to the Commentaries.

### 11.2.2.1. FG Hamburg II 79/64 <sup>[27]</sup>

The *Finanzgericht* has held that all provisions that are formulated identically to the OECD MC must be interpreted in the light of the OECD Commentaries.

### 11.2.2.2. BFH I R 47/90 <sup>[28]</sup>

The *Bundesfinanzhof* further stated that if the wording of a tax treaty differs from the wording of the OECD MC, the tax treaty nevertheless has to be interpreted in the light of the Commentaries to the OECD MC, unless it is clear that the different wording was chosen in order to give a different meaning to the tax treaty term.

In summary, German courts generally interpret tax treaty terms in accordance with the Commentaries of the OECD MC. It is, however, disputed whether it is possible to apply a later version of the Commentaries to a tax treaty concluded before the modification (or clarification) of the Commentaries. <sup>[29]</sup>

## 11.2.3. Other commentaries/means of interpretation

Germany does not furnish technical explanations to its tax treaties. The courts have not yet referred to the UN Model Convention <sup>[30]</sup> or the technical explanations of the US Model. In order to come to a common interpretation in both Contracting States, unilateral documents or statements issued by the German government after the conclusion of the tax treaty are generally disregarded by the courts. <sup>[31]</sup> In the past, the *Reichsfinanzhof* had a different view; this view, however, was no longer upheld by the *Bundesfinanzhof*.

### 11.2.3.1. RFH I Aa 323 <sup>[32]</sup>

The German *Reichsfinanzhof* felt bound by the explanation of the Ministry of Finance and interpreted the tax treaty in accordance with the explanation.

### 11.2.3.2. RFH IV 233/38 <sup>[33]</sup>

The *Reichsfinanzhof* stated that the directives of the Ministry of Finance constitute an authentic interpretation of tax treaties. Arguments based on object and purpose must not lead to an interpretation differing from the point of view of the Ministry of Finance.

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<sup>26</sup> See Vogel op. cit. Intro. marg. note 125 seq.; Ault, 4 *Interfax* (1994) p. 144 et. seq.; Lang, SWI 1995, p. 412 et seq., Prokisch, SWI 1994, p. 54 et. seq.

<sup>27</sup> FG Hamburg, 20.05.1965, EFG 1965, p. 551.

<sup>28</sup> BFH, 31.07.1991, BFHE 165, p. 392.

<sup>29</sup> See FG Hamburg, 09.08.1985, EFG 1986, p. 63; BFH, 10.07.1996, BSiBl. II 1997, p. 15 et seq.; Vogel op. cit. Intro. marg. note 127; Lang op. cit.

<sup>30</sup> In a decision of 1933, the *Reichsfinanzhof* has, however, cited the Model Conventions of the League of Nations and its commentaries in order to interpret a provision in a tax treaty, see RFH VI A 988/31, VI A 1252/31 of 25.04.1933, RSiBl. 1934, p. 417.

<sup>31</sup> See Vogel op. cit. Intro marg. note 110.

<sup>32</sup> RFH, 27.07.1931, StW 1931, p. 1809.

<sup>33</sup> RFH, 19.04.1939, RSiBl. 1939, p. 878.

### 11.2.3.3. BFH I R 26/73 <sup>[34]</sup>

According to the *Bundesfinanzhof*, however, the subjective view of the treaty negotiators is only relevant if this view can be traced in the wording of the tax treaty. Otherwise, it cannot be proven that the treaty negotiators already had this view when negotiating the tax treaty and that this subjective interpretation was shared by the other Contracting State.

### 11.2.4. Article 3(2) OECD MC issues

The interpretation concerning Art. 3(2) OECD MC by the German courts is not very uniform. In some decisions the courts decided that a tax treaty term has to be interpreted primarily with regard to the context of the tax treaty; in other decisions German courts interpreted a tax treaty term in the light of the domestic law without even considering the context of the tax treaty. <sup>[35]</sup>

#### 11.2.4.1. BFH III R 125/69 <sup>[36]</sup>

In this decision the *Bundesfinanzhof* had to decide whether a silent partnership fell within the ambit of the business profit article of the DTC Germany-Switzerland. The tax court first regarded the history of the conclusion of the tax treaty and the object and purpose of the convention. Having found a plausible interpretation of the business profit article, the court refused to look at the interpretation of the term in domestic tax law. As a conclusion, the reference to domestic tax law is only possible if the primary means of interpretation - the context of the tax treaty - does not lead to consistent results. Concerning Art. 3(2) OECD MC, the court did not cite any literature.

#### 11.2.4.2. BFH I R 69/93 <sup>[37]</sup>

Here, the *Bundesfinanzhof* had to interpret the term "to be due" contained in Art. 28(3) DTC Germany-Switzerland. The court first looked into the domestic tax law and did not find any definition of the term there. It therefore concluded that as the German domestic tax law does not employ the tax treaty term, an interpretation based on Art. 3(2) OECD MC is not possible. The treaty terms must be interpreted in accordance with the context of the tax treaty. The *Bundesfinanzhof* did not cite any literature at all.

#### 11.2.4.3. FG Hamburg VII 244/98 <sup>[38]</sup>

The tax court stated that all terms not explicitly defined in the tax treaty have to be interpreted in accordance with the context of a tax treaty. An interpretation in the light of the domestic tax law is only possible if the contextual interpretation does not lead to consistent results. For this conclusion the tax court cited the Vogel commentary.

#### 11.2.4.4. BFHIR 176/66 <sup>[39]</sup>

When interpreting the term "income from sources within the US" contained in Art. XV(lb) DTC Germany-USA 1954, the *Bundesfinanzhof* first tried to give these terms the same meaning as in domestic tax law. This interpretation in the light of the domestic law did not lead to consistent results. The court, therefore, concluded that the context of the tax treaty required a different interpretation and paid attention to the object and purpose of the treaty for interpreting these terms. The court did not cite any literature at all.

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<sup>34</sup> BFH, 19.09.1975, *BSiBl.* 1975, p. 584.

<sup>35</sup> See Vogel op. cit. Art. 3 marg. note 119.

<sup>36</sup> BFH, 15.01.1971, *BSiBl.* II 1971, p. 379.

<sup>37</sup> BFH, 06.10.1993, *BSiBl.* II 1994, p. 318.

<sup>38</sup> FG Hamburg, 30.05.2000, *EFG* 2000, p. 1048.

<sup>39</sup> BFH, 02.05.1969, *BSiBl.* II 1969, p. 579.

#### 11.2.4.5. BFHIR39/85 <sup>[40]</sup>

In this judgment the *Bundesfinanzhof* had to interpret the term "sale, exchange and transfer" contained in Art. X DTC Germany-India. It first concluded that the term is not explicitly defined in the tax treaty and then referred to the ordinary meaning of these words in German law. Having found the interpretation of the words, the court briefly stated that the context of the tax treaty does not require a contextual interpretation. The court did not make reference to any literature.

#### 11.2.5. Foreign evidence

Concerning evidence in a foreign language, Sec. 52(1) FGO refers to the general rules of procedure according to which the language spoken at court has to be German. <sup>[41]</sup> Motions by a party made in a foreign language are irrelevant. <sup>[42]</sup> If one of the parties or a witness does not understand German, the court has the obligation to furnish an interpreter.

However, different rules are available for documents. Section 155 FGO refers to Sec. 142(3) ZPO allowing documents in a foreign language as evidence. <sup>[43]</sup> As the court is obliged to inquire all the facts it will demand all the relevant documents available irrespective of their language. It is not necessary that the foreign document fulfil all the requirements necessary for a valid German document (e.g. signature, date). If all members of the court understand the foreign language, there is no need to translate the document. If only one member of the court has difficulties in understanding the foreign language the court will demand an official translation of the document. The costs of the translation are parts of the general costs of the proceedings, which means that the losing party has to pay for the costs of the translation as well. <sup>[44]</sup> In cases where the court understands the language of the document but a party does not speak the language and demands a translation into German, this party has to bear the costs of the translation.

#### 11.2.6. Foreign tax law

Concerning domestic law, the law cannot be proven. The parties can argue that the tax law should be interpreted in one of the other ways and try to convince the court, but the parties cannot agree on the interpretation of a certain statute. It is always for the court to decide how to interpret the law. In domestic situations the facts have to be proven, the law can never be proven. Foreign tax law, however, can be proven. <sup>[45]</sup> The court is free to ask competent administration or expertises of universities or foreign institutions. <sup>[46]</sup> In contrast to international private law, in tax law the court does not apply foreign tax law, it is always the domestic law that creates the tax liability. It is only possible that the court has to inquire the foreign tax law in order to know whether a tax liability calculated in accordance with German tax law has to be reduced. This is the case when the credit or the exemption method applies. In case of the credit method, the taxpayer only receives a credit if the tax paid in the source State is levied in accordance with the tax law of the other State and the taxpayer has no claim to a refund of the tax. <sup>[47]</sup> The court has to inquire whether both conditions are met and, therefore, analyse the foreign tax law. In many cases Germany grants an exemption in its tax treaties only under the condition that the income is subject to tax

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<sup>40</sup> BFH, 14.03.1989, BSiBl. 11 1989, p. 599.

<sup>41</sup> Sec. 55 (1) FGO states: "§§ 169, 171b bis 197 des Gerichtsverfassungsgesetzes über die Öffentlichkeit, Sitzungspolizei, Gerichtssprache, Beratung und Abstimmung gelten sinngemäß". Sec. 184 Gerichtsverfassungsgesetz has the following wording: "Die Gerichtssprache ist deutsch".

<sup>42</sup> See Spindler in Hübschmann/Hepp/Spitaler, *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, Köln, loose-leaf March 2000, Sec. 52 FGO marg. note 74; Albers in Baumbach/Lauterbach/Albers/Hartmann, *Kommentar zur Zivilprozessordnung*, München, 64th ed. 2006, Sec. 184 GVG marg. note 3: *Schriftsätze und Eingaben in fremder Sprache sind schlechthin unbeachtlich, können nicht einmal als (unzulässiger) Antrag angesehen werden und wahren keine Frist, wenn keine Übersetzung beigelegt wird.*

<sup>43</sup> Sec. 142 (3) ZPO has the following wording: "Das Gericht kann anordnen, dass von infremder Sprache abgefassten Urkunden eine Übersetzung beigebracht werde, die ein... Übersetzer angefertigt hat".

<sup>44</sup> According to Sec. 135 FGO the losing party pays all the costs of the proceedings. The winning party only has to pay part of the cost, if it was their fault that the evidence was introduced late and therefore the proceedings took longer time than usual; see Sec. 137 FGO. If one party loses in part and wins in part the costs will be attributed fractionally see Sec. 136 FGO.

<sup>45</sup> Sec. 155 FGO in connection with Sec. 293 ZPO.

<sup>46</sup> See List in Hübschmann/Hepp/Spitaler, op. cit. Sec. 81 FGO marg. note 15.

<sup>47</sup> See Sec. 34c (1) EStG: "Bei unbeschränkt Steuerpflichtigen, die mit ausländischen Einkünften in dem Staat, aus dem die Einkünfte stammen, zu einer der deutschen Einkommensteuer entsprechenden Steuer herangezogen werden, ist die festgesetzte und gezahlte und keinem Ermäßigungsanspruch mehr unterliegende Steuer auf die deutsche Einkommensteuer anzurechnen, die auf die Einkünfte aus diesem Staat entfällt. For tax treaty law see Vogel op. cit. Art. 23 marg. note 130.

in the other Contracting State (so-called subject to tax clause). [48] In this situation the court has to inquire whether the income is taxable in the other Contracting State. An interesting question arises whether a court has to examine the compatibility of the foreign tax law with EU law. [49] In case the foreign tax law violates the four freedoms and, as a result, the foreign tax must not be levied, the residence State is not obliged to give a tax credit for the taxes paid or grant a tax exemption for the income not subject to tax in the other country. It could be argued that otherwise taxpayers might get a double dip. On the one hand, they receive a full credit in the residence State and on the other hand they can reduce their tax liability in the source State relying on EU law. But the taxpayer also faces double taxation. The residence State might refuse to credit the foreign taxes and the source State interprets EU law differently and does not reduce its source taxation without a referral to the ECJ.

### 11.2.7. Foreign court decisions and foreign administrative practice

German courts have made reference to foreign court decisions. As far as this author is aware, German courts do not refer to foreign administrative practice in the context of a decision.

#### 11.2.7.1. BFHIR 109/68 [50]

In this case a German resident suffered a loss from an activity in Austria. The German tax administration refused to take the Austrian negative income into account for calculating the income and for calculating the income tax rate. The taxpayer wanted to offset the foreign losses against the German income for calculating the tax rate. According to the tax treaty in force between Germany and Austria, Germany *may* take into account the exempted income in calculating the amount of tax when it exempts foreign income from tax. The tax administration interpreted the notion "may" as giving discretionary powers to the tax administration. It, therefore, believed itself to be free whether or not to apply a proviso safeguarding progression. The *Bundesfinanzhof* decided that the proviso safeguarding progression cannot be applied at the discretion of the tax administration. The court cited two decisions of Austrian courts [51] to underline that the other Contracting State interprets the proviso safeguarding progression in the same way.

#### 11.2.7.2. BFHVB51/80 [52]

This decision dealt with an exemption in VAT tax. According to the 6th Directive, services provided for arranging loans have to be tax exempt. Germany had not implemented the Directive and did not grant this exemption in its domestic law at that time. The *Bundesfinanzhof* decided that the taxpayer cannot directly rely on the Directive as a directive is addressed to the Member State and does not grant direct rights for the taxpayer. It refused to refer the case to the ECJ citing a decision of the French *Conseil d'Etat* [53] that had decided in the same way. As a result the legal situation seemed to be clear for the *Bundesfinanzhof*.

The literature emphasizes the need to take into consideration the relevant decisions of foreign courts. [54] The goal of avoiding double taxation and double non-taxation can only be achieved by interpreting the tax treaty in the same way. This common interpretation requires attention to be paid to the interpretation of the other Contracting States and, therefore, examination of the decisions of the courts of the other Contracting States.

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48 See Vogel op. cit. Art. 6-22 marg. note 31 et seq.

49 See Schönfeld, in Flick/Wassermeyer/Baumhoff, *Kommentar zum Außensteuerrecht*, Köln, loose-leaf November 2005, Sec. 34c EStG marg. note 39.

50 BFH, 25.05.1970, BStBl. II 1970, p. 660 et seq.

51 The two decisions cited were "Erkenntnis des österreichischen Verwaltungsgerichtshofs Z162/60 vom 21. Oktober 1960, Sammlung der Erkenntnisse und Beschlüsse des Verwaltungsgerichtshofes, Jahrgang 15, 1960, Nr. 2309, S. 670, sowie Erkenntnis des österreichischen Verfassungsgerichtshofs, B 274/61 vom 29. März 1962, Sammlung der Erkenntnisse und wichtigsten Beschlüsse des Verfassungsgerichtshofes, 27. Heft, 1962, Nr. 4176, S. 156..

52 BFH, 16.07.1981, HFR 1981, p. 480 et seq.

53 The decision cited was *Conseil d'Etat*, 22 December 1978, Nr.1 1604.

54 See Vogel op. cit. Intro, marg. note. 114 et seq.; Wassermeyer in Debatin/Wassermeyer, *Doppelbesteuerung*, München, loose-leaf, October 2002, Art. 23A marg. note. 46.

## 11.3. Article 234 EC Treaty

### 11.3.1. Cases involving application of EU law that have not been referred to the ECJ

#### 11.3.1.1. BFHIR6/99 <sup>[55]</sup>

The *Bundesfinanzhof* implicitly stated in its judgment of 1 January 2003 that the German profit consolidation rules (*Organschaft*) constitute a violation of the EC Treaty.

The facts of the case were as follows: A company incorporated in the US and having its place of effective management in Germany owned nearly 100% of the shares of a German company. The German subsidiary agreed to transfer all of its profits to its parent company. Under German tax law this profit transfer agreement leads to the taxation of the profits earned by the controlled company at the level of the controlling company. The controlling company is allowed to set off its own loss against the transferred profits. However, the profit transfer agreement was only recognized for tax purposes if the controlling company has its seat and place of effective management in Germany. <sup>[56]</sup> Here, the controlling company did not qualify for these conjunctive requirements as it was incorporated in the US. As a result, according to domestic law, the profit transfer did not have any tax consequences.

The *Bundesfinanzhof* held - based on the *Überseering* judgment of the ECJ <sup>[57]</sup> - that companies incorporated in another Member State of the EU and moving to Germany must have the same rights as companies incorporated in Germany. The EU company, therefore, qualifies for being a controlling company in the sense of the German consolidation regime as the German requirements violate the freedom of establishment and the free movement of capital.

The US company, although not being able to rely on the four freedoms of the EC treaty, can claim the same rights under the non-discrimination provision of Art. 24(4) DTC Germany-US 1989. <sup>[58]</sup>, <sup>[59]</sup> It had, therefore, the right to function as a controlling company and the German company as the controlled company could transfer its profits to the controlling company. The stricter domestic provisions were derogated by the non-discrimination provision of the tax treaty.

In this author's opinion, the reasoning of the *Bundesfinanzhof* was incorrect. <sup>[60]</sup> The *Überseering* judgment of the ECJ could not influence the interpretation of the tax treaty non-discrimination provision. Article 24(4) DTC Germany-US 1989 demands that German companies that are controlled by US parent companies are treated in the same way as German companies controlled by German companies. However, the tax treaty does not require Germany to treat German companies that are controlled by US companies in the same way as German companies controlled by foreign EU companies. The objects of comparison are resident owned companies only. <sup>[61]</sup> So even if the EC Treaty allows foreign EU companies to qualify for being controlling companies in the sense of the consolidation regime this does not have any influence.

#### 11.3.1.2. *Meindl* case

In another tax case - not involving tax treaties - the lower tax court of Düsseldorf directly applied the EC Treaty and did not refer the case to the ECJ. However, the decision of the lower court was appealed by the tax administration and the *Bundesfinanzhof* required a preliminary ruling in order to have the

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<sup>55</sup> BFH, 29.01.2003, IStR 2003, p. 422 et seq. with comments by Rust, IStR 2003, p. 658 et seq.

<sup>56</sup> See Sec. 14 N° 3 KStG old version.

<sup>57</sup> ECJ, 05.11.2002, Re C-208/00 (*Überseering*). ECR, 2002, p. 1-9919 et seq.

<sup>58</sup> BFH, 29.01.2003, IStR 2003, p. 422 et seq. (423): "Die Entscheidung wirkt sich zwar unmittelbar nur auf die EG-Mitgliedsstaaten aus. Juristische Personen anderer (Drift-) Staaten können im Hinblick darauf keine Gleichbehandlung mit Angehörigen der Mitgliedsstaaten einfordern. Wegen des in Art. 24 Abs. 4 DBA-USA 1989 enthaltenen bilateralen Diskriminierungsverbots verhält es sich für eine US-Kapitalgesellschaft jedoch anders."

<sup>59</sup> Art. 24(4) DTC Germany-US 1989 has the following wording: "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected."

<sup>60</sup> See Rust, IStR 2003, p. 658 et seq.

<sup>61</sup> See Avery Jones et al., 31 *European Taxation* 10 (1991) p. 310 et. seq. (339).

right interpretation of the freedom of establishment. [62] This case deals with the requirements for a joint assessment. In Germany, couples may opt for a joint assessment. [63] If a couple elects joint assessment, the income earned by wife and husband will be summed up. [64] The tax burden of the couple will be calculated by doubling the tax on the half of the joint income (so-called splitting tariff). [65] Due to the progressive tax rate, twice the tax burden on a semi-tax base normally is more advantageous than a single tax on a regular tax base. [66] Most couples therefore opt for a joint assessment.

The joint assessment, however, is only possible if the couple comply with the following three requirements: the couple has to be married, they have to live together at least one day within the taxable year and both spouses have to be subject to unlimited tax liability. [67]

In consequence of the *Schumacher* judgement of the ECJ, [68] the requirement of the unlimited tax liability of both spouses was facilitated. Nowadays, [69] it is sufficient if one of the two spouses is subject to unlimited tax liability [70] in Germany and the other spouse is a resident of an EU or EFTA country. Additionally, either at least 90% of their joint income must be domestic income or their joint income not taxable in Germany must not exceed DM 24,000. [71]

In the taxable year 1997 the Austrian national G. Meindl was living and working in Germany. His wife and his newborn child were living in Austria. Mr Meindl earned all his income (DM 138,422) in Germany. His wife received wage continuation and maternity benefits from the Austrian State. The payments of the Austrian State amounted in 1997 to AUS 189,703 (DM 26,995) and were not taxable in Germany. The payments would have been taxable, however, if his wife had been subject to unlimited tax liability in Germany as foreign wage continuation and foreign maternity benefits are not exempt from tax in Germany. Therefore, the joint income not taxable in Germany surmounted the borderline of DM 24,000. The 90% requirement was not met either as less than 90% ( $138,422/165,417 = 84\%$ ) of their joint income was domestic income. According to the wording of the German provision, Mr Meindl did not fulfil the requirements for a joint assessment.

The lower court of Düsseldorf interpreted the 90% rule in the light of the freedom of establishment. The court based its arguments on the *Walentin* decision of the ECJ. [72] In this judgment the European Court of Justice decided that the source State is obliged to grant all personal deductions if the taxpayer only earns tax exempt income in the residence State. Transferring this doctrine to the *Meindl* case the court came to the conclusion that Germany has to grant the personal deductions also for Mrs Meindl as the maternity benefits and wage continuation are tax exempt according to Austrian law. As a result, the tax court interpreted the 90% rule as not including income that is tax exempt in another EU Member State.

### 11.3.2. Referral ex officio

Courts in Germany are obliged to interpret the law in question. The courts have to submit a question for a preliminary ruling if the interpretation of EU law is unclear. Domestic rules of procedure do not limit the possibility of a court to refer the case to the ECJ if the question of the interpretation of EU law is relevant for the judgment. In contrast, not referring the question to the ECJ might constitute under certain

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62 BFH, 28.06.2005, DB 2005, p. 2002 et seq. pending at the ECJ *Meindl* C-329/05.

63 See Sec. 26 EStG.

64 See Sec. 26b EStG.

65 See. Sec. 32a (5) EStG.

66 For some exceptions see Seeger in Schmidt, *Einkommensteuergesetz*, München, 25th ed. 2006, Sec. 26 EStG marg. note 17. E.g. the separate assessment is more beneficial if one spouse has high tax exempt income which is taken into account for proviso safeguarding progression, or if one spouse is entitled to a loss carry forward.

67 See Sec. 26 (1) EStG.

68 ECJ, 14.02.1995, Re C-279/93 (*Schumacher*), ECR 1995,1-225 et seq.

69 Sec. Ia (1) N° 2 entered into force in 1996, the provision could be also applied with retroactive effect if the tax assessment was not yet definitive.

70 Unlimited tax liability according to Sec. 1 (1) EStG (depending on residence) or fictitious unlimited tax liability according to Sec 1 (3) EStG (if more than 90% of the income is earned in Germany). Independent of whether Sec. 1 (1) EStG or Sec. 1 (3) EStG is applicable the 90% domestic income requirement has to be fulfilled.

71 Currently, the boarder line of EUR 12,272 must not be exceeded.

72 ECJ, 01.07.2004, Re C-169/03 (*Wallentin*), ECR 2004,1-6443.

conditions a breach of the German constitution since the ECJ is regarded as the lawful judge to which access must be guaranteed. <sup>[73]</sup>

### 11.3.3. Application of Article 234(3) by highest courts

#### 11.3.3.1. BFHIR57/02 <sup>[74]</sup>

The *Bundesfinanzhof* did not submit a question for a preliminary ruling to the ECJ because the question had already been addressed by the ECJ. The *Bundesfinanzhof* had to decide regarding the following case: A Dutch resident taxpayer provided independent services in Germany. The taxpayer earned only parts of her income in Germany. Germany taxed her as a nonresident and therefore did not grant the personal allowance. Due to the denial of the personal allowance the taxpayer was taxed at a higher rate than resident taxpayers. Relying on the *Gerritse* decision of the ECJ, <sup>[75]</sup> the *Bundesfinanzhof* decided that the denial of the personal allowance did not constitute a violation of the EC Treaty. It cited the relevant part of the *Gerritse* decision: <sup>[76]</sup>

It is for the referring court to verify, in this case, whether the 25% tax rate applied to Mr Gerritse's income is higher than that which would follow from application of the progressive table. In order to compare comparable situations, it is necessary in that respect, as the Commission has rightly pointed out, to add to the net income received by the person concerned in Germany an amount corresponding to the tax-free allowance. According to the Commission, which carried out that calculation, application of the progressive table, in a case such as that at issue in the main proceedings, would lead to a rate of tax of 26.5%, which is higher than that actually applied.

The *Bundesfinanzhof* concluded that the tax would be higher than the tax actually levied if one applies the tax regime for a resident taxpayer and adds an amount corresponding to the personal allowance. As it was possible to transfer the reasoning of the ECJ to this case, the *Bundesfinanzhof* did not see the necessity to refer the case to the ECJ; this question had already been addressed by the ECJ.

#### 11.3.3.2. BFHIR54/03 <sup>[77]</sup>

In this judgment the *Bundesfinanzhof* decided not to refer the case to the ECJ believing that the interpretation of the EU law is evident. The facts of the case are as follows: A Russian company received a dividend from a German company. According to Art. 10 para. 1 DTC Germany-Russia, source taxation of the dividends is limited to 15% if the beneficial owner of the dividend is a resident of the other Contracting State. Source taxation is reduced to 5% if the beneficial owner is a company resident of the other Contracting State and owning at least 10% of the dividend distributing company. Additionally, these shares must have a value of at least DM 160,000. As the *Bundesfinanzhof* interpreted the term "value" as "nominal value" of the shares, the Russian company did not qualify for the 5% reduction. Consequently, the representatives of the Russian company argued that the partnership agreement between Russia and the European Union, as well as Art. 56 EC Treaty granted a most-favoured nation treatment. As in many other tax treaties concluded by Germany the source taxation for dividends is reduced to 5% without a "value of the share requirement", the Russian company wanted to obtain this 5% reduction contained in other tax treaties as well.

<sup>73</sup> Art. 101 (1) German Constitution: "Niemand darf seinem gesetzlichen Richter entzogen werden." ("No one may be removed from the jurisdiction of his lawful judge."). See Schulze-Fielitz, in: Dreier, Grundgesetz Kommentar, Tübingen, 2000, Art. 101 GG marg. note 61.

<sup>74</sup> 19.11.2003, BFH/NV 2004, 766.

<sup>75</sup> 12.06.2003, Re C-234/01 (Gerritse), ECR 2003, I-5933.

<sup>76</sup> 12.06.2003, Re C-234/01 (Gerritse), ECR 2003, I-5933 marg. note 54.

<sup>77</sup> 26.05.2004, IStR 2004, 833 seq.

Concerning this argument, the *Bundesfinanzhof* held that the legal position is clear. Neither the partnership agreement nor Art. 56 EC Treaty grant a most-favoured nation treatment. The *Bundesfinanzhof* - citing the *CILFIT* judgment of the ECJ - concluded that there could not be any reasonable doubt about the right interpretation of the case and refused to refer the case to the ECJ, although the representatives of the Russian company had demanded the referral. <sup>[78]</sup>

#### 11.4. List of abbreviations

Abs.	: Absatz (paragraph)
AO	: <i>Abgabenordnung</i> (General Tax Code)
BFH	: <i>Bundesfinzhof</i> (highest German tax court)
BFHE	: <i>Entscheidungen des Bundesfinanzhofs</i> (German Journal)
BStBl.	: <i>Bundersteuerblatt</i> (Official Tax Gazette)
DB	: <i>Der Betrieb</i> (German Journal)
ECJ	: European Court of Justice
ECR	: <i>European Court Reporter</i>
ed.	: Edition
EFG	: <i>Entscheidungen der Finanzgerichte</i> (German journal)
EstG	: <i>Einkommensteuergesetz</i> (Income Tax Act)
EuGH	: <i>Europäischer Gerichtshof (ECJ)</i>
FG	: <i>Finanzgericht</i> (German tax court)
FGO	: <i>Finanzgerichtsordnung</i> (Tax Procedure Act)
FVG	: <i>Gesetz über die Finanzverwaltung</i> (Tax administration Act)
GG	: <i>Grundgesetz</i>
GVG	: <i>Gerichtsverfassungsgesetz</i> (Procedure tax Act)
HFR	: <i>Höchstrichterliche Finanzrechtsprechung</i> (German Journal)
KStG	: <i>Körperschaftsteuergesetz</i> (Corporate Income Tax Act)
marg.	: marginal
RFH	: <i>Reichsfinanzhof</i> (Highest tax court of the former Reich)
RStBl.	: <i>Reichsteuerblatt</i> (Official Tax Gazette)
StuW	: <i>Steuer und Wirtschaft</i> (German journal)
ZPO	: <i>Zivilprozessordnung</i> (Civil Procedure Act)

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<sup>78</sup> The wording of the decision is as follows: "Der Senat kann diese Frage selbst beurteilen und muss nicht die von der Klägerin angestrebte Vorabentscheidung durch den Gerichtshof der Europäischen Gemeinschaften (EuGH) einholen. Er ist als letztinstanzliches Gericht zwar nach Art. 234 Abs. 3 des Vertrages zur Gründung der Europäischen Gemeinschaft (EGV) im Grundsatz verpflichtet, Fragen zur Auslegung europäischen Gemeinschaftsrechts dem EuGH vorzulegen. Das gilt jedoch nicht, wenn über die richtige Anwendung dieses Rechts kein vernünftiger Zweifel herrschen kann (EuGH-Urteil vom 6. Oktober 1982 Rs. 283/81 "C.I.L.F.I.T.", EuGHE 1982, 3415, Tz. 16). Diese Situation liegt im Streitfall vor, da sich aus Wortlaut und Systematik des maßgeblichen Abkommens Mar ergibt, dass hieraus die von der Klägerin angestrebte Rechtsfolge nicht abgeleitet werden kann."

## Chapter 12 – Italy

### 12.1. Main features of tax law procedure

#### 12.1.1. Constitutional principles governing tax litigation; the Italian procedural laws and the principles on fair trial

The principle of fair trial was introduced in the Italian Constitutional system through Constitutional Law 25 November 1999, No. 2, amending Art. 111 of the Italian Constitution. <sup>[2]</sup> In particular, Art. 111(1) and (2) <sup>[3]</sup> of the Italian Constitution reads:

1. The law shall be administered by means of a fair trial governed by law. 2. All trials shall ensure the adversarial principle between the parties, which shall have an equal status, before an independent and impartial court. The law shall lay down provisions to ensure that trials are of a reasonable length, [translation by author]

As per the wording of the provision, Art. 111 of the Italian Constitution applies to disputes relating to tax proceedings. <sup>[4]</sup> That would in principle render the Italian Constitutional system more advanced than the EU law system <sup>[5]</sup> with respect to such disputes; indeed, under the case law of the European Court of Human Rights, <sup>[6]</sup> Art. 6 <sup>[7]</sup> of the Convention for the Protection of Human Rights and Fundamental Freedoms, embodying the same principles on fair trial, does not apply to disputes relating to tax proceedings. <sup>[8]</sup>

The formal introduction of such principles in the Italian legal system should represent a step forward in the evolution of the rules governing tax litigation in Italy, some features of which still reflect the earliest administrative nature of tax litigation, whereby there was no equality of status between the parties, nor an independent judge for the proceedings.

Indeed, even though the development of the legislation on tax law procedure has brought tax litigation closer to the model of the civil law proceedings - archetype of the trial based on the principles of equality status and right of full defence - still some basic attributes and some provisions of tax law litigation do not comply with principles of fair trial. In particular, as will be detailed in the following paragraphs, Italian scholars consider that (among other features) the nature of the tax judge and the rules on burden of proof and on evidence in tax litigation conflict with the basic principles of fair trial.

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<sup>2</sup> Tesauro, F., "Giusto processo e processo tributario", *Rass. Trib.* 1 (2006) p. 11 et seq.

<sup>3</sup> The remaining paragraphs concerning criminal trials.

<sup>4</sup> See Tesauro op. cit.; Gallo, F. "Verso un 'giusto processo' tributario", *Rass. Trib.* 1 (2003) p. 11 et seq.; Russo, P., "Il giusto processo tributario", *Rass. Trib.* 1 (2004) p. 11 et seq.; Manzoni, E., "Processo tributario e costituzione. Riflessioni circa l'incidenza della novella dell'art. 111 della Costituzione sul diritto processuale tributario", *Riv. Dir. Trib.* 1 (2001) p. 1095 et seq.; Marcheselli, A., "Il giusto processo tributario in Italia. Il tramonto dell'interesse fiscale?", *Dir. Prat. Trib.* 1 (2001) p. 793 et seq.; Garcea, A., "La giurisdizione delle Commissioni tributarie ed il giusto processo", *Dir. Prat. Trib.* 1 (2001) p. 474 et seq.

<sup>5</sup> Gallo id. p. 11.

<sup>6</sup> European Court of Human Rights, *Ferrazzini vs. Italy* - 44759/98 [2001] ECHR 464 (12 July 2001).

<sup>7</sup> Which reads, at para. 1: "In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. Judgment shall be pronounced publicly but the press and public may be excluded from all or part of the trial in the interests of morals, public order or national security in a democratic society, where the interests of juveniles or the protection of the private life of the parties so require, or to the extent strictly necessary in the opinion of the court in special circumstances where publicity would prejudice the interests of justice."

<sup>8</sup> It applies, however, to refund proceedings with a tax law origin, as stated in *The National & Provincial Building Society, the Leeds Permanent Building Society and the Yorkshire Building Society vs. the United Kingdom* - 21319/93; 21449/93; 21675/93 [1997] ECHR 87 (23 October 1997); to proceedings regarding pre-emption of the Treasury, as stated in *Hentrich vs. France* - 13616/88 [1994] ECHR 29 (22 September 1994); to proceedings regarding penalties connected to tax laws, as stated in *Vastberga taxi Aktiebolag and Vulic vs. Sweden* - 36985/97 [2002] ECHR 621 (23 July 2002). Note that the most prominent Italian scholars (see Gallo op. cit. p. 15 and Tesauro op. cit. pp. 16-17) consider that the Italian tax law proceeding shall fall within the purview of Art. 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms.

In this respect, the strengthening of the protection of taxpayers in the litigation phase granted by Art. 111 of the Italian Constitution should inspire, on the one hand, the legislator in future amendments to the tax litigation system and, on the other, curtail Italian courts from continuing to justify procedural rules regarding tax litigation that actually make the protection of rights before tax courts less effective than that granted by ordinary judges. <sup>[9]</sup>

### 12.1.2. Features of tax law procedure: The judge

Under Italian laws, tax litigation falls within the jurisdiction of special judges. <sup>[10]</sup> The tax judges - whose expertise and functions are governed by Presidential Decree 31 December 1992, n. 545, <sup>[11]</sup> as amended <sup>[12]</sup> - are organized as first instance tax court (*Commissione Tributaria Provinciale*) and tax court of appeal (*Commissione Tributaria Regionale*), the former with jurisdiction over the cases involving tax offices included in the territorial competence of each Italian provincial capital, the latter existing as second instance court for the tax cases decided by first instance tax courts of the provincial capitals of each respective region. Each tax court is appointed a president of the court and is divided into sections, composed of a president of the section, a vice-president and of not less than four tax judges; each section decides with the majority of three judges.

The Supreme Court (*Corte di Cassazione*) acts as a judge of last instance. <sup>[13]</sup> However, the Supreme Court is the judge of legitimacy and its sole function is to ensure that the judge deciding on the merits applies the law correctly. Its role is to ensure the exact observance and uniform interpretation of the law (known as *nomofilachia*). The Supreme Court is divided into specialized divisions (*Sezioni*, amongst which the *Sezione Tributaria* is specialized in tax law cases). On important cases, usually where there are jurisdictional overlaps, a special Court (*Sezioni Unite*) is appointed, with a substantially larger number of judges chosen from the different divisions.

