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"*Tax treaty overrides: tension between Paraguayan Constitutional Law and the Vienna Convention on the Law of Treaties. An economic and legal analysis of the feasibility of implementing Double Taxation Treaties with uncertain reciprocity*"

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Introduction

Entering into bilateral Double Taxation Conventions (DTC) promotes crossborder movement of people and capital and reduces the harmful effects of double taxation and double non-taxation over the flows of Foreign Direct Investment (FDI) to developing countries. As other international conventions between two (or more) states, DTC relies on reciprocity. However, this principle is not usually anchored in the Constitutions of treaty partners as it is in Paraguay, where reciprocity is expressly required for the validity and existence of DTC. Therefore, a problem would arise if Paraguay enters into a DTC with a potential tax treaty-overriding partner. Treaty overrides are unilateral nullifications of treaty clauses through subsequent domestic legislation. Through the eyes of the Paraguayan Constitution ("*Constitución de la República*" or "CR"), this would imply direct and unconditional termination by the Paraguayan side. However, is this solution the best legal alternative? Is it economically effective for the involved parties? Are there other possibly milder solutions? Foreign and national investors often model their long-term international business and investment plans based on the legal certainty that the recipient country's overall legal system offer, including investment protection laws and double taxation treaties. Therefore, the decision to retaliate a treaty override with direct termination could entail severe economic consequences for foreign investors.

As opposed to unconditional termination, the Vienna Convention of the Law of Treaties (VCLT) allows a more tempered alternative when international agreements are breached. Additionally, the field of Law and Economics, as an undisputable tool for the scrutinity of the effectiveness of private transactions between particulars, offers another dimension to the purely legal discussion: the economic costs of unconditional termination and its effectiveness compared to treaty continuation when overrides occur.

This paper will examine the perspective that Law and Economics offer to International Tax Law and Constitutional Law for analyzing which legal solution could be more efficient when the expansion of Paraguay's DTC network includes negotiating or even entering into double tax agreements with possible tax treaty overriders. The normative strain of terminating the DTC without further discussion, or finding gentler solutions will be discussed under the light of the economic effectiveness, in order to find the most amicably resolution for the involved parties.

A. First Chapter: Cross-border investments and tax treaty overrides

The Republic of Paraguay finds itself amidst a progressional industrialization of its economy. Although this process already started a few years ago, there is still a long path ahead for reaching regional standards.[1] For this purpose, national and foreign investors require a solid legal framework and investment-friendly policies based on the rule of law. Among the manifold alternatives to facilitate and attract FDI[2], developing countries and emerging markets have profited from the legal and economic advantages of putting into effect DTC with more developed economies and regional partners[3].

The implementation of these instruments allows the avoidance of international double taxation as well as international double *non*-taxation. Furthermore, it also causes a spillover effect of FDI internally.[4] This section is intended to provide with a general overview of both legal and economic advantages of enhancing Paraguay's DTC network in the current socioeconomic climate, in order to display the growth possibilities that DTC provide for investors and treaty partners.

I. Fostering FDI through DTC: Economic overview

1. A brief comment on the fundaments of DTC and the Model Conventions

The globalization of the economy implies dynamic crossborder activities along

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[1] As mentioned by *David*, A. and *Roldos*, J. on their article for the World Economic Forum dated December 2016 (last access: April 19, 2018): https://www.weforum.org/es/agenda/2016/12/paraguay-enfrenta-un-deficit-de-infraestructura. A comprehensive analysis of Paraguay's infrastructure problems and challenges are also exposed in *Ferrario*, C., Country studies of tax systems and tax reforms in Latin America, in: *Barreix* et al [Ed.], Tax in LatAm, pp. 268, 279.

[2] Foreign Direct Investment, understood as "*ownership of assets in one country by foreign residents for purposes of controlling the use of those assets*". Refer to *Margalioth,* Tax system to promote Developing Countries, Va. Tax Rev. 2003-2004, p. 168.