The very peculiar feature of tax judges is that they need not to be professional, full-time, judges (*giudici togati*). They need not be part of the ordinary judiciary, considered as such because judges established and governed by the judicial order form it. The Constitution guarantees the independence of the ordinary judiciary from interference by any other State power in its activity of interpreting the law and assessing facts. In order to become a professional judge, candidates take part in competitive examinations, passing through various levels, and duties are assigned after a training period.

Conversely, as provided by Art. 4 of Presidential Decree 31 December 1992, n. 545, besides ordinary judges, also professionals, former public administration's employees, former tax authorities' employees, etc. may act as tax judges. Nevertheless, according to the rules in force and to the jurisprudence of the Constitutional Court, <sup>[14]</sup> tax courts have jurisdictional nature.

Notwithstanding the existence of rules embodying non-eligibility and non-compatibility criteria, it appears that tax courts cannot be considered as satisfying the requirements, which a judge of a fair trial should satisfy.

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<sup>9</sup> Gallo op. cit. p. 16.

<sup>10</sup> The jurisdiction of tax courts is determined by Art. 2 of Legislative Decree 31 December 1992, No. 546, which has been recently modified. Article 12 of the Finance Act 2002, amending Art.2 of decree 546/92, transferred to the tax court all controversies regarding all kinds of taxes, including the regional, provincial and municipal ones. Note also that under the Italian Constitution, the judiciary function can be performed exclusively by ordinary judges as appointed and regulated by the laws governing the judiciary administration. In this respect, Art. 102 of the Italian Constitution provides that no special judges can be appointed in the Italian system besides the special judges, as are the tax judges, already existing at the time of enactment of the Constitution itself; such principle has been confirmed by the Constitutional Court in order 23 April 1998, n. 144.

<sup>11</sup> Such Decree constitutes the enactment of Delegation Law 30 December 1991, n. 413. In particular, Art. 30 of the Delegation Law was intended to enlarge significantly the areas of competence of the tax judges: the question of compliance of such provision has been remitted to the Constitutional Court, which was called upon to decide whether such an enlargement of the competence of the tax judges was in compliance with the constitutional principle embodied in Art. 102 of the Constitution (see note 10 supra), i.e. to decide upon whether the addition of new cases in the jurisdiction of the tax judges could be interpreted as the institution of further special judges, besides the existing ones. The Constitutional Court, in its order 23 April 1998, n. 144, decided that the enlargement of the jurisdiction of tax courts was compliant with Art 102 of the Constitution.

<sup>12</sup> Latest amendments are those introduced by Decree Law 30 September 2005, n. 203, converted into law by Law 2 December 2005, n. 248.

<sup>13</sup> Among other things, it rules on conflicts of jurisdiction in terms of both subject matter and territory.

<sup>14</sup> Constitutional Court, decision 27 December 1974, No. 287 and 3 August 1976, No. 215; see also Cass., SS. UU., 6 February 1984, No. 871.

Besides the possible lack of specific professional expertise, tax courts seem to lack the requisite of independence, and this circumstance might clearly jeopardize their impartiality. In fact, under the law currently in force, there are very strong connections between the tax judges and the Ministry of Finance; for example, it is provided that the judges of tax courts are appointed by the President of the Italian Republic upon proposal of the Ministry of Finance, which defines the vacancies and rules on incompatibility. Further, the Ministry of Finance decides the compensation of tax judges and has disciplinary powers over them; moreover, the staff employees of tax courts are employed by the Ministry of Finance and are entitled to the same salaries as other employees of the same Ministry. <sup>[15]</sup>

In this respect, the most prominent Italian scholars suggest that professional judges should rule *de iure condendo* tax law proceedings.

### 12.1.3. The procedure and the decision

Tax law proceedings are regulated by the provisions of Legislative Decree 31 December 1992, No. 546 (hereinafter "Decree 546/92"). Article 1(2) of Decree 546/92 provides for a general reference to the Code of Civil Law Procedure, for the matters not therein regulated. Decree 546/92 does not provide for specific rules relating to international tax law cases.

Tax courts cannot judge in advance on actual cases but only as a consequence of claims against acts of the tax authorities, listed in Art. 19 of Decree 546/92, amongst which are notices of assessment and express or tacit denials of refund of taxes. Nevertheless, tax proceedings are not merely aimed at the annulment of an act of the tax authorities, but rather they are aimed at ruling on the underlying juridical relationship.

This implies that the judgement of the tax court is not strictly confined by the vices of the act challenged by the taxpayer (but for the definition of the object of the case, i.e. the *petitum*), but entails also the duty of the judge of applying all the provisions of law necessary for ruling on the case. Indeed, the *iura novit curia* principle applies also in tax proceedings. <sup>[16]</sup> Note that, with reference to the sources of knowledge for the judge, Ministerial Circulars issued by the Italian tax authorities are not binding on the judge. <sup>[17]</sup>

Tax proceedings before tax courts are basically written proceedings, given that under Art. 33 of Decree 546/92, a public hearing occurs solely upon specific request by one or both of the parties. Such provision was remitted to the Constitutional Court for the judgement of its compatibility with the constitutional principles embodied in Arts. 24, 53 and 101 of the Constitution; however, the Court dismissed the case. <sup>[18]</sup>

The decision of the tax court shall detail the grounds of the judgement. A specific reason shall be detailed if the tax court decides to deviate from the generally applicable principle on the costs, which is the principle "cost follows the procedure", as provided by Arts. 91 and 92 of the Code of Civil Law Procedure. <sup>[19]</sup>

The decisions of tax courts are made public with the deposit with the secretary's office of the tax court.

### 12.1.4. The burden of proof

The issue of the burden of proof in tax proceedings is very complex and has been much debated ever since the introduction of such proceedings. <sup>[20]</sup>

<sup>15</sup> Tesouro op. cit. pp. 22-23.

<sup>16</sup> Gallo, F., "L'applicazione d'ufficio del diritto comunitario da parte del giudice nazionale nel processo tributario e nel giudizio di cassazione", *Riv. Dir. Int. Priv. e proc.* 2 (2003) p. 439. The principle of *iura novit curia* is embodied in Art. 113 of the Code of Civil Law Procedure.

<sup>17</sup> Falsitta, G., *Manuale di diritto tributario*, Padova: CEDAM, 2005, p. 63.

<sup>18</sup> *Corte Cost.* 23 April 1998, No. 141.

<sup>19</sup> A strongly criticized issue is that regarding the regime of the costs of the procedure in case of early termination of the proceedings under Art. 46 of Decree 546/92; Gallo op. cit. "Verso un 'giusto processo' tributario" p. 25 expresses the view that such regime is not compatible with the principle of fair trial.

<sup>20</sup> Amongst the most recent publications on the matter, Cipolla, G.M., *La prova tra procedimento e processo tributario*, Padova: CEDAM, 2005, p. 511 et seq. describes all the different positions of Italian scholars on the matter; see also Cipolla, G.M., "Riflessioni sull'onere della prova nel processo tributario", *Rass. Trib.* 3 (1998), p. 671 et seq. and "Sulla ripartizione degli oneri probatori nel processo tributario tra nuovi (quanto, forse, ormai tardivi) sviluppi giurisprudenziali e recenti modifiche normative", *Rass. Trib.* (2006); Russo, P., "Problemi della prova nel processo tributario", *Rass. Trib.* 2 (2000), p. 375 et seq.

As a general principle, it is nowadays accepted by Italian scholars and case law that in tax proceedings, the burden of proof stays with the party that has the interest of proving the alleged fact, regardless of its formal position in the proceeding, whether as plaintiff or defendant. In this respect, it shall be pointed out that, in substance, in tax law proceedings, the disputed issue is either the right of the tax authorities of obtaining the payment of the tax, in case of challenge of an assessment by the taxpayer (*processi di impugnazione*), or the right of the taxpayer to obtain the refund of undue tax, in case of a claim regarding the denial of the refund on the part of the tax authorities (*processi di rimborso*).

Indeed, the general rule applies, whereby *judex judicare debet iuxta alligata et probata partium*.

Therefore, the burden of proof might stay with the tax authorities or with the taxpayer, depending on the circumstances of the case. Against this general principle, however, some procedural rules of Decree 546/92 show that in tax law proceedings, the tax authorities still have some advantages when compared to the taxpayer, and that therefore the equal status of the parties is not always guaranteed.

In particular, with reference to the *processi di impugnazione*, the rules on the terms for appearance, combined with the respective positions of the parties, are as such as seriously jeopardizing the right of full defence of the taxpayer.

In fact, on the one hand, it is provided that the taxpayer shall appear in the proceeding within a mandatory time limit, whilst the tax administration can, as a matter of fact, appear at a very later moment, given that the term provided for its appearance is not mandatory. On the other hand, it shall be considered that, even though the express indications of the reasons is a necessary element of the notice of assessment, the construction of such condition is not strict, and the reasons of the notice - which in fact shall constitute the evidence, which will become a proof in the trial phase - can also be described in a generic manner by the tax authorities.

The combination of these two circumstances can easily put the taxpayer in the position of not being able to know, in a timely manner, the arguments which the tax authorities will use in the trial phase of the proceedings. [21] The principle of equal status of the parties with specific reference to the right of defence is, therefore, seriously jeopardized.

### 12.1.5. The rules on evidence

Tax litigation is substantially based on the acquisition in the trial of documents, or written proofs already existing in the pre-trial phase, together with the application of a quite large number of presumptions contained in Italian tax laws. [22]

With regard to documents and written evidence, besides the documents produced by the parties, Art 7 of Decree 546/92 provides that the tax courts can make use of experts' summons, or require that technical offices of the public administration or of the tax police produce specific technical reports, which might be useful for the court to decide upon particularly complex issues. Moreover, tax courts are empowered by Art 7 of Decree 546/92 to order inspections, and require data, information and clarifications, which can be useful to value the facts of the case.

As far as foreign written evidence in particular is concerned, it is worth recalling some principles regarding its validity before Italian courts.

Under the general rule of civil procedural law embodied in Art. 122 of the Code of Civil law procedure, the Italian language is compulsory in any trial. As a consequence, also in tax proceedings, documents drafted in a foreign language shall be produced by the parties with a translation. [23] This is a burden of the party that produces the evidence to support its position.

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21 Tesauro op cit. p. 26; Gallo op. cit. "Verso un 'giusto processo' tributario", p. 20.

22 Magnone Cavatorta, S. in Consolo, C. and Glendi, C., *Commentario breve alle leggi del processo tributario*, Padova: CEDAM, 2005, p. 54.

23 On this point Cass. 10831/94; Cass. 21 November 1996, No. 10268. In tax cases, *Comm. Trib. Reg. di L'Aquila*, 15 February 2000, No. 60.

With specific reference to tax treaty cases, generally certificates of residence issued by the competent authorities of the other Contracting States are accepted without the need of specific formalities, provided that it is clear that the document has been issued by the competent foreign authority. [24] As to formal requirements, such principle was confirmed, with reference to an exchange of information procedure between Italy and the United States, by a decision of the Supreme Court: [25] in that occasion, the Court stated that a document issued by the US authorities, which exchanged the information under the Italy-US tax treaty, was a valid evidence in the case, even though it was neither signed nor dated, because it was indisputable that it was issued by the competent authority of the other Contracting State.

In this respect, the Supreme Court stated the principle that the formal requirements of a document are governed by the domestic laws of the foreign State of origin.

With reference to the value of presumptions in tax litigation, a broad distinction shall be made between the presumptions, either refutable or not, that are provided by tax laws, and those, known as presumptions *hominis*, which can be used by the judge in valuating the facts of the case.

The former presumptions apply by operation of law, and there is no issue regarding their validity; the presumptions *hominis*, on the other hand, in order to be legitimately used by the judge to rule on a case, shall be certain and reliable, univocal and consistent. [26] Particular issues are dealt with by Italian tax law jurisprudence with reference to the admissibility of chains of presumptions (so-called *presumptio de presunto*). [27]

Notwithstanding the general reference to the rules provided by the civil law procedure, the parties to a tax dispute cannot satisfy the burden of proof through testimonial evidence nor by oath. Such limitation imposed by tax law procedure is seen by the most prominent Italian scholars as a *vulnus* to the principles of fair trial. [28] Indeed, the limitation jeopardizes the principle of equal status between the parties before the judge: this is mainly due to the fact that the tax authorities, in the assessment phase, can utilize declarations made by third parties to ground their assessment; even though it is accepted that the taxpayer can oppose to those declarations other written declarations by third parties, Italian scholars still consider that the tax authorities have an advantageous position before the tax courts in this respect.

The Constitutional Court declared the compatibility of the rule on testimonial evidence in tax law proceedings with the Italian Constitutional principles in 2000; [29] however, as a consequence of the amendments to Art. 111 of the Constitution mentioned at paragraph 12.1. above, there is room for referring again to the Constitutional Court on the compatibility of the rule on testimonial evidence in tax law proceedings with the Italian Constitutional principles on fair trial. [30]

## 12.2. International tax treaty case law

### 12.2.1. Introduction: Issues faced by Italian judges in interpreting tax treaties

National courts face peculiar issues when applying tax treaties. The preliminary operation is the interpretation of the text of the treaty; being an international agreement, its interpretation implies both the choice of the rules and principles of such interpretation, and the choice regarding what sources of

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24 In this respect, see Ministerial Resolution 26 July 1999, No. 126/E. Further, it is to be noted that with reference to a few tax treaties concluded by Italy (namely those with Austria, France, Portugal, Switzerland) there are specific forms, which non-residents can make use of to enjoy tax treaty benefits.

25 Cass. 24 November 1999, No. 3254. See also *Comm Trib Prov. di Como*, 18 January 2005, No. 108/7/04, where the tax court accepted as a valid evidence for the purposes of enjoyment of foreign tax credit, the demonstration that the foreign taxes were definitively paid abroad given by means of the foreign certificates issued by the competent foreign authorities. On evidence for the application of Council Directive 90/435/EEC, see *Comm. Trib. Prov. Di Firenze*, 17 January 2004, No. 40, which considered as a valid evidence of the existence of one of the conditions required for application of the Directive a copy of the shareholders' book and of the financial statements of a foreign company, duly kept under the laws of the foreign country of residence of the shareholder.

26 As provided, as general rules, by Art. 2729 of the Italian Civil Code, by Art. 38(3) of Presidential Decree 29 September 1973, No. 600, with reference to income taxes, and by Art. 54 of Presidential Decree 26 October 1972, No. 633, for VAT.

27 In general, case law excludes the validity of chains of presumptions as means for the judge to evaluate the facts of a case. See, among others, Cass. 23 June 1994, No. 6033; Cass. 9 April 2002, No. 5045; Cass. 25 October 1991, No. 11376. Contra: Cass. 11 January 1992, No. 239; Cass. 23 January 1991, No. 604. On the matter, Cicala, M., "Presunzioni, indizi e verità processuali", *Il fisco* 38 (2004) p. 6467 et seq.

28 Tesauro op. cit.; Gallo op. cit. "Verso un 'giusto processo tributario"; Russo op. cit.; Manzoni op. cit.

29 Corte Cost. 21 January 2000, No. 18; the decision of the Constitutional Court has been strongly criticized by the scholars quoted at note 28 supra.

30 Gallo op. cit. "Verso un 'giusto processo tributario".

interpretation may be used under those principles. As a separate operation in the application of a tax treaty, [31] the judge can also face qualification problems. [32]

In particular, with respect to the issue regarding the rules of interpretation, which shall be used when applying a tax treaty, the judge is called to assess whether a tax treaty shall be interpreted under the domestic rules of interpretation, [33] or rather under the rules on interpretation of international agreements, i.e. Arts. 31, [34] 32 [35] and 33 [36] of the Vienna Convention on the Law of Treaties (hereinafter "VCLT") and international customary rules.

The issue arises because, on the one hand, tax treaties, though being international agreements, are enacted and become part of the Italian system as ordinary laws. [37] In this respect, it is accepted by the relevant Italian doctrine [38] that treaties, as part of the international legal system, should be interpreted under the rules of interpretation provided by international laws and customs.

On the other hand, the VCLT is itself an international agreement of uniform law ratified and enacted in Italy with ordinary law (Law 12 February 1974, No. 112), and its position within the sources of law vis-à-vis the purely domestic provisions on the interpretation of the law (see note 33) should be investigated.

In this respect, the assessment of whether the VCLT provisions (see notes 34, 35 and 36) should take precedence over the domestic rules of interpretation does not indeed have a great relevance to the question of the choice of the method of interpretation by the Italian judge. In fact, the hermeneutic methods indicated by both pieces of law do in substance coincide, being literal, teleological and systematic interpretation.

Rather, the prevalence of the VCLT over domestic laws on interpretation can have a great importance considering that:

- the VCLT makes reference to a number of sources of interpretation, or means of interpretation, whilst the Italian legal system (and especially the tax system) is based on the legality principle, [39] whereby solely laws or acts that have the force of laws can bind the judge;

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31 On the relationship between qualification and interpretation in the context of application of the law, Xavier, A., "Il problema delle qualificazioni nel diritto tributario internazionale", *Riv. dir. trib.* (1994) p. 528.

32 On the meaning of qualification in the context of tax treaties, Vogel, K., *Double Tax Conventions*, The Hague - Boston: Kluwer, 1997, pp. 52-54.

33 The governing rule for the interpretation of domestic laws is contained in Art. 12 (1) of the General Preamble to the Italian Civil Code and states that "In the application of the law, no sense shall be given other than that made clear by the proper meaning of the words according to their connection, and from the intention of the legislator" (author's unofficial translation).

34 Art. 31, VCLT, headed "General rule of interpretation" reads: "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 interpretation of a 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 connexion with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. 3. There shall 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; (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."

35 Art. 32, VCLT, headed "Supplementary means of interpretation" reads: "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 which is manifestly absurd or unreasonable."

36 Art. 33, VCLT, headed "Interpretation of treaties authenticated in two or more languages" reads: "1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail. 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."

37 Tax treaties are typically enacted with the special procedure of the "order of execution", whereby a self-executing international act is introduced in the Italian system as a whole, with no adjustments, by making reference and giving full execution to the text of the treaty as stipulated by the Contracting States. For reference in English see Galli, G. B. and Miralò, A., "National Report - Italy", Florence IFA Congress, *Cahiers de droit fiscal international*, 1993, LXXVIIIa, p. 387; Bizzioli, G., "Tax treaty Interpretation in Italy", in *Tax Treaty Interpretation*, Lang, M. (ed.), Deventer: Kluwer, 2001, p. 197 et seq.

38 Conforti, B., *Diritto Internazionale*, Napoli: Editoriale Scientifica, 2004, p. 102; Melis, G., *L'interpretazione nel diritto tributario*, Padova: CEDAM, 2003, pp. 638-639; Bariatti, S., *L'interpretazione delle convenzioni internazionali di diritto uniforme*, Padova: CEDAM, 1986, p. 175 et seq.; contra, at international level, Edwardes-Ker, M., *Tax Treaty Interpretation*, Dublin: In-Depth Publishing, 1995, loose-leaf version, para. 99.01.

39 See Cass. 28 October 1966, No. 2693 and 12 March 1965, No. 416. In this respect, note that in the Italian legal system, under the terms of Art. 1 of the General Preamble to the Civil Code, "The sources of law are the following: 1) laws, 2) regulations (...), 4) customs", as well as the Constitution and the provisions of the European Union [unofficial translation by author].

- the application of the VCLT implies the search for a common interpretation of treaties, [40] whilst Italian judges showed a tendency to interpret international treaties executed in Italy with ordinary laws as purely domestic laws. [41]

That being stated, the question of the prevalence of the VCLT over domestic law on interpretation shall be answered in the positive. [42] Indeed, as agreed by the generally accepted Italian legal doctrine, [43] as an international treaty, the VCLT shall prevail over purely domestic provisions of law as *lex specialis*.

Moreover, as the rules on interpretation of the VCLT represent principles of international customary law, [44] they would enter the Italian legal system by operation of Art. 10(1) of the Constitution [45] and have in such system the high ranking similar to constitutional provisions. [46] Under such explanation, the VCLT rules shall apply both to treaties entered into force prior to and after the entry into force of the VCLT itself, as well as to treaties concluded with non-VCLT states. [47]

Finally, the (implicit) acknowledgement of the role of the principles of the VCLT envisaged in the case law of the European Court of Justice (ECJ), might also have a weight with respect to the applicability of such principles in the Italian order as a consequence of the mechanism of adjustment to Community law. Indeed, it is to be noted that the ECJ, without expressly stating any general principles regarding the role of the VCLT, has shown a clear tendency to utilize the interpretation rules indicated by the VCLT. [48]

In this respect, the Italian Supreme Court recently stated the principle whereby national judges can apply general principles or doctrines developed by the ECJ when applying domestic tax laws. [49] This could represent a further argument to confirm the applicability of the VCLT in the interpretation of tax treaties in Italy.

## 12.2.2. Italian case law on the rules and means of interpretation of treaties

### 12.2.2.1. Non-tax case law on rules and sources of interpretation of treaties

The analysis of some of the most significant decisions of the past decades involving application of international agreements by Italian judges shows prima facie that non-tax courts, when compared to tax courts, appear to be more responsive and attentive to the international law dimension of the cases.

Indeed, generally non-tax judges seem more inclined to investigate and determine the meaning and scope of a treaty term or provision in such a way as to allow the application of the treaty provision in a manner consistent with the purpose of the treaty itself. Obviously, such an interpretation, which should in principle be shared by the other(s) Contracting State(s), is the one which allows a uniform application of the treaty,

40 Bariatti, op. cit. pp. 167 and 281; Melis op. cit. p. 631 et seq.

41 Melis id. pp. 638-639, who refers to the judgement of the Italian Supreme Court of 27 February 1979, No. 1273, in *Riv. Dir. Int.*, 1980, p. 537 et seq.

42 For a more detailed analysis in English on the status of international agreements in the Italian legal order, Bracco, P., "County Survey - Italy", in *Tax treaties and domestic law*, Amsterdam: IBFD Publications BV, 2006, Vol. 2 EC and International Tax Law Series, p. 245 et seq.; Bizioli op. cit.; Galli and Miraulo op. cit.

43 Among others, Conforti, B., "La specialità dei trattati internazionali eseguiti nell'ordine interno", in *Studi in onore di G. Balladore Pallieri*, II, Milano, 1978, p. 187; Carbone, S.M., "Le norme di diritto internazionale convenzionale, il loro rapporto con le norme di diritto internazionale privato e la loro interpretazione", in *Studi in onore di Victor Uckmar*, Padova, 1997, p. 184; Pisano, R., "il rapporto tra norme interne, diritto convenzionale e diritto comunitario", in *Aspetti fiscali delle operazioni internazionali*, Milano: Egea, 1995, pp. 419-120.

44 Vogel op. cit. p. 21; Melis op. cit. pp. 602-603. Both authors quote the relevant international case law.

45 Art. 10(1) of the Constitution reads: "the Italian legal system shall conform with the generally recognized rules of international law" [unofficial translation by author].

46 The system of sources of Italian law is based on the principles of hierarchy and competence. In accordance with the hierarchical principle, a higher-level source prevails over a lower-level source and cannot be abrogated or modified by it. The highest level in the hierarchical scale is the Constitution, followed by institutional laws and laws regarding Constitutional amendments. At a lower level than the Constitution, the institutional laws and Constitutional amendments are the ordinary laws or Acts of Parliament. This level has residual normative competence in the sense that the law can discipline any matter not expressly reserved by the Constitution for a particular source. At a level corresponding to that of Acts of Parliament there are legislative decrees and decree laws, that are norms with the force of law enacted by the government on the basis of a delegation of powers from Parliament, in the case of legislative decrees, or justified by the urgency of the matter to be dealt with, in the case of decree laws. The fact that these decrees have the same hierarchical level as Acts of Parliament means that they may abrogate or modify previously approved ordinary legislation and, on the same principle, they may not be abrogated or modified by sources at a sub-legislative level. The lowest level of the hierarchy is that of customs which, unlike the other sources, is not a normative act but a de facto source, originating from the constant repetition, continuing over time, of a given type of behaviour, considered to be legitimate.

47 Bizioli op. cit. p. 208.

48 Bariatti S., Qualificazione e interpretazione nel diritto internazionale private comunitario: prime riflessioni, in *Riv. dir. priv. e proc.*, 2006, 2, pp. 366 and ff., who analyses the principles on interpretation developed by the case law of the ECJ and their adherence to those indicated in the VCLT. In particular, the Author refers to cases C-283/81 (Clifit), C-338/95 (Wiener), C-461/03 (Gaston Schul) and related Opinion of Advocate General Ruiz-Jarabo Colomer, C-33/78 (Goudain c. Nadler), T-172/01 (M. c. Corte di Giustizia) and T-43/90 (Diaz Garcia c. Parlamento).

49 Cass. 25 October 2005, No. 22932; Supreme Court judgement 29 April 2005, No. 20398.

and, as such, attains the aim for which the treaty was concluded. <sup>[50]</sup> As mentioned, the success of such an operation depends, for international agreements, not only upon the methods selected for the interpretation of their text, but also, and much more heavily, upon the selection of the means, which are used for the purposes of such an interpretation.

Despite that, a comprehensive and reasoned analysis of the status of the VCLT in the Italian legal system has not been provided so far by Italian case law. In this respect, statement of the main principle on application of the VCLT can be found in a landmark decision regarding the application of the European Convention on the adoption of children, done at Strasbourg on 24 April 1967. <sup>[51]</sup> On that occasion, the Supreme Court, preliminarily, stated clearly that conventional provisions shall be interpreted with the interpretative rules codified in the VCLT, "under the fundamental principle whereby the interpretation of a piece of law shall be carried out on the basis of the hermeneutical criteria of the legal order (in the case at issue, the international legal order) which it belongs." (unofficial translation by author)

With further reference to the role of the VCLT, it is noteworthy that the applicability of the VCLT partly grounded the repeal by the Constitutional Court of a reference from the Criminal court of Rome. <sup>[52]</sup> The question was raised in a case involving application of the procedural rules on international letters rogatory. The Constitutional Court stated that the reference from the Criminal Court was not admissible on the grounds that the issue involved a conflict of interpretation between the Italian laws regulating the matter and the international customs on the same matter. In the opinion of the Court, the remitting judge, who should have made recourse to all the means of interpretation available, should have resolved such conflict; in particular, due to the fact that an international agreement was involved, the judge should have referred to the principles of the VCLT. Even though the Constitutional Court did not expand in considering the role of the VCLT, its conclusion makes clear that it shall be considered amongst the applicable hermeneutic rules in Italy.

Turning to the application of (non-tax) treaties by Italian judges, an example of search for a common autonomous interpretation of a treaty term, exclusively based on the interpretative criteria of the VCLT, can be found in a Supreme Court decision, dealing with the application of the Vienna Convention on diplomatic relations, done at Vienna on 18 April 1961. <sup>[53]</sup> The issue regarded the interpretation of what should be considered as an action regarding property rights, as opposed to one regarding obligations under the Convention. The Court applied Arts. 31 and 32 VCLT, and based its decision on the purpose and of the historical circumstances of the conclusion of the Convention; moreover, the Court relied - in general terms - on the relevant Italian and foreign legal doctrine and case law.

Another example of search for a uniform application of a convention is represented by an order of the Criminal Court of Milan regarding criminal international letters rogatory, <sup>[54]</sup>, <sup>[55]</sup> envisaging application of the European Convention on mutual assistance in criminal matters, done at Strasbourg on 20 April 1959. The Court decided on the basis of the purpose and of the context of the treaty under Art. 31 VCLT, rejecting a purely formal and literal interpretation of the law. Interestingly - as this proved not to be common at all in Italian jurisprudence - the Court relied also on the interpretation of the treaty adopted by a court of another State.

In this latter respect, an impressive decision by an Italian lower Court ruling on application of the United Nations Convention on Contracts for the International Sale of Goods (opened for signature on 11 April

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<sup>50</sup> Vogel K., Double Tax Conventions, quoted, pp. 39-40, with reference to tax treaties observes that: "Tax treaties are meant to allocate tax claims equally between the contracting states. This goal can only be achieved if a treaty is applied consistently by the authorities and courts in both contracting states. Therefore, the mandate to interpret a tax treaty "in the light of its object and purpose (art. 31.1,VCLT) leads to the requirement that states should seek the treaty interpretation which is most likely to be accepted in both contracting states (the goal of "common interpretation"). The most important recognition here is that courts and administrative bodies charged with applying a double tax treaty take into consideration and evaluate the merits of relevant decisions made by comparable institutions in other contracting states and, if necessary, by those of third states".

<sup>51</sup> Cass. 21 July 1997, No. 7950.

<sup>52</sup> Corte Cost., Ord. 4 July 2002, No. 315.

<sup>53</sup> Cass. 16 December 1987, No. 9321.

<sup>54</sup> Tribunale di Milano, Sez. II pen, Ord. 22 November 2001 del.

<sup>55</sup> Cass. 15 October 2002, No. 34576 and 8 November 2002, No. 37774.

1980, 19 I. L.M. 668, entered into force the 1 January 1998), interpreted the Convention in the light of foreign case law. [56] The court referred to about 40 foreign court decisions and arbitral awards from Austria, France, Germany, the Netherlands, Switzerland and the United States. It had done so, however, with the awareness that foreign case law is not binding. [57] Indeed, the court expressly stated that foreign case law, "albeit non-binding, as suggested by a few legal writers, must nevertheless be taken into account in order to guarantee and promote a uniform application of the Vienna Sales Convention." [58] The decision really reveals the great attention of the judge towards the need to promote uniformity in application of an international agreement.

Conversely, in a decision on the application of the Treaty of Friendship, Commerce and Navigation concluded by Italy and West Germany on 21 November 1957, [59] the Supreme Court adopted a pure unilateral interpretation of a term of the Treaty based on express reference to the domestic rule of interpretation of the law (Art. 12 of the General Preamble to the Civil Code, see at [note 33](#) above); moreover, the Supreme Court repealed the decision of the Court of Appeal, which gave a different meaning to that term to meet the constitutional principle of non-discrimination of foreigners, on the grounds that the inequality of treatment was fully justified by the intentions of the Contracting States and by the existence of the reciprocity condition. [60]

With further reference to the actual application of the VCLT, in the mentioned decision regarding adoption, [61] the Supreme Court made a precise application of the interpretation criteria of the VCLT. The case concerned the assessment of the self-executing character of Art. 6 of the European Convention on the adoption of children done at Strasbourg on 24 April 1967. [62] The Supreme Court applied and explained, one at a time, literal interpretation and comparison of different languages of the Convention; the Court then applied systematic interpretation, by making reference to the *rapport explicatif* to the Convention, from which it derived also the subjective interpretation, i.e. that based on the intention of the Contracting States.

Teleological interpretation under Art. 31 VCLT was also expressly carried out in case law regarding application of The Hague Convention of 25 October 1980 on the civil aspects of international child abduction. [63] The Supreme Court clarified that in the light of the principles of Art. 31 VCLT, conventions on human rights are not directed to the protection of any interest of the Contracting States but have as a direct purpose the protection of categories of individuals.

Other notable cases of application of the VCLT provisions can be found in different decisions regarding criminal international letters rogatory, [64] envisaging application of the European Convention on mutual assistance in criminal matters, done at Strasbourg on 20 April 1959, where the Court, besides a teleological interpretation based on the text of Art. 1 of the Convention itself, explicitly applied Art. 31(3) VCLT and based its decision on the consideration of the subsequent practice of the Contracting States in the application of the treaty; in particular, such subsequent practice concerned the formalities of documents to be transmitted amongst the competent authorities.

Similarly, with further reference to the means of interpretation, in a case involving application of Art. VIII, Sec. 16 of the Headquarters Agreement between Italy and FAO of 31 October 1950 [65] - whereby FAO

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[56] *Tribunale di Vigevano*, 12 July 2000; for comments on such decision, Veneziano, A., "*Mancanza di conformità delle merci ed onere della prova netta vendita internazionale: un esempio di interpretazione autonoma del diritto uniforme alla luce dei precedenti stranieri (Tribunale di Vigevano, 12 luglio 2000, n. 405)*", in *Diritto del commercio internazionale*, 2001, p. 509 et seq.; Ferrari, F., "Truly uniform application of CISG: Tribunale di Vigevano (Italy), 12 July 2000", *Uniform Law Review* 1, 2001 pp. 203-205. An abstract of the case is available in English in the UNILEX database at: [www.unilex.info/case.cfm?pid=1&do=case&id=387&step=Abstract](http://www.unilex.info/case.cfm?pid=1&do=case&id=387&step=Abstract).

[57] Ferrari, F., "Tribunale di Vigevano: Specific Aspects of the CISG Uniformly Dealt With", *Journal of Law and Commerce* (Spring 2001), pp. 225-239.

[58] The decision of the *Tribunale di Vigevano* is noteworthy also because it quoted, apart from decisions published in law reviews, decisions published in the UNILEX database as well as in other online databases.

[59] Cass. 28 July 1986, No. 4811.

[60] There was no evidence in the case that Italian citizens would have obtained in Germany a treatment as beneficial as that claimed by the appellant in Italy.

[61] Cass. 21 July 1997, No. 7950.

[62] Art. 6 (1) reads: "The law shall not permit a child to be adopted except by either two persons married to each other, whether they adopt simultaneously or successively, or by one person.

[63] Cass. 22 November 1997, No. 11696.

[64] Cass. 15 October 2002, No. 34576 and 8 November 2002, No. 37774.

[65] Cass., SS.UU., 18 May 1992, No. 5942.

enjoys immunity from any form of jurisdiction in Italy - the *Sezioni Unite* of the Supreme Court based their decision on a subsequent practice in the application of the treaty. In particular, under express application of Art. 31(3) VCLT the Court based its ruling on (literally, quoted in English in the text of the decision) "the manner in which the Parties have actually conducted themselves in carrying out the contract". Indeed, the Court considered that such practice - evidenced in an exchange of correspondence between the competent diplomatic bodies - constituted a subsequent practice of application of the agreement, which the interpreter shall consider as the expression of the real and shared meaning of the unclear provisions of the treaty. Besides that, the Court also explored the differences between the English and the Italian versions of the text of the treaty.

#### 12.2.2.2. Tax case law on rules and sources of interpretation of treaties

With further reference to the rules and means of interpretation of international agreements, in deciding cases involving application of tax treaties, the Italian Supreme Court has so far taken an approach opposite to that adopted in deciding cases involving application of other (non-tax) treaties.

Indeed, the Court substantially rejects the application of the principles of the VCLT in deciding tax treaty cases.

In two identical decisions dating back to 2000 the Court expressly denied application of VCLT. <sup>[66]</sup> The dispute regarded the applicability of Art. IX of the tax treaty between Italy and the UK, done on 4 July 1960 (not currently in force), governing royalty payments, with respect to an Italian local tax ("ILOR", currently abolished). In this respect, on the one hand, the Italian domestic laws governing ILOR provided that the tax should apply to royalty income arising in Italy, except where the income was subject to withholding taxation in Italy; Art. IX of the Treaty, on the other hand, provided that royalties paid by an Italian resident to a UK resident should be taxable solely in the UK, unless the recipient had a permanent establishment in Italy. The result was that, being such royalty payments exempted from withholding taxation in Italy under application of the tax treaty, they were subject to the local tax under the Italian domestic tax law. The problem arose because ILOR was introduced in the Italian tax system after the conclusion of the Treaty, and, therefore, the tax authorities concluded that it was out of the scope of application of the Treaty.

The defence of the taxpayer invoked application of Arts. 27 and 31 VCLT and, in particular, opposed that:

- the treaty should have been interpreted in good faith in the light of its object and purpose; as a consequence, literal and restrictive interpretations should have been avoided, given that the aim of the treaty is the restriction of the taxing power of the Contracting States in order to facilitate the transactions amongst the economic operators of such States;
- a Contracting State cannot invoke application of domestic laws to override treaty obligations;
- the purpose of Art. 31 VCLT is to enlarge the scope of the treaty so that it can achieve its goal;
- the list of taxes included in the Treaty is not exhaustive.

The laconic decision of the Supreme Court on the point, without detailing the juridical grounds of the statement, asserted that the clauses of the VCLT on the interpretation of treaties "provide for hermeneutic criteria, which cannot be considered decisive for ruling on the case" (author's unofficial translation). The decision on the case, which, however, ruled in favour of the taxpayer, was based on Community law.

As far as the means of interpretation indicated in the VCLT are concerned, an earlier decision of the Supreme Court in 1988 expressly refused to take into consideration what can be considered as one of the means of interpretation under Art. 31 VCLT. <sup>[67]</sup>

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<sup>66</sup> Cass. 1 June 2000, No. 9942 and 2 February 2000, No. 1122.

<sup>67</sup> Cass. 24 May 1988, No. 3610, commented by Garbarino, C, "Note a margine del 'Caso Onduline': interpretazione funzionale delle convenzioni contro le doppie imposizioni e procedura amichevole", *Dir. prat. trib.*, 1989, p. 970 et seq., and "Tassazione delle royalties nel caso in cui la stabile organizzazione sia 'sostituita' da partecipazione da parte di soggetto estero", *Dir. prat. trib.*, 1989, p. 547 et seq.; Santa Maria, A., "Sul valore dell'interpretazione dell'art. 11 del Trattato fra Italia e Francia per evitare le doppie imposizioni del 29 novembre 1958 ai sensi detto scambio di lettere del 5 ottobre 1989", *Dir. prat. trib.*, 1991, p. 1413 et seq.

The case involved application of a terminated Italy-France tax treaty, done on 29 October 1958; in particular, the interpretation problem arose with respect to Art. 11 of the Treaty, which provided that royalties should have been taxable in the State of residence of the beneficial owner, unless the latter had in the Contracting State where the royalties arose a permanent establishment. Such exception, under Art. 11 of the Treaty, applied also where a permanent establishment was substituted by a shareholding in a company in that State. The debated issue was the meaning of the term "substituted" in the light of the purpose of the treaty provision.

In this respect, the peculiar situation of the case was that the tax authorities of the Contracting States reached an agreement regarding expressly the interpretation of the treaty provision involved. However, the Supreme Court, taking a purely domestic tax law perspective and a very strict formalistic approach, expressly ignored the contents of such agreement, on the grounds that it was not formalized by the competent authorities, but rather merely included in internal administrative guidelines with respective domestic value in Italy and in France.

More specifically, Art. 26 of the treaty at issue provided for three different mutual agreement procedures, which, in order to bind the Contracting States, should be stipulated and formalized by the competent authorities, namely:

- regulations agreed upon by the tax authorities of the Contracting States "as may be necessary for carrying out the provisions" of the treaty;
- agreements for the interpretation of unclear provisions of the treaty;
- agreements for the avoidance of double taxation requested by a treaty entitled taxpayer.

Article 26(4) of the Treaty further provided: "if it appears that agreement would be facilitated by negotiations, such negotiations should be entrusted to a Mixed Commission composed of representatives of the two states appointed by the highest administrative authorities thereof.

In the case at issue, the Mixed Commission indeed held the meetings and reached agreement on the interpretation of Art. 11 of the Treaty, but did not formalize such conclusion in a shared document but merely issued domestic guidelines; in the claim before the Supreme Court, the taxpayer brought as evidence the minutes of the meeting of the Mixed Commission.

The Court considered that such minutes did not have any legal relevance and were not binding in ruling on the case, as they did not have any force of law, but merely represented the documentation of a negotiation, as mentioned by Art. 26(4), quoted above. On similar grounds, the Supreme Court refused to take into consideration the French practice on the interpretation of the disputed provision, as expressed in the French administrative guidelines issued following the meeting of the Mixed Commission.

Without expanding on the matter of the ranking of mutual agreement procedures amongst the means of interpretation of international agreements, it appears that in the case under discussion, irrespective of the instrument adopted by the tax authorities of the Contracting States to convey their agreement on the interpretation of the treaty term, the tax authorities behave as such as clearly demonstrating the existence of such an agreement on the interpretation of Art. 11 of the Treaty.

As a consequence, even where one accepts to consider - due to the lack of formalization - that there was no "subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions" within the meaning of Art. 31 VCLT, it is hardly disputable that the conduct of the tax authorities of the Contracting States represented a "subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" under Art. 31 VCLT, which the Court should have taken into consideration in ruling on the case.

To conclude on this point, it appears that in deciding tax cases, Italian courts pay very little attention to the foreign practice and case law of the other Contracting States regarding application and interpretation of

tax treaties. With respect to foreign sources of knowledge for the judge, however, a very debated decision of the Supreme Court, in interpreting the definition of permanent establishment, made express reference to the definition of permanent establishment contained in para. 12 of the German tax law *Abgabeordnung* of 16 March 1976, in order to argue that a number of European subsidiaries of a group operated in Italy through a "multiple permanent establishment". [68]

In more general terms, it appears that the Supreme Court is reluctant when dealing specifically with tax treaty law to exercise its peculiar function known as *nomofilachia*, i.e. the function of ensuring the exact observance and uniform interpretation of the law. Indeed, it appears that the Supreme Court does not generally make a great effort in interpreting tax treaty provisions in order to ensure a uniform interpretation of such pieces of law. In this respect, a significant example might be found in a decision regarding the application of Art. 11 of the Italy-Germany Tax Treaty. [69]

The disputed point of the case was the applicability of Art. 11(3) of the Treaty, providing that "(...) interest (...) shall be taxable only in the Contracting State of which the recipient of the interest is resident, if the recipient is the beneficial of the interest and the interest is paid: (a) in connection with sale on credit of goods or merchandise delivered by one enterprise to another enterprise; (b) in connection with the sale on credit of industrial, commercial or scientific equipment; (...)".

In particular, it was disputed whether the provision might also be applicable to the interest arising from the delayed payment in the case where the delay of the payment was agreed by the parties subsequent to the execution of the sale of material to be used for the repair of industrial furnaces, rather than coincidentally with the execution of the sale. In substance, the Court should have decided whether in the interpretation of the disputed treaty provision (i) the case involving a delay in payment of the price agreed subsequent to the execution of the sale contract shall be treated as a "sale on credit" within the meaning of the treaty provision, and (ii) whether the material to be used for the repair of industrial furnaces shall be considered as "goods" or as "industrial equipment" within the meaning of the treaty provision.

The Court, surprisingly, did not give any interpretation of the provision of the treaty, and merely annulled the decision of the court of second instance, on the grounds that it did not explain the reasons behind the interpretation of the treaty provision under which the same court of second instance ruled that such provision was applicable to the case disputed.

Indeed, the Supreme Court ruled on the case by making exclusive reference to the domestic provisions governing the taxation of interest.

#### **12.2.2.2.1. Tax case law on rules and sources of interpretation: Relevance of the OECD Model Convention and Commentaries**

On the relevance of the OECD Model Convention and its Commentaries in deciding tax treaty cases, the Italian Supreme Court has so far denied any relevance within the Italian system when dealing expressly with the nature of such means of interpretation.

More to the point, it appears that the Court applies exclusively the domestic principle of legality, whereby the judge is bound solely by acts having the force of law, and omits to explore whether and to what extent the Commentaries might have any other relevance or otherwise deserve appreciation in the process of interpretation of tax treaties. [70]

Indeed, very recently the Supreme Court, in a case regarding the notion of permanent establishment for VAT purposes, clearly stated that the Commentaries to the OECD Model Convention do not have any force of law and shall be regarded as a mere recommendation for the OECD countries not binding

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68 Cass. 7 March 2002, No. 3368.

69 Cass. 10 September 2004, No. 18314.

70 On this matter, Pijl, H., "The OECD Commentary as a Source of International Law and the role of the Judiciary", 46 *European Taxation* 5 (2006) p. 216 et seq.; Ward, D. A., "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process", 60 *Bulletin for International Taxation* 3 (2006) p. 97 et seq.; Ellis, M.J., "The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process - Response to David Ward", 60 *Bulletin for International Taxation* 3 (2006) p. 103 et seq.

for the judiciary. <sup>[71]</sup> In that decision, the Court also clarified that the amendments introduced in 2005 in the Commentaries to Art. 5 of the OECD Model shall have no relevance in ruling on that case, due the circumstance that Italy has made an express reservation on those points of the Commentaries. <sup>[72]</sup>

The Supreme Court had already taken such position in 2000, stating that the case should have been ruled exclusively on the basis of Italian domestic law, excluding any relevance in the qualification and interpretation of the case to both the OECD Model Convention, and to the Protocol of the treaty involved.

<sup>[73]</sup>

Notwithstanding such statements of principle, however, Italian courts often refer to the Commentaries to the provisions of the OECD Model in deciding tax cases. <sup>[74]</sup>

## 12.3. Article 234 EC Treaty

### 12.3.1. Direct application of Community law by Italian courts in tax treaty cases

Direct application of Community law in cases involving tax treaties occurred in two analogous decisions of Italian lower tax courts in 2000. <sup>[75]</sup>

In both cases, involving application of the Italy-Netherlands tax treaty, the issue was whether a 5% withholding tax on the refund of the equalization tax (currently abolished), granted in connection with dividend distributions to Dutch parents of Italian subsidiaries meeting the requirements for application of Council Directive 90/435/EEC (hereinafter "the Parent-Subsidiary Directive"), was compatible with the Directive's regime.

Article 10(2) of the Treaty allows a withholding tax up to the amount of 5% of the gross dividends distributed by an Italian company to a Dutch parent, under given conditions. According to the Italian tax authorities, such withholding tax should apply both to the dividends and to the refund of the equalization tax, given that the latter is to be treated as a profit distribution. <sup>[76]</sup> The refund of the equalization tax is granted by Art. 10(3) of the Treaty, stating that a Netherlands resident receiving dividends from an Italian company is entitled to the refund of the amount corresponding to the equalization tax owed, if applicable, by that company in respect of those dividends, subject to the deduction of the withholding taxes mentioned at Art. 10(2).

In a Ministerial Circular the Italian tax authorities expressed the view that the equalization tax was to be levied on the refund of the equalization tax granted by the Treaty to Dutch shareholders, unlike the case for the corresponding provisions of the Italy-Germany and Italy-France tax treaties, under which the withholding tax on the refund of the equalization tax should not apply; such conclusion was based, in the opinion of the tax authorities, on the circumstance that no equalization tax was provided for by the laws of the Netherlands.

The tax courts found that the national and treaty provisions as interpreted by the Italian tax authorities violated the non-discrimination principle laid down in Art. 6 of the EC Treaty, in that Dutch shareholders of Italian companies were granted a less favourable tax treatment when compared to that granted to German and French shareholders. The tax courts, in this respect, recalled the principles expressed by the ECJ in the *Saint Gobain* case, <sup>[77]</sup> whereby the Member States, competent to allocate taxing powers between themselves with tax treaties with a view of eliminating double taxation, shall not disregard Community law.

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<sup>71</sup> Cass. 28 July 2006, No. 17206.

<sup>72</sup> See, amongst the reservations in the Commentary to Art. 5, OECD MC, 2005: "Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs". On the reasons for introduction of such amendments, see Bracco op. cit. pp. 266-268.

<sup>73</sup> Cass. 1 June 2000, No. 9942 and 2 February 2000, No. 1122.

<sup>74</sup> Amongst others, Cass. 25 May 2002, No. 7689; Cass. 15 May 2002, No. 7682; Cass. 7 March 2002, No. 3367; Cass. 27 November 1987, No. 8820.

<sup>75</sup> Namely a tax court of first instance, *Comm. Trib. Prov. di Cuneo*, sez. III, 9 March 2000, No. 17; and a tax court of second instance, *Comm. Trib. Reg. di Torino*, sez. XXXI, 7 June 2000, No. 30/31/00. Note that the decisions were issued prior to the issuance by the ECJ of the judgements in cases C-294/99, *Athinaiki Zythopoiia AE vs. Elliniko Dimosio*, in 2001 and C-58/01, *Océ van der Grinten vs. Commissioners of Inland Revenue*, in 2003.

<sup>76</sup> Italian scholars do not share this view. See Maisto, G., "La direttiva CEE relativa al regime tributario dei dividendi nei rapporti fra società-figlie e società-madri", *Riv. Dir. Trib.* I, 1992 p. 583; Manzitti, A. and Ludovici P., "Regime tributario dei dividendi comunitari", *Le società*, 1993, p. 1336.

<sup>77</sup> C-307/97, *Compagnie de Saint-Gobain vs. Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

With further reference to the application of Community law by Italian judges, it is worth mentioning a copious jurisprudence of the Supreme Court.

Indeed, the *Sezioni Unite* of the Italian Supreme Court quite recently issued a decision settling a much-debated issue in judicial application of tax treaty law in Italy, which also implied the assessment of compatibility with Community law of the Italian practice in the application of a terminated tax treaty with the United States. [78]

The disputed matter was the applicability of Art. 8 of the tax treaty between Italy and the United States done on 30 February 1955, governing royalty payments, with respect to an Italian local tax ("ILOR", currently abolished). In particular, the issue regarded the subjection to ILOR of royalties paid by Italian residents to US residents not having a permanent establishment in Italy after 1 January 1982, [79] in the force of the temporary regime introduced by the Exchange of Notes of 13 December 1974, and prior to the execution of the subsequent tax treaty on 11 December 1985. This issue was substantially similar to that described above at 12.2.2.2. with regard to royalty payments under the Italy-UK tax treaty; however, under the Exchange of Notes mentioned above, it was provided that the tax treaty covered individual income tax and corporate income tax, whilst no mention was made of the local tax ILOR.

In this respect, a first set of decisions ruled, on the basis of domestic and tax treaty law, that ILOR should apply to the royalty payments. [80]

In 2000, two decisions of the Supreme Court reached the opposite conclusion on the basis of the interpretation of the tax treaty provision in the light of Community law. [81] In particular, these decisions considered that the tax treatment of the royalties was incompatible with the principle of non-discrimination as provided by Art. 12 of the EC Treaty, which the Court deemed also applicable with respect to residents of non-EU countries. [82]

In 2001, the Supreme Court repealed such interpretation and ruled that ILOR was applicable to the royalty payments, also on the grounds that the non-discrimination principle does not apply to third-country residents without a permanent establishment in the EU. [83] The *Sezioni Unite* finally shared such conclusion.

Even though the latter conclusion regarding the scope of application of Community law appears to be correct in the specific case, [84] the *Sezioni Unite* did not reach it after fully analysing the case in the light of Community law, as the ECJ would have done. Indeed, the *Sezioni Unite* did not, preliminarily, assess whether the case did fall under the scope of application of Community law, for its objective and subjective features; neither did it analyse which principle of Community law should have applied, whether the general principle of non-discrimination or any of the fundamental freedoms. Rather, the *Sezioni Unite* merely

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78 Cass., SS.UU., 20 November 2003, No. 17632.

79 The domestic provisions affecting application of ILOR to royalty payments, which gave rise to the case, entered into force on 1 January 1982. On the taxation of royalties paid to non-residents not having a permanent establishment in Italy prior to 1 January 1982, the *Sezioni Unite* ruled in decision 30 November 1983, No. 7184, that they were not subject to ILOR.

80 Cass. 26 March 1993, No. 3637; Cass. 21 February 1995, No. 1872; Cass. 9 September 1996, No. 8166; Cass. 7 November 1996, No. 9718; Cass. 26 September 1997, No. 9457; Cass. 25 January 2000, No. 810.

81 Cass. 8 May 2000, No. 5768 and 28 October 2000, No. 14253.

82 Such conclusion is indeed disputable. The decisions contain interesting and convincing arguments regarding Art. 307 of the EC Treaty; on this point see Pistone, P., "Reviviscenza del tributo sostituito ove un trattato contro le doppie imposizioni escluda il tributo sostitutivo: riflessi sul principio di non discriminazione", *Rass. Trib.* 5, (2002) p. 1753.

83 Cass. 30 November 2001, No. 3410, with comments by Pistone id. p. 1748 et seq. On such judicial overlap see also Cass. 21 November 2002, No. 2684.

84 Pistone id. pp. 1754-1755, who grounds such assessment on the following arguments:

- that the non-discrimination principle embodied in Art. 12 of the EC Treaty applies as *lex generalis* solely where the case is out of the scope of application of the four fundamental freedoms;
- that the non-discrimination principle does not generally cover relations with third countries;
- that, in the case at stake, the free movement of capital principle could have applied and such principle also includes movements of capital to and from non-EU countries;
- that the facts of the case, however, date back to 1982, when Art. 67 et seq. of the EC Treaty did not provide for direct application of free movement of capital (prior to Directive 88/361/EEC, liberalizing movement of capital).

The author expresses the opinion that with reference to the current legislation, a reference for preliminary ruling to the ECJ would have been necessary.

stated that the question had no relevance, as no detrimental difference in treatment was imposed by the taxation of the royalties received by the US residents, when compared to that of royalties received by EU or non-EU residents, under Italian domestic laws and tax treaties. The decision of the *Sezioni Unite*, in substance, appears poorly explained, especially considering that the role of the *Sezioni Unite* was to settle a judicial overlap involving Community law.

With respect in general to domestic judicial overlaps in the context of interpreting domestic or treaty provisions in the light of Community law, it is worth recalling the principles stated by the ECJ in a case brought by the Commission against Italy in a successful infringement proceeding. [85] In that case, the ECJ ruled against Italy due to the fact that Italian national courts repeatedly decided a certain legal issue in conflict with Community law, following the established case law of the Italian Supreme Court.

Indeed, the ECJ explained that a Member State's failure to fulfil obligations may, in principle, be established under Art. 226 EC Treaty whatever the agency of that State whose action or inaction is the cause of the failure to fulfil its obligations, [86] and that, in particular, the scope of national laws, regulations or administrative provisions must be assessed in the light of the interpretation given to them by national courts. [87] The Court, indeed, concluded that, in the case at stake, the effects of the disputed provision of Italian law should have been determined in the light of the construction which the national courts gave it.

[88] In that regard, the ECJ observed that:

[...]isolated or numerically insignificant judicial decisions in the context of case-law taking a different direction, or still more a construction disowned by the national supreme court, cannot be taken into account. That is not true of a widely-held judicial construction which has not been disowned by the supreme court, but rather confirmed by it. Where national legislation has been the subject of different relevant judicial constructions, some leading to the application of that legislation in compliance with Community law, others leading to the opposite application, it must be held that, at the very least, such legislation is not sufficiently clear to ensure its application in compliance with Community law."

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### 12.3.2. Tax treaty cases not remitted under Art. 234 EC Treaty on the basis of *acte-éclairé* principle

An express application of the *acte-éclairé* principle by the Italian Supreme Court can be found in the last instance decision of one the cases described above at 12.3.1.

In this respect, it is not immediate to answer the question as to whether the Court properly applied the *CILFIT* doctrine on *acte éclairé*. [90] Indeed, the reasoning developed by the Supreme Court in the decision on the referral to the ECJ is apparently contradictory.

The request for the reference for a preliminary ruling to the ECJ advanced in the case brought before the Supreme Court covered:

- The question of the compatibility with the EC Parent-Subsidiary Directive of the application of the withholding tax *on the dividends* distributed by an Italian subsidiary to its Netherlands parent in connection with the refund of the equalization tax.

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85 Case C-129/00, *Commission vs Italy*, [2003] ECR I-4637. With reference to Member States' liability for acts of the judiciary, see Case C-224/01, *Köbler v. Austria*, [2003] ECR I-10239; Case C-453/00, *Kuhne & Heitz* [2004] ECR I-837; Case C-173/03, *Traghetti del Mediterraneo SpA vs. Italy*, rendered on 13 June 2006.

86 Para. 29 of the decision.

87 Para. 30 of the decision.

88 Para. 31 of the decision.

89 Paras. 32 and 33 of the decision.

90 Case C-283/81, *CILFIT* [1982] ECR 3415.

- The question of the compatibility with the EC Parent-Subsidiary Directive of the application of a withholding tax *on the equalization tax* refunded by a Netherlands parent company under Art. 10 of the Italy-Netherlands tax treaty.

With reference to the first question, the Supreme Court rejected the request for referral to the ECJ on the grounds that:

[...]on the question of compatibility of tax treaties with Directive 90/435/CEE, in connection with the application of withholding tax on dividends distributed by an EU resident subsidiary to its parent resident in another Member State, the ECJ already ruled, in a similar case, with decision 25 September 2003, in C-58/01, *Océ van der Grinten vs. Commissioners of Inland Revenue* (hereinafter "*Océ*"). (author's unofficial translation)

On the basis of such consideration, the Supreme Court declared the compatibility of the withholding tax on the dividends with the EC Parent-Subsidiary Directive.

In the *Océ* case, a UK subsidiary distributed dividends to its Dutch parent company. At the same time, it paid advance corporation tax in respect of those dividends. Under Art. 10(3)(c) of the UK-Netherlands income tax treaty, the parent was granted a tax credit equal to half of the advance corporation tax. A tax equal to 5% of the aggregate of the dividends and the tax credit was then applied to the parent under Art. 10(3)(a) of the UK-Netherlands treaty.

The ECJ ruled upon the following issues:

- whether the charge applied under Art. 10(3)(c) of the UK-Netherlands treaty on the dividends distributed by a UK subsidiary to its EU parent and on the related tax credit is a withholding tax under the terms of Art. 5(1) of the Directive;
- if it is a withholding tax under the terms of Art. 5(1) of the Directive, whether it is preserved by Art. 7(2) of the Directive.

The ECJ stated that the charge on the dividends is a withholding tax under the terms of Art. 5(1) of the Directive, whilst that on the tax credit is not, due to the fact that a tax credit cannot be considered as a profit distributed under the Directive; therefore the charge on the dividends is in principle prohibited by Art. 5(1) of the Directive, whilst the charge on the tax credit is not.

However, the ECJ sustained that the charge on the dividends was preserved by Art. 7(2) of the Directive; it did so on the grounds that, basically, Art. 7(2) preserves domestic tax provisions forming

an integral part of a body of domestic or agreement based provisions which are designed to lessen economic double taxation of dividends (which is in principle so in the case of a bilateral convention for the avoidance of double taxation) and relate to the payment of tax credits to the recipients of dividends. <sup>[91]</sup>

As the ECJ considered that the disputed withholding tax on the dividends shall indeed "be regarded as falling within a body of agreement-based provisions relating to the payment of tax credits to the recipient of dividends and designed thereby to mitigate double taxation", the consequence was the assessment of its compatibility with the Directive. <sup>[92]</sup>

Returning to the Italian Supreme Court's decision, in order to verify whether the *CILFIT* doctrine was correctly applied by the Court, it is preliminarily necessary to demonstrate if the cases were similar, even

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<sup>91</sup> Para. 85 of the Judgement.

<sup>92</sup> Para. 88 of the Judgement.

though not identical. In other words, it shall be assessed whether the Italian case regarding application of withholding tax on the amount of the dividends and of the refund of the equalization tax, could be legitimately considered similar to the UK case regarding application of the charge on the amount of the dividends and of the tax credit.

The answer could have been given in the positive, when considering that, in substance, the refund of the equalization tax and the tax credit pursue a similar result in cross-border dividend distributions, i.e. the elimination of economic double taxation on the dividends. <sup>[93]</sup>

However, the Italian Supreme Court did not explain the reasons behind its decision of considering the case as being *acte éclairé* by the ECJ with the *Océ* precedent.

Rather, the Italian Supreme Court considered that:

[...]the reasoning of the ECJ regarding the applicability of the withholding tax on the tax credit, cannot apply to the refund of the equalization tax, given that the tax credit, as explained by the ECJ, is meant to eliminate economic double taxation, whilst the equalization tax plays the different, almost opposite, role of aligning virtual tax credits with effective tax credits. (author's unofficial translation)

It therefore appears that the decision of the Italian Supreme Court is based on a contradictory rationale. Indeed, as mentioned, the *Océ* decision on the withholding tax on dividends was substantially based on the applicability of the exception clause of Art. 7(2) of the Directive to the dividend distribution and to the tax credit as forming part of a single piece of law intended to eliminate double taxation. On the other hand, the Italian Supreme Court considered that the case lodged before it concerned provisions whose rationale is not the elimination of double taxation.

As a consequence, apparently the Italian Supreme Court should have either considered the *Océ* decision as not being a relevant precedent for the purposes of the *acte-éclairé* principle; or it should have taken the reasoning developed in the *Océ* decision as a relevant precedent, but it should have applied it *a contrario* to state the non-compatibility of the Italian withholding tax on dividends with Art. 5(1) of the Directive.

In fact, if the assumption taken by the Italian Supreme Court is that the legislation regarding the equalization tax is not intended to eliminate double taxation, as a result of the *Océ* doctrine itself, it cannot be preserved by the exception clause of Art. 7(2) of the Directive. As a consequence, any withholding on dividends distributed in connection with the refund of the equalization tax shall be prohibited by Art. 5(1) of the Directive.

With reference to the second question, which was proposed by the parties to the case for referral to the ECJ, i.e. the question of compatibility with the EC Parent-Subsidiary Directive of the withholding tax on the refund of the equalization tax, the Supreme Court selected as a relevant precedent for application of the *acte-éclairé* principle the ECJ judgement in case C-294/99 *Athinaiki Zythopoiia AE vs. Elliniko Dimosio* (hereinafter "*Zythopoiia*").

The *Zythopoiia* case regards the compatibility with Art. 5(1) of the EC Parent-Subsidiary Directive of a Greek tax, which is very similar to the Italian equalization tax. In greater detail, in the case brought before the ECJ, a Greek subsidiary distributed dividends to its Dutch parent company. The subsidiary's profits included tax-free income and income taxed at reduced rates upon realization. Upon distribution of dividends, the taxable profits of the distributing company were grossed up by the income tax corresponding to the income subject to special taxation. Corporate income tax on such adjusted profits would not have been payable if the profits had been retained by the subsidiary. The issue raised before the ECJ was whether or not the increase in the taxable profits in respect of the tax-free and specially

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<sup>93</sup> Sozzi, C., "Dividendi intracomunitari fra convenzioni internazionali e direttiva 'madre-figlia'", *Riv. Dir. Trib.* 5 (2005) p. 190; contra, Manganelli, A., "Tax treaties and Anti-Avoidance Implications of the Implementation of the Parent-Subsidiary Directive", 33 *European Taxation* 10 (1993) p. 337.

taxed income meant that the income was subject to a withholding tax that was incompatible with Art. 5(1) of the EC Parent-Subsidiary Directive.

The ECJ decided that the levy of the tax was prohibited by Art 5(1) of the Directive, basically on the grounds that "the chargeable event for the taxation at issue in the main proceedings (...) is the payment of dividends. In addition, the amount of tax is directly related to the size of the distribution." <sup>[94]</sup>

The Italian Supreme Court, considering the similarity of the Greek tax with the Italian equalization tax, ruled that the withholding tax on the refund of the equalization tax was incompatible with Art. 5(1) of the Directive, on the grounds that the levy on the refund of the equalization tax would not be legitimate because it would represent a tax on an undue charge.

Consistently with the approach described above on the nature of the equalization tax, the Supreme Court also considered that the exception clause of Art. 7(2) of the EC Parent-Subsidiary Directive shall not apply due to the fact that the equalization tax system is not intended to eliminate double taxation. As a consequence of that, the Supreme Court ruled that the lower judge shall disregard the disputed domestic and agreement based provisions when ruling on the merits of the case.

In this respect, even though *Zythopoiia* ruled upon the nature of a tax similar to the Italian equalization tax, and not upon the nature of the withholding tax on the refund on such equalization tax-like charge, it appears that the *acte-éclairé* principle was correctly applied by the Supreme Court on the point of compatibility of the withholding tax on the refund of the equalization tax with the EC Parent-Subsidiary Directive.

### 12.3.3. Tax treaty cases not remitted under Article 234 EC Treaty on the basis of *acte-clair* principle

The *acte-clair* principle was invoked by the Supreme Court in 1999 in the case detailed above at 12.2.2.2. regarding the taxation of royalties under the Italy-UK tax treaty. <sup>[95]</sup>

As mentioned, the dispute regarded the applicability of the Italy-UK tax treaty with respect to an Italian local tax ("ILOR", currently abolished). In this respect, on the one hand, the Italian domestic laws governing ILOR provided that the tax should apply to royalty income arising in Italy, except where the income was subject to withholding taxation in Italy; the Treaty, on the other hand, provided that royalties paid by an Italian resident to a UK resident should be taxable solely in the UK, unless the recipient had a permanent establishment in Italy. The result was that, being such royalty payments exempted from withholding taxation in Italy under application of the tax treaty, they were subject to the local tax under the Italian domestic tax law.

The Supreme Court directly applied Community law, as required by one of the parties, and decided not to refer the case to the ECJ for a preliminary ruling. In this respect, it considered that "interpretation of domestic laws is out of the competence on preliminary ruling of the ECJ." (unofficial author's translation)

The Court found that the tax regime of royalties resulting from concurrent application of Italian domestic laws and tax treaty provisions as interpreted by the tax authorities was incompatible with the non-discrimination principle embodied in Art. 6 of the EC Treaty (now Art. 12).

In the opinion of the Court, in fact, UK residents receiving royalties from an Italian company were disadvantaged when compared to Italian residents receiving royalties from an Italian company, in that the former would suffer ILOR taxation on the income whilst the latter would not.

In this respect, the Supreme Court quoted ECJ cases regarding free movement of workers <sup>[96]</sup> and freedom of establishment, <sup>[97]</sup> apparently misunderstanding the relationship between the freedom of

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<sup>94</sup> Para. 28 of the decision.

<sup>95</sup> Cass. 25 November 1999, No. 1122.

<sup>96</sup> Case C-279/93, *F.K.-A. vs. S.*

<sup>97</sup> Case C-270/83, *Commission vs. France (avoir fiscal)*.

establishment principle and the non-discrimination principle. Indeed, the Supreme Court affirmed in the decision that the case law of the ECJ shows that "the non-discrimination principle applies to the right of free establishment in the field of direct taxation." <sup>[98]</sup> (author's unofficial translation)

Moreover, the Court took a position with respect to the issue of "most favoured nation treatment" stating that the non-discrimination principle does not imply that the UK resident involved in the case might have invoked application of a more favourable treatment provided by a tax treaty concluded by Italy with another country. In that regard, the Supreme Court quoted ECJ case C- 336/96 (*Gilly*).

The decision of the Supreme Court does not appear as a whole to be satisfying. Indeed, on the application of the non-discrimination principle, the Court ignores the basic principle under which Art. 6 of the EC Treaty (now Art. 12) applies solely with respect to disputes lodged before the competent courts that do not fall within the scope of application of a fundamental freedom. In the case at stake, it appears that the case would fall within the purview of the free movement of capital principle or of the freedom of establishment. As a consequence, the non-discrimination principle shall not apply.

With reference to the "most favoured nation treatment", the decision of the Supreme Court appears indeed to be superficial; moreover, the question - all the more at the time of the decision - was far from being definitively clarified by the ECJ itself. Therefore, it appears that the Supreme Court should have indeed stayed proceedings and referred the question to the ECJ for a preliminary ruling.

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<sup>98</sup> The decision quotes, further, C-330/91 (*Commerzbank*), C-1/93 (*Halliburton*), C-250/95 (*Futura participations*).

## Chapter 13 – Netherlands

### 13.1. The nature of rules governing tax litigation

#### 13.1.1. Tax-law proceedings versus other kinds of proceedings

##### 13.1.1.1. General description of the proceedings

###### 13.1.1.1.1. Objection and appeal

Tax may be levied by means of a tax assessment imposed by the tax inspector (e.g., income tax or corporate income tax) or by self-assessment in the form of filing a tax return (e.g. for VAT or dividend withholding tax). <sup>[2]</sup> Taxpayers may file an objection to the tax assessments <sup>[3]</sup> or their own tax returns (e.g., their dividend withholding tax return). The objection must be filed within six weeks after the tax is levied (i.e. within six weeks of the date of the tax assessment or return). If the Dutch Revenue rejects the objection, the taxpayer may appeal to the District Court (*Rechtbank*) within six weeks. Tax cases constitute separate proceedings that are generally subject to the same rules that govern other administrative law proceedings. Both parties (the taxpayer and the Dutch Revenue) may appeal the District Court decision to the Court of Appeals (*Gerechtshof*) within six weeks. <sup>[4]</sup> Finally, both parties may appeal the Court of Appeals decision to the Dutch Supreme Court (*Hoge Raad der Nederlanden*) within six weeks of the former decision. The Supreme Court only reviews the correct application of the law <sup>[5]</sup> and compliance with all formalities, and does not rule on questions of fact. Pursuant to Art. 234 of the EC Treaty, only the Supreme Court has the obligation to refer questions to the ECJ for a preliminary ruling.

The statutory limitation requires that a decision be issued within six weeks after the oral arguments are held. This deadline can be extended by another six weeks under special circumstances. This limit is often exceeded in tax cases, even without any special circumstances, and even though there are no consequences for this unless a tax penalty is imposed: if the reasonable term set forth in Art. 6 of the European Convention on Human Rights is exceeded, the amount of the penalty may be reduced. The Supreme Court issued guidelines in this respect in a recent decision. <sup>[6]</sup> According to the Supreme Court, in the absence of special circumstances, the District Court decision should generally be issued within two years after the date of the criminal charge, i.e. the date the relevant authority took an action against the taxpayer from which the latter could reasonably infer that a tax penalty would be imposed. Generally, the appeal to the Court of Appeals should take no more than two years from institution to decision. The same goes for the proceedings before the Supreme Court. <sup>[7]</sup> This means that a six-year period for tax proceedings held before the District Court, Court of Appeals and Supreme Court is generally considered reasonable.

###### 13.1.1.1.2. Oral versus written proceedings

All proceedings in tax cases start with an exchange of written documents, followed by oral arguments. Oral arguments can be waived by the Court, after consent of the parties, but this seldom happens, except in Supreme Court proceedings.

In tax cases, as in any other administrative law proceedings, parties need not be represented by a lawyer. Taxpayers may represent themselves or choose anyone else to represent them. Representation

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<sup>2</sup> If insufficient tax is levied by the tax assessment or return, an additional tax assessment (*navorderingsaanslag* or *naheffingsaanslag*) may be imposed.

<sup>3</sup> Including the additional tax assessments; see [note 2](#).

<sup>4</sup> Under certain circumstances, the parties may bypass the Court of Appeals proceedings and appeal the District Court's decision directly to the Supreme Court.

<sup>5</sup> The Supreme Court only reviews the correct application of Dutch law and international law, but does not rule on matters touching on the national laws of other States.

<sup>6</sup> Supreme Court, 22 April 2005, *BNB* 2005/337.

<sup>7</sup> In the relevant case, the Supreme Court reduced the tax fine by 10% because more than two years had passed between the filing of the appeal with the Supreme Court and the issuance of a decision on that appeal.

by a lawyer is mandated only for oral arguments before the Supreme Court, which themselves are not mandatory and seldom take place. [8] It may be that oral arguments before the Supreme Court would serve little purpose, since that Court does not rule on issues of fact.

#### 13.1.1.1.3. Reimbursement of litigation costs

Taxpayers may incur various expenses in pursuing tax proceedings but will always have to pay filing fees if they appeal to the District Court, [9] Court of Appeals [10] or Supreme Court. [11] If the taxpayer prevails on appeal, the filing fees are fully reimbursed. In other cases, the relevant court may decide to reimburse all or part of the filing fees. [12]

In addition to filing fees, the taxpayer may incur travel expenses, loss of income and legal fees. Although legal representation is not mandatory, the complexity of the tax system prompts many taxpayers to hire tax lawyers, tax advisers or accountants for legal assistance.