[3] Regional measures to avoid international double taxation have been put in place not only by the leading authorities on the matter (OECD and UN) but also by regional multilateral organs. As way of example, we can cite: 1) Decision Nº 578 of the Andean Community (also known as the Andean Model Convention); 2) The Southern African Development Community Model Convention (see: *Pickering*, Tax Treaty Policy Framework, UN Papers 2013, p. 4); and 3) The Association of Southeast Asian Nations (ASEAN) Model Convention. For an extensive explanation of regional MC refer to *Valta*, Intl. StR, pp. 351-360 and 609. For the purposes of this work, none of the Model Conventions drafted by individual countries are being considered (e.g. the US-MC; or the German *Verhandlungsgrundlage* or "negotiation basis").

[4] The scope of this paper is limited to FDI exclusively, instead of Portfolio investments. See *Menck*, Direktinvestitionen in Entwicklungsländern, HWWA-Report Nr. 183 (1998), p. 13.

with continuous movement of capital and people throughout different locations and jurisdictions. One of the main driving forces of these internationalized businesses is the generation of incomes and value-added in new markets, maximizing local benefits and incentives and minimizing costs. Tax authorities, eager to collect part of the revenue of said activities, do not overlook these circumstances. However, a problem arises when different jurisdictions exercise their taxing rights (and duties) in an uncoordinated[5] manner and over the same activity and/or taxpayer.

Hence, incomes are usually subject to equivalent taxes both at the source state, where the economic activity takes place and at the residence state of the taxpayer, where he is also considered a resident according to his domestic tax rules. Therefore, different tax administrations apply different income tax laws over identical income and taxpayer during the same period.[6] This duplicated exercise of tax powers gives rise to international economic double taxation, and when it affects the same taxpayer, juridical double taxation.[7]

In response to this phenomenom, a great number of States conclude bilateral DTC in order to equally and fairly distribute their taxing rights arising from crossborder operations. This leads to avoid collisions from the tax powers of different States, which look forward to taxing the same object or subject matter.[8] In this sense, the Organization for Economic Cooperation and Development (OECD) historically took a leading role[9] in drafting Model Conventions (MC) of DTC, which serve as negotiation basis for these kind of treaties, along with profuse *soft law*[10] embodied as Commentaries to the Model Conventions, the Action Plan for fighting the Base Erotion and Profit Shifting (BEPS) phanomenom along with the G20 and other multilateral instruments[11] in the field of Tax Law.

Later on, the UN also drafted a MC aimed at protecting the economic interests

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[5] *De Pietro*, Tax Treaty Override and Need for Coordination, WTJ 2015, p. 77.
[6] Hence limiting the analysis to *juridical* double taxation. The OECD's Committee on Tax Affairs defined juridical double taxation as "*the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods*". OECD (2015), Model Tax Convention on Income and on Capital 2014 (Full version), OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264239081-en.
[7] Further to international doublé taxation: *Brähler*, Intl. StR, p. 20 ff.
[8] *Krapp*, De iuris interp., p. 126.
[9] Including non-OECD Member States.
[10] Due to the lack of *opinio juris*. See *Stein/v. Buttlar/Kotzur,* VölkerR, Rn. 129.
[11] Like the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI) or the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*. For the importance of international exchange of tax information, see *Vermeend/van der Ploeg/Timmer*, Taxes & Economy, p. 291.

from less developed countries (LDC), due to preferential allocation of certain taxing rights in the source State (usually LDC) rather than in the residence State,[12] and thus leaving a major tax substrate in source States.[13] And as previously quoted, the delegation of this substrate should likely happen through bilateral measures rather than unilateral measures, because otherwise developing countries would have to rely on their richer peers' good will to enact legislation encouraging outbound investment without having active participation in this process.[14] This could lead to a loss of tax revenue where it is needed the most. Since P. Musgrave's stated the theory of *inter-nation equity*, the task of allocating taxing rights within international tax law has become a fairness dilemma when developing countries or LDC are involved.[15]