As a general rule, the following applies: [13] If the taxpayer loses, each party pays their own expenses; if the taxpayer wins, however, a request for reimbursement of the expenses can be made to the tax authorities. The taxpayer can also be ordered to reimburse the Dutch Revenue's litigation costs, but only in cases of abuse of law, which is extremely rare. Legal fees are reimbursed according a flat-rate system (duties performed by a lawyer are awarded points, which are then converted into a sum to be reimbursed). In most cases, the awarded reimbursement covers only a fraction of the actual fees. In certain cases (in exceptional circumstances), it is possible to depart from the above-described system, which may result in the full reimbursement of the actual fees. In practice, this only happens in instances of unreasonable behaviour on the part of the Dutch Revenue (such as asserting frivolous arguments). According to the Supreme Court, the mere issuance of a tax assessment in breach of Community law does not amount to an exceptional circumstance. [14]

In the *D* case, [15] the question posed was whether Community law precluded "a legal costs scheme such as that in issue, under which, in principle, only a limited contribution is made towards legal costs where a citizen is successful in proceedings brought before the national courts for breach of Community law by a Member State." The Advocate-General, Ruiz-Jarabo Colomer, reasoned in his opinion that it is for the referring court to draw its own conclusions about its own procedural system and to analyse that system's compliance with EC requirements (i.e. the principles of effectiveness and equivalence). If, however, the ECJ were to take the place of the national court, his alternative view was that the Dutch procedural rule, which, in the case at hand, allowed recovery of only a little over EUR 2,000 out of a total of EUR 12,500 in fees, may infringe the principle of the effectiveness of Community law, "since it is liable to render recourse to legal proceedings fruitless and to deter the holders of rights under Community law from defending them." [16] The ECJ did not answer the question regarding the Dutch legal costs scheme, since it ruled that there had been no infringement of EC law.

In another case, a non-resident taxpayer claimed full reimbursement of fees because the tax inspector had initially refused to apply the lower tax rate for resident taxpayers, even after the *Asscher* case had been decided. [17] The Supreme Court held that a breach of Community law is in this regard no different than a breach of national law. In other words: a breach of Community law does not per se entail a specific circumstance that would justify a full reimbursement of fees. In any event, according to the

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8 Written arguments may be submitted instead of oral arguments but must be submitted by a lawyer.

9 EUR 37 or EUR 138 for individuals (natural persons) and EUR 276 for others (Sec. 27b of the General Tax Act ("AWR")).

10 EUR 103 or EUR 207 for individuals and EUR 414 for others (Sec. 271 of the AWR).

11 EUR 103 or EUR 207 for individuals and EUR 414 for others (Sec. 29a of the AWR).

12 Sec. 8:74 of the General Administrative Law Act ("Awb").

13 The reimbursement of costs for judicial proceedings is governed by Sec. 8:75 of the Awb and a regulation based on this section, the Decree dated 22 December 1993 (Decree containing additional rules regarding judgments for costs in administrative law proceedings; *Besluit houdende nadere regels betreffende de proceskostenveroordeling in bestuursrechtelijke procedures*).

14 Supreme Court, 7 October 2005, *BNB* 2005/374.

15 ECJ, 5 July 2005, case *C-376/03, D.*, ECR I-5821.

16 See paras. 110-112 of the opinion of Advocate-General Ruiz-Jarabo Colomer.

17 ECJ, 27 June 1996, case *C-107/94, Asscher*, ECR I-3089.

Supreme Court, the reimbursement was an additional matter to be dealt with according to national law. <sup>[18]</sup> Furthermore, the Supreme Court held that the national rules did not breach the principle of effectiveness, since taxpayers could only be ordered to reimburse the Dutch Revenue's litigation costs in cases of abuse of law, and because, in exceptional circumstances, it is possible to depart from the flat-rate system. <sup>[19]</sup>

### 13.1.1.2. The judges

There are no special tax courts, although the various courts competent for tax cases do have special tax chambers that deal exclusively with tax cases. The District Courts and Courts of Appeals decide relatively straightforward cases in a one-judge chamber, while a three-judge chamber hears more difficult cases. The Supreme Court decides in either a three- or five-judge chamber. The judges are not necessarily educated as tax lawyers, although in practice at least one of them, and usually most of them, are tax-law specialists.

There are approximately 20 advocate-generals with the Supreme Court, <sup>[20]</sup> five of whom are currently tax specialists. These advocate-generals are not public prosecutors. Their job is similar to that of an advocate-general with the ECJ: they deliver impartial and independent Opinions to the Supreme Court. Opinions are not mandatory in tax cases; it is up to the advocate-generals to decide whether they deliver an Opinion in a particular case. This happens in approximately 10-15% of the cases.

### 13.1.1.3. The decisions

There is no system of dissenting and/or concurring opinions, which means that decisions tend to be rather short. There is no fixed format for court decisions and they may be rendered in either written or oral form, except for Supreme Court decisions, which must be in written form. Written decisions may be redacted and sent to third parties, subject to the court's permission. <sup>[21]</sup> This permission is only denied if the court believes it would be impossible to sufficiently safeguard the confidentiality of personal or financial data, and the public interest in the availability of the decision is outweighed by the interest in confidentiality, which seldom happens.

The decisions released may be accessed via a website ([www.rechtspraak.nl](http://www.rechtspraak.nl)). The decisions are also sent to commercial publishers for publication in legal periodicals, which are commonly accompanied by annotations by renowned tax specialists.

### 13.1.1.4. Literature and administrative practice

Literature presumably does influence administrative practice but it is difficult to quantify that influence because the courts rarely refer to literature.

Administrative practice is far more important because taxpayers can rely on it under the "general principles of proper management" (*algemene beginselen van behoorlijk bestuur*). The principle of trust is especially relevant. For example, if the Dutch Revenue takes a certain position, the taxpayer may rely on it, on the basis of this principle, even if this position later proves to be *contra legem*. The same goes for the principle of equal treatment. If the Dutch Revenue has a certain beneficial policy, it is required to follow it in all equal cases, even if its application is *contra legem*.

## 13.1.2. Burden of proof

The tax laws do not mention the burden of proof, the rules concerning which are established through case law. The exception arises in the event that the taxpayer fails to fulfil certain legal obligations, such as

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<sup>18</sup> In this regard, the Supreme Court referred to the ECJ's decision dated 12 September 2000, in joined cases [C-397/98](#) and [C-410/98](#), *Metallgesellschaft and Hoechst*, ECR I-1727; its decision dated 6 December 2001, in case [C-472/99](#), *Clean Car Autoservice GmbH*, ECR I-9687; and its decision dated 4 December 2003, in case [C-63/01](#), *Evans*, ECR I-14447.

<sup>19</sup> Supreme Court, 17 December 2004, *NJ* 2005, 361, BNB 2005/239. See also Supreme Court, 7 October 2005, *BNB* 2005/374.

<sup>20</sup> The oldest ranking is referred to as procurator-general, the second-oldest ranking as deputy procurator-general.  
<sup>21</sup> ecs. 27g, 27j(3), and 30 of the AWR.

timely filing a correct tax return and providing requested information. In such a case, the burden of proof shifts to the taxpayer.

In principle, each party has to state and prove the elements relevant to their position; in other words, the tax inspector has to prove the elements regarding taxability, while the taxpayer has to prove the elements regarding deductions and exemptions.

### 13.1.3. Rules of evidence

In tax litigation, the courts are free to admit whatever evidence they choose and are not limited to certain kinds of evidence. <sup>[22]</sup> Courts may even use their own knowledge and experience in making rulings, and are free to evaluate the evidence as they will. Courts may call witnesses and appoint experts and interpreters. Parties may also call witnesses, including experts, and current case law prescribes that parties offering to prove their position by calling witnesses generally cannot be precluded from doing so. <sup>[23]</sup> It is uncertain whether this case law will be affirmed after the introduction of the possibility of appealing to the District Court, since the Supreme Court has explicitly referred to the lack of a second instance. <sup>[24]</sup> Taxpayers now have a second opportunity to prove their positions, which may result in a relaxation of the standards set by the Supreme Court.

### 13.1.4. Special rules applicable to international law cases

There are no special rules applicable to international law cases.

## 13.2. International tax treaty case law

### 13.2.1. Relevance of the Vienna Convention on the Law of Treaties ("VCLT")

According to Art. 4 of the VCLT, "the Convention applies only to treaties which are concluded by States after the entry into force of the present Convention with regard to such States." For the Netherlands, the VCLT entered into force on 9 May 1985. However, an exception exists for the application of any rules to which treaties would be subject under international law independently of the Convention; in other words rules of customary international law which already applied and were merely codified by the VCLT. The Dutch Supreme Court held that the VCLT may be considered to have codified already applicable public international law on the interpretation of treaties. <sup>[25]</sup>

The *communis opinio* is that the general rule of interpretation of Art. 3(2) is a *lex specialis* that overrides Arts. 31-33 of the VCLT. <sup>[26]</sup> These articles are relevant, however, if Art. 3(2) of an OECD-patterned tax treaty itself must be interpreted, or if this provision might not apply in the case at hand. Articles 31-33 of the VCLT are applied in both tax and non-tax cases, although they are not often applied explicitly. A clear example is the Supreme Court ruling about a provision in the Payroll Tax Act, which provides that payments made in the context of surrendering pension rights are regarded as wages for previous employment duties performed. The effect anticipated by the legislature was that the payments would be classified as income from employment (Art. 15 of the OECD Model Convention ("OECD MC")), which is commonly taxable in the source State, instead of pension income (Art. 18 of the OECD MC), which is commonly taxable in the State of residence. As a result, the Netherlands would be able to tax the payments made to a taxpayer who worked in the Netherlands and surrendered the pension rights while resident in another State only if the pension rights were granted during the period in which the employment duties were performed in the Netherlands. In the case at hand, the taxpayer, who lived in Singapore, had been employed for 23 years and three months, nearly five and a half years of which were

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<sup>22</sup> See Supreme Court, 22 June 1960, *BNB* 1960/255; and 24 March 1971, *BNB* 1971/84.

<sup>23</sup> Supreme Court, 12 March 2001, *BNB* 2001/178.

<sup>24</sup> Apart from the appeal to the Supreme Court itself, which is not involved in any factual research.

<sup>25</sup> Supreme Court, 29 June 1990, *NJ* 1992, 106 (*Gabriëlle Wehr*), para. 3.7.

<sup>26</sup> See Engelen, F., *Interpretation of Tax Treaties under International Law*, Amsterdam: IBFD Publications BF, 2004, Doctoral Series 7, pp. 477-480 and Wattel, P.J. and Marres, O., "Characterization of Fictitious Income under OECD-Patterned Tax Treaties", *European Taxation* (43) 2003-3 p. 70.

spent working in the Netherlands. Some of the pension rights (i.e. those attributable to the employment duties performed outside the Netherlands) were surrendered. The issue in dispute was whether the payments, or a part thereof, could be taxed by the Netherlands under Art. 15 of the Netherlands-Singapore DTC, or whether the Netherlands should exempt the income under Art. 18 of that Treaty. The Supreme Court held that since treaties have to be interpreted in good faith, as embodied in Art. 31 of the VCLT, a treaty provision which grants the right to tax pension income to the State of residence cannot be eroded by a national law provision that taxes income from surrendering pension rights as employment income. <sup>[27]</sup>

### 13.2.2. Relevance of the Commentaries on the Articles of the OECD MC

According to Supreme Court case law, the OECD Commentaries are of great importance for the interpretation of a treaty that conforms to the OECD MC. For example, because the Ireland-Netherlands tax treaty followed the OECD MC as closely as possible, and Art. 8(9) of the Treaty was virtually identical to Art. 10(5) of the OECD MC, the Supreme Court held that the OECD Commentary on the latter provision was "of great importance" (and not merely "of some support," as the Court of Appeals had held). <sup>[28]</sup> The Supreme Court has referred to the OECD Commentaries on other occasions as well. Some examples are in the decisions analysed below, regarding fictitious income <sup>[29]</sup> and the treaty classification of liquidation proceeds. <sup>[30]</sup> These decisions indicate that the mere fact that the treaty was based on the OECD MC was sufficient impetus for taking the Commentary into account.

The Supreme Court has occasionally also referred to a *later* version of the OECD Commentaries. In one case, it referred to the Commentaries on the OECD MC of 1963 and to later Commentaries on later Models for the interpretation of the 16 June 1959 tax treaty between the Netherlands and Germany, but only in a negative sense: it declined the position taken by one of the parties, the taxpayer, and held that this position was not supported by the OECD Commentaries. <sup>[31]</sup> In another case, it referred to a post-treaty Commentary in a positive sense. In this case, the Supreme Court had to decide whether the consideration for the repurchase of shares was to be classified as a dividend or a capital gain under the tax treaty concluded by the Netherlands and Belgium on 19 October 1970. The Supreme Court held that the income was not explicitly classified as either one of these categories, and that the OECD Commentaries of both 1963 and 1977 stated that the source State is entitled to tax the income as dividend, but that none of these facts excluded the possibility that the source State could treat the income as a capital gain (according to the Supreme Court, the decisive factor is whether the source State taxes the income as dividend income or as a capital gain under national law). <sup>[32]</sup>

Two other cases dealt with the meaning of the term "being present" in Art. 15(2)(a) of the tax treaties with Nigeria and Brazil (which conform to Art. 15(2)(a) of the 1977 OECD MC). Taking the wording of the provisions in its context, the Supreme Court held that the term "is present" referred to physical presence. <sup>[33]</sup> As an additional argument, the Supreme Court referred to para. 5 of the OECD Commentaries of 1992 on Art. 15 of the OECD MC. Both treaties predated the date of issue of these Commentaries: the Nigeria-Netherlands treaty was concluded on 11 December 1991 and the Brazil-Netherlands treaty was concluded on 8 March 1990; the Commentaries were amended with effect from 23 July 1992. With respect to the Nigeria-Netherlands treaty, one should bear in mind that these changes were based on the OECD report entitled "The 183 day rule: some problems of application and interpretation," of 24 October 24 1991. <sup>[34]</sup> There are no indications, however, that the parties took this report into account. Other interesting facts are

<sup>27</sup> Supreme Court, 5 September 2003, *BNB* 2003/380, para. 3.5. This judgment was confirmed in the Supreme Court judgment of 13 May 2005, *BNB* 2005/232-235.

<sup>28</sup> Supreme Court, 2 September 1992, *BNB* 1992/379.

<sup>29</sup> Supreme Court, 5 September 2003, *BNB* 2003/379 and 381; Supreme Court, 18 June 2004, *BNB* 2004/314.

<sup>30</sup> Supreme Court, 12 December 2003, *BNB* 2004/123, para. 3.5.

<sup>31</sup> Supreme Court, 9 December 1998, *BNB* 1999/267.

<sup>32</sup> Supreme Court, 12 December 2003, *BNB* 2004/123, para. 3.5.

<sup>33</sup> Supreme Court, 21 February 2003, *BNB* 2003/178 (Nigeria) and *BNB* 2003/177 (Brazil).

<sup>34</sup> Published in *Model tax convention on income and on capital/Organisation for Economic Co-operation and Development*, Vol. II, OECD Committee on Fiscal Affairs, 2000, part C., Calculation of the 183-day period, pp. R(9)-6 through R(9)-11.

that neither Brazil nor Nigeria are members of the OECD; when the treaty was concluded, neither State had published its non-member position on Art. 15 of the OECD MC, [35] and, according to the explanatory notes, neither State used the OECD MC as a starting point in its negotiations with the Netherlands.

The Supreme Court has not explicitly considered the status of the OECD Commentaries in relation to the VCLT. In this author's view, the OECD Commentaries' version in place at the time of the conclusion of a tax treaty may be regarded as "context" under Art. 31(2) of the VCLT for purposes of interpreting that treaty if it was based on the OECD MC and it was also presented to the national parliaments (the ratifying authorities) as having been based on that Model Convention. Later versions of the Commentaries have the same status as either (i) published policy regulations (with the result that, depending on national administrative law, taxpayers may rely on these later versions under the principle of legitimate expectation), or (ii) supplementary means of interpretation under Art. 32 of the VCLT, comparable to authoritative literature, for instance. [36]

### 13.2.3. Other commentaries or means of interpretation

This author has not come across references by Dutch courts to other model conventions or commentaries on those conventions. [37]

The Official Commentary to the VCLT has played a role in the interpretation of Art. 24(3) of the Canada-Netherlands tax treaty. The question was whether the non-discrimination provision also applied to capital contribution tax, since Art. 24(3) referred to "any taxation," and since capital contribution tax was not listed in Art. 2 as one of the taxes covered by the Treaty. The Supreme Court stressed that, pursuant to Art. 31 of the VCLT, the term "any taxation" should be interpreted "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." [38] As a complementary means of interpretation (i.e. in interpreting the general rule of interpretation of the VCLT) the Supreme Court referred to the Official Commentary on Art. 31 (1) of the VCLT, which, for the purposes of determining the ordinary meaning of the terms, requires taking the treaty as a whole into account, and not just a particular phrase taken out of context. The Supreme Court further reasoned that "object and purpose" were limited to the taxes on income and that expanding the scope of the Treaty would undermine the ordinary meaning of Art. 2. As a result, the Supreme Court held that "any taxation" only referred to the taxes mentioned in Art. 2 of the Treaty.

The explanatory memoranda submitted to parliament are important resources for interpreting tax treaties. Many Supreme Court decisions refer to these memoranda [39] (or the absence of a relevant remark in these memoranda). [40]

For example, with reference to the Dutch explanatory memorandum to the Netherlands-Israel social security treaty, the Supreme Court held that sickness allowances fell outside the scope of the Treaty. [41] In another case, with reference to both the Dutch explanatory memorandum and the Swiss notes to the 1966 Protocol to the Treaty, [42] it held that the company's authorized capital (*maatschappelijk kapitaal*) should be interpreted as being its issued capital (*geplaatst kapitaal*). [43]

Another issue is the importance of mutual agreements (see Art. 25 of the OECD MC). Such a mutual agreement is a treaty and, therefore, is binding under international law. Under Dutch constitutional law,

35 Brazil's position was not published until 1997.

36 Wattel, P. and Maries, O., "The Legal Status of the OECD Commentary and the Question of Static or Ambulatory Interpretation of Tax Treaties", *European Taxation* (43) 2003-7/8 p. 234.

37 Other than in the Opinions the Advocate-Generals have submitted to the Supreme Court.

38 Supreme Court, 1 November 2000, *BNB* 2001/19, para. 3.4.

39 See e.g. Supreme Court, 2 September 1992, *BNB* 1992/379; Supreme Court, 4 November 1992, *BNB* 1993/38; and Supreme Court, 13 October 1999, *BNB* 2000/123.

40 See e.g. Supreme Court, 25 May 1994, *BNB* 1994/219; Supreme Court, 13 November 1996, *BNB* 1997/54; Supreme Court, 8 November 2002, *BNB* 2003/48; and Supreme Court, 21 February 2003, *BNB* 2003/177 and 178.

41 Supreme Court, 13 October 1999, *BNB* 2000/123.

42 "Message du Conseil federal a l'Assemblée federate concernant l'approbation de la convention qui modifie et complete la convention entre la Suisse et les Pays-Bas en vue d'eviter les doubles impositions dans le domaine des impots sur le revenu et sur la fortune", 8 July 1966, *Feuille federate*, 118th year, vol. 1, no. 9523, p. 1361 et seq.

43 Supreme Court, 4 November 1992, *BNB* 1993/38.

however, treaties are only binding on the Netherlands if they are approved by Parliament (either tacitly or explicitly). [44] An exception exists for implementing treaties that deal exclusively with the implementation or execution of a previously approved treaty; these treaties only need parliamentary approval if such approval is requested by a member of Parliament. [45] Individuals are bound by a treaty if it is officially published in the *Treaty Bulletin (Tractatenblad)*. [46] In a case concerning a mutual agreement between the Netherlands and Germany under Art. 25 of the Netherlands-German tax treaty, the Supreme Court decided that the agreement was not binding on the courts. The agreement had not been approved by the Parliament. It is unclear whether the agreement qualified as an implementing treaty according to the Supreme Court. Either way, it did not bind the courts because it had not been published. The agreement was only mentioned in a Decree issued by the Deputy Minister of Finance. The Supreme Court held as follows (unofficial translation):

The first complaint correctly argues that the Court [of Appeals] could not have decided only on the grounds of...the Decree that the word "temporary" in Article 10(2)...of the Treaty [with Germany] is not relevant, and that for this reason the taxpayer is not entitled to relief for double taxation. Indeed, the Decree contains no more than an announcement that the competent German and Dutch authorities have reached agreement under Article 25 of the Treaty on the interpretation of certain points of the Treaty. Such an announcement concerning the agreement reached, a written report of which was, for that matter, not published separately in any form, cannot absolve the court of the obligation to interpret the Treaty if an appeal is made to a Treaty provision in a case before the court.

[47]

It is interesting to note that also the German *Bundesfinanzhof* did not consider itself to be bound by the same agreement (unofficial translation):

In interpreting Article 10(2)(1) of the double taxation treaty with the Netherlands, it is irrelevant that the German and Dutch tax authorities reached an accord on the interpretation of that provision in 1995...Such agreements are binding in an international law context (see Article 31(3)(a) and (b) of the Vienna Convention on the Law of Treaties dated May 23, 1969), but, as a consequence of Article 59(2) of the Constitution, they in themselves cannot amend or supersede mandatory acts of consent and, thus, they are not binding under domestic law. [48]

According to German standards, the agreement is thus binding under international law but does not bind the courts and the taxpayers because of the lack of parliamentary approval. [49]

Although, like their German counterparts, the Dutch courts and taxpayers may not be bound by the agreement, the Dutch Revenue may be bound by this agreement with respect to the taxpayers who might wish to rely on it. Section 36 of the OECD Commentaries on Art. 25 of the OECD MC also states that "mutual agreements...are binding on administrations...." In this author's view, the taxpayer may rely on the agreement on the basis of the principle of trust (*vertrouwensbeginself*; see 13.1.1.4. above).

Irrespective of whether the agreement may be binding in any way, it may influence the interpretation of the relevant tax treaty. According to Art. 31 (3) of the VCLT, the following must be taken into account, along with the treaty context:

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44 Art. 91(1) of the Constitution.

45 Secs. 7(b) and 8 of the Approval and Publication of Treaties Act.

46 Art. 93 of the Constitution. For the hierarchy of national and international laws within the Dutch legal system, see Pijl, H., "Country Survey: Netherlands" in *Tax Treaties and Domestic Law*, Maisto, G. (ed.), Amsterdam: IBFD Publications BV, 2006, Vol. 2 EC and International Tax Law Series, pp. 281-293.

47 Supreme Court, 29 September 1999, *BNB* 2000/16, para. 3.6.

48 BFH 10 July 1996, I R 4/96, *BFHE* 181, 158, *BStBl* 1997, II, 15, para. 3d.

49 Refer Vogel, K., *Doppelbesteuerungsabkommen (DBA) der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen. Kommentar auf der Grundlage der Musterabkommen*, Munich: Beck Juristischer Verlag, 2003, 4th ed., marginal note 137.

- 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; and
- c) any relevant rules of international law applicable to the relationship between the parties.

Since the agreement was apparently made on behalf of the competent authorities of Germany and the Netherlands as referred to in Art. 25 of the Treaty, and as defined in Art. 2(3) of the Treaty, the agreement may be considered to be an agreement between the parties within the meaning of Art. 31(3)(a) of the VCLT. <sup>[50]</sup>

#### 13.2.4. Issues relating to Article 3(2) of the OECD MC

Under Art. 3(2) of the OECD MC, undefined treaty terms have the meaning they have under national law, unless the context requires another interpretation. In several cases, the Supreme Court has disregarded a national law interpretation on the basis of treaty provisions that conform to Art. 3 (2) of the OECD MC. First of all, interpretation according to national law has been denied in some cases because there was no relevant tax law definition of the treaty term. This has been the situation in the above-mentioned cases regarding the interpretation of the term "is present" in Art. 15 (2)(a) of the tax treaties with Nigeria and Brazil. <sup>[51]</sup> In the absence of a national tax law definition, these terms have been interpreted according to their ordinary meaning and according to the Commentaries to Art. 15 of the OECD MC.

Secondly, according to the Supreme Court, the national tax law meaning is not decisive if this would lead to an artificial shift in the right to tax. This is decided in various cases regarding the taxation of "fictitious" income. Since 1997, several provisions have been aimed at preventing tax avoidance by taking deemed income into account. For example, if a shareholder performs activities for a company in which it holds a substantial interest, the shareholder is deemed to be employed by the same company (Art. 4(d) Payroll Tax Act). Furthermore, if employees (deemed or otherwise) who have a substantial interest in the company that employs them do not receive adequate remuneration, they are deemed to receive a "normal" wage (Sec. 12a of the Payroll Tax Act). In a case in which the shareholder was resident in Belgium, the Dutch Revenue aimed to tax the "normal" wage the shareholder received for the activities he performed in the Netherlands. In two cases, the Supreme Court had to decide whether this "fictitious wage" should be considered to be income the shareholder derived from his employment in the Netherlands as mentioned in Art. 15(1) of the 1970 double taxation treaty between the Netherlands and Belgium. The Supreme Court held that although these fictions could generally be applied, this was different in a case in which the State applying those fictions would extend its taxation rights under the treaty by applying a distribution rule that would grant it more taxation rights than the normally applicable distribution rules. This was the case, since the amount of the fictitious wage would eventually be received by the same shareholder as dividend income or a capital gain, leaving the Netherlands with a limited, or no, right to tax. As a result, the fiction could not be applied. <sup>[52]</sup> The Supreme Court held:

The Treaty is based on the OECD MC. As stated in Note 13 of the Commentary on Article 3 of the Model Convention, the objective of a provision such as that set forth in Article 3(2) is to strike a balance between the need to ensure the "permanency of commitments" for the Contracting States, in order to prevent a state from nullifying part of the treaty by later amending its national law using terms that the treaty does not define, and the need to keep the Treaty practically applicable by avoiding dependency on outdated concepts. The first requirement, which is expressed in the

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<sup>50</sup> Id.  
<sup>51</sup> Supreme Court, 21 February 2003, *BNB* 2003/178 (Nigeria) and *BNB* 2003/177 (Brazil).  
<sup>52</sup> Supreme Court, 5 September 2003, *BNB* 2003/379 and 381.

reservation referring to the context, is insufficiently met if the principle of reciprocity on which the treaty is based no longer has a foundation in national law that forms part of the context within which the Treaty must be applied (see note 12 to the aforementioned Commentary on Article 3(2)). Therefore, a subsequent, unilateral amendment of the national law of one Contracting State, that has no corresponding provision in the national law of the other Contracting State, cannot legally justify a shift in the right to tax allocated and agreed upon when the Treaty was concluded. <sup>[53]</sup>

Another fiction regards the deemed interest taken into account if an individual who holds a substantial interest in a company provides that company with a loan. Again, the Supreme Court decided that this fiction could not be applied if the individual was resident in Belgium for treaty purposes. <sup>[54]</sup>

The judgment of the Supreme Court (5 September 2003, *BNB* 2003/380 - described in 13.2.2. above) also dealt with a legal fiction (wherein income derived from surrendering pension rights was treated as wages). Contrary to its holding in those cases, the Supreme Court in this case did not refer to the "permanency of commitments" but to the principle of good faith. It is not entirely clear why the Supreme Court applied different reasoning. One explanation might be that the legal provisions in this case, unlike those in the others, were specifically designed for the purpose of granting the right to tax to the Netherlands.

### 13.2.5. Foreign evidence

Under Dutch law, there is no relevant difference between foreign and domestic evidence. Procedural law confers discretion on the courts to admit and evaluate the evidence.

### 13.2.6. Foreign tax law

Foreign tax law may be relevant for the application of a double tax treaty (e.g. for determining the State of residence under Art. 4 of the OECD MC; see below). The law, whether foreign or domestic, need not be proven by any party. The court is presumed to know the law (*ius curia novit*) and is obliged to apply the relevant legal provisions ex officio. <sup>[55]</sup>

The Supreme Court, however, may not reverse a District Court or Court of Appeals decision on the ground that the decision misinterprets foreign law. <sup>[56]</sup> Only if the interpretation by the District Court or Court of Appeals is incomprehensible can the Supreme Court issue such a ruling. <sup>[57]</sup>

The Supreme Court has provided some guidance for determining foreign tax residency under Art. 4(1) of the former Belgium-Netherlands tax treaty of 1970, which, insofar as is relevant, conforms with the OECD MC. According to the Supreme Court, the decisive factor is whether the taxpayer is legally subject to tax and not whether they are actually taxed. If, however, a taxpayer is actually taxed in another Contracting State, they are generally deemed to be legally subject to tax. This is only different if the tax inspector can prove that the information on which the foreign tax authorities base their belief that the taxpayer is resident in that foreign country for tax purposes is incorrect or incomplete, or if the levy of tax cannot reasonably be based on the national law of the Contracting State. The latter proof must be stated and accounted for by the tax inspector. <sup>[58]</sup>

### 13.2.7. Foreign court decisions and administrative practice

Obviously the jurisprudence of the European Court of Human Rights and ECJ (and the European Free Trade Association Court) are of great importance. Sometimes reference to ECJ case law is even made when EC law is not directly in question. For example, in 8 February 2002, *BNB* 2002/184, a

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<sup>53</sup> Para. 3.4.4.

<sup>54</sup> Supreme Court, 18 June 2004, *BNB* 2004/314, Sec. 3.4.4.

<sup>55</sup> See para. 3.6 of the opinion of Advocate-General in the Supreme Court decision dated 3 January 2001, *BNB* 2001/194.

<sup>56</sup> Sec. 79(1)(b) of the Judiciary Organization Act (*Wet op de rechterlijke organisatie*).

<sup>57</sup> See e.g. Supreme Court, 24 July 2001, *BNB* 2001/338.

<sup>58</sup> Supreme Court, 12 May 2006, no. 40 450, V-N 2006/27.4.

Dutch-resident taxpayer received royalties from Japan that were part of the profit of a Swiss permanent establishment. The taxpayer claimed both a credit for Japanese withholding tax (under the Japan-Netherlands tax treaty) and an exemption of the Swiss permanent establishment's profits (under the Switzerland-Netherlands tax treaty). <sup>[59]</sup> The Supreme Court denied the credit, on the ground that crediting withholding tax on income that is actually exempt under another tax treaty would conflict with the purpose of the relevant provision in the Japan-Netherlands tax treaty. As an additional argument, it referred to the decision in the *Saint Gobain* case, <sup>[60]</sup> reasoning that such crediting would also conflict with the objective of having the State where the permanent establishment is situated grant the credit for foreign withholding tax.

The Dutch courts rarely <sup>[61]</sup> refer to foreign court cases (other than ECJ and ECHR cases), but this does not mean that these foreign court cases are irrelevant. Advocate-Generals to the Supreme Court often refer to foreign court cases in their opinions, <sup>[62]</sup> and these opinions presumably have a great influence on the Supreme Court.

### 13.3. Article 234 EC Treaty

#### 13.3.1. Cases involving the application of EU law, which have not been referred to the ECJ

Unlike the Supreme Court, the District Courts and Courts of Appeal are not required to refer a case to the ECJ if there is a question regarding the application EC law. As examples, reference is made to cases in which the Courts of Appeals have decided to apply EC law directly, but the Supreme Court has referred the case to the ECJ. These are the following direct tax cases: <sup>[63]</sup> *Halliburton Services BV*, <sup>[64]</sup> *Asscher*, <sup>[65]</sup> *Verkooijen*, <sup>[66]</sup> *De Groot*, <sup>[67]</sup> *Bosal Holding*, <sup>[68]</sup> *Magpar VIBV*, <sup>[69]</sup> *Senior Engineering Investments BV* <sup>[70]</sup> and *Orange European Smallcap Fund*. <sup>[71]</sup> In almost all of these cases, the Courts of Appeals had rejected the taxpayer's position. Only in the *Verkooijen* case and the *Orange European Smallcap Fund* case did the Court of Appeals rule that Dutch national law *failed* to conform with EC law.

In some direct tax cases that have not been, or have yet to be, referred to the ECJ by the Supreme Court, various Courts of Appeals have detected infringements of EC law. One case dealt with discrimination against parties classified as non-resident corporate shareholders for dividend withholding tax purposes. If a corporate shareholder receiving dividends from a Dutch-resident company is entitled to the participation exemption (for corporate income tax purposes), an exemption for dividend withholding tax is also available. This exemption is not available if the shareholder is not subject to corporate income tax in the Netherlands. In a case in which a Luxembourg company claimed that it would have been eligible for an exemption from Dutch dividend withholding tax had it been resident in the Netherlands, the Court of Appeal of Den Bosch ruled in favour of the taxpayer. <sup>[72]</sup> The Deputy Minister of Finance has appealed this decision to the Supreme Court. According to Advocate-General Wattel, this disparate treatment results in

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<sup>59</sup> Actually, the treaty only provides for the credit of Swiss profits tax. However, under the policy published by the Dutch Ministry of Finance, the taxpayer may opt for the application of the exemption method.

<sup>60</sup> ECJ, 21 September 1999, *C-307/97, Compagnie de Saint-Gobain*, ECR I-6161.

<sup>61</sup> An example might be the Amsterdam Court of Appeals decision dated 4 September 2003, no. 01/1655, *V-N 2003/49.1.1.*, which referred to the verdict of the *Bundesfinanzhof* of 29 January 1986, IR 22/85, *BFHE* 146, 132. This, however, was merely a discussion of the arguments put forward by the taxpayer.

<sup>62</sup> E.g. see the comparative law overview given by Advocate-General in his Opinion in Supreme Court, 21 February 2003, *BNB 2003/177* and 178. An interpretation was published in Wattel and Marres, "The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties", op. cit. pp. 222-235.

<sup>63</sup> It is interesting to note that the following references are all made in cases in which the Advocate-General had delivered an Opinion (which only happens in approximately 10-15 % of all cases). In the *Senior Engineering* case (see [note 70](#) below), the Advocate-General opined that Dutch tax legislation did not conform with EC law (but for reasons other than those indicated by the ECJ). In the other cases, the Advocate-General had advised referring the case to the ECJ.

<sup>64</sup> ECJ, 12 April 1994, case *C-1/93, Halliburton Services BV*, ECR I-1137.

<sup>65</sup> ECJ, 27 June 1996, case *C-107/94, Asscher*, ECR I-3089.

<sup>66</sup> ECJ, 6 June 2000, case *C-35/98, Verkooijen*, ECR I-4071.

<sup>67</sup> ECJ, 12 December 2002, case *C-385/00, De Groot*, ECR I-3801.

<sup>68</sup> ECJ, 18 September 2003, case *C-168/01, Bosal Holding*, ECR I-2479.

<sup>69</sup> ECJ, 18 May 2006, case *C-509/04, Magpar VI BV*.

<sup>70</sup> ECJ, 12 January 2006, case *C-494/03, Senior Engineering Investments BV*.

<sup>71</sup> Case *C-194/06, Staatssecretaris van Financiën v Orange European Smallcap Fund NV*.

<sup>72</sup> Den Bosch Court of Appeals, 9 September 2005, no. 03/1980, *V-N 2005/51.20*.

an infringement of the free movement of capital; since he considers this to be an *acte clair*, his view is that referring the case to the ECJ is unnecessary. <sup>[73]</sup> The *Amurta* case (case C-379/05) concerned a similar issue. The factual difference here was the presumption that the Portuguese shareholder was eligible for a full credit in his home country.

Another case is one that was decided by the Den Bosch Court of Appeals, and preceded the similar *Van Hilten* case. <sup>[74]</sup> Both cases concerned the levy of inheritance tax on the value of all assets transferred by virtue of the law governing inheritance following the death of a Netherlands national who had emigrated from the Netherlands. The main difference between the two cases was that Mrs Van Hilten had become a resident of Switzerland, whereas the deceased in the other case had moved to Belgium. Under Dutch law, inheritance tax is levied on the value of all assets if the deceased is a resident of the Netherlands at the time of death. Netherlands nationals are deemed to be resident in the Netherlands if they die within 10 years of having emigrated from the Netherlands. In the case of the deceased who resided in Belgium, the Den Bosch Court of Appeals ruled that the fictitious residence rule resulted in discrimination against Dutch nationals, and, thus, that it violated Art. 18 (8A) of the EC Treaty. <sup>[75]</sup> In the *Van Hilten* case, Art. 18 of the EC Treaty did not apply because the deceased had moved outside the EU. Nevertheless, this might have resulted in a violation of the freedom of capital movement, which also applies to movements of capital between a Member State and a non-Member State. The Den Bosch Court of Appeals referred the case to the ECJ, and asked whether the relevant legislation was permitted under Arts. 73C (57) and 73 D (58) of the EC Treaty.

Another example of the Court of Appeals' having detected an infringement without referring the case to the ECJ is a case similar to the *Barbier* case. <sup>[76]</sup> In the *Barbier* case, the ECJ summarized its holding as follows:

Community law precludes national legislation concerning the assessment of tax due on the inheritance of immovable property situated in the Member State concerned according to which, in order to assess the property's value, the fact that the person holding legal title was under an unconditional obligation to transfer it to another person who has financial ownership of that property may be taken into account if, at the time of his death, the former resided in that Member State, but may not be taken into account if he resided in another Member State.

The Amsterdam Court of Appeals rendered a similar decision three years earlier, instead of referring the case to the ECJ. <sup>[77]</sup>

### 13.3.2. Referral ex officio

Under Dutch procedural law, the Courts may apply the relevant law ex officio. It appears from the *Van Schijndel and Van Veen* case that if national law confers on courts and tribunals the discretion to apply binding rules of law on their own motion, these courts have the obligation to do so if the legal protection persons derive from the direct effect of Community law provisions is at stake. This obligation is derived from the principle of cooperation set forth in Art. 10 of the EC Treaty, which states that national courts are obliged to safeguard the legal protection persons derive from the direct effect of Community law provisions. <sup>[78]</sup> Therefore, Dutch courts *must* apply binding EC provisions on their own motion. Since Art. 234(2) is not binding, the District Courts and Courts of Appeals are not obligated to refer a case to the ECJ if there is a question regarding the application EC law. By contrast, that is precisely the obligation of

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<sup>73</sup> Opinion of 10 May 2006, 42 679, V-N 2006/40.17.

<sup>74</sup> ECJ, 12 May 2005, Case C-513/03, *Erven van M. E. A. van Hilten-van der Heijden*. The earlier case was Den Bosch Court of Appeals, 12 December 2002, V-N 2003/5.22.

<sup>75</sup> Den Bosch Court of Appeals, 12 December 2002, V-N 2003/5.22.

<sup>76</sup> ECJ, 11 December 2003, case C-364/01, *Heirs of H. Barbier*, ECR I-15013.

<sup>77</sup> Amsterdam Court of Appeals, 18 October 2000, V-N 2000/50.5.6 and 2001/11.2.1.

<sup>78</sup> ECJ, 14 December 1995, cases C-430/93 and C-431/93, *Van Schijndel and Van Veen/Pensioenfonds Therapeuten*, ECJ I-4599, point 14.

the Supreme Court, under Art. 234(3) of the EC Treaty (whether requested by one of the parties or applied ex officio).

An example of a case in which a Court of Appeals has referred a case ex officio to the ECJ for a preliminary ruling is the *Wielockx* case. [79] This case concerned a physiotherapist, resident in Belgium but practising in (and therefore taxable in) the Netherlands, who was denied a tax deduction (profit allocation to an "old-age reserve") because he was not resident in the Netherlands. Wielockx claimed the deduction on the basis of (i) the non-discrimination provision in the double taxation treaty between Belgium and the Netherlands, (ii) the general principle of equal treatment, and (iii) Art. 26 of the International Covenant on Civil and Political Rights. The Court of Appeals denied these claims but referred the case to the ECJ for a preliminary ruling on the question of whether the denial of the deduction would violate the freedom of establishment. Although the deduction was denied under purely national law, the double taxation treaty between Belgium and the Netherlands was relevant in connection with the rule of reason. The ECJ held that the disparate treatment violated the freedom of establishment, and that there was no rationale for this treatment under the coherence justification, since the relevant Belgian income was dealt with in the Netherlands-Belgium tax treaty provision regarding pensions (at least, the ECJ thought so), as a result of which the correlation between the deductibility of contributions and the taxation of the income shifted from national level to another level, that of the reciprocity of the rules applicable in both Contracting States. [80]

### 13.3.3. Application of Article 234(3) by the Supreme Court

According to the *CILFIT* [81] judgment, highest national courts cannot decide EC law questions without a preliminary referral unless the application of EC law is so obvious as to leave no room for any reasonable doubt as to the manner in which the point of law raised is to be resolved, and the matter is equally obvious to the courts of the other Member States and the ECJ. Since not all ECJ case law is clear and consistent, [82] and since it makes no sense to flood the ECJ with preliminary questions, it is obvious that the *CILFIT* criteria are probably not applied faithfully in any of the EC Member States - and in any event not in the Netherlands.

There are many *acte clair* cases [83] and also quite a few *acte éclairé* cases, [84] but not many regarding tax treaties. An example is a case in which an insurance company could not effectively credit foreign dividend withholding tax under the ordinary credit method set forth in various tax treaties concluded by the Netherlands, whereas Dutch dividend withholding tax would be creditable without limitation. According to the Supreme Court, this disparate treatment did not violate the right of free establishment (the free movement of capital was not mentioned in this case, because the relevant facts predated the liberalization of capital movements). [85] A comparable issue was at stake in the *Orange Fund* case, which was recently referred to the ECJ by the Supreme Court. [86]

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79 ECJ, 11 August 1995, case C-80/94, *Wielockx*, ECR I-0249.

80 This judgment led the then Deputy Minister of Finance to write a critical editorial regarding the ECJ's case law on direct taxation. Vermeend, W., "The Court of Justice of the European Communities and direct taxes: 'Est-ce que la justice est de ce monde'", 24 *EC Tax Review* 2 (1996) pp. 54-55.

81 ECJ, 6 October 1982, case 283/81, *CILFIT*, ECR I-3415.

82 See Terra, B. and Wattel, P., *European Tax Law*, Deventer: Kluwer Law International, 2005, 4th ed., p. 190.

83 Recent direct tax cases include Supreme Court, 23 January 2004, *BNB* 2004/142 (although A-G Wattel had issued an opinion recommending that the case be referred); and Supreme Court, 3 February 2006, *BNB* 2006/192.

84 See e.g. the post-*Leur Bloem* case of Supreme Court, 4 February 1998, *BNB* 1998/176, and the post-*De Groot* case of Supreme Court, 7 May 2004, *BNB* 2004/262. In the latter case, EC law was applied ex officio by the Supreme Court.

85 Supreme Court, 27 August 1997, *BNB* 1998/2.

86 Case C-194/06, *Staatssecretaris van Financiën v Orange European Smallcap Fund NV*.

## Chapter 14 – Spain

### 14.1. The nature of rules governing tax litigation

#### 14.1.1. Tax law procedure versus other kind of procedure

Before the submission of the case to the ordinary courts, tax law cases in Spain are subject to an autonomous procedure. This special structure of the procedure implies that the taxpayer who disagrees with a tax situation must claim first of all to the Tax Administration through two ways: the *recurso de reposición* and/or the *reclamación económico-administrativa* and, afterwards, if the Tax Administration rejects that claim, the taxpayer can submit the case to the general judicial procedure, in which rules of procedure applicable to other branches of law (such as administrative or civil law procedure) are applied.

Concerning the structure of the general judicial procedure, there are tribunals of first instance (with a single judge), which are the lowest tribunals, and the possibility of review proceedings before the courts of appeals, i.e. the *Audiencia Provincial* <sup>[2]</sup> ("AP"), the *Tribunal Superior de Justicia* <sup>[3]</sup> ("TSJ"), if the AP dismisses the appeal and the *Tribunal Supremo* (Supreme Court, "TS"), if the appeal before the TSJ of the Autonomous Community does not succeed. In this sense, the TS is the highest court in Spain, as it represents the last instance.

Apart from that, the *Audiencia Nacional* (National Court, "AN") has a limited scope of judgement as it only deals with concrete issues such as terrorism, trafficking of drugs, etc; and, finally, the *Tribunal Constitucional* (Constitutional Court, "TC") deals with the application of the fundamental rights provided in the Spanish Constitution of 1978.

As stated above, in case the Tax Administration rejected the *reclamación económico-administrativa*, the taxpayer could submit the case to the general judicial procedure. In this context there are not any peculiarities of tax cases in comparison with the rules of procedure applicable to other branches of law. The independent judges of the AP, TSJ and TS are specialized in a particular materia so that four different divisions can be distinguished, which deal with civil, criminal, administrative and social law, respectively. Tax cases are analysed by the judges specialized in administrative law (*procedimiento contencioso-administrativo*). Additionally, each division is often integrated by more than one section in order to be more expeditious.

The tax/administrative proceedings are identical to the general judicial procedure, based on the adversary principle. Once the taxpayer issues the claim form against the Tax Administration, it is necessary to serve it on the defendant. The service of the claim form is followed by the acknowledgement of service by the Tax Administration, which in this way places the claimant on the court record. The proceedings start with the permission/ leave of the court, which ensures that the parties are on an equal footing and studies the complexity of the issues in question. In due course the taxpayer (claimant) can explain briefly the details of the claim (the particulars of claim in written form include both the statements of fact and the legal grounds) and the remedy asked for to the independent judges. The position of the Tax Administration is also taken into account during the hearing through the defence of the claim.

Afterwards there is also a period allowed for the gathering, submission and consideration of evidence. The parties can submit whatever kind of evidences to the consideration of the court: documentary evidence, oral testimonies, evidence of witnesses, tax expert reports/opinions, etc. It is also possible that the court orders the issue of an injunction in order to avoid the commission of a tax crime during the procedure.

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<sup>2</sup> The territorial jurisdiction of the AP relates to each province of Spain.

<sup>3</sup> The territorial jurisdiction of the TSJ relates to each Autonomous Community. It should be borne in mind that Spain is divided into 17 Autonomous Communities. In case that a TSJ denies the claim, the petitioner can submit the case to the TS, which is the last instance.

After having studied the matter in dispute and the views expressed by the parties on the issues at stake, the proceedings come to an end and the court gives judgement for/against the taxpayer/Tax Administration. The decision contains not only the counsel for each of the parties and the questions of law related to the facts as found, but also the *ratio decidendi* and sometimes other passing comments (*obiter dicta*). The *ratio decidendi* is based on the legal doctrine and constitutes a precedent (authority) for similar cases in the future. Finally, the ruling is based on the *ratio decidendi* and is usually expressed by the court as follows: The court gives judgement for the taxpayer for the amount claimed, or the court would dismiss this appeal, etc.

As regards the particularities of the tax law procedure, there are two means through which taxpayers can file their demands against the Tax Administration, which are discussed in the following two sections.

#### 14.1.1.1. Recurso de reposición

*Recurso de reposición* constitutes an optional appeal for the taxpayer in order to challenge an administrative action. <sup>[4]</sup> When a taxpayer considers that the Tax Administration has abused, usurped or exceeded its functions, it is not possible to submit the case directly to the ordinary courts. Instead, the taxpayer is obliged to claim first to the tax authorities, because of the inherent power which is conferred to the Administration in order to review its own actions.

In this line, it can be affirmed that the *recurso de reposición* is an administrative appeal. The competent authority to examine and decide the case is the same one that performed the action disputed. For that reason, although the taxpayer can always use this appeal, it seems advisable that this is only done when the administrative action is clearly wrong, in other words, when the defect or mistake is so evident that it can be denied.

Further, two important features of both procedures should be noted: firstly, neither in the development of the *recurso de reposición* nor in the *reclamación económico-administrativa* (see 14.1.1.2. below) is the intervention of a lawyer required, whilst the taxpayer can act on their own; and, secondly, both procedures are gratuitous for the taxpayer.

The procedure begins at the request of the taxpayer, who must issue a claim form within one month after the performance of the administrative action disputed. The particulars of the claim refer to the action in question: tax event, tax base, taxable year, etc, and the reasons upon which the claimant disagrees with the Tax Administration. This claim must be issued in written form. <sup>[5]</sup> The tax authority must decide the issue within one month after the claim was issued by the taxpayer. The proceedings are rather short and expeditious. Usually, only documentary evidence is admitted, as the competent authority to decide is the same that performed the action.

Taking into account the time limits, the tax authority decides expressly in favour or against the taxpayer by one month since the claim form was issued. The absence of express resolution in this period means a rejection of the claim, so that the taxpayer can issue a *reclamación económico-administrativa* by the next month.

It should be emphasized that the claim form involves the temporary suspension <sup>[6]</sup> of the administrative action provided that the taxpayer guarantees the tax sum, the interests and the correspondent recharges during the period of examination and decision of the case. However, if the administrative action disputed is

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<sup>4</sup> The *recurso de reposición* is regulated in Arts. 222-225 of the Spanish General Tax Act and in the Royal Decree 520/2005, of 13 May (Arts. 21-27).

<sup>5</sup> A model of the *recurso de reposición* for the taxpayer is available on the website of the Spanish Tax Administration (*Agencia Estatal de la Administración Tributaria*, "AEAT") at [www.aeat.es](http://www.aeat.es).

<sup>6</sup> See, related both to the *recurso de reposición* and to the *reclamación económico-administrativa*: Morés Jiménez, Ma.T., "Notas sobre la suspensión de la ejecución de los actos tributarios", *Civitas Revista Española de Derecho Financiero* No. 80 (1993) p. 655; Lago Montero, J.Ma., "La suspensión de las liquidaciones tributarias en la reposición y en la vía económico-administrativa", Madrid: Tecnos Editorial, 1994; Checa González, C., *La suspensión en vía económico-administrativa de la ejecución de los actos administrativos tributarios*, Pamplona: Aranzadi Editorial, 1999; Chico De La Cámara, P., *La suspensión de la ejecución de los actos tributarios sin garantía y con garantía distinta del aval*, Pamplona: Aranzadi Editorial, 2001; Fabra Valls, M.J., "La suspensión de los actos impugnados en materia tributaria", Madrid: Tecnos Editorial, 2001.

the imposition of a sanction to the taxpayer, the suspension of the sanction operates automatically without any warranty.

Finally, although the general rule is that this appeal is optional to the taxpayer, who can decide to file directly the *reclamación económico-administrativa*, there is an exception concerning the actions of the local tax administrations. <sup>[7]</sup> In this case the issue of the *recurso de reposición* is binding on the taxpayer, inasmuch as there is not *reclamación económico-administrativa* in the context of the local tax authorities.

#### 14.1.1.2. Reclamación económico-administrativa

As noted above, the *reclamación económico-administrativa* <sup>[8]</sup> constitutes an administrative appeal that the taxpayer has to file before submitting the case to the ordinary courts.

Articles 226 and 227 of the Spanish General Tax Act <sup>[9]</sup> (*Ley General Tributaria* ("LGT")) envisage the issues to which the *reclamación económico-administrativa* can be filed. <sup>[10]</sup> Basically, it concerns administrative actions that impose taxes or sanctions derived from tax violations, tax returns, tax assessments, etc. The competent authority to decide the appeal depends on the case in question. Articles 228 and 229 LGT refer to the *Tribunales económico-administrativos regionales y locales* ("TEAR" and "TEAL") and to the *Tribunal económico-administrativo central* <sup>[11]</sup> ("TEAC"). The TEAR are located in each Autonomous Community and the TEAL in Ceuta and Melilla, whereas the TEAC is situated in Madrid and represents the second and last instance to which the taxpayer can submit the case.

There are two types of procedure in order to resolve the *reclamación económico-administrativa*. The general one (which implies submitting the case firstly to the competent TEAR and, in case it does not succeed, to the TEAC) and a summary procedure, <sup>[12]</sup> which constitutes a new and short procedure applicable to certain tax claims.

The competent authority of its own motion (*ex officio*) takes the following steps once the taxpayer has filed the claim. The proceedings are rather similar to the ones of a judicial procedure: the administrative tribunal examines the statements of the case (pleadings); there is also a period allowed for the gathering, submission and consideration of evidence; the tribunal can ask for a report from the authority which performed the action disputed in order to clarify some doubts, etc. In general, the taxpayer can submit whatever kind of evidence to the consideration of the administrative tribunals, but there is not usually the intervention of tax experts as this is a procedure in which the Tax Administration is judge and party. On the contrary, in case the appeal does not succeed and the taxpayer goes to the courts, the tax advisers/experts will be essential for the judicial decision.

The administrative tribunal must deliver a decision within one year after the claim form was filed. Article 238 LGT settles other forms through which the proceedings come to an end, such as the discontinuance (the taxpayer can discontinue at any time by serving a notice of discontinuance), or the abandonment of the action, which differs from the discontinuance in the fact that the party who discontinued can always file a new claim form as long as the limitation period has not expired.

With regard to the structure of the decisions, they are quite similar to the judicial decisions: firstly, there is a broad description of the facts and of the pleadings of both parties; secondly, the administrative tribunal explains the legal grounds applicable to the issue and, lastly, the tribunal concludes with the decision. The influence of the literature on tax decisions is not very relevant in Spain, neither in the context of the administrative decisions nor in judicial decisions. Nevertheless, the administrative practice constitutes

<sup>7</sup> See Olañeta Fernández-Grande, R., *El recurso de reposición en la Hacienda local*, Valencia: Tirant lo blanc, 2003.

<sup>8</sup> The regulation of the *reclamación económico-administrativa* is contained both in the Spanish General Tax Act (Arts. 226-248) and in the Royal Decree 520/2005, of 13 May (Arts. 28-65).

<sup>9</sup> General Tax Act 58/2003, of 17 December.

<sup>10</sup> See Arias Velasco, J., "El contribuyente ante los Tribunales económico-administrativos y los Tribunales de Justicia", *Tribuna fiscal* No. 80 (1997) p. 77; Benítez de Lugo y Guillén, F., "El procedimiento económico-administrativo. Normativa aplicable y ámbito de aplicación", *Nueva fiscalidad* No. 15 (2004) p. 9; González Grajena, F.J., "La revisión en vía administrativa en la nueva Ley General Tributaria", *Nueva fiscalidad* No. 6 (2004) p. 77.

<sup>11</sup> In spite of being called 'tribunals', the TEAC, TEAR and TEAL are not judges but members of the Tax Administration, i.e. they do not constitute judicial authorities as they do not belong to the Administration of Justice; on the contrary, they belong to the Tax Administration as civil servants.

<sup>12</sup> The summary procedure is only possible with regard to claims filed from 1 July 2005.

an important element to take into account by the administrative tribunals in order to solve the concrete question.

The administrative decisions are available on the website of the TEAC/TEAR directly (<http://serviciosweb.minhac.es/apps/doctrinateac/>) or through the Tax Administration's website ([www.aeat.es](http://www.aeat.es)).

### 14.1.2. Burden of proof

According to Art. 105 LGT the burden of proof in tax law cases lies with the taxpayers, although they can accomplish this obligation by indicating the elements of proof under the Tax Administration. In this sense, Art. 214 LGT - which refers to the administrative review procedures - remits to the general rules of proof laid down in Arts. 105 to 108 LGT.

Taking this idea as the fundamental premise, it should be emphasized that concerning the *recurso de reposición* it is not possible to deposit new documents in the course of the procedure, whereby the taxpayer is only allowed to present documentary evidence together with the claim form at the beginning of the procedure.

Likewise, in the *reclamación económico-administrativa* the objective is to simplify the proof, which means that whatever type of evidence (expert reports/opinions, evidences of witnesses, oral testimonies, etc) has to be incorporated to documents by notary's deed, or submitted to the Secretary of the administrative tribunal. Apart from this, there are no special features applicable in the rules on the burden of proof regarding tax litigation.

### 14.1.3. Rules on evidence

There are no particularities concerning rules on evidence applicable to tax litigation apart from those noted above. The unique characteristic of the administrative procedure in comparison with the judicial procedure is, as commented previously, the fact that in the former, although all kinds of evidence are admitted, the documentary evidence is the most important. <sup>[13]</sup> In contrast, rules on evidence applicable to tax litigation do not basically differ from those of the civil law procedure, in which the court must ensure that the parties are on an equal footing.

### 14.1.4. Special rules applicable to international (tax) law cases

In general terms, it can be said that there are no special rules or principles deviating from the ones applicable in domestic situations that apply whenever international (tax) law comes into play. Notwithstanding that premise, there are some criteria that should be taken into consideration dealing with an international case, such as the principle of equity (fairness), the principle of common interpretation, the principle of reciprocity, the principle of dynamic interpretation or the principle "*ut res magis valeat quam pereat*". In accordance to this last principle, in those situations where more than one interpretation is possible, tax courts should apply the solution that permits the treaty to effectively accomplish its objectives.

## 14.2. International tax treaty case law

### 14.2.1. Relevance of the 1969 Vienna Convention on the Law of Treaties ("VCLT")

Tax treaties are international agreements, thus, Arts. 31 to 33 VCLT are in principle applicable in order to determine their interpretation. This Convention, which entered into force on 27 January 1980, embodies a system of provisions directly binding in Spain due to the ratification of the VCLT by the Spanish parliament on 2 May 1972 (Spanish *Official Bulletin* 13 June 1980). In addition, it should be borne in mind that even though the VCLT had not been ratified by Spain, its rules would also be applied, as they are part of

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<sup>13</sup> See Cano García, J., "*La actividad probatoria en el procedimiento económico-administrativo*", *Crónica tributaria* No. 79 (1996) p. 23; Peris García, P., *La prueba en la reclamación económico-administrativa y en el recurso contencioso*, Pamplona: Aranzadi Editorial, 1997.

customary international law. The Spanish practice reflects, however, that whereas both the Constitutional Court and the Supreme Court have usually noted the relevance of the VCLT (whose regulations have been neglected more often than by the courts) <sup>[14]</sup>, this author, on the contrary, is not aware of any case in which the VCLT has been explicitly applied to the interpretation of tax treaties.

Consequently, it can be concluded that despite their theoretical application to tax treaties, the general principles of interpretation of the VCLT are not of great influence in Spain. <sup>[15]</sup> The Commentaries on the OECD Model Convention, for example, do not have an appropriate characterization in the VCLT. Logically, tax treaties being a specific kind of international agreements, the general provisions of the VCLT are not enough to rule accurately the status of such an important tool for the interpretation of double taxation conventions.

Moreover, some Spanish authors have also indicated the strict extent the VCLT gives to the term "context" - apart from the little attention paid to this expression by the Vienna Convention - as well as the restrictive conditions required in order to use the complementary materials related to the tax treaty by the interpreter. <sup>[16]</sup> As Casero Barrón argues, it can be considered that all materials which can be useful to the interpretation objective must be used in order to clarify as much as possible the meaning of a tax treaty term. Nevertheless, the previous suggestion involves the problem of the weight that has to be given to each of the materials mentioned, as no solution is provided by the VCLT to this question.

To make matters worse, statistics show that the competent authorities of the Contracting States usually apply the international principles of interpretation codified in the VCLT with different intensity. Then, taking Arts. 31-33 VCLT as the starting point, in comparison with several States that follow an objective or a subjective approach, others focus on the importance on the text itself, whereby the final result is an unequal value of the elements taken into consideration. The last remark brings us back to the criteria used by Spanish interpreters in relation to double taxation conventions. At first glance, they are not identical to those included in the VCLT, but most of them are quite similar to the rules provided by Arts. 31-33 (as is discussed in more detail below).

On the whole, this shows that the internal principles used in the interpretation of international agreements do not differ so much from the international rules included in the VCLT. As an example of the application of Arts. 31-33 VCLT to non-tax treaties the ICJ's *Case of the territorial conflict between the Jamahiriya Arabe Libya and Chad* can be noted. <sup>[17]</sup> In this case, the context (Art. 31(2) VCLT) is represented by the Good neighbourhood Convention between France and Libya of 1955. The International Court of Justice affirmed that the conclusions reached by the Court were reinforced by the treaty context and by the aforesaid Convention specially, which had been signed at the same time as the Treaty in question - *Case of the frontier controversy terrestrial, insular and maritime*. <sup>[18]</sup> Recourse to the complementary ways of interpretation (Art. 32 VCLT) had an important role in this affair.

In relation to tax treaties, a good example regarding Art. 31(2)b VCLT could be, for instance, that Spain produces a technical explanation for its tax treaty with Canada and this country later publicly announces its acceptance of the Spanish explanation of the Canada-Spain tax treaty. <sup>[19]</sup> In any case, it is convenient to note that when referring to domestic principles of interpretation in this context, it does not comprise the criteria contained in Arts. 1281-1289 of the Spanish Civil Code ("CC") (which govern the interpretation of

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<sup>14</sup> National courts have generally been applying the internal rule of interpretation (Art. 3(1) of the Spanish Civil Code) instead of the provisions of the VCLT to clarify the meaning of tax treaty terms. Indeed, even some rulings of the Supreme Court - although not concerning tax treaties - for instance, those of 20 and 21 January 1992, followed that philosophy, which, fortunately, does not constitute the general rule in the present. See e.g. the decision of the Constitutional Court of 28 September 1995, in which this judicial authority insists on the application of the VCLT in the interpretation of international treaties.

<sup>15</sup> Calderón Carrero, J.M. and Piña Garrido, Ma.D., "Interpretation of tax treaties", 39 *European Taxation* 10 (1999) p. 380.

<sup>16</sup> Casero Barrón, R., "La interpretación en Derecho español de los tratados internacionales para evitar la doble imposición. El papel del Consejo de Estado. Propuesta revitalizante o regeneracionista (I)", *Carta Tributaria* No. 288 (April 1988) p. 5. In the opinion of this tax author, that situation shows the inappropriate character of the VCLT as regards tax treaty interpretation.

<sup>17</sup> International Court of Justice ("CIJ"), *Recueil* (1994) p. 6.

<sup>18</sup> CIJ, *Recueil* (1992) p. 584.

<sup>19</sup> See, in this respect, Fernández de Casadevante Romani, C., "La interpretación de las normas internacionales", Pamplona: Aranzadi Editorial, 1996.

private contracts), but only those provided in Art. 3(1) CC, [20] which, as previously indicated, have much in common with the VCLT rules.

### 14.2.2. Relevance of the Commentaries on the Articles of the OECD Model Convention ("OECD MC")

Among the several model conventions for the avoidance of international double taxation existing so far, the OECD MC is the most extended, as it is followed not only by Member countries in their bilateral negotiations but also by non-member countries, as well as in the work of a number of worldwide or regional international organizations in this field. Indeed, both the United Nations Model [21] and the United States Model Treaty [22] use the OECD MC as a basic instrument of reference, which reflects its great importance. As recommended by the Council of the OECD, [23] when concluding or revising bilateral conventions,

[...]member countries should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservations contained therein and their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention. [24]

The existence of the OECD MC has facilitated bilateral negotiations and made possible a desirable harmonization in this field. The majority of the double taxation conventions concluded by Spain follow the pattern and, in most cases, the main provisions of the OECD MC.

As a consequence of the impact of the OECD MC, the Commentaries on its provisions have become a widely accepted guide in Spain to the interpretation and application of the articles of such bilateral treaties. Nevertheless, some important questions remain still unresolved. To begin with, it is necessary to precise the real status of the Commentaries for the purpose of treaty interpretation. Then, the underlying question is: Could we consider the Commentaries included in the term "context" used in Art. 31(1) VCLT or in the so-called "preparatory work" within the meaning of Art. 32 VCLT? The Spanish tax authorities and courts do not usually refer to the nature, legal force and rank of the OECD Commentaries. In this line, the words of the Supreme Court in its decision of 3 June 2000 can be noted. [25] As a summary of facts, the taxpayer, a German subsidiary of the General Motors Group (Adam Opel AG), transferred to the Spanish subsidiary of the Group the exclusive property right of a computer software program in 1982. As consideration for the delivery of the software the German subsidiary received in return shares of the Spanish subsidiary.

The tax authorities regarded the transfer as a licence of the right to use the software and, therefore, as a contract for which the consideration in-kind in the form of shares should be regarded as a royalty under Art. 12 of the Germany-Spain tax treaty (subject to withholding tax in Spain at a rate of 5%). The taxpayer, on the other hand, argued that the contract should be regarded as a sale so that the payment in-kind in the form of shares should be treated as a capital gain to which Art. 13(3) of the Treaty applied. According to that treaty provision, Germany would have the exclusive right to tax the payment in-kind.

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20 The purport of Art. 3(1) CC, as the legal basis of domestic interpretation, states that the law must be interpreted according to the proper meaning of the words, in relation to the context, the historical and legal antecedents, the social circumstances present at the moment of its application and especially taking into account the goal of the provisions.

21 *United Nations Model Double Taxation Convention between Developed and Developing Countries*, New York: United Nations Publications, 1980. It also reproduces a significant part of the Commentaries of the OECD Model Convention.

22 *United States Model Income Tax Treaty of 1981*.

23 See OECD Council Recommendation, 30 July 1963; Recommendation, 11 April 1977; Recommendation, 1 September 1992; Recommendation, 21 September 1995.

24 OECD: *Model Tax Convention on Income and on Capital*, Introduction, 15 July 2005 (condensed version), Paris: OECD Committee on Fiscal Affairs.

25 RG. 6206/1995. Decision published in *Asociación española de asesores fiscales ("AEDAF")*: "Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 1998-1999-2000)", Aranzadi Editorial (2002) p. 257.

The question was whether the transfer of software in exchange of shares qualifies as an alienation of property under Art. 13 (capital gains) of the Treaty or as a transfer of know-how under Art. 12 (royalties). The Supreme Court held in favour of the taxpayer. The Court observed that the transaction had to be considered as an alienation of the full ownership of the intellectual property rights of the software program to the Spanish company. Further, the Court observed that the transaction led to an increase of the shareholding of the German company in the Spanish company so that the compensation in the form of a payment in-kind qualified as a capital expenditure instead of income. This being the case, the Court concluded that the compensation should be regarded as a capital gain, which was in accordance with Art. 7(e) of the Spanish Income Tax Act 61/1978.

Subsequently, in respect of the Treaty, the Court decided that the regime for capital gains under Art. 13 applied. For this decision, the Court found support in Para. 5 of the OECD Commentaries 1977 on Art. 13, which explained that the words "alienation of property" are used to cover in particular capital gains resulting from the transfer of property to a company in exchange for stock. The Court held that the Spanish Tax Administration was bound to the authentic interpretation given by the OECD Commentary because of the fact that Spain had not made an observation on the matter in the Commentary. Consequently, the Court concluded that Germany had the exclusive right to tax the compensation on the basis of Art. 13(3) of the Treaty.

Different thesis can be found, however, in the Spanish literature on this subject. <sup>[26]</sup> In this author's opinion, although the first cited would surely be the best solution, it is, however, truly difficult to integrate the Commentaries in the strict definition of "context" given by Art. 31(2) VCLT. On the other hand, if, though, the OECD Commentaries are considered as a "preparatory work" - as a second group of scholars do <sup>[27]</sup> - their interpretative value will be only complementary and consequently limited. From the point of view of other authors, the Commentaries could be understood in the sense of Art. 31(3)(c) VCLT, as the relevant rules of international law applicable in relations between the parties. <sup>[28]</sup> This author, however, does not agree with that opinion to the extent that, strictly speaking, the Commentaries not being binding cannot be considered real rules of international law.

After carefully studying the various solutions noted above, it is the view of this author that the OECD Commentaries constitute a major source of interpretation that should be included in the "context" of each tax treaty. <sup>[29]</sup> Taking this as a departure point, it is suggested that the VCLT be slightly modified by adding this specific tool of tax treaty interpretation, which is not contained in that Convention because of the general character of the VCLT. The relevance of this interpretative instrument does not allow for it to be identified with "preparatory work" - which corresponds to a minor level - and with its complementary effects. <sup>[30]</sup>

Another interesting question regarding the OECD Commentaries was the possibility to apply them in the interpretation of earlier tax treaties. The OECD Committee made it clear to resolve this controversy between authors by recommending that all tax treaties - including those entered into before the revisions of the Commentaries - be interpreted in the light of the updated Commentaries. Thus, the ambulatory or

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<sup>26</sup> See Martín Jiménez, A.J., "Los Comentarios al MC OCDE: su incidencia en el sistema de fuentes del Derecho Tributario y sobre los derechos de los contribuyentes", *Carta tributaria, monografías* 20/2003.

<sup>27</sup> See Borrás Rodríguez, A., "Los convenios Internacionales para evitar la doble imposición desde el punto de vista de la teoría general de los tratados internacionales", *Estudios de doble imposición internacional*, Madrid: Instituto de Estudios Fiscales, 1979, p. 36; Baena Aguilar, A., "Editorial", *Revista de Derecho Financiero y Hacienda Pública* No. 242 (1996) p. 895-897; Tovillas Morán, J.Ma., "La interpretación de los Convenios de doble imposición y la cláusula general de interpretación del Modelo de Convenio de la OCDE", *Revista Latinoamericana de Derecho Tributario* No. 0 (1996) p. 113.

<sup>28</sup> In this respect, there is also a group of authors who understand both the new Model Convention and its Commentaries as a "subsequent practice", in the sense of Art. 31(3) (b) VCLT, of the States that take part in it. See, among others, De Juan Peñalosa, J.L., "Modelo 92", *Impuestos* No. 15-16 (1993) p. 31. On the contrary, the present author agrees with Lang in that the OECD Model and Commentary "can equally not be seen as 'subsequent practice' as Article 31 (3) b of the Vienna Convention specifies. (...) there has to be a difference between treaty interpretation as set out in Article 31 (3) b of the Vienna Convention and treaty amendments."

<sup>29</sup> Lang, M., "Later Commentaries of the OECD Committee on Fiscal Affairs, not to affect the interpretation of previously concluded tax treaties", 25 *Intertax* 1 (1997) p. 8. The OECD Commentaries provide not only aids to treaty interpretation but also include suggestions, guidelines and analysis concerning a wide variety of double taxation issues and problems. Furthermore, the Commentaries are much easier to change than the Model Treaty itself because dissenter countries can and do register reservations to the Commentaries on particular articles of the Model Treaty.

<sup>30</sup> The OECD does not intend for the Commentaries to have such limited role.

dynamic theory is adopted rather than the static. In Spain, both the TEAC <sup>[31]</sup> and the *Dirección General de Tributos* <sup>[32]</sup> ("DGT") have been using the OECD MC and the Commentaries as general criteria in the interpretation of tax treaties. Only when the wording of the treaty provision is very clear is no reference made to the OECD Commentary. On balance, it is possible to affirm that the Spanish tax rulings and court decisions often refer to the OECD Commentaries and reports, <sup>[33]</sup> which sometimes intend to resolve the doubts arising in the interpretation of tax treaties or reinforce the meaning reached by using other methods; <sup>[34]</sup> or provide the characterization of income and transactions or determine whether a permanent establishment exists. Moreover, the OECD Commentaries and reports have been used in Spain for the interpretation of domestic tax legislation as well (such as transfer pricing rules) - which, of course, has nothing to do with tax treaties. <sup>[35]</sup>

Finally, it should be borne in mind that the OECD Commentaries are not binding - as the OECD Committee itself declared in the Model's Introduction - in the interpretation of tax treaties. <sup>[36]</sup> Nevertheless, as the network of tax conventions increases the relevance of the Commentaries as a generally accepted guide becomes greater. In fact, even though the Spanish courts do not consider the OECD Commentaries as binding rules, <sup>[37]</sup> they often include some paragraphs of the Commentaries in their decisions with regard to the interpretation and application of tax treaties. (See, for instance, the sentence of the AN of 27 February 2003 concerning the interpretation of Arts. 5 and 7 of the double taxation convention between Spain and the United Kingdom. <sup>[38]</sup>)

### 14.2.3. Other commentaries/means of interpretation

Although the mutual agreement procedure clause is generally included in the tax treaties concluded by Spain, this mechanism has seldom been used for the purpose of determining the meaning of a tax treaty term. In this author's opinion, a significant element is the absence of any provision requiring the competent authorities to reach an agreement or providing an alternative dispute resolution procedure in case the one established in Art. 25 (3) OECD MC fails in achieving that objective. <sup>[39]</sup>

In the words of the OECD Committee, the result of this procedure resolving general difficulties of interpretation or application of the Convention is "binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement." <sup>[40]</sup> This means that both Contracting States will be bound by the solution agreed through this procedure. In fact, there is no appeal in Spain against results of the mutual agreement procedure.