2. Paraguay's DTC network

a. The present…

Paraguay's concurrence in the international tax arena went almost unnoticed until the country joined the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes[16] and the framework to implement the OECD/G20's BEPS project in 2016 to combat multinational tax avoidance[17] and has been a Member of the OECD's Development Centre since February 2017.[18] Most recently, Paraguay signed on 29 May 2018 the amended version of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters[19], in order to boost fiscal transparency and

[12] *Daurer*, Tax Treaties, p. 23.
[13] *Valta,* Intl. StR, p. 142.
[14] *Vann*, Richard J., International Aspects of Income Tax, in: *Thuronyi* [Ed.], Tax Law D&D, p. 736.
[15] "*The claim of source countries to tax income produced within their borders is analogous to a nation's long-recognized claim of sovereignty over natural resources within its boundaries.*" *Graetz*, Taxing International Income, Tax Law Review 2001, p. 297 f.
[16] See http://www.oecd.org/ctp/paraguay-joins-the-global-forum-on-transparency-and-exchange-of-information-for-tax-purposes.htm (last access: May 23, 2018).
[17] See https://mnetax.com/36-non-oecd-non-g20-countries-join-beps-international-15980 (last access: May 23, 2018).
[18] As per Decision C-62 144 from OECD's Counsil, on February 1, 2017 Paraguay received the official Invitation Letter AG/2017.064.gms from OECD's Secretary General Ángel Gurría to join the organization's Development Centre. Document available at: http://www.oecd.org/dev/paraguay-becomes-member-of-oecd-development-centre.htm.
[19] OECD and Council of Europe (2011), The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol, OECD Publishing. http://dx.doi.org/10.1787/9789264115606-en. Updated version of signatory jurisdictions available at: http://www.oecd.org/tax/exchange-of-tax-information/Status_of_convention.pdf. The multilateral

combat international tax evasion. Despite these efforts towards openness to the international tax arena, the country's DTC network has still found itself in an embryonic stage.

To date, Paraguay has only two signed and ratified Conventions for the Avoidance of Double Taxation of Income and Capital[20]: one with the Republic of China (Taiwan)[21] which was signed back in 1994 and internalized through Law Nº 3.972/08 and with the Republic of Chile (introduced into the Paraguayan legal order through Law Nº 2.965/05). Both Treaties followed the OECD-MC.[22]

b. ...and the future

Now it seems Paraguay is willing to take further actions to enhance its limited bilateral relationships. Under the framework of investment projects in 2017, the Government approached the State of Qatar[23], United Arab Emirates[24] and the Oriental Republic of Uruguay to enter into DTC with these jurisdictions. From these bilateral negotiations, a preliminary text of Double Tax Convention was signed between Paraguay and Qatar and between Paraguay and Uruguay. However, the Paraguayan Congress has not enacted both Treaties into domestic legislation yet. A DTC with The Federal Republic of Brazil was also signed in the year 2000 but it has not been ratified as of today.[25]

The social and economic conjuncture is clearly propitious soil for these tax favorable policies to happen. This raises the following question: how should the DTC network expand? From a purely technical point of view, Paraguay can opt to choose

instrument is not yet in force in Paraguay, due to the fact that Congress has to ratify it and deposit the ratification instruments before it becomes legally enforceable.

[20] For the purpose and scope of this paper, the Treaties for the Avoidance of Double Taxation from Land, River and Air Traffic Services will not be analysed.

[21] According to EY's "Tax Alert" dated January 25, 2018, Taiwan's Legislative Yuan approved several tax reforms previously announced during September 2017, which would *inter alia* increase the attractivity of Taiwan's DTC network (including the DTC Paraguay-Taiwan). Full text of the Tax Alert available at (last access: April 19, 2018): http://www.ey.com/gl/en/services/tax/international-tax/alert--taiwan-enacts-tax-reform-proposals.

[22] Although the DTC Paraguay-Chile incorporates some clauses from the UN-MC. Exemplary to this: *Madariaga*, J./*Yáñez*, F., Chile Report, in: *Lang* et al [Ed.], OECD/UN Model Conventions, p. 232.

[23] Source: http://www.economia.gov.py. (Last access: May 23, 2018).

[24] Source: http://www.economia.gov.py. (Last access: May 23, 2018).

[25] The outdated text of the DTC should be reviewed prior to legislative introduction into Paraguayan legal order, due to the countries' engagement with the OECD/G20's BEPS project to introduce anti-abusive clauses in DTC and the several changes introduced by the OECD and the UN to their Model Conventions.

the most convenient Model Convention to its own interests. After all, they are facultative instruments[26] drafted by international organizations for Members and Non-Members to profit from. Global consistency of application of DTC is key because otherwise, treaty negotiation would turn into expensive and never-ending procedures.[27] Likewise, the harmonic international interpretation of DTC provisions would very likely suffer and become contradictory, if every country decides to re-invent the wheel rather than adopting the existing models.

However and despite the aforegoing, the question of whether developing countries really need a broader DTC network has been raised by certain schollars.[28] The costs, complexity of the specific field of international law and the long bi- or multilateral negotiations elevate scepticism against government representatives, which are in charge of outlining the country's tax policy. However, despite these inherent diplomatic and technical costs and challenges, the advantages of DTC are worldwide known and respected. Now, to the question of which of the existing MC Paraguay should choose, it is a matter of convenience.

The prominent role of the OECD since the drafting of their first MC in 1963 is undisputable, to the extent that tax administrations and courts from Non-OECD Member states consistently adopted their Model Convention and follow the Commentaries' interpretative rules almost *verbatim*, even when, according to the prevailing scholar opinion,[29] the Commentaries are not internationally binding.[30] Nonetheless, considering that the OECD is composed of a majority of industrialized countries, the Model drafted by this organization is better suited for protecting the interests of more advanced and larger economies, usually capital exporters.

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[26] "Non-binding recommendations", see: *Valta,* Intl. StR, p. 349. Expanatory to facultative instruments: *Goode/Kronke/McKendrick*, TCL, Rn. 1.57(b) and 5.08.

[27] Vogel refers to this harmonic understanding as "Principle of Common Interpretation". *Vogel*, DTT Interpretation, Berkeley J of Intl' Law 1986, p. 38.

[28] *Daurer*, Tax Treaties, p. 50 f.

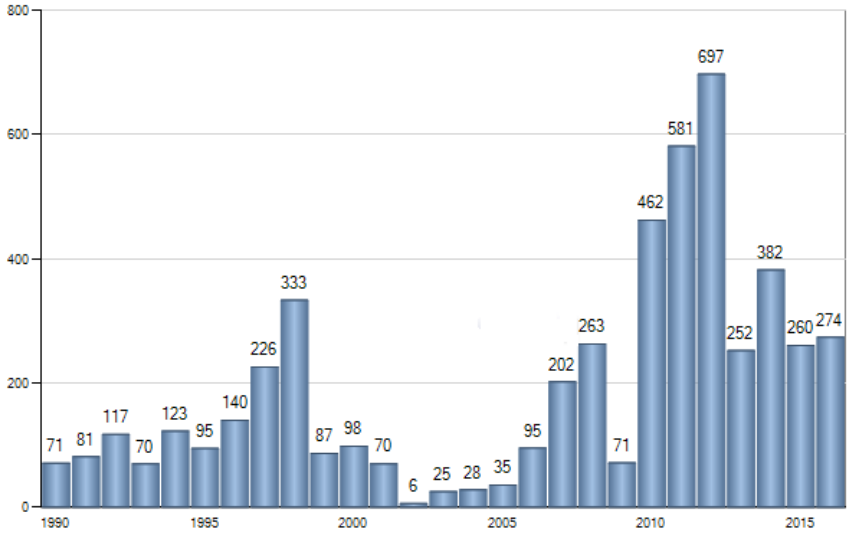
[29] "*That the OECD Commentaries do not give rise to binding obligations in international law by virtue of the application of the principles of good faith, acquiescence and estoppel or protection of legitimate expectations.*" The discussion over the *acquiescence principle* in Public International Law (Temple of Preah Vihear Case, Cambodia v. Thailand – ICJ Reports 1962) and its theoretical extension to DTC is quite interesting. See *Engelen*, Frank, How "acquiescence" and "estoppel" can operate to the effect that the states parties to a tax treaty are legally bound to interpret the treaty in accordance with the Commentaries on the OECD Model Tax Convention, in: *Douma/Engelen* [Ed.], Legal Status of OECD Commentaries, pp. 55, 64. Furthermore: *Vogel*, Influence of the OECD Commentaries in Treaty Interpretation, Tax Treaty Monitor 2000, p. 614.