Regarding the status of these agreements in the VCLT, the present author does not see any obstacle - in spite of the silence of the Spanish tax commentators - to consider them "subsequent agreements" in accordance with Art. 31(3)(a) of the VCLT.

A further aspect this author would like to raise is the tendency of the Spanish tax courts to apply the national law as recourse for the interpretation of tax treaties, instead of the tax treaty law. <sup>[41]</sup> For instance, the TSJ of the Canary Islands in its decision of 24 October 1994 considered Art. 10 of the Spanish

<sup>31</sup> See e.g. Resolutions of the TEAC ("RRTEAC") of 30 April 1996, 6 November 1996 and 9 April 1997.

<sup>32</sup> The resolutions of the *Dirección General de Tributos* are available through its website ([www.meh.es/PortaVAreas+Tematicas/Impuestos/Direccion+General+de+Tributos/Direccion+general+de+tributos.htm](http://www.meh.es/PortaVAreas+Tematicas/Impuestos/Direccion+General+de+Tributos/Direccion+general+de+tributos.htm)).

<sup>33</sup> DGT used the OECD 'Thin Capitalisation' report in order to interpret tax treaty provisions in its Resolution ("RDGT") of 17 October 1994. Furthermore, there have been cases where a domestic law has not been applied as the tax authorities interpret on the basis of the OECD MC and Commentaries. For instance, in RDGT of 23 December 1983 the DGT determined the taxable base of a permanent establishment in accordance with the Commentaries to Art. 7(2) OECD MC, without applying the Spanish Royal Decree.

<sup>34</sup> RRTEAC of 29 August 1993 and 30 April 1996.

<sup>35</sup> Calderón Carrero, J.M. and Piña Garrido, Ma.D., "Interpretation of tax treaties", op.cit. p. 385. See e.g. RRTEAC of 23 March 1988 and 18 July 1990.

<sup>36</sup> As Vogel noted, its binding nature would not yet be justified either under international law or under the constitutional law of most member countries. Vogel, K., "Tax Treaty news", 54 *Bulletin for International Fiscal Documentation* 3 (2000) p. 98.

<sup>37</sup> See SSTS of 15 June 2002 and 12 February 2003.

<sup>38</sup> Decision published in AEDAF: "*Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 2001-2002-2003)*", Thomson-Aranzadi Editorial (2004) pp. 121-123.

<sup>39</sup> Nowadays the OECD tends to improve the mutual agreement procedure through an arbitration mechanism. See the OECD Report of 27 July 2004, "Improving the process for resolving international tax disputes" ([www.oecd.org/dataoecd/44/6/33629447.pdf](http://www.oecd.org/dataoecd/44/6/33629447.pdf)) and the Draft of the Centre for Tax Policy and Administration (OECD) of 1 February 2006 ("Proposals for improving mechanisms for the resolution of tax treaty disputes").

<sup>40</sup> Para. 36 of the OECD Commentaries to Art. 25.

<sup>41</sup> See, in this respect, RTEAC of 11 June 1997 and STSJ of Madrid of 5 June 1996.

Value Added Tax Act in order to discern the meaning of "ships in international traffic", with regard to the application of Art. 8 of the tax treaty between Spain and Morocco. Obviously, the tax court should have taken into account not the domestic law, but the OECD MC and its Commentaries on that provision, which do not coincide with the meaning given by the internal law.

Although this practice should be avoided, as the law primarily applicable is not national law but international law and, in particular, the qualification rules provided by tax treaties, there are still some tax courts that maintain this incorrect attitude and only refer secondly to double tax treaties. See, for example, the SSAN of 15 June 1993, 10 October 1995 and 12 December 1995. In these cases, <sup>[42]</sup> the AN interpreted "software" as a literary work by referring to the meaning of that term in a Spanish act (Act 16/1993, of 23 December - not now in force). In contrast, concerning the same question and tax treaty (Spain-US), the RTEAC of 29 September 1993 concluded a different solution, <sup>[43]</sup> as it qualified the computer programs as scientific work, taking into account the OECD Commentaries to the 1992 OECD MC.

The same incorrect argument, i.e. the use of internal law as a means of interpretation of tax treaty terms, is used in the SAN decision of 20 July 2000 <sup>[44]</sup> (dealing also with the qualification of software programs as a literary or scientific work) and in the STS decision of 29 July 2000. <sup>[45]</sup>

Concerning this latter case, the taxpayer, a German subsidiary of the General Motors Group (Adam Opel AG) transferred to the Spanish subsidiary of the General Motors Group 81% of the property rights of the technology and software that was specific for a type of car (model S). As consideration for the delivery of the technology and software, the German subsidiary received in return shares of the Spanish subsidiary.

The tax authorities regarded the transfer as a licence of the right to use the technology and software and, therefore, as a contract for which the consideration in-kind in the form of the shares should be regarded as a royalty under Art. 12 of the Treaty (subject to withholding tax in Spain at a rate of 5%). According to the tax authorities, the transfer could not be regarded as a sale giving the Spanish company full title of ownership of the technology and software because of the fact that from the Spanish civil law perspective a contract of sale must have a concrete and specific object, not a general one. Since the contract between the Spanish and the German company of the group referred to a general transfer of 81% of the technology and software, it did not have the specific characteristics of a sale. Hence it had to be regarded as a transfer of the right to use industrial property and know-how.

The taxpayer, on the other hand, argued that the contract should be regarded as a sale so that the payment in-kind in the form of shares should not be treated as a royalty but as a sale to which Art. 13(3) of the Treaty dealing with capital gains applied. According to that treaty provision Germany would have the exclusive right to tax the payment in-kind.

In other words, the question was whether the transfer of the technology and software should be regarded as a sale to which Art. 13(3) (capital gains) of the treaty applied, or as a licence of the right to use the technology and software to which Art. 12 (royalties) of the Treaty applied. The Supreme Court held in favour of the tax authorities. The Court reasoned that under Spanish intellectual property legislation (under Spanish law software is intellectual property) it is not possible to transfer specific (non-standard) software programs. Spanish law permits a transfer of only the right to use specific software. Subsequently, after having considered the various and complex features of the contract, the Court concluded that it was not a sale but rather should be regarded as vesting a right to use the technology and software so that payment in-kind was a royalty subject to tax in Spain at a rate of 5% under Art. 12 of the Treaty.

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<sup>42</sup> Decisions published in AEDAF "Fiscalidad internacional. Convenios de doble imposición. Doctrina, y jurisprudencia de los tribunales españoles", Aranzadi Editorial (1998) pp. 112-120.

<sup>43</sup> Decision published in AEDAF, id. pp. 71-75.

<sup>44</sup> See, in the same line, SAN of 6 May 1997.

<sup>45</sup> Decision published in AEDAF "Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 1998-1999-2000)", Aranzadi Editorial (2002) pp. 262-285.

#### 14.2.4. Article 3(2) OECD MC issues

Obviously, it is of much importance that tax treaties are interpreted the same way in both countries (the principle of common interpretation) because otherwise income may be taxed twice or not at all. For that reason, tax agreements based on the OECD MC, such as the treaties concluded by Spain, contain - in addition to the provisions of the VCLT - an internal rule of interpretation. Article 3(2) OECD MC provides that undefined terms used in a treaty have the meaning that they have under the domestic law of the country applying the treaty, unless the context requires otherwise. <sup>[46]</sup> Therefore, the application of the aforesaid article involves a three-stage process: firstly, it should be determined whether the treaty itself provides or not a definition of the term; if a definition is not provided, the domestic meaning of the term must be adopted, as long as the treaty context does not require a different meaning.

As the OECD Committee on Fiscal Affairs stated, <sup>[47]</sup> "the context is determined in particular by the intention of the contracting states when signing the convention as well as the meaning given to the term in question in the legislation of the other contracting state" (an implicit reference to the principle of reciprocity on which the Convention is based). Basically, not only do Spanish tax treaties follow the rule established by Art. 3(2) OECD MC but also the Spanish tax authorities and courts observe the requirements of this article. <sup>[48]</sup> As an example of this, the following resolutions and decision can be noted: RTEAC of 29 August 1993; RDGT of 13 January 1995; SAN of 12 December 1995.

In case reference is made to the Spanish domestic legislation - which is only possible when a treaty definition does not exist - the meaning of the term undefined "may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law" <sup>[49]</sup> of Spain, whether or not a tax law. However, as the OECD Committee adds, "where a term is defined differently for the purposes of different laws of a contracting state, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws".

Finally, as far as Spanish treaty practice is concerned, reference made by Art. 3(2) OECD MC to domestic legislation does not extend to "concepts" but only to "terms" used in this kind of conventions.

#### 14.2.5. Foreign evidence

Generally speaking, Spanish tax courts accept documents formed abroad in order to satisfy the onus of proof of the party applying the tax treaty. Moreover, the tax authorities have often denied the application of a treaty where there was no certificate of residence issued by the authorities of the other Contracting State. <sup>[50]</sup> In this sense, the following resolutions of the DGT, among others, can be noted: 7 May 1992, 7 September 1993, 30 June 1994, 24 June 1997, 28 May 1998 and 21 June 1999.

Spanish tax authorities require tax authorities of the other Contracting State, and not other kind of authorities, to issue the certificate. Furthermore, to be valid as a mean of proof this certificate must demonstrate a tax residence, not another kind of residence such as an administrative or professional one. For this reason, some RRDGT have denied the validity of water or gas receipts, registration (census) certificates and other similar documents in order to prove the tax residence and, subsequently, the application of the tax treaties in question. <sup>[51]</sup> For instance, in the aforementioned RDGT of 7 May 1992, the tax authority stated that a certificate of nationality did not satisfy the onus of proof of the tax residence

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<sup>46</sup> See Ribes Ribes, A., "Convenios para evitar la doble imposición internacional: interpretación, procedimiento amistoso y arbitraje", Madrid: Edersa Editorial, 2003, *Colección Biblioteca de los tributes* n°5.

<sup>47</sup> Para. 12 of the OECD Commentaries to Art. 3(2).

<sup>48</sup> An exception to this general rule is the Spanish tendency to apply a "static interpretation" of the term in question - particularly when a Contracting State has changed the domestic meaning of a term and this amendment alters the taxing powers agreed by both Contracting States - rather than the "dynamic interpretation" recommended by the OECD. See RTEAC of 11 June 1997.

<sup>49</sup> Para. 13.1 of the OECD Commentaries to Art. 3(2).

<sup>50</sup> See e.g. the RTEAC of 22 December 2000 regarding the tax treaty between Germany and Spain. In the same line, see the RTEAC of 9 February 2001 and the SAN of 15 February 2001.

<sup>51</sup> See e.g. the following RRDGT: 21 October and 30 November 1992, 21 November 1994 and 25 May 1998. Also in this line, the RRTEAC of 6 November 1990 and 5 November 1991.

of the party in Mozambique. Similarly, both the TEAC and the AN noted that the tax residence can be justified neither by cards of residence or passports, nor by other unauthentic documents. In this context, the RTEAC of 4 December 1998 and the SAN of 27 June 2002 should be borne in mind.

In addition, Spanish tax courts require the foreign certificates of residence to be individual, as was settled by the SAN of 19 June 2003.

On the other hand, some cases in which the tax authorities rejected the foreign evidence by arguing that the information included in them was not sufficient, or because of the possible incompetence of the foreign authorities that issued the document, should be noted. See, in this respect, the RTEAC of 9 April 1997 and the SSAN of 1 June and 21 September 2000.

It should also be noted that as far as some tax treaties are concerned, there are specific models of certificates of residence to be issued by the State of residence so that, provided certain conditions are met, the Spanish tax courts would not accept these documents as foreign evidence in order to apply a tax treaty. Against these strict requirements of the foreign certificates of residence required by the tax courts, most of the Spanish tax authors underlined the right of the parties to prove the residence through other means. [52]

In addition to this, the fact that Spanish tax courts do not accept documents drafted in another language as a valid means of proof unless they have been translated to Spanish is also remarkable. Needless to say, in these cases, the party who pretends to prove the residence abroad has to bear the costs of the translation.

#### 14.2.6. Foreign (tax) law

In general terms, Spanish courts never consider foreign tax law for the purposes of the decision, or from a procedural viewpoint either in the context of the decision. This author has not found any judicial decision in this respect, although it is undoubted that Spanish courts should take into account foreign law as an indispensable tool of interpretation when it is indicated in the OECD MC.

As worded, Art. 4(1) OECD MC makes an explicit reference to the domestic legislation of the Contracting State in order to determine - for the purpose of tax - whether a person fulfils the conditions required in order to be a resident of that State. The purport of this provision is to avoid the possibility of a person - individual or juridical - to be considered as a resident in the two Contracting States. From the viewpoint of the present author, this objective has been reached in particular by the Commentaries to this article, which preclude the problem of a conflict of residence in the scope of double tax treaties. [53]

Moreover, some explicit references to domestic law can be readily found in the following provisions of the OECD MC: Art. 6(2) expressly refers to the internal law of the Contracting State in which the property is situated in order to determine the meaning of the term "immovable property" for treaty interpretation purposes. Nevertheless, the provision specifies on the one hand certain things that must always be included in this expression and, on the other hand, some others that shall not be regarded as "immovable property". In line with it, another reference of this kind is found in Art. 10(3) OECD MC, which, after having defined the term "dividends" for its correct understanding in the treaty context, also includes "income from other corporate rights", which have the same taxation treatment as income from shares by the domestic legislation of the State of which the company that makes the distribution is a resident.

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52 Calderón Carrero, J.M., "Artículo 6", in Baena Aguilar, Á. et al., *Comentarios a la Ley del Impuesto sobre la Renta de No Residentes*, Madrid: Editorial Civitas, 1999, pp. 89 and 91; Serrano Antón, F., "Cuestiones relevantes sobre la residencia fiscal de las personas físicas en la tributación española e internacional", in VVAA: *Fiscalidad internacional. XLVIII Semana de Estudios de Derecho Financiero*, Madrid: Instituto de Estudios Fiscales-Fundación para la promoción de los estudios financieros, 2004, p. 232; Tovillas Morán, J.Ma., "Propuestas para mejorar el trato fiscal de las personas expatriadas", *II Fisco* No. 110 (2005) p. 46; Ribes Ribes, A., "La problemática de los certificados de residencia en el Impuesto sobre la Renta de No Residentes", *Quincena fiscal* No. 21-22 (December 2005), pp. 22-23.

53 See García Prats, F.A., "Triangular cases and residence as a basis for alleviating international double taxation. Rethinking the subjective scope of double tax treaties", 11 *Intertax* (1994) p. 482.

A few steps further back in time, the wording of Art. 11(3) in the 1963 OECD Draft Convention <sup>[54]</sup> provided another good example of reference to the internal law, by stating that this expression encompass, apart from the incomes expressly referred, other kinds of income that the State in which the income arises assimilates to income from money lent in its taxation law.

To sum up, it can be concluded that whereas in the first and the third cases reference is made to the internal legislation of the State of source, in the second situation, however, the criteria adopted points out to the State in which the company distributing the dividends has its residence. In this author's opinion, this implies that the establishment of a general rule on this issue does not make sense at all, depending on each particular situation and kind of income the convenience of referring to the domestic law of the State of source or residence. <sup>[55]</sup>

Further, the present author considers that no reference to any domestic legislation in terms of treaty interpretation is made in Art. 23 OECD MC. The qualification mentioned by this provision is not made by the State of source but by the treaty rules agreed upon by both of the Contracting States. Therefore, whether according to these settlements - that are binding for the two parties - the State of source is entitled to tax income or properties of a resident of the other Contracting State, which must provide in its internal tax law some methods to avoid an international double taxation situation. The unique aim of the reference to domestic law of the State of reference made by Art. 23 OECD MC is to oblige this State to prevent its residents from double taxation that will probably derive from situations in which, as both parties agreed, the right to tax corresponds to the State of source, although the person liable to be taxed is not a resident of this State. In this author's view, reference to internal legislation for interpretation of tax treaty terms has nothing to do with it.

In any event, and reverting to the question of a "static" versus a "dynamic" meaning, the author of this chapter agrees with the commentators in considering the ambulatory interpretation the best solution, even though it is important not to lose sight of the significant problem that the aforesaid approach involves since it permits a country to amend its tax treaties unilaterally depending on the nature of the amendment. <sup>[56]</sup>

Apart from that, the SAN of 10 June 1997, in which the AN should have considered foreign tax law for the purposes of the decision, should be highlighted. <sup>[57]</sup> The issue concerned a Spanish resident bank, with a subsidiary in Brazil, which claimed to deduct a sum, under the concept of "monetary revision", from its total tax base. Even though this operation is not possible under the Spanish tax legislation, the Brazilian law permitted it (due to the permanent and serious inflation of this country), and that was the crux of the question. In other words, the AN refused to consider not only the tax treaty between Spain and Brazil of 1974, but also the Brazilian internal law with regard to the deduction of such "losses" of the subsidiary in Brazil, and only applied the Spanish domestic law. Evidently this case constitutes an example of a practice that should be avoided by the Spanish tax courts.

#### 14.2.7. References to foreign court decisions and foreign administrative practice

At first sight, Spanish tax treaty interpretation does not usually take in consideration another State's tax authority practice on this topic. Neither is unilateral practice followed by the other Contracting State binding at all, because only a uniform understanding of the treaty term concerned could be binding on both of the Contracting States on the basis of Art. 31(3)(b) VCLT.

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<sup>54</sup> In the 1963 OECD Draft Convention, Art. 11(3) read as follows: "3. The term 'interest' as used in this Article means income from government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the state in which the income arises".

<sup>55</sup> In the author's view, another allusion to domestic law is included in Art. 12(4) OECD MC when referring to the internal taxation treatment of both Contracting States in the specific case concerning royalties set out in this provision.

<sup>56</sup> For instance, whether a Contracting State modifies its domestic law in a way that substantially alters the agreement between the two Contracting States, and which was not contemplated by both of them, that amendment is equivalent to a treaty override.

<sup>57</sup> Decision published in AEDAF: "*Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 1996-1997)*", Aranzadi Editorial (2000) pp. 109-111.

In contrast to other subjects (e.g. Law of the Sea) in relation with the so-called "subsequent practice" is very important, on the content of tax treaties concluded by Spain the relevance of that general practice followed by the parties after having signed the convention is practically non-existent. For this reason, it would be rather difficult that this "subsequent agreement" could modify any tax treaty provision.

But not only do Spanish tax courts carefully study foreign court decisions as regards treaty interpretation, but Spanish tax commentators do also. Even though these decisions are not binding on the tax authorities in Spain, they are very useful as a guidance of how other countries understand the same provision and they provide helpful examples to both the scholars and the courts in reaching - as much as possible - uniformity in the tax treaty interpretation criteria.

### 14.3. Article 234 EC Treaty

#### 14.3.1. Cases involving the application of EU law that have not been referred to the ECJ

There is no case dealing with the application of tax treaties in which Spanish courts decided to apply EU law directly, without referring the case to the ECJ.

#### 14.3.2. Referral ex officio

There is no case involving the application of tax treaties in which Spanish courts made use of such discretionary power and remanded a case to the ECJ even if the parties did not explicitly request to do so.

The singular case that can be cited is a writ issued by the Supreme Court on 3 October 2001 (No. 547/1998) in which the Court observed some doubts on the interpretation of the European law and referred the case, according to Art. 234 EC Treaty, to the ECJ for a preliminary ruling.

#### 14.3.3. Application of Article 234(3) by highest courts

On the basis of the *acte-clair* theory, the Spanish Supreme Court decided not to refer the case to the ECJ, for instance, in the following decisions: STS 15 March 1991, STS 19 January 1993 (case number 5214/1989), STS 20 September 1996 (case number 10628/1991), STS 10 February 1997 (case number 4806/1991), STS 27 April 1998 (case number 210/1995), STS 1 July 1999 (case number 372/1995), STS 8 July 1999 (case number 378/1995), STS 10 July 1999 (case number 404/1995), STS 15 July 1999 (case number 374/1995), STS 25 January 2003 (case number 8376/1998), STS 20 June 2005 and STS 20 March 2006.

As regards tax cases, the application of the aforementioned theory can also be noted in the following decisions of the Supreme Court: STS 31 October 1996 (case number 796/1994), STS 29 October 1998 (case number 8738/ 1992), <sup>[58]</sup> STS 3 March 2001 (case number 8913/1995), <sup>[59]</sup> STS 17 November 2001 (case number 2194/1996), <sup>[60]</sup> STS 27 June 2002 (case number 4518/1997), <sup>[61]</sup> STS 6 November 2004 (case number 682/1999).

With regard to cases involving the application of tax treaties, only the following Supreme Court decisions can be noted: 15 July 2002 (case number 4517/1997) <sup>[62]</sup> and of 12 February 2003 (case number 8720/1998). <sup>[63]</sup>

In the first case, the controversial issue focused on the consolidated regime that is applied for by a permanent establishment - located in Spain - of a company resident in Belgium (Solvay et Cie, S.A.),

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<sup>58</sup> The case concerned the application of the Spanish Value Added Tax ("IVA").

<sup>59</sup> The case concerned the application of the Spanish Transfer Tax and Stamp Duties ("ITPAJD").

<sup>60</sup> The case concerned the application of the "ITPAJD".

<sup>61</sup> The case concerned the application of the "ITPAJD".

<sup>62</sup> Decision published in AEDAF "Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 2001-2002-2003)", Thomson-Aranzadi Editorial (2004) pp. 611-614.

<sup>63</sup> Decision published in AEDAF "Fiscalidad internacional. Convenios de doble imposición. Doctrina y jurisprudencia de los tribunales españoles (Años 2001-2002-2003)", Thomson-Aranzadi Editorial (2004) pp. 614-618.

regarding the tax bases of the different Spanish resident subsidiaries that belong to the permanent establishment. Whereas the Belgian company argued that Art. 24(4) of the tax treaty between Spain and Belgium of 24 September 1970 (in force at the time) should be applied, the Supreme Court considered both the Royal Decrees 15/1977 of 25 February and 1414/1997 of 17 June as the relevant rules applicable to the case. According to these, the consolidated taxation system requires a "prevailing company" resident in Spain that owns a 50% of the dependent share companies. Even though this latter requisite is fulfilled, the problem points at the prevailing company, which is not a company *stricto sensu* but a permanent establishment.

Further, the Supreme Court observed that OECD Commentaries on Art. 24 OECD MC do not have legal force, in spite of being authentic interpretation, so they cannot base an appeal to higher court for the reversal of a decision of a lower court.

It should be borne in mind, however, that the petitioner referred not to the OECD Commentaries but to Art. 24 of the tax treaty between Spain and Belgium. In other words, although the mentioned article provides the principle of non-discrimination by virtue of the nationality in broad terms, the OECD upholds this principle regarding permanent establishments by virtue of their activities or location. A permanent establishment situated in a State cannot receive a less favourable tax treatment in comparison with a resident entity.

Fortunately this issue will no longer arise, as the Spanish tax regulations have already resolved the question by granting the permanent establishment located in Spain the possibility of being "prevailing companies" and, therefore, to be levied through the consolidated tax regime. Additionally, the Supreme Court denied the request of the petitioner in order to refer the case to the European Court of Justice on the basis of the *acte-clair* theory.

The underlying question was whether Art. 52 EC Treaty applied to this case and, consequently, there was a violation of the right of free establishment. Notwithstanding the provisions of Art. 234(3) EC Treaty, <sup>[64]</sup> the Supreme Court argued that the duty contained in that article disappears when the national judge has no doubt at all on the interpretation of the European provision. <sup>[65]</sup> In this author's view, the Supreme Court ignored the fact that the application of that doctrine also requires that the court applying it considers that this clarity would be also evident for the rest of the judicial authorities and for the ECJ.

Obviously, it would have been desirable that the Supreme Court referred the case to the ECJ, as it would have surely concluded that infringement of the European law had occurred. Besides, it can also be questioned whether the Supreme Court properly applied the principles of law laid down by the ECJ in its decision of 6 October 1982 (Case 283/81, *Cilfit*), which detailed the doctrine already contained in the Court's decision of 27 March 1963 (*Da Costa*), and which is also reflected in the so-called *Pescatore* doctrine. <sup>[66]</sup> Indeed, the practice reveals that more often than not, the Spanish highest courts do not apply this theory based on the absence of doubts in order to avoid superfluous remissions to the ECJ, but rather, to decide unilaterally, in favour of the Member State, whatever discussion about the extent of their community duties. <sup>[67]</sup>

The Supreme Court held the same incorrect arguments in its decision of 12 February 2003 (concerning the same company but different taxable year) and again rejected a request for a preliminary ruling from

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<sup>64</sup> Likewise, the Spanish literature has underlined the connection between Art. 234 EC Treaty and Art. 24(2) of the Spanish Constitution, and also recognized as an exception to that obligation the fact that the terms of the European provision are so clear that referral to the ECJ becomes superfluous.

<sup>65</sup> This polemical decision has been criticized by most of the national and international literature. See *Tax News Service* 18 November 2002 (IBFD): "Supreme Court rejects request for ECJ preliminary ruling regarding refusal to grant tax consolidation regime to Spanish permanent establishment of Belgian company"; Raventós Calvo, S., "La cuestión prejudicial ante el TJCE en materia fiscal: una tendencia preocupante", *Quincena fiscal* (January 2003) II; Vogel, K., "On discrimination of permanent establishments", *Tax Treaty Monitor*, February 2003; De Juan, A., "Supreme Court rejects request for preliminary ruling from European Court of Justice regarding tax consolidation regime", *International Transfer Pricing Journal* (March-April 2003); García Heredia, A., "La discriminación de establecimientos permanentes de sociedades de otros Estados miembros. A propósito de la STS de 12 de febrero de 2003", *Aranzadi Jurisprudencia tributaria* (October 2003). In the opinion of this last author that situation could support an appeal for legal protection (application for a declaration of fundamental rights) before the Spanish Constitutional Court.

<sup>66</sup> *Pescatore*, P., "Las cuestiones prejudiciales. Artículo 177 del Tratado CEE", in Rodríguez Iglesias, G.C. and Liñán Noguera, D.J., *El Derecho comunitario europeo y su aplicación judicial*, Madrid: Editorial Civitas, 1993.

<sup>67</sup> See Fernández Segado, F., "El juez nacional como juez comunitario europeo de Derecho común. Las transformaciones constitucionales dimanantes de ello", *Revista mexicana de Derecho constitucional* No. 13 ([www.juridicas.unam.mx/publica/rev/constit/cont/13/ard/ard2.htm](http://www.juridicas.unam.mx/publica/rev/constit/cont/13/ard/ard2.htm)).

the ECJ regarding refusal to grant the tax consolidation regime to a Spanish permanent establishment of a Belgian company.

## Chapter 15 – Judicial errors under tax treaties and their remedies

### 15.1. The issue(s)

This chapter deals with judicial "errors in law" when they arise in tax treaty matters and the remedies available when the "wrong" decisions become final.

Errors in the legal reasoning which lead a court to a decision have legal significance and constitute grounds for appeal under the tax systems of most States. For the appellant, the decision is a "wrong decision" and can thus be appealed because the court failed to apply the proper legal reasoning, and this is indeed ground for asking judicial review. The situation is different when a court of highest level delivers the decision, which is therefore a final decision. In cases regarding exclusively internal law, the decision of a court of highest level can indeed almost never be a wrong decision (with a few exceptions regarding primarily factual mistakes that may be corrected through special proceedings). Obviously, one may wonder how to reconcile this statement with decisions contrasting on points of law delivered by different courts or even by the same court, but this is more a statement of fact rather than a legal argument.

If one looks at tax treaties, the situation is different and the expression "wrong decisions" may also have a (legal) meaning for decisions delivered by courts of last instance. The (wrong) decision, for example, may be the basis for the taxpayer to obtain credit in the other Contracting State, which may reject relief on the basis that the decision is "wrong" because it is not in accordance with the relevant convention.

More empirically, one other element of distinction from domestic tax cases is that the decision of the court of last instance may be contrary to the decision of another court of last instance, namely the highest court of the other Contracting State. Even in those situations, however, there is some reluctance to accept that decisions may be wrong and it is said that these are autonomous interpretations (this is, for instance, the expression used by the French *Commissaire du Gouvernement* in the *Malet* case in which directors' fees were found to be other income, <sup>2</sup> while in the United States were regarded to be income from professional services, leading to double exemption, which was found to be not unusual in international cases).

The subject of judicial errors in law and wrong decisions raises several questions: do judicial errors in tax treaty matters constitute treaty override? Are they frequent? If so, which judicial or administrative remedies are available to cure them? Is there a reason for remedies specifically tailored for (tax) treaty judicial errors which do not currently exist and which would not otherwise be available under other branches of law? Which ad hoc remedies may be considered? Should these remedies also be available when the error is to the prejudice of the tax authority of a Contracting State rather than of the taxpayer?

All these issues are relevant for scholars but practitioners are not insensible to the subject either, as judicial errors in law may also become an obsessive threat for experienced litigators.

The subject has grown in significance in recent years as national decisions on tax treaties now circulate more frequently and more rapidly among countries, and are debated within the entire international tax community, so that inconsistencies are more likely to be pointed out by commentators. Reliance on foreign court decisions in interpreting tax treaties - as now advocated by tax literature - may make the subject gain even more attention. Finally, assistance in cross-border collection of taxes either at EU level or at bilateral level may be a further reason for scrutiny to the extent that a Member State or a Contracting State may be bound to enforce in its territory a final (wrong) decision delivered, as the case may be by either another Member State or the other Contracting State, on a provision of the bilateral convention concluded between

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<sup>2</sup> *Conseil d'Etat*, 26 February, 1992, No. 83461, in 52 *Revue du droit fiscal* 2459 (1992).

the two States (existence and validity of the revenue claim cannot indeed be disputed in the State granting assistance). [3]

## 15.2. Do judicial errors in tax treaty matters constitute tax treaty override?

Firstly, it is worthwhile to draw the legal distinction - if any - between judicial errors in tax treaty matters and "tax treaty override", a well-established expression widely used in tax circles. The latter expression was paid much attention during the 1980s when the United States rather openly expressed sympathy for overriding treaty provisions through the enactment of domestic laws, thus alerting most Contracting States and the OECD, which undertook specific work on the subject resulting in the "OECD Report on Treaty Overrides 1989". In the Report, "treaty override" includes primarily

[...]the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations. (OECD Report on Treaty Overrides 1989, para. 4)

In the first place, the above-mentioned definition excludes judicial override, which is different from enactment of domestic legislation, and puts emphasis on the *intent* to override, a conduct which is unlikely to be adopted by a court unless internal law so permits. The Report is thus centred on domestic law overriding a treaty.

It is, however, the Report itself that makes reference to a situation in which

[...]a court decision deviates from the common interpretation, explicitly accepted or tacitly implied by the treaty partners, of a provision based on the text of the treaty ... *It is the Court's decision in the first place which may be seen as overriding the treaty* (emphasis added).

These situations exist in practice. [4] In the *Onduline* case, [5] for instance, the Italian Supreme Court disregarded the common interpretation of the Contracting States on the definition of "royalties" as expressed in written memoranda exchanged by their competent authorities; the Court disregarded the common intention which, in the Court's view, failed to be followed by legislative approval in both Contracting States. The Court ignored the argument that the interpretation agreed *after* the conclusion of the treaty between the tax authorities of the two Contracting States may constitute common interpretation amounting to the "subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" under Art. 31(3)(b) of the Vienna Convention on the Law of Treaties of 1969 (VCLT) [6], [7].

Similarly, in Belgium the Court of Appeals of Gent disregarded the interpretation agreed by the Contracting States on the ground that the text of the treaty rule was clear so that recourse to common intention of

3 Art. 27(6), OECD Model Convention; Art. 12(1) Council Directive 76/308/EEC of 15 March 1976 on mutual assistance for the recovery of claims.

4 See also Ward, D.A. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, Amsterdam: IBFD Publications BV, 2005, p. 37 note 82 and the bibliography quoted therein.

5 Decision 24 May 1988, No. 3610 (O.F.I.C. v. *Finanze*), in *Dir. prat. trib. II* (1988) p. 547.

6 The Commentary to Art. 31(3)(b) of the VCLT puts an emphasis on such element of interpretation on the ground that it "constitutes objective evidence of the understanding of the parties as to the meaning of the treaty" and considers it as "an authentic means of interpretation alongside interpretative agreements". Reference to recourse of the subsequent practice element in the interpretation of tax treaties is dealt with by F. Engelen, *Interpretation of Tax Treaties under International Law*, Amsterdam, IBFD Publications, 2004, who emphasises (at p. 234) how the subsequent practice may amount to authentic interpretation of the treaties if it evidences "the existence of a tacit agreement made between all the parties regarding the interpretation of the treaty. This implies that some degree of uniformity and consistency is essential before the practice may be regarded as establishing an authentic interpretation of the treaty". It is submitted that the bilateral nature of double taxation conventions should give particular weight to consistent subsequent practice of the (two) parties to the treaty, as it evidences a coincidence of views of all the parties. M. N. Shaw, *International Law*, Cambridge: Cambridge University Press, 2005, indicates (at p. 841) that subsequent practice may have a dual role, as it may act as an instrument of interpretation, but may also mark an alteration in the legal relations between the parties established by the treaty in question.

7 It is worth noting that following the quoted judgement of the Italian Supreme Court, the Italian and French Ministries of Finance executed an official Exchange of Letters to agree on what was their common interpretation of the definition of "royalties" for the purposes of that convention and which was different from the one purported by the Supreme Court (cf. A. Santa Maria, "Sul Valore dell'Interpretazione dell'art. 11 del Trattato fra l'Italia e la Francia per Evitare le Doppie Imposizioni del 29 Ottobre 1958 ai Sensi dello Scambio di Lettere del 5 Ottobre 1989", *Dir. Prat. Trib. I* (1989), 1413. On the interpretative role of subsequent agreements on the interpretation of tax treaties, cf. also: G. Maisto, "The observations on the OECD Commentaries in the interpretation of tax treaties", 59 *Bulletin for International Fiscal Documentation* 1, (2005), p. 14.

the two States was unnecessary. <sup>[8]</sup> The Belgian decision points out the difficulty to establish whether disregard of common intention amounts to override because common interpretation - if contrary to the treaty - can be ignored by the Court and could not be regarded as treaty override. It is however evident that such decisions are wrong insofar as regardless of the conclusion courts failed to argumentate on the reasons why the common interpretation agreed by the two contracting States is wrong and should thus be disregarded.

A similar decision - equally disregarding common intention - was issued in Germany, where the Federal Tax Court refused to be bound by a mutual agreement on the definition of "frontier worker". <sup>[9]</sup>

Lastly, similar decisions were issued in France, where the *Conseil d'Etat* disregarded a mutual agreement procedure for establishing the treaty residence of an individual by arguing that the case was to be resolved pursuant to another tie-breaker rule, <sup>[10]</sup> and in the UK, where the Inland Revenue denied the application of a treaty to UK branches of non-residents on the basis of Art. 1 and despite a contrary mutual agreement procedure. <sup>[11]</sup>

It is also surprising that in some cases the interpretation agreed under competent authority is subsequently retracted when the case is before the tax courts. <sup>[12]</sup> It has been reported that this may occur especially in common law countries, where "since courts are the final arbiters on the meaning of a treaty, there is nothing to prevent the revenue authorities from resiling from a mutual agreement and arguing against an agreed interpretation before the courts." <sup>[13]</sup> The conclusion is indeed different in some civil law countries that restrict the scope of the decision to the grounds presented by the parties unless rules of procedures expressly provide otherwise.

Another reason for denying interpretation agreed with the other State may be found in the level of autonomy of the defence of the tax authority before tax courts, which then becomes another element of differentiation in the treaty practice of the Contracting States.

In Italy, for instance, the tax office that issues the assessment cannot be represented by a third party before the first level tax court, whereas it can be represented by the State's Advocate (*"Avocatura dello Stato"*) in front of the second level tax court, <sup>[14]</sup> although this rarely applies in practice. In proceedings before the Supreme Court, the assessing tax office is usually represented by the State's Advocate. Although the State's Advocate has a certain discretion in defending the assessing tax officials, he is bound by the object (*petitum*) of the litigation and the grounds (*causa petendi*) as determined before the first level tax court, which can no longer be amended, not even before the Supreme Court. This feature of procedural law leads to the conclusion that the assessing tax office maintains the responsibility and control of the scope of the appeal so that the responsibility for the departure from common interpretation cannot be attributed to the State's Advocate. On the same subject, it should be mentioned, however, that the assessing tax office (tax agency, *"Agenzia delle Entrate"*) is independent from the office in charge for mutual agreement procedures (Ministry of Economy and Finance, *"Ministero dell'Economia e delle Finanze"*). The interpretation laid down in mutual agreement procedures is therefore not legally binding upon the assessing tax officials (apart from not being legally binding upon the taxpayer and judges).

In some States, common interpretation - if made publicly available - may create a legitimate expectation that the taxpayer may enforce and validate judicially to challenge contrary tax assessments.

<sup>8</sup> Decision of 20 June 1996. See Goris, P.F. and Smit, P.M., "Belgium. Court Disregards Mutual Agreement in Treaty with the Netherlands", 37 *European Taxation* 1 (1997) p. 20. See also the decision of the Belgian Supreme Court of 7 November 1961, *Du Bultet v. Etat Belge*, quoted in Avery Jones, J. et al., "The legal nature of the Mutual Agreement Procedure under the OECD Model Convention", *British Tax Review* 6 (1979), p. 346 and the decision of the Court of Appeals of Antwerp of 29 June 1982, commented in 23 *European Taxation* 12 (1983) p. 387.

<sup>9</sup> Decision of 10 December 2001 in the case IB 94/01.

<sup>10</sup> The case is commented in 23 *European Taxation* 10 (1983) p. 355, and in Baker, P., *Double taxation conventions and international tax law*, London: Sweet & Maxwell, 1994, p. 421.

<sup>11</sup> *I.R. C. v. Commerzbank AG and I.R. C. v. Banco do Brasil SA*, commented in Baker, *Double taxation conventions and international tax law*, op cit.

<sup>12</sup> See also the Norwegian *Heerema* case, commented in Skaar, A.A., "The Continental Shelf and Tax Treaties - A Case Study", *British Tax Review* 3 (1993) p. 189 et seq. It is reported that the Swiss tax authorities did not honour the exchange of letters between them and the Norwegian tax authorities. Notwithstanding this, the Supreme Court of Norway ruled that the exchange of letters was binding on the Norwegian tax authorities and on the same court.

<sup>13</sup> Baker, *Double taxation conventions and international tax law*, op cit., p. 424.

<sup>14</sup> Art. 12(4) of Legislative decree No. 546/1992.

In Italy, for example, the "Bill of Rights of the taxpayer" ("*Statute dei diritti del contribuente*") <sup>[15]</sup> prevents the levying of penalties when the taxpayer followed instructions laid down by the tax authorities and subsequently amended. This provision has been interpreted <sup>[16]</sup> as implementing the general principles of good administration ("*buon andamento*") and of impartiality ("*imparzialità*") of the Administration, as well as of ability to pay and equality, <sup>[17]</sup> and for this reason the protection may also apply to the tax. To date, however, the subject has never been raised.

Other less evident situations of judicial errors may be found when the court decision either overlooks treaty rules that should have applied to the case or misinterprets them (in doing so the court would ignore altogether case law in the other Contracting State or consistent views expressed on the subject matter by scholars or the OECD Commentary). Here, the decision is simply wrong because the court wrongly interprets and applies a treaty provision. There is not necessarily a departure from common interpretation but the decision is simply connotated and affected by judicial errors in law, and determining whether or not they amount to conscious or deliberate violation of treaty obligations is legally meaningless.

Do these errors constitute treaty override? The expression "treaty override" and its definition as contained in the OECD Report do not by themselves have any legal meaning but simply define the scope of the conduct of a State that - either through domestic legislation, administrative practice or judicial decisions - violates treaty obligations. Errors have a broader and sometimes different scope; in the first place, they do not necessarily prevent treaty law to prevail over domestic law. For instance, the error may lie with the application of the wrong treaty provision or the application of a treaty when the treaty was not applicable (such as furnishing information to the competent authority of the other State when this was not permitted under the treaty).

A good example may be found in Australia where the Court applied the business profits article to gains on shares arising to a non resident employee from a stock options plan <sup>[18]</sup>

Furthermore, unlike a single error, judicial treaty override seems to require a consistent violation of a treaty provision and not an isolated wrong decision. Another element of differentiation is that situations exist in which judicial override is not a judicial mistake to the extent that internal law permits a domestic provision to prevail over a treaty rule.

Lastly, judicial errors of law under tax treaties permit no distinction between conscious or unconscious override developed in the OECD Report.

### 15.3. Are judicial errors frequent?

The next issue to explore is: are judicial errors frequent? Yes, they are but this is true only for some States, not all. There is an element of relativity in this reply. Frequency is not expressed in absolute terms because of the limited amount of cases delivered on tax treaties; furthermore, it should also consider the wrong decisions that are not final (decision of lower courts) which are settled and never go to appeal before the highest level. These decisions are not readily publicized so the perception of the frequency of judicial errors may be misled.

In any event, scholars and commentators in many countries report periodically wrong decisions on tax treaties, some of which clearly depart from "common interpretation".

Further to the examples mentioned above in which courts disregarded common interpretation, several other cases of likely judicial errors can be cited. Yet, in Italy in recent years the Supreme Court consistently departed from the OECD Commentary interpretation on permanent establishment under Art. 5 of the OECD Model Convention (the so-called *Philip Morris* case); <sup>[19]</sup> in particular, the Court took

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<sup>15</sup> Art. 10(2).

<sup>16</sup> See Italian Supreme Court (decision No. 21513 of 2006).

<sup>17</sup> These principles are laid down by Arts. 97(1) and 53(1) and (3) of the Italian Constitution.

<sup>18</sup> Administrative Appeals Commission - Taxation Appeals Divisions, *AAT Case*, 11, 185, 11 July, 9 August 1996.

<sup>19</sup> Decisions 7 March 2002, No. 3368; 25 May 2002, No. 7682 and 25 July 2002, No. 10925.

the view that (i) an Italian company can be the permanent establishment of a group of companies and that (ii) attendance at meetings may amount to the "power to conclude contracts" and thus determine the existence of an agency permanent establishment.

#### 15.4. Are judicial errors in tax treaty law above average?

For countries that report wrong decisions, one should question whether or not the errors reflect the average level of negligence in reviewing cases or even tax cases. There is no doubt that in Italy in many instances the level of diligence of tax decisions on tax treaties is below average compared to other tax decisions or to non-tax decisions, and this is due not only to the lack of knowledge of treaty rules - the OECD Commentary, the Vienna Convention on the law of treaties - but also to the fact that tax treaties relying more on common interpretation require a level of attention and scrutiny of the intention of the two States that is far above average. Furthermore, court decisions are generally brief and concise, and this does not help to alert the court itself on the weakness of the sequence of its reasoning. Also, courts may be misled since rules of procedure do not require the parties to provide full disclosure of legal arguments. Furthermore, litigators are not generally familiar with tax treaty law and do not cooperate closely with tax practitioners in preparing the brief.

General weaknesses that can be shared with domestic cases may also be mentioned. For instance, rules of procedure may spur errors when courts are bound by the scope of the claim presented by the parties so that the court's freedom to elaborate legal arguments may be limited.

If the level of judicial errors on tax treaties is in some States above average, there are sound practical reasons for developing remedies. The limited scope of the problem, which is shared by a few States, is only apparent because wrong decisions delivered in such few States have derivative effects in all the other (several) Contracting States.

There might also be legal reasons and grounds for special rules remedying treaty judicial errors in law that would not otherwise be available for judicial errors in general. Indeed, this particularly pertinent reason may be found in the State's duty to meet international obligations. In this respect, it is evident that, pursuant to international law, a State's responsibility may include that which arises from the conduct of the judiciary, which surely is an organ of the State, [20] although one may wonder whether the principle of immunity of the judiciary from the government may restrict the scope of the State's liability for the judicial decisions. [21] From the perspective of EC legislation, a Member State may be liable for the decisions of national judges that trigger a sufficiently serious breach of EC legislation. [22] However, liability does not arise when the decision infringing EC legislation is isolated or is an exception to the general judicial interpretation recognized in the same Member State, or been overruled by the decision of a higher judicial body.

Furthermore, the effects of a wrong judicial decision may go beyond the individual case in the event that in the relevant Contracting State judicial decisions are binding (in other States the wrong decision might be limited to the decided case and have less significant ramifications).

#### 15.5. Do internal remedies exist for the review of final wrong decisions?

The judicial or administrative remedies available under internal law to review wrong decisions - when available - find constraints that are the expression of the principle of legal certainty, such as the concept of "res judicata", under which a *final* judgment cannot be ignored or derogated.

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20 The liability of a State for the behaviour of its judiciary has been dealt with by the Report of the International Law Commission, 53rd session, Doc. A/56/10. Particularly, Art. 4 of the International Law Commission draft articles on State Responsibility for internationally wrongful acts states that: "The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, *judicial* or any other functions, whatever position it holds in the organisation of the State, and whatever its character as an organ of the central government or of a territorial unit of the State" (emphasis added).

21 Schwarzenberger, G., *International law*, London: Stevens, 1968, p. 145, affirms that "In order to live up to the minimum standard of international law, a state is also expected to grant to the judiciary a maximum of independence from the executive. It would, therefore, be unreasonable to hold a state, which complies with the principle of immunity from the judiciary from government direction, responsible for acts of the judiciary within the legitimate scope of their judicial duties.

22 Judgement of the ECJ of 9 December 2003, case C-129/00, *Commission v. Italian Republic*. See also EGJ, case C-224/01, *Köbler v. Austria*.

Domestic law remedies are generally unhelpful. For instance, under Italian law special rules govern the "*giudizio di revocazione*" (revocation), namely judicial proceedings to review a final judgment. However, this is possible only when either the final decision is the result of wilful negligence of one of the parties [23] or of the judge, [24] or when evidence proved to be false [25] or when decisive evidence was found after the decision, which could not be produced at the time of the proceedings. [26] Another cause for the *revocazione* is the factual mistake [27] (which is not relevant for the purposes discussed here because it has to do with error on factual circumstances and not error in law). [28]

An exception to the lack of remedies to revert final wrong decisions may be found in the operation of the European Convention on Human Rights. A recent Italian Supreme Court decision highlights that a final domestic decision may be overruled by the Court of Strasbourg if the national decision is contrary to the provisions of the ECHR. [29] The decision confirms that domestic provisions may allow overruling final decisions only in exceptional circumstances but also confirms that a final domestic decision, if contrary to the ECHR, may be overruled by the Court of Strasbourg. The Supreme Court's conclusion is grounded on the fact that ECHR proceedings are expressly subject to the condition that all available national judicial remedies have been exhausted.

The decision indicates that a treaty may provide for derogation to the principle of *res judicata* and that final decisions may thus be overruled through a treaty provision. Commentators, however, have taken the view that the derogation is possible inasmuch the *res judicata* is a condition for instituting the proceeding before the Court of Strasbourg.

Existing domestic judicial remedies are therefore not helpful.

Turning to non-judicial remedies, in most countries internal laws prevent tax authorities to exercise their discretion and decide to withdraw an assessment that became final by virtue of a (wrong) final decision delivered by a local court.

In Italy, for instance, the tax authority may decide to withdraw an assessment which became final by virtue of a final judicial decision to the extent that the *res judicata* does not impinge on the merit of the case. [30] Consequently, such discretion might be exercised if the decision made the assessment final on the basis of procedural rules, such as late filing of the appeal.

The reason for this constraint is that once the court decision has ascertained the legitimacy of the assessment, the act to revoke is not only the assessment for which the tax authority would be empowered to exercise the right to withdraw, but also the judicial decision on which the tax authority has no jurisdiction.

A supreme example of this limit under the internal laws of EU Member States may be found in the EU Arbitration Convention, [31] which requires taxpayers to either let the time for appeal expire or withdraw appeals in order to apply for the arbitration proceedings. This condition is set:

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23 Art. 395(1)(1) of the Italian Code of Civil Procedure.

24 Art. 395(1)(6) of the Italian Code of Civil Procedure.

25 Art. 395(1)(2) of the Italian Code of Civil Procedure.

26 Art. 395(1)(3) of the Italian Code of Civil Procedure.

27 Art. 395(1)(4) of the Italian Code of Civil Procedure.

28 The other cause for *revocazione* is the contrariness to a final decision previously delivered to the same parties (Art. 395(1)(5) of the Italian Code of Civil Procedure) and is also not relevant for the purposes here discussed.

29 Supreme Court, First Criminal Chamber, decision No. 32678 of 3 October 2006.

30 See Stevanato, D., *L'autotutela dell'Amministrazione finanziaria*, Padova: Cedam, 1996, p. 180 and Ficari, V., *Autotutela e riesame nell'accertamento del tributo*, Milano: Giuffrè, 1999, p. 294. It should be noted that the *res judicata* cannot be affected even by a retroactive provision (unless such provision is also explicitly applicable in case of *res judicata*). That being said, it should also be noted that a minority view has been maintained that, although a final decision on the merit of the case cannot be overruled, the party to the litigation may not enforce the favourable decision (Caponi, *L'efficacia del giudicato civile nel tempo*, Milano: Giuffrè, 1991, p. 294). Although such view was expressed with regard to the case of retroactive legislation, one may wonder whether the same reasoning can be maintained with regard to the possibility for the tax authorities not to enforce a previous favourable final decision, thus not collecting the tax or refunding the tax already collected.

31 Convention 90/436/EEC of 23 July 1990.

Where the domestic law of a Contracting State does not permit the competent authorities of that State to derogate from the decisions of their judicial bodies ... [32]

France and the United Kingdom have expressly declared that they will avail themselves of Art. 7(3) AC in the context of the unilateral declarations under the Arbitration Convention, but more Member States take the same view and regard themselves bound by final Court decisions:

Although France and the United Kingdom are the only Contracting States that made a formal declaration that this provision applies in their countries, a survey demonstrated that a large majority of the Contracting States (and EU Acceding Countries) apply/would apply the same rules in practice.

[33]

The possibility to overrule this principle has been discussed in the context of EU law, which is, however, characterized by the exclusive jurisdiction of the European Court of Justice on the interpretation of EU law. This exclusivity granted by the Treaty of Rome makes it possible to consider a "priority" of ECJ interpretation on any interpretation given by courts of the Member States and also consider the effects of such ECJ interpretation on prior local court's decisions that become final, determined on the effects of the "res judicata" between the parties. In particular, the ECJ examined the extent to which, under the principle of Community solidarity contained in Art. 10 EC Treaty, an administrative body is required to reopen a decision that has become final as a result of a judgment of a national court, in order to ensure the full operation of Community law, as it is to be reinterpreted in the light of subsequent ECJ case law. The affirmative reply given by the ECJ makes it clear that the reopening of the decision is subject to the condition that under national law, the administrative body has the power to reopen the decision. [34]

## 15.6. Is termination or suspension of the treaty a suitable remedy to wrong decisions?

A second possible remedy is termination or suspension of the treaty based on the provisions of the specific treaty or on Art. 60 of the Vienna Convention on the law of treaties, under which:

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.

However, this is not a remedy to the party that was injured by the error in law but rather a remedy to the Contracting State which suffered wrong interpretation and the treaty override. As the House of Lords stated in the *Collco* case:

[...]although the infringement of a treaty may cause loss to individuals, the only person properly entitled to complain of such infringement is the other party to the treaty.

Indeed, the taxpayer's remedies to the breach of the treaty are non-existent. [35]

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32 Where the domestic law of a Contracting State does not permit the competent authorities of that State to derogate from the decisions of their judicial bodies, para 1 shall not apply unless the associated enterprise of that State has allowed the time provided for appeal to expire, or has withdrawn any such appeal before a decision has been delivered. This provision shall not affect the appeal if and in so far as it relates to matters other than those referred to in Art. 6.

33 Report on the Activities of the EU Joint Transfer Pricing Forum in the Field of Business Taxation October 2002-December 2003. Particularly, it was stipulated that Art. 7 (3) of the Arbitration Convention is self-executing and does not specifically require a formal declaration to be applicable.

34 Judgment 13 January 2004 (*Kuhne & Heitz NV v. Produktschap voor Pluimvee en Eieren*, case C-453/00) in ECR 2004, I, p. 837. See also the recent judgement of 16 March 2006 (*Rosmarie Kapferer v. Schlank & Schick GmbH*, case C-234/04).

35 See Edwardes-Ker, M., *Tax Treaty Interpretation*, Dublin: In-Depth Publishing, 1995, looseleaf, chap. 31, Part IV, pp. 8-9.

Secondly, it is arguable when "material breach" exists. <sup>[36]</sup> Although the same Art. 60 defines "material breach" as the "violation of a provision essential to the accomplishment of the object or purpose of the treaty", the evaluation whether a certain violation is material is not altogether clear. In this respect, it is to be further mentioned that the International Law Commission so explained the use of the term "material", instead of "fundamental":

The term "fundamental" might be understood as meaning that only the violation of a provision directly touching the central purposes of the treaty can ever justify the other party in terminating the treaty. But other provisions considered by a party to be essential to the effective execution of the treaty may have been very material in inducing it to enter into the treaty at all, even although these provisions may be of an ancillary character <sup>[37]</sup>.

The vagueness of the notion of "material" breach is self-evident <sup>[38]</sup>. Moreover, in line with the remarks above, the material breach may also be due to the case law of the Contracting State, although a single decision should most likely not amount to a material breach. <sup>[39]</sup>

### 15.7. Do remedies to wrong decisions currently exist under the OECD Model Convention?

A judicial error of a court of one Contracting State may fall under the mutual agreement procedure laid down by Art. 25(2) of the Model Convention to resolve issues of "taxation which is not in accordance with the convention." In this context, the Commentary considers situations in which the internal law *res judicata* principle may constitute an impediment to the avoidance of double taxation arising from the judicial error of a Contracting State:

If a claim has been finally adjudicated by a Court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. *In other States, the competent authority is bound by the court decision. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.* (para. 24 of the Commentary on Art. 25 of the Model Convention) (emphasis added)

The solution advocated by the Commentary is both unreasonable and impracticable insofar as it puts the burden of the judicial error of a Court of one Contracting State on the other Contracting State (this is the situation in which the final wrong decision in State A permits undue enrichment of State A and an undue loss for State B).

### 15.8. Can treaty remedies to wrong decisions be found in changes to the Commentaries of the OECD Model Convention?

Following the Italian Supreme Court decisions in *Philip Morris*, the OECD Commentaries were amended to clarify the interpretation adopted by the Court and this change to the Commentaries caused the Italian observation to paras. 33,41.1 and 42 of the Commentary to Art. 5:

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<sup>36</sup> Doernberg, R., "Selective Termination or Suspension of Income Tax Treaty Provisions", 2 *Tax Notes International* 11 (1990) p. 1131.

<sup>37</sup> *Yearbook of the International Law Commission*, 1966, Vol. II, p. 255.

<sup>38</sup> As indicated by M. N. Shaw, op. cit. [note 6](#) (p. 853): "customary law supports the view that something more than a mere breach of a term in an agreement would be necessary to give the other party the right to abrogate the agreement".

<sup>39</sup> See the judgements of the ECJ in the cases [C-129/00](#), *Commission v. Italian Republic*, and [C-224/01](#), *Köbler v. Austria*.

Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs.

Most recently, an Italian Supreme Court decision confirmed the departure from the view expressed by the Commentary:

[...] the foreign enterprise can demonstrate that the Italian person carries on a business activity on the grounds of the elements set out by article 5 of the OECD Model Convention as well as of presumptive elements, such as the identity of the individuals who act on behalf of the foreign company and for the Italian company, or the participation in the negotiation or entering into of contracts, even in the lack of any power to represent or act for the principal. In this sense, no decisive relevance is to be attached to the recent amendment to the Commentaries to article 5 of the OECD Model Convention, according to which the fact that the a local branch participates in the negotiation of contracts in the interest of the foreign company in itself cannot lead to consider the branch as the permanent establishment of the foreign company. In fact, left aside the non-binding effect of the Commentaries (which have no force of law) - which cannot weigh more than a recommendation towards the OECD member States - it is worth mentioning that the Italian government made a reservation to such amendment, according to which - in the interpretation of the Model Convention - the Italian jurisprudence on this particular issue cannot be ignored. <sup>[40]</sup>

This is the only observation to the entire Commentary that makes reference to jurisprudence of a Contracting State and retains some ambiguity because, unlike other observations, Italy did not express its disagreement to the interpretation contained in the Commentary. <sup>[41]</sup> Furthermore, the observation does not clarify whether the jurisprudence not to be ignored is that current at the time of the 2005 OECD update (static interpretation) or that prevailing at the date of application of the treaty (ambulatory interpretation). Similarly, the observation does not refer to prevailing jurisprudence so that contrasting decisions may make the observation inactive.

The above reaction to the *Philip Morris* jurisprudence indicates that changes to the Commentaries to adjust or cure the effects of wrong court decisions may have uncertain results, especially in States for which jurisprudence is either binding or traditionally carries significant authoritative weight and can thus be hardly disregarded by the tax authorities. Indeed, the change made to paras. 33,41.1 and 42 of the Commentaries to overrule the Italian Supreme Court had the following undesired effects:

- a. the Italian tax authority did not object to what would have otherwise being regarded as common interpretation but had to save the effects of Italian jurisprudence on the same subject; and
- b. the Italian Supreme Court had to put emphasis on the Commentary as being a mere recommendation and reiterate its own interpretation of permanent establishment, which was contrary to the view expressed by the 2005 OECD update.

Would the conclusion of the Court have been any different in the absence of the change to the Commentaries? Most likely, the Italian Supreme Court would have simply reiterated its interpretation but could, instead, have revisited its view on the subject.

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<sup>40</sup> Supreme Court (*Corte di Cassazione*), Tax Chamber, Decision No. 17206 of 25 January 2006 (*VAT Office of Arezzo v. U.G.E. S.A.*), commented in 1 *Il Fisco* 46 (2006), p. 7110 et seq.

<sup>41</sup> Doernberg, R., op. cit., indicates: "Although Article 60 (3) (b) does not itself indicate whether any violation of an essential provision constitutes a material breach or whether the violation itself must be material, the better view is that the violation itself needs to be material for Article 60 to be invoked. While the history of the Vienna Convention is far from clear on this point, the International Law Commission's commentary does state: "The Commission, however, was unanimous that the right to terminate or suspend must be limited to cases where the breach is of a serious character".

Thus, changes to the Commentaries are not in principle a panacea to contrast "judicial errors" in tax treaty matters. In the first place, they do not cure the effects of the decision that was found alleged to be wrong; furthermore, these changes create difficulties on the relationship between the tax administration and the judiciary of the same State (the tax authority may find it difficult to depart from well-established case law solely on the basis of the Commentaries).

### **15.9. Can treaty remedies to wrong decisions be found in changes to the OECD Model Convention?**

One further possible course of action is the commitment of the Contracting States' tax authorities to undertake not to enforce decisions of the respective judicial bodies that are contrary to the common interpretation of both States.

This remedy is well-reflected in the reaction shown by Italy and France to the Italian Supreme Court decision in the *Onduline* case: at the time of the conclusion of a new treaty in 1989, the two States exchanged notes dealing with the interpretation of the royalties' article under the old Convention:

In order to regulate any litigation pertaining to the application of the ... Convention [and agreed that] any taxation which is not final... be regulated as necessary in accordance with this interpretation.

On the one hand, the notes show a possible solution but also, on the other, its weakness constituted by the legal instrument used by the parties (an exchange of notes amounting under certain countries to an international treaty and requiring ratification process).

Perhaps Contracting States could include some language in the tax treaty at the time of negotiation to the effect that common interpretation of both States shall have priority on contrary judicial decision of either State's Courts and that the two States shall, under such circumstances, abstain from enforcing those decisions that thus violate the common interpretation. This view and course of action relies in some States on the administrative law principle of good administration.

Alternatively, Art. 25 could be amended to also permit competent authority in the presence of a final decision.

Furthermore, the treaty could provide on the one hand the obligation of each Contracting State to inform the other Contracting State on any decision regarding the treaty which is contrary to any common interpretation agreed by the two States; on the other hand, the treaty could establish the obligation of local courts to suspend the proceedings related to the interpretation of a treaty which is contrary to common interpretation or to case law of the other Contracting State and permit competent authority between the two tax administrations.

## Chapter 16 – Handling of judicial override

### 16.1. What is "judicial override"?

Even the best doctor in the world cannot treat his patient if he has not correctly diagnosed the illness. Likewise, we cannot handle judicial treaty overrides if this kind of override is not first clearly defined and analysed. For some, this preliminary task is practically impossible. Hans Pijl, for instance, in his report on the treatment of judicial treaty overrides in the Netherlands, published in *Tax Treaties and Domestic Law*, considers that

[...]the question of judicial override cannot be considered useful... Of course, individual commentators protest against certain decisions of the courts ... but in the Netherlands, as far as the author is aware, no situation has arisen where it is reasonable to assume that a majority of tax experts and the tax administrations of both countries would not agree with a court interpretation of a treaty provision. <sup>[2]</sup>

As for Professor Augusto Fantozzi, he conceded in his conclusions in the same volume that determining whether there is a judicial override derives in most cases from an arbitrary interpretative evaluation. <sup>[3]</sup>

There is indeed a sort of conceptual contradiction in the term "judicial treaty override" where the court in question is a higher court: Who, other than the Supreme Court, could say that this Supreme Court decision is overriding a tax treaty and unduly applying domestic law? Admittedly, this contradiction disappears in dualist systems where a more recent domestic law may derogate to a previous tax treaty or where the right under the treaty is not incorporated into the domestic law. In the UK, in the *UBS/ AG* case, Special Commissioners, including John Avery Jones, decided that

[...]on the true construction of the Treaty the Appellant is entitled to claim payment of the tax credit on dividends under 243 of the Taxes Act 1988. But that the Taxes Act has not incorporated such a right into UK law and accordingly the appeal is dismissed.

Besides this situation, cases coming to mind are extreme: for instance, a court does not apply a treaty that is beyond doubt applicable or applies it obviously outside its scope. A good example is provided by the case of *Cudd Pressure Control Inc* before the Tax Court of Canada in 1995. <sup>[4]</sup>

However, even then, there may be a doubt as to whether there is an override. Take, for example, the decision of the Swiss Federal Court of 28 November 2005 in *A holding Aps*. The Swiss tax administration denied repayment of the tax withheld upon a dividend paid by a Swiss company to its Danish parent company on the grounds that the latter was interposed solely for the purposes of obtaining the benefit of the Switzerland-Denmark tax treaty. This Treaty, however, contains no specific anti-avoidance provision. At first sight, applying an anti-avoidance provision resulted in a judicial treaty override. But the Swiss court decided as if the Treaty contained an anti-avoidance clause, by reference to the OECD Commentaries and a body of academic writing. Indeed, the OECD provides that

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<sup>2</sup> *Tax Treaties and Domestic Law*, G. Maisto, ed, Amsterdam: IBFD Publications BV, 2005, Vol. 2 EC and International Tax Law Series, p. 303.

<sup>3</sup> Id., p. 407.

<sup>4</sup> See Ian Roxan, "Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment", 25 *Interfax* 367 (1997).

[to] the extent... anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them.

This means that there is no override per se but only by reference to the position taken as to the scope and meaning of a tax treaty by a third party, in the absence by assumption of any possible appeal before a higher court.

This third party might be - besides the OECD and academics - the public interpretation of the treaty by the tax administration of the relevant State or even of the Contracting State, the legislator that, directly or indirectly, turns down the judicial interpretation, and, (why not?) the common sense of taxpayers, to give some examples. But in most cases nothing establishes that this interpretation should prevail or that of the court; in other words, that there is a judicial treaty override.

Even if the courts of the two Contracting States give conflicting interpretations of a tax treaty, nothing indicates which court is overriding the treaty.

For instance, French and Luxembourg courts decided respectively that an immovable profit realized by a resident company in the other country is only taxable in this other country if the company has a permanent establishment (France) or is always taxable in the other country irrespective of the existence or absence of any PE (Luxembourg). Which court was right?

Moreover, if a court changes its position, who could say that its first decision was a judicial override and not the second, which in the future might itself be reversed if the court comes back to its first interpretation? This is all the more difficult - if not impossible - since there is very often room for conflicting interpretations that are neither an obvious nor a definite judicial override.

In reality, strictly speaking, what is called "judicial treaty override" would be more aptly termed "judicial-supposed treaty override".

## 16.2. Remedies to "judicial overrides"

Who is going to look for remedies to the judicial override? First, parties to the procedure before the court, either the tax authorities or the taxpayer. But also the tax authorities of the other Contracting State and even of a third-party State, which could look to the decisions of foreign courts on the interpretation of a treaty provision. In some cases, other taxpayers can also be concerned by a supposed override. In the case of *Hallminster*, of 25 February 2004, the French *Conseil d'Etat* held that a British company which had sold a piece of real estate had realized a business profit in France, but was not taxable in France failing any permanent establishment in that country. The French tax authorities then turned on French companies realizing immovable profits in the UK, without having a PE in that country, and taxed them on such profits. Had the *Conseil d'Etat* overrode the UK-France treaty - which nobody knows - the consequences were detrimental to French taxpayers and not only beneficial to British taxpayers. Therefore, many may look for remedies against a supposed judicial override in many circumstances, but how will they handle it?

Not surprisingly, remedies at the disposal of the taxpayers are not and cannot be the same as for tax authorities, as can be seen in distinguishing between judicial and non-judicial remedies against a deemed treaty overriding a judicial decision.

### 16.2.1. Judicial remedies

By assumption, the judicial decision at stake is rendered by the higher tax court; otherwise, it is up to the higher tax court to decide whether or not the decision rendered by a lower court is a treaty override.

Is there then a procedure whereby a final decision of the higher tax court may be reviewed? French law provides for it but only in private law matters. The action is brought before the court that rendered the

criticized decision and tends to reform it. It is only open where one of the parties has committed a fraud. This is obviously not an appropriate remedy. I would be surprised if this conclusion was significantly different in other countries.

Turning then to remedies from international courts, in theory, several courts have competence in tax matters, such as the European Court of Human Rights or the ICSD Tribunal. But leaving aside the Court of Human Rights, only States may bring an action before a court. Moreover, States may not bring such actions as long as the injured party has not exhausted all local remedies.

At least, in most cases, both states involved - both Contracting States, in this case - should agree to refer the matter to the international court involved.

We can therefore consider that an action before an international court is not a realistic remedy to a judicial treaty override.

Does the European Court of Justice constitute an exception? In theory, yes, in so far as a tax treaty override results in infringing one fundamental freedom principle of the EU Convention. Take, for example, the *Saint Gobain* case. The German tax authorities argued that the German branch of a French company of the Saint Gobain group was not entitled to the exemption of the dividends received from the United States and Switzerland, even though such exemption is explicitly provided by the corresponding bilateral tax treaties. This override was considered by the ECJ to be an infringement to the EU Convention.

One could make a step forward and imagine that a German court, instead of raising a prejudicial question to the ECJ, would have decided that the relevant provisions of those two treaties do not apply. What is the remedy against this judiciary tax treaty override that infringes the EU Convention? The ECJ may neither reform the national judgment nor force the national authorities to reform this judgment which is *res judicata*. The only remedy would be for the national authorities to indemnify the taxpayer. Failing that, an "action for failure to fulfill obligation" could be brought by the EU Commission upon request of the taxpayer, before the ECJ with a view to confirming the State's obligation to indemnify.

In the *Köbler* decision of 30 September 2003, the ECJ did indeed decide that

The principle that Member States are obliged to make good damage caused to individuals by infringements of Community law for which they are responsible is also applicable where the alleged infringement stems from a decision of a court adjudicating at last instance where the rule of Community law infringed is intended to confer rights on individuals, the breach is sufficiently serious and there is a direct causal link between that breach and the loss or damage sustained by the injured parties.

It is clear that a remedy could only be found with the ECJ in very exceptional cases through complicated proceedings.

In reality, the only judicial remedy would be to obtain from the higher national court to reconsider its decision in the future and render a decision supposed not to overlap the relevant tax treaty. Obviously, this is always uncertain and the initial taxpayer finds no protection in it.

### **16.2.2. Non-judicial remedies**

Non-judicial remedies can be applied essentially, if not exclusively, by the States and the tax authorities involved in the relevant bilateral treaty. Such remedies pertain principally to the States. If they consider that a court in charge of applying a bilateral treaty proceeded to an override, it is up to them to mutually solve the question.

The first method consists of renegotiating an [amendment] which defines the common interpretation of the treaty and brings to an end the override to which the court of one of the States is responsible.

The case of the Franco-Luxembourg convention was previously noted, which gave rise to contradictory interpretations from the French as well as the Luxembourg Supreme Courts. France and Luxembourg very recently signed an amendment that clarifies (via the addition of several provisions to the Convention) the interpretation to be given to the existing Convention. From now on, immovable capital gains will be taxable whatever the circumstances, in the State where the real estate giving rise to the gain is located, even if they belong to a company and this company has no permanent establishment in that State. This was the interpretation of the Supreme Court of Luxembourg.

Conversely, the second method consists in terminating the tax treaty on the grounds of Art. 60 of the Vienna Convention. The argument could be that the courts of one of the two States do not correctly apply the treaty and that this override constitutes a "material breach" in the meaning of Art. 60, para 3 of the Vienna Convention.

An intermediary method consists in providing an obligation to renegotiate in such circumstances in the tax treaty. It is unclear whether treaties concluded by the US include such a provision. Strictly speaking, the triggering factor in those treaties is a change in the laws relevant to the convention. Should we consider that a judicial decision is in substance tantamount to a law?

The tax authorities, rather than the States themselves, could consider other remedies, such as those detailed below.

They could be unilateral measures. For example, upon request of the taxpayer, the tax administration may recognize the existence of an override by the court that decided the case and decide not to apply the decision.

The tax administration may also change its doctrine, to try to lead the courts to change their position in order to avoid a supposed judiciary override. The French *Conseil d'Etat* decided in the *Natexis* case, of 26 July 2006, that a 1997 administrative ruling on the Franco-Brazilian tax treaty was legal in limiting the right to a matching credit to cases where a Brazilian tax, however minimal, has been withheld. This ruling overturns a previous ruling that gave the opposite interpretation to the Treaty. Retroactively, a decision having applied this earlier ruling would have constituted a judicial treaty override. The confirmation of the legality of the new ruling by the *Conseil d'Etat* brought it to an end.