[30] *Weiss*, F., Interpretation of tax treaties in accordance with the commentaries on the OECD Model Tax Convention under the Vienna Convention on the Law of Treaties, in: *Douma/Engelen* [Ed.], Legal Status of OECD Commentaries, p. 136.

The Paraguayan economy however looks forward to attracting foreign investments and profit from the affluence of wealth that new industries generate. Therefore, the UN, aware of the existence of a somewhat distorted distribution or allocation of taxing rights between rich and poor countries, developed a Model Convention[31] that, as mentioned above, allows the source country to retain more taxing rights and hence, revenues.[32]

3. Economic advantages of DTC: Increase of FDI

The figure below shows the flow of inbound FDI during the last twenty-five years (1990-2015),[33] which after significant peaks during the period 2010-2012 did not continue to grow steadily:



[31] United Nations Model Double Taxation Convention between Developed and Developing Countries, 2017 Update, United Nations, New York 2018, (ST/ESA/PAD/SER.E/).

[32] Cfr. e.g.: *Daurer*, Tax Treaties; *Halka/Trepelkov/Tonino* [Ed.], UN: Protecting Tax Base of Developing Countries; *Stefaner/Züger* [Ed.], Tax Treaty Policy and Development; *Viherkenttä*, Tax Incentives; *Lennard*, UN-MC and OECD-MC – Differences and Recent Developments, Asia-Pacific Tax Bulletin 2009. It is important to remark that residence taxation plays a significant role in international tax law and treaty law, which normally leads to double taxation in developing countries and emerging markets. Unilateral, bilateral or multilateral tax policies should address the elimination of this fiscal barrier. *Daurer*, Tax Treaties, p. 22. It is the author's opinion that Paraguay's Ministry of Finance's technical team should advocate for adopting the UN-MC in future DTC negotiations or at least contemplating features from the UN-MC which maximize the source country's taxing rights. This deserves of course a separate analysis.

[33] Source: The figure belongs to the United Nations Conference on Trade and Development (UNCTAD) and represents inward flows of FDI in Million of US Dollars, exclusively. Link: http://unctadstat.unctad.org (last access: April 27, 2018).

Although there is no visible correlation between the entry into force of the DTC Paraguay-Chile and the DTC Paraguay-Taiwan with the increased economic growth shown above, there are still evidences from academic sources that show a close relationship between international tax policies and economic growth.[34] Among the various alternatives to maximize and optimize tax revenues from direct investment in a continued way, we will focus on the role of DTC for generating spillovers in the domestic economy.[35] According to Paraguay's Development Guidelines issued by the World Bank Group, inclusive economic growth represents a central issue of the Government's Agenda for Joint Cooperation and Work for the years 2015-2018.[36] Economic growth is achievable through diverse tax policies, and among them is the so-called *spillover* effect[37] from FDI.

Margalioth points out that the existence of FDI in developing countries involves the incorporation of valuable assets to the national economy, which, besides the aggregated value added to local production, ends up increasing the taxable basis of foreign investors.[38] The presence of development factors increaseS economic and social welfare, such as the creation of new work places and boosts consume (or indirect) taxation.[39] This approach is not new for tax policy makers.[40] Several studies and academic work shows that tax policy has a central function for stimulating the economy in developing countries, which profit from investment-friendly legislative

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[34] *Easson*, Tax Incentives, ATF 1992(9), p. 418. Other scholars believe that DTC are not decisive for increasing FDI, and that the same goal could be reached through unilateral measures such as reduction of statutory withholding tax rates, see *Baker*, DTT and their effect on FDI, 21 Int J of the Economics of Business (2014), p. 360.

[35] *Dunoff/Trachtman*, Econ. Analysis of Intl. Law, 24 Yale J. Int'l L (1999), p. 18.

[36] Report Nr. 82487-PY: "*Strategic Alliance with the Republic of Paraguay for the years 2015-18*", Rn. 41. World Bank Group publication (December 2014). Available under: http://documents.worldbank.org/curated/en/953251468333540614/pdf/936190SPANISH00x385409B00PUBLIC00PY.pdf (last access: April 19, 2018).

[37] For a comprehensive explanation, see *Margalioth,* Tax system to promote Developing Countries, Va. Tax Rev. 2003-2004, pp. 167 f.

[38] *Margalioth,* Tax system to promote Developing Countries, Va. Tax Rev. 2003-2004, p. 168.

[39] According to the last Report from Paraguay's Tax Administration ("*Subsecretaría de Estado de Tributación*" or "*SET*"), the country's total tax revenue from the year 2017 was of USD 2.256 Million, of which USD 1.196 Million proceed from Value Added Tax – IVA (53%) and USD 800,5 Million from Corporate Income Tax – IRACIS (35,48%). It is clear that the tax revenue from indirect taxes is greater than revenues from direct taxes, which is why this segment of taxation could be greatly benefited from additional revenue sources as FDI. Source (last access: April 19, 2018): http://www.set.gov.py/portal/PARAGUAY-SET/Home/est?folder-id=repository:collaboration:/sites/PARAGUAY-SET/categories/SET/Estadistica/recaudaciones-tributarias

[40] *Vann*, R., International Aspects of Income Tax, in: *Thuronyi* [Ed.], Tax Law D&D, p. 772. See also: *Easson*, Tax Incentives, ATF 1992(9).

behaviours.[41] In this vein, Reimer mentions that there is a growing tendency to structure internal tax laws and DTC to secure foreign capitals, foreign workforces, among others.[42]

II. Tax treaty overrides

The literature defines treaty overriding as unilateral nullifications of treaty clauses through subsequent domestic legislation,[43] regardless of the practical application of the overriding statute.[44] The OECD refers to them as: "*a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State.*"[45] In turn, De Pietro defines tax treaty overrides as the disruption of the delicate balance between international tax law and domestic tax law, as established by the OECD-MC's distributive rules.[46] We emphasize on legislative overrides, because overrides could be also originated from Court or administrative decisions.[47] Treaty overrides can sometimes happen without the parties even being aware of them (unintentional overrides). A national legislature regulating tax matters could overlook certain treaty provisions and rule in spite of them, without knowing or desiring to breach international obligations.[48]

Treaty overrides should be also measured by the magnitude of the breach. Each individual case must be scrutinized to conclude if the breach is material[49] or not, in order to ponder which legal alternative should be taken, i.e. suspension, termination or other milder remedies. As McNair stressed it out, "*when the stipulation broken is such that the breach of it can properly be described as a fundamental breach of the*

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[41] Regarding the stimulation function of taxes in developing countries, refer to *Valta,* Intl. StR, p. 145 f.
[42] *Reimer*, E., Internationales Finanzrecht, in: *Isensee/Kirchhof* [Ed.], HStR XI, ³2013, § 250, Rn. 51.
[43] *Lehner*, M., Grundlagen, in: *Vogel/Lehner* [Ed.], DBA, Rn. 194 ff.
[44] "*Treaty overrides* as "*legislative overrides*": „*[T]he moment when a treaty override occurs coincides with the adoption of the new conflicting domestic law, regardless of its application.*" *De Pietro*, Tax Treaty Overrides, pp. 56, 217 f.
[45] OECD (2015), "R(8). Tax treaty override", in *Model Tax Convention on Income and on Capital 2014 (Full Version)*, OECD Publishing, Paris (henceforth the "OECD Report on Tax treaty override"); *De Pietro*, Tax Treaty Overrides.
[46] *De Pietro*, Tax Treaty Override and Need for Coordination, WTJ 2015, p. 96.
[47] Mausch categorizes legislative overrides as "open" overrides and judicial overrides as "hidden" overrides: *Mausch*, Treaty Overriding, pp. 21, 26. Cfr. *De Pietro*, Tax Treaty Override and Need for Coordination, WTJ 2015, p. 77; OECD Report on Tax treaty override, p. 3.
[48] *Rendón*, R./ *López-Velarde*, O., Taxpayers & Treaty Override, 20 Int'l Tax Rev. (2009), p. 36.
[49] Art. 60(1) and Art. 60(3)(b) VCLT: "*A material breach of 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… A material breach of a treaty, for the purposes of this article, consists in: the violation of a provision essential to the accomplishment of the object or purpose of the treaty.*".

treaty"[50], then there would not be much choice but to terminate the treaty, even if the economic consequences would be devastating.

In view of the above, a realistic and pragmatic suggestion would be to incorporate one further condition in order to terminate a tax treaty due to an intentional and fundamental breach, and it is the continuation of said contravention in time. Not only must a tax treaty override be *fundamental* and *desired* to justify the termination of the convention, but it should also be continued in time. This could prevent unnecessary terminations, in case a material but unintended breach occur.

1. Violation of international law

The VCLT enshrines the principle *pacta sunt servanda*[51] which compels the parties to abide by their assumed obligations and perform them in good faith. In this sense, the parties are not allowed to break treaty obligations based on their domestic laws.[52] Although these provisions seem to be clear enough to deter the international community from infringing treaty commitments, because treaty violations would corrode the country's reputation within the international community of civilized nations, the practice demonstrates that it is not uncommon for tax treaty overrides to happen. The negative effects of treaty overrides are qualified by De Pietro as the most damaging manifestation of lack of effectiveness of international law, which in turn leaves economic operators unprotected.[53] Whether justified or not, as it will be explained below that tax treaty overrides remain being a clear-cut violation of international law and principles.[54]

2. Justification of tax treaty overrides

The big question that needs to be addressed is: why do some legislatures and courts override international treaties? I will try to answer it in three separate strands:

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[50] *McNair*, A., The Law of Treaties, pp. 539-86 (1961), cited by *Kirgis*, Questions about Art. 60 VCLT, Cornell Intl. Law J 1989, p. 553.
[51] Art. 26 VCLT: "*Every treaty in force is binding upon the parties to it and must be performed by them in good faith.*".
[52] Art. 27 VCLT: "*A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to article 46.*".
[53] *De Pietro*, Tax Treaty Override and Need for Coordination, WTJ 2015, p. 76.
[54] According to Art. 27 und 60 VCLT. Also: *Lehner*, M., Grundlagen, in: *Vogel/Lehner* [Ed.], DBA, Rn. 197.

2.1. Contrary to Paraguay[55], the Constitutions of numerous countries do not organize the internal hierarchical structure of positive norms for placing international conventions, including DTC, above national laws and statutes. This is e.g. the case of the United States[56] and of the Federal Republic of Germany[57]. Therefore, certain countries override double taxation conventions because their constitutions allow it.

2.2. As a consequence of the aforementioned, the Courts in treaty-overriding states sometimes render interpretations of statutes favoring domestic legislation in detriment of tax treaty obligations. This is known as judicial treaty overrides.[58]

2.3. Finally, and perhaps the only legitimate argument for *understanding* the rationale of overriding treaty obligations, is when states pass domestic legislature against treaty

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[55] See Section C. below.

[56] Supremacy Clause (Art. VI, cl. 2): "*This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be supreme Law of the Land…*". On his article from 1994, Sachs identifies historic tax treaty-overriding statutes passed by Congress during the period 1962-1990. *Sachs*, 19th Century Doctrine of Treaty Override, 47 Tax Law (1994), pp. 870 ff. In turn, Townsend states: "*Changing the treaty by override may violate international law even though it does not violate internal U.S. law." Townsend*, Tax Treaty Interpretation, 55 Tax Law (2001), p. 238. On the status of tax treaties, Doernberg remarks: "*Within the United States, a treaty between the United States and a foreign country is the supreme law of the land and shares this status with domestically enacted federal legislation.*" *Doernberg*, Legislative Override of Income Tax Treaties, 42 Tax Law (1989), p. 200.

[57] Article 59(2)(1) of the German Fundamental Law (*Grundgesetz*) provides that "*Agreements that regulate political relations of the federation or affect objects of federal legislation require the consent or cooperation, in the form of a federal law, of the respective corporate bodies that are responsible for federal legislation.*". Moreover, regarding customary international law or the general principles of public international law, Article 25 of the German Fundamental Law provides "*The general rules of international law shall be an integral part of federal law. They shall take precedence over the laws and directly create rights and duties for the inhabitants of the federal territory.*" *Möllers*, C./*Wischmeyer*, T., Developments in German Constitutional Law: The Year 2016 in Review, in: *Albert* et al, Global Review of Constitutional Law 2016. (Electronic copy available at: https://ssrn.com/abstract=3000905). In the words of the eminent international tax scholar Klaus Vogel referring to Art. 59(2)(1): "*In Germany, treaties have no priority over domestic law; they are, however, as far as possible, considered to be special provisions, with the result that they are not altered by a subsequent law unless the law expressly contradicts their provisions.*" *Vogel*, DTT Interpretation, Berkeley J of Intl' Law 1986, p. 22.

[58] In the US: see Reid v. Covert, 354 U.S. 1, 18 (1957); in Germany: A seminal case from the German Federal Constitutional Court (*Bundesverfassungsgericht*) known as the *Görgülü* case (2 BvR 1481/04, BVerfGE 111, 307) laid the foundations for subsequent judicial tax treaty overrides by stating that "*international treaty law in general supersedes federal statutory law and that the parliament may deviate from international treaties only to protect 'fundamental constitutional principles'*"; Decision from the German Finance Court from Rheinland-Pfalz (*Finanzgericht Rheinland-Pfalz*) dated 30 June 2009, 6 K 1415/09, EFG, 1649 (2009) and the Decision from the German Federal Constitutional Court dated 15 December 2015, BvL 1/12; in Mexico: Second Chamber of the Supreme Court of Justice in 2007 in the *Global Vessels Mexico, S. de R.L. de C.V.* case. See *Möllers*, C./*Wischmeyer*, T., Developments in German Constitutional Law: The Year 2016 in Review, in: *Albert* et al, Global Review of Constitutional Law 2016; very explanatory also: *Lehner*, M., Grundlagen, in: *Vogel/Lehner* [Ed.], DBA, Rn. 201. *Rendón*, R./ *López-Velarde*, O., Taxpayers & Treaty Override, 20 Int'l Tax Rev. (2009), p. 37.

provisions with the aim of curtailing inappropriate use of tax treaties with the sole purpose of obtaining tax advantages, i.e. treaty abuse.[59] The underlying logic here is, if states must perform treaty obligations in good faith, so do the taxpayers.[60] However the OECD is reluctant to accept this postulate and strongly condemns treaty overrides even if they are grounded on the higher interest of states of preserving their tax base when taxpayers improperly benefit from tax treaties by creating artificial cross-border structures that allows them to reduce their tax burden.[61]

Legislative overrides illustrates what international lawyers call monist and dualist systems of law, where under the latter one international law and domestic law are two separate normative bodies independently applied from one another.[62] Vogel includes a third category[63], where the treaty conclusion powers are distributed into the Executive, in charge of negotiating the same with other states,[64] and the Legislative Branch, in charge of introducing the treaty into the domestic juridical order for the same to enter into force and become binding among the parties.[65] In view of the above, Paraguay qualifies for Vogel's third category.

Additionally, the Paraguayan Constitution requires that all signatory states ratify the treaties and exchange or deposit the ratification instruments for the convention to become binding.[66]

B. Second Chapter: Economic perspective of Tax Treaty Overrides and Direct Treaty Termination

The 'comeback'[67] of Law and Economics started at the first half of the 20th

[59] *Ault*, H./*Arnold*, B., Overview, in: *Halka/Trepelkov/Tonino* [Ed