Bilateral measures may also be taken by the tax authorities of the two States involved, such as a common interpretation of certain treaty provisions. However, these interpretations, likewise administrative rulings, are not opposable in court. This, for example, was the judgment made by the Dutch *Hoge Raad* in a decision of 29 September 1999. A mutual agreement between the Netherlands and Germany on the interpretation of a provision of the Treaty with Germany was not opposable in the Dutch courts, failing official publication in the Treaty Bulletin. The Italian Court of Cassation had previously held in a decision of 24 May 1988 that the minutes of a joint meeting of the competent authorities on the interpretation of the 1958 Franco-Italian tax treaty "were in no way binding on the judges: *'sono de excludarsi i verbali della discussione tenute dalle Commissioni miste per l'interpretazione della convenzioni'*." Eventually, however, the French and Italian authorities decided to drop the case.

### 16.3. Conclusion

To conclude, I would suggest the following:

- first, that a judicial tax treaty override is a very uncertain concept
- second, that the efficiency of the remedies is as uncertain as the concept itself.

Besides those examples provided above, one could cite the Commentary on the OECD Model Convention. It was modified after the 2002 *Philip Morris* decision, supposed to be a treaty override. In a decision of 25 January 2006, the Italian Court of Cassation has confirmed its previous interpretation. This decision is relative to VAT but it would be identical if corporate tax was involved and thus a tax treaty.

This does not mean, however, that the subject is irrelevant. On the contrary, it is far from being uncommon that the suspicion of a deemed judicial override is founded, even if it is in most cases rather subjective. But curing it is difficult. This is not surprising. After all, in our legal system everything ends up in principle with a Supreme Court decision, irrespective of whether it is just or wrong.

## Chapter 17 – Procedural conditions for the implementation of tax treaty obligations under domestic law

### 17.1. Tax treaty law and domestic law

Double taxation conventions are bilateral treaties under public international law. Most of these treaties are drafted along the lines of model conventions developed by international organizations. The most successful model conventions are those prepared by the OECD. Tax treaties that follow these models deal mainly with the allocation of taxing rights. Different types of income and capital are allocated to the Contracting States. One Contracting State is called the residence State, the other the source State. Depending on the type of income or capital the taxing rights are either exclusively allocated to the residence or the source State, or they are split between the two. If the source State may levy taxes, it is up to the residence State to provide for relief from double taxation. The residence State has to either exempt the foreign-sourced income or to credit the foreign tax.

Other tax treaty provisions serve other purposes, of these, the relevance of the non-discrimination clauses of Art. 24 OECD Model Convention should be emphasized. <sup>[2]</sup> Furthermore, Art. 26 OECD Model Convention deals with exchange of information:

The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. <sup>[3]</sup>

However, as Klaus Vogel correctly points out, the rule does not include a directive regarding the manner in which the exchange shall be effected nor is it intended to do so. <sup>[4]</sup> In order to implement these provisions, Member countries have to apply their domestic procedural law.

This conclusion can be drawn in respect to other provisions of the OECD Model Convention as well. However, the "mode of application" of certain articles of the OECD Model Convention is mentioned several times in the Convention: Art. 10 para. 2 and Art. 11 para. 2 can serve as examples. These provisions limit the taxing rights of the source State for dividend and interest income. According to the second sentence of these provisions, the "competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation." These provisions give the impression that the mode of application can only be settled by both States via joint action. However, Contracting States usually decide jointly on fundamental issues such as applying the tax treaty limitation at source or levying the full amount of withholding tax first and granting a refund afterwards. The manner in which these principles are implemented usually depends on domestic law provisions. One reason for these developments is quite often constitutional constraints, since in most countries mutual agreements are not approved by the government and therefore cannot replace a legal basis that has to be provided under domestic law.

Article 27 OECD Model Convention raises similar issues: "The Contracting States shall lend assistance to each other in the collection of revenue claims." Although Art. 27 OECD Model contains a lot of

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<sup>2</sup> See the contributions in Lang, Schuch and Staringer (eds.) *"Die Diskriminierungs-verbote im Recht der Doppelbesteuerungsabkommen"* (2006); Klaus Vogel, *On Double Tax Conventions*, 3rd ed. (1996) Art. 24 m.no. 1 et seq.; Van Raad, *Non-discrimination in international tax law* (1986); Rust, in Voget/Lehner (eds.) *DBA*, 4th ed. (2003) Art. 24 m.no. 1 et seq.; Wassermeyer, in Wassermeyer, Lang and Schuch (eds.) *"Doppelbesteuerung"* (2004) Art. 24 m.no. 1 et seq.

<sup>3</sup> See Hendricks, *Internationale Informationshilfe im Steuerverfahren* (2004) pp. 122 et seq.

<sup>4</sup> Vogel, op. cit. *On Double Tax Conventions*, 3rd ed. (1996) Art. 26 m.no. 33.

detailed provisions, Art. 27 para. 1 last sentence refers to the mutual agreement procedure as well: "The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this article." However, for similar reasons as those mentioned above, the application of domestic law provisions is necessary in order to determine the more detailed implementation of this article.

The only explicit procedural provision contained in the OECD Model Convention is Art. 25:

Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. <sup>[5]</sup>

On the one hand, Art. 25 OECD Model Convention provides for a procedure to ensure the application of a tax treaty. On the other hand, Art. 25 para. 1 of the Convention mentions the phrase "irrespective of the remedies provided by the domestic law of those States". This phrase makes it clear that there is not only still room for the Contracting States to apply their domestic law, but that these tax treaty provisions assume that there are remedies in the domestic law of those States, in order to ensure the proper application of the tax treaty.

Therefore, one has to distinguish between substantive rules and procedural rules; for example, substantive rules about allocation of taxing rights, non-discrimination, exchange of information and collection of revenue claims are part of tax treaty law. However, it is up to the Contracting States to determine the procedural conditions in order to make the tax treaty obligations function in practice. The separation between substantive and procedural rules is also relevant for countries whose treaties under international public law do not have "self-executing" character and therefore cannot be applied directly but have to be implemented by domestic provisions. While Contracting States are obliged to allocate their taxing rights according to the rules provided by the tax treaty, they are nevertheless free to decide upon the manner how they want to achieve that.

However, legal experience in many areas of law shows how closely related substantive and procedural provisions are. Very often it is almost impossible to draw a clear borderline between substance and procedure: <sup>[6]</sup> If someone is entitled to a certain right under substantive law, he can only make use of his right if he fulfils the criteria under procedural law to do so. If there is no, or not sufficient, legal protection, entitlement to a right is completely meaningless.

It is quite easy to provide examples of such situations in the tax treaty area: If a country requires a resident of a Contracting State to show a certificate of residence, and this taxpayer is not able to produce such a form because the tax authorities of the residence State refuse to grant such a certificate, the withholding tax reduction the taxpayer is entitled to under the tax treaty in the source State is completely worthless. <sup>[7]</sup>

## 17.2. EC law and domestic law

The problems just described are not unique. They arise very often when States are bound by obligations under international public law or supranational law to grant certain rights to their citizens, residents or other individuals or entities, and when, at the same time, it is up to these States to determine the procedure under which these rights are granted to the individuals or entities. A well-known example of such a situation is EC law. The EC Treaty and EC secondary law impose numerous obligations on

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<sup>5</sup> See the reports in Lang and Züger (eds.) *Settlement of Disputes in Tax Treaty Law* (2002).

<sup>6</sup> Schuch and Stieglitz, "DBA- und EU-Diskriminierungsverbote und Verfahrensrecht", in Lang, Schuch and Staringer (eds.), op. cit. *Die Diskriminierungsverbote im Recht der Doppelbesteuerungsabkommen* (2006) p. 407 (pp. 409 et seq.).

<sup>7</sup> Lang, "General Report", in IFA (ed.) *Double Non-Taxation*, CDFI 89a (2004) p. 73 (pp. 90 et seq.).

the Member States. Member States have to grant certain rights to individuals. However, most EC law provisions do not contain any procedural provisions. Therefore, it is up to the Member States how they want to implement these obligations.

The ECJ started to deal with this problem in 1976. <sup>[8]</sup> Since then, there is well-established ECJ case law, which had been described by the court in the following way:

This diversity between national systems derives mainly from the lack of Community rules on the refund of national charges levied though not due. In such circumstances, it is for the domestic legal system of each Member State to designate the courts and tribunals having jurisdiction and to lay down the detailed procedural rules governing actions for safeguarding rights which individuals derive from Community law, provided, first, that such rules are not less favourable than those governing similar domestic actions (principle of equivalence) and, second, that they do not render virtually impossible or excessively difficult the exercise of rights conferred by Community law (principle of effectiveness) (see, in particular, Case [C-231/96 Edis](#) [1998] ECR I-4951, paragraph 34). <sup>[9]</sup>

This case law has its origin in *Rewe Zentralfinanz* <sup>[10]</sup> and *Comet*. <sup>[11]</sup> The reasoning of the Court, which has been repeated since, <sup>[12]</sup> is rather short:

The prohibition laid down in article 13 of the treaty and that laid down in article 13 of regulation no 159/66/eec have a direct effect and confer on citizens rights which the national courts are required to protect. Applying the principle of cooperation laid down in article 5 of the treaty, it is the national courts which are entrusted with ensuring the legal protection which citizens derive from the direct effect of the provisions of community law. Accordingly, in the absence of community rules on this subject, it is for the domestic legal system of each member state to designate the courts having jurisdiction and to determine the procedural conditions governing actions at law intended to ensure the protection of the rights which citizens have from the direct effect of community law, it being understood that such conditions cannot be less favourable than those relating to similar actions of a domestic nature. Where necessary, articles 100 to 102 and 235 of the treaty enable appropriate measures to be taken to remedy differences between the provisions laid down by law, regulation or administrative action in member states if they are likely to distort or harm the functioning of the common market. In the absence of such measures of harmonization the right conferred by community law must be exercised before the national courts in accordance with the conditions laid down by national rules. The position would be different only if the conditions and time-limits made it impossible in practice to exercise the rights which the national courts are obliged to protect. This is not the case where reasonable periods of limitation of actions are fixed. The laying down of such

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<sup>8</sup> ECJ 16 December 1976, 33/76, *Rewe-Zentralfinanz eG et Rewe-Zentral AG v. Landwirtschaftskammer für das Saarland* [1976] ECR 01989. ECJ 16 December 1976, 45/76, *Comet BV v Produktschap voor Siergewassen* [1976] ECR 02043.

<sup>9</sup> ECJ 10 July 1980, 826/79, *Amministrazione delle finanze dello Stato v Sas Mediterranea importazione, rappresentanze, esportazione, commercio (MIRECO)* [1980] ECR 02559, para. 4; ECJ 10 July 1980, 811/79, *Amministrazione delle finanze dello Stato v Ariete SpA* [1980] ECR 02545, para. 4; ECJ 27 March 1980, 61/79, *Amministrazione delle finanze dello Stato v Denavit italiana Srl* [1980] ECR 01205, para. 25; ECJ 9 November 1983, 199/82, *Amministrazione delle Finanze dello Stato v SpA San Giorgio* [1983] ECR 03595, para. 12; ECJ 15 September 1998, [C-260/96, Ministero delle Finanze v Spac SpA](#) [1998] ECR I-04997, para. 18; ECJ 15 September 1998, [C-231/96, Edilizia Industriale Siderurgica Srl \(Edis\) v Ministero delle Finanze](#) [1998] ECR I-04951, para. 34; ECJ 17 November 1998, [C-228/96, Aprile Srl, in liquidation, v Amministrazione delle Finanze dello Stato](#) [1998] ECR I-07141, para. 18; ECJ 9 February 1999, [C-343/96, Dilexport Srl v Amministrazione delle Finanze dello Stato](#) [1999] ECR I-00579, para. 25; ECJ 7 December 2000, [C-482/98, Italy v Commission](#), [2000] ECRI-10861, para. 33; ECJ 11 November 2002, [C-62/00, Marks & Spencer plc v Commissioners of Customs & Excise](#) [2002] ECR I-06325, para. 34; ECJ 6 October 2005, [C-291/03, My Travel plc v Commissioners of Customs & Excise](#), para. 17. ECJ 2 October 2003, [C-147/01, Weber's Wine World Handels-GmbH, Ernestine Rathgeber, Karl Schlosser, Beta-Leasing GmbH v Abgabenberufungskommission Wien](#) [2003] ECR I-11365, para. 103; ECJ 17 June 2004, [C-30/02, Recheio - Cash & Carry SA and Fazenda Publica/Registo Nacional de Pessoas Colectivas](#) [2004] ECR I-06051, para. 17.

<sup>10</sup> ECJ 16 December 1976, *Rewe-Zentralfinanz eG et Rewe-Zentral AG v. Landwirtschaftskammer für das Saarland*, 33/76, para. 5.

<sup>11</sup> ECJ 16 December 1976, 45/76, *Comet BV v Produktschap voor Siergewassen* [1976] ECR 02043, paras. 11 et seq.

<sup>12</sup> ECJ 27 March 1980, *Amministrazione delle finanze dello Stato v Denavit italiana Srl*, 61/79, para. 25; ECJ 10 July 1980, 826/79, *Amministrazione delle finanze dello Stato v Sas Mediterranea importazione, rappresentanze, esportazione, commercio (MIRECO)* [1980] ECR 02559, para. 13; ECJ 10 July 1980, 811/79, *Amministrazione delle finanze dello Stato v Ariete SpA* [1980] ECR 02545, para. 12.

time-limits with regard to actions of a fiscal nature is an application of the fundamental principle of legal certainty protecting both the taxpayer and the administration concerned.

The ECJ did not seem to be much concerned about the legal basis for this judgment. The only provision of the EC Treaty it referred to is today's Art. 10 EC, at that time Art. 5. This provision is very general:

Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks. They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty.

Article 10 EC Treaty summarizes what is self-evident: It is clear that a State (as it would be true for any individual in the case of a civil law contract that is a party to a treaty is obliged to take all appropriate measures to ensure fulfilment of the obligations arising out of this Treaty. Thus, it is no coincidence that Art. 10 EC serves as a provision to which the ECJ refers when the Court develops principles it cannot derive from any other provision of the Treaty. <sup>[13]</sup> Other examples of case law the Court has developed by referring to Art. 10 EC are the judgments on state liability <sup>[14]</sup> and on granting interim relief. <sup>[15]</sup> Article 10 EC therefore is considered to have a kind of supplementary effect: <sup>[16]</sup> Here the true legal basis for such case law is the EC Treaty as a whole and its object and purpose, which requires "effet utile".

Authors have convincingly pointed out that Art. 10 EC is an expression of the principle "pacta sunt servanda", <sup>[17]</sup> which is well established in international public law and explicitly mentioned in Art. 26 of the Vienna Convention on the Law of Treaties (VCLT): "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." Although courts tend to refer to Art. 26 VCLT quite often, the influence of this provision on the outcome of court decisions or - more generally - on the content of treaty obligations is slight. If Art. 26 VCLT had not been included in the Vienna Convention of the Law of Treaties, treaties under international law would probably not be interpreted differently. It is quite evident that a State that has concluded an agreement with another State and thus has accepted obligations, must fulfil these obligations. Art. 26 VCLT is not needed in order to ensure this. There are good reasons to believe that similar considerations apply for Art. 10 EC Treaty.

Having accepted this premise, one has to conclude that the reason why the ECJ developed its case law on the principles of equivalence and effectiveness is not the specific wording of Art. 10 EC, but the idea that Member States should not be able to excuse themselves from their EC law obligations by introducing domestic procedural provisions that limit the entitlement to the rights conferred by EC law to taxpayers. The ECJ refrained from focussing on subjective criteria. It is wise that the ECJ does not examine whether the intention of the Member State was to limit access to the EC Treaty when its legislature introduced a certain procedural provision. Such criteria are always unsatisfactory. Like taxpayers who have to prove that they did not have the intention of circumventing a certain tax obligation, Member States would always try to hide their true intentions and their success would depend on the quality of their "cover-up".

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<sup>13</sup> Kahl, in Callies and Ruffert (eds.) *Kommentar zum EU-Vertrag und EG-Vertrag*, 2nd ed. (2002) Art. 10 m.no. 15 attributes a loophole-closing function to Art 10.  
<sup>14</sup> ECJ 19.11.1991, C-6/90 and C-9/90, *Francovich and Bonifaci / Italy* [1991] ECR I-5357, para. 35; ECJ 5 March 1996, C-46/93, *Brasserie du Pêcheur SA v Bundesrepublik Deutschland* and *The Queen v Secretary of State for Transport, ex parte: Factortame Ltd and others* [1996] ECR I-1029, para. 31; ECJ 26 March 1996, C-5/94, *The Queen v H. M. Treasury, ex parte British Telecommunications plc.* [1996] ECR I-1631, para. 38; ECJ 23 May 1996, C-5/94, *The Queen v Ministry of Agriculture, Fisheries and Food, ex parte: Hedley Lomas (Ireland) Ltd.* [1996] ECR I-02553, para. 24; ECJ 8 October 1996, C-178/94, *Erich Dillenkofer, Christian Erdmann, Hans-Jürgen Schulte, Anke Heuer, Werner, Ursula and Trosten Knor v Bundesrepublik Deutschland* [1996] ECR I-4845, para. 20; ECJ 10 July 1997, C-261/95, *Rosalba Palmisani v Istituto nazionale delta previdenza sociale (INPS)* [1997] ECR I-4025, para. 24.  
<sup>15</sup> ECJ 19 June 1990, C-213/89, *The Queen/Secretary of State for Transport, ex parte Factortame* [1990] ECR I-2433, para. 21.  
<sup>16</sup> Ehrke-Rabel, *Gemeinschaftsrecht und österreichisches Abgabenverfahren* (2006) p. 68. On these lines, Bogdandy, in Grabitz and Hilf (eds.) *Das Recht der Europäischen Union* (2005) Art 10 m.no. 11 et seq.  
<sup>17</sup> Althuber, "Gemeinschaftsrechtliche Anforderungen an das nationale Abgabenverfahrensrecht", in Althuber and Toifl (eds.) *Rückforderung rechtswidrig erhobener Abgaben* (2005) p. 37 (pp. 38 et seq.). On these lines, Fischer, Köck and Karollus (eds.) *Europarecht*, 4th ed., para. 1490; Kahl, op. cit., Art. 10 m.no. 3.

Once one looks for objective criteria to determine the amount of room a Member State has in which to manoeuvre it is quite obvious to require that "the procedural conditions governing actions at law intended to ensure the protection of the rights which citizens have from the direct effect of community law, [...] cannot be less favourable than those relating to similar actions of a domestic nature". However, a Member State can still try to avoid granting rights conferred to its citizens under EC law by imposing restrictive procedural conditions on "actions of a domestic nature" as well. From this point of view it is understandable to require in addition that "the conditions and time limits" must not make "it impossible in practice to exercise the rights which the national courts are obliged to protect." If one has to accept that Community law does not contain procedural provisions and that it is therefore up to the Member States "to determine the procedural conditions governing actions at law intended to ensure the protection of the rights which citizens have from the direct effect of community law", it is convincing to require that these domestic provisions are both effective and equivalent to "actions of a domestic nature".

### 17.3. Consequences for tax treaty law

EC law and tax treaty law are to a certain extent comparable. Of course, the EC has emerged as a supranational institution and the EC Treaty is considered to be a legal instrument on its own. However, the EC Treaty is still a public law treaty as well. Furthermore, the situation is quite similar in other respects. Neither the EC Treaty nor tax treaties provide for detailed procedural provisions. The EC Treaty leaves it to the Member States, and tax treaties to the Contracting States to determine the procedural conditions under which the rights conferred on citizens or taxpayers under these rules may be exercised. Both Member States and Contracting States may feel tempted to determine these conditions in a very restrictive way if they are no longer interested in granting the rights they originally agreed to grant to citizens or taxpayers when they concluded the EC Treaty or a tax treaty. If it were impossible to derive any principles from the EC Treaty and the tax treaties which have to be followed by States when they determine the procedural provisions, both the obligations under the EC Treaty and the obligations under bilateral treaties would be meaningless: If States were not limited at all in this respect, the application of EC law or tax treaty law would ultimately be voluntary on the side of the States. Thus, if one accepts the competence of the States to determine the procedural conditions and at the same time seeks to avoid that fulfilment of treaty law obligations becomes completely voluntary for the States, it is not surprising to arrive at similar results as the ECJ did: To require that the principles of equivalence and effectiveness are followed by domestic legislators and administrative authorities is quite convincing, especially if one takes into account that the idea of "effet utile" plays an important role in international public law.

Of course, one could argue that Art. 10 EC provides a legal basis for the case law developed by the ECJ, while there seems to be no legal basis in tax treaty law to derive these principles from the OECD Model Convention and from those tax treaties drafted along the lines of the OECD Model. However, two responses can be given: Firstly, the phrase "irrespective of the remedies provided by the domestic law of those States" in Art. 25 para. 1 OECD Model Convention seems to imply that "remedies provided by the domestic law" exist and that they are relevant for the application of tax treaties. The term "remedies" is not defined and has therefore to be interpreted in the light of the context in which it is used. [18] It is not impossible to assume that the standard of legal protection is relevant which had been developed in the Contracting State for similar actions of domestic nature, and that the term "remedies" has to be understood in such a way that these remedies, and the system of legal protection as a whole, are effective. One cannot assume that the drafters of the OECD Model Convention had remedies in mind which were not effective. Secondly, one may question whether Art. 10 EC is the true real basis for this case law of the ECJ, as has been pointed out already. There are good reasons to believe that the legal basis for the ECJ case law on equivalence and effectiveness is the object and purpose of the EC Treaty

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18 For the autonomous interpretation of tax treaties, which is supported by Art. 3 para. 2 OECD Model Convention, see Lang, "Die Bedeutung des originär innerstaatlichen Rechts für die Auslegung von Doppelbesteuerungsabkommen (Art 3 Abs 2 OECD-Musterabkommen)" in Burmester-Endres (Hrsg) *Außensteuerrecht, Doppelbesteuerungsabkommen und EU-Recht im Spannungsverhältnis*, FS für Helmut Debatin (1997), p. 283 (pp. 283 et seq.).

as a whole. If one goes this far, one could argue as well that the legal basis for the application on these criteria in the context of tax treaty law is also the OECD Model Convention and the bilateral treaties following the Model as a whole.

#### 17.4. Practical consequences

If one accepts the criteria of equivalence and effectiveness as limitations for the domestic legislator in determining procedural conditions for the entitlement of tax treaty benefits, it is, of course, not clear in all situations what consequences this may have. Quite often the treaty context is unique and not completely comparable to a purely domestic context: For example, it is difficult to compare the situation in which a withholding tax, on the one hand, has to be levied under domestic law and, on the other hand, is reduced under a tax treaty, to a purely domestic situation in which a withholding tax has to be levied, without any reduction. What is the equivalent domestic situation here? Is it possible to derive from this comparison that the withholding tax reduction provided by the tax treaty has to be applied at source and the system of "retain and refund" is in conflict with tax treaty law? I have my doubts as to whether one can go that far.

However, if the general domestic rule for asking for a refund of a tax that had been levied unlawfully provides for a five-year period, while the domestic rules providing for a refund of the amount of withholding tax, which had been levied despite a withholding tax reduction under a treaty, allow that refund only within three years, the conflict with treaty law is obvious. <sup>[19]</sup> There is no reason to impose more restrictive conditions on taxpayers who want to exercise their rights under a tax treaty than on taxpayers who are in similar domestic situation. However, if the tax treaty itself provides for a shorter period for refund, no objections can be raised. In such a case the specific tax treaty rule takes precedence over the general principles. These principles have to be applied in the absence of specific procedural provisions contained in a treaty.

Another issue is the question which party has to provide evidence. In many countries, it is up to the tax authorities to establish the facts. However, in a tax treaty context tax authorities tend to assume that the burden of proof shifts to the taxpayer. The burden is upon the taxpayer to provide evidence. Applying the principle of equivalence, one may ask whether it is in line with tax treaties to impose more restrictive conditions upon taxpayers who want to get tax treaty entitlement compared to taxpayers in a domestic situation. However, the question arises whether the tax treaty situation and the domestic situation is really comparable as far as the burden of proof is concerned. One could distinguish between tax treaty situations that enable tax authorities to ask the tax authorities of the other Contracting State for their support in establishing the facts and other tax treaty situations where tax authorities do not have these opportunities. A situation where the tax authorities are neither in a position to establish the facts themselves, because they cannot operate abroad, nor to get support from their counterparts in the other Contracting State, could be considered as not comparable. This example shows that similar arguments could be raised as are already familiar from discussions in the EC law context.

The principle of effectiveness may play a role as well. In practice, the requirement of having to show a certificate of residence to the tax authorities of the source State in order to obtain entitlement to treaty benefits in the source State quite often prevents taxpayers from exercising the rights which are conferred to them under a tax treaty. If the tax authorities of the residence State refuse to issue such a certificate, the taxpayer does not have any access to the treaty. Therefore, one has to require that the tax authorities of the source State accept alternative evidence as well in order to get treaty entitlement. Otherwise, procedural conditions are too restrictive so that they are not in line with the effectiveness principle. <sup>[20]</sup>

Lastly, I address the issue of how to solve a situation if a domestic provision, which is applicable for tax treaty situations, is in conflict with the above-mentioned principles. Unlike EC law, tax treaties do not

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<sup>19</sup> Lang, op. cit., "General Report", p. 73 (pp. 116 et seq.).

<sup>20</sup> For a similar reasoning see *Conseil d'Etat*, 17 June 1987, No. 64549, *Droit Fiscal* 1987, No. 46, COM 2076, p. 1268, concl. Martin Laprade, which pointed out that the tax authorities may not deprive international tax treaties of their legal effect by setting up formalities that are not required by the treaty itself.

always have the power to override conflicting domestic provisions. On the contrary, the answer to this question depends on the specific constitutional issues in a Contracting State. From empirical evidence we know that in most countries there is no general precedence of tax treaty over domestic law. <sup>[21]</sup> In these States it is possible for the domestic legislator to set aside an obligation the State has agreed under a tax treaty. If this is the case, such a situation may arise in the context of procedural issues as well. There is no difference with any other treaty override: On the one hand, States may infringe the obligations they have accepted when they concluded a tax treaty by introducing conflicting domestic law, on the other hand it is part of a systematic interpretation to try to avoid results that constitute a breach of international law obligations.

Thus, if there is no clear evidence to the contrary, one should assume that a domestic legislator did not intend to override a treaty obligation. Even if the intention is clear, there is still the question whether this attempt is successful, since the intention of the legislator is only one aspect that has to be taken into account in the interpretation process. However, nothing distinguishes such a situation from other attempts to override treaty obligations.

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<sup>21</sup> See the national reports in Lang (ed.) *Tax Treaty Interpretation* (2001).

## Chapter 18 – Conclusions

[*Ed. note:* Following a panel discussion chaired by Prof. Fantozzi and comprising John Avery Jones, Michael Lang, Jean Pierre Le Gall, Philippe Martin and Jacques Sasseville, Prof. Fantozzi closed the seminar by summarizing the day's discussions and presenting his conclusions.]

### 18.1. Introduction

This is the third time we meet in Milan to discuss important issues arising in the field of international law and EC law, and involving tax matters.

This is, also, the third time I have been assigned the honour and duty to conclude the seminar, distilling the elements emerging from the high-level speeches heard during the day. Today, I will try to approach my task differently than I have done in the last two seminars, where, starting from the interesting findings of the panellists, I took a wide-angle view to draw "conclusions" intended in their proper linguistic sense of final settlement, which concludes a reasoning. By contrast, what I will try to do here is to change my conclusions into a proposal - a starting point for the future.

This choice is due to the fact that the approach I took in previous seminars would lead to a mere redundancy of the conclusions raised by the panellists and a simple enumeration of the main features of the cases illustrated by the national reporters and by the panellists today in their reports.

### 18.2. Main arguments of the seminar

Actually, if I decided to adopt the former approach, to sum up the main issues related to the courts decisions on tax treaty law, I would single out three main arguments:

1. rules governing tax litigation;
2. means of interpretation to be used by judges; and
3. unorthodox decisions, their consequences and possible remedies.

#### 18.2.1. Rules governing tax litigation

The analysis of the first argument would conduct me, from a domestic point of view, to give an overview of the differences and similarities between the tax law procedures of common law countries and those of civil law countries, and to the analysis of every rule in the light of the fair trial.

From the EC point of view, on the one hand, I would focus on the activity of remittance of national cases to the European Court of Justice under Art. 234 EC Treaty. In such a case, the analysis would have been focused on the direct application of Community law by national courts in tax treaty cases due to the lack of uncertainty. I refer to the *acte éclairé* principle and to that of *acte clair*.

On the other hand, I would draw my conclusions by speaking about the preliminary ruling procedure of the ECJ and by focusing, in particular, on the respect of the procedural rules by governments, In such a context, it would be interesting to deeply study the well-known *Irap* case. <sup>[2]</sup> But this would deviate from my aim.

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<sup>2</sup> ECJ, 3 October 2006, *Irap*, C-475/03.

### **18.2.2. Means of interpretation to be used by judges**

Moreover, if I left my conclusions as conclusions and not as a starting point, I would approach the second argument (i.e. means of interpretation to be used by judges) trying to set the boundaries of the interpretation of tax treaties given by the courts under both a theoretical and a practical point of view.

This would imply, first of all, the repetition of the principle that customary law, as codified in Arts. 31 to 33 of the 1969 Vienna Convention on the law of treaties, provides judges with the means for interpreting treaties (including tax treaties). Furthermore, from a practical ground, setting the borders of courts' interpretation would entail, also, the examination of the different judgments issued by both domestic and EC courts to verify the effective application of such interpretative means.

Secondly, I would shift the attention to the issues related to the conflicts of qualification and to the interpretation of domestic legislation done by courts according to treaty articles patterned on Art. 3(2) of the OECD Model.

Moreover, in the context of the approach I used in the last two seminars, another object of investigation would be given by the consideration that domestic courts have of foreign court decisions and foreign tax practice.

Lastly, my conclusions could not leave aside the interpretative value of the OECD Commentaries.

You can easily see that, had I chosen this approach, my conclusions would have been a mere repetition of what the national reporters and the panellists have already analysed exhaustively.

### **18.2.3. Unorthodox judgments, their consequences and the possible remedies**

Passing to the third argument of the issues related to court decisions - the study of unorthodox judgments, their consequences and the possible remedies - is the subject which cues my proposal. In this regard, being coherent with my today's aim, I will not focus my attention on the concept of judicial override, which I discussed at last year's seminar, when I expressed my doubts on such a concept according to the fact that it derives from an arbitrary interpretative evaluation.

I will not answer, thus, to the questions I raised last year, when I affirmed that dealing with judicial override implies the identification of

- a) who is in charge to determine that a particular judgement generates a treaty override? and
- b) when should such a determination be performed?

In particular, with reference to this moment, I asked the question: Can a single judgement be considered by the international community as a judicial override? Or shall the international community wait and see if the judicial position consolidates before attacking the conclusions reached by the national court?

My conclusions - sorry, my starting point for the future - leaves aside all the arguments discussed today, which have been deeply and completely analysed by the national reporters and by the panellists. My proposal is to answer to the question: How can the international community avoid judicial errors? Or better yet: How can courts avoid unorthodox judgments?

In other words, my purpose should not be searched in summing up the judicial, legislative or administrative remedies that can be performed after a judgment is considered unorthodox, but my aim is to find a technical system to stay away from unorthodox judgments or to avoid contradictory interpretations from the highest courts of the States involved in a treaty case. This is, in short, according to the well-known principle that "prevention is better than cure".

## **18.3. Coordination as solution to unorthodox interpretations**

In this context, I do believe that the answer must be found in coordination. A few years ago Professor Van Raad proposed that

... [a] panel of independent tax treaty experts be established to submit upon the request of courts and competent authorities (and perhaps, also, at a later stage, of taxpayers and tax authorities) an opinion on the interpretation of a given treaty provision and its application to the case under consideration. [3]

I think it useful to bring back in the taxation arena the proposal of Van Raad and try to develop it further, distinguishing between coordination of courts dealing with tax treaty cases involving the application of EC law and coordination related to cases not involving Community issues.

### 18.3.1. Coordination for tax treaty cases involving the application of EC law

As for the first cases, I merely limit my intervention reminding that, in 2001, the Commission of the European Community proposed to develop guidance on important ECJ rulings and to coordinate, via appropriate communications from the Commission, the implementation of said rulings. [4]

In my view, the action of the Commission should involve the ECJ judges and the national courts, obviously, at their highest level.

### 18.3.2. Coordination for tax treaty cases not involving the application of EC law

On the other hand, the coordination of courts dealing with tax treaty cases not involving the application of EC law has to be implemented *ex novo*.

The first step is to identify the subjects to be involved. In my view, there would not be an efficient coordination without the involvement of the judges themselves. We do not need new sources of interpretation coming from an independent body. What we, indeed, need is an official involvement of the highest courts. We need an environment where judges from different countries exchange their technicalities and take key decisions that constitute, at least, a moral obligation vis-à-vis the counterparts of a trial: tax payers and tax authorities.

The second step is to identify at what level the coordination activity should operate. In my view, the coordination must be performed at two levels. The first one should involve as many national courts as possible. The second level should involve the national courts of the States interested by a specific tax treaty case, even if the case is pending under just one of the courts.

The outcomes from the first level of coordination should be used as guidelines in interpreting tax treaties. The second level should resolve specific issues raised under national courts in interpreting tax treaties rather than creating "contradictory interpretations" generating double taxation or double non-taxation.

Once we have determined the subjects involved and the levels of coordination, we need to identify the organization which should be involved in the coordination activity of first level.

A few years ago I would have replied without any doubt: the OECD. Nowadays I am a little bit doubtful about its involvement. During last year's seminar I touched upon the issue of the decreasing value of the Commentaries due to their continuous modification and to the fact that, if someone wanted to think badly, the rationale of some modification occurred in 2003 and 2005 could be found in a reaction of the OECD to the French judgment on compatibility of the CFC legislation with tax treaties [5] and to the Italian judgment on the "multiple permanent establishment". [6]

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3 Van Raad, K., "International Coordination of Tax Treaty Interpretation and Application", *Intertax* (2001), p. 212 and "Interpretation and Application of Tax Treaties by Tax Courts", *European Taxation* (1996), p. 3.  
4 See the communication from the Commission to the Council, the European Parliament and the Economic and Social Committee "Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities", COM (2001) 582 final, 23 October 2001.  
5 *Conseil d'Etat*, 28 June 2002, *Société Schneider Electric* case.  
6 Cass. 7 March 2002, Nos. 3367 and 3368; 25 May 2002, No. 7682 and 6 December 2002, No. 17373.

My concern about the involvement of the OECD in the coordination activity increases when I look at the consequences in Italy of the 2005 update of the Commentaries. I refer, first of all, to the Italian observation to the Commentary to Art. 5, which reads

Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases failing in the above paragraph.

Secondly, attention is drawn to the recent case regarding the notion of PE for VAT purposes of the *Corte di Cassazione*, [\[7\]](#) which states that the OECD Commentaries do not have any binding force and that the 2005 update does not have any relevance with regards to the case, due to the mentioned Italian reservation to Art. 5.

This being said, I would suggest perhaps the involvement of the United Nations as host organization and I would suggest the procedure adopted by the International Law Commission as the procedure for the coordination activity of first level.

As to the second level of coordination, I would suggest setting up tax-clearing houses, where national courts meet to solve contradictory interpretations or conflicts of qualification. The clearing-house approach, however, could be institutionalized through an apposite article in tax treaties.

Until next year

In closing, like every year, I would like to thank Professor Guglielmo Maisto, who gave us an Italian yearly occasion to discuss interesting subjects, and my thanks to all of you for coming to Milan and for your participation in our seminar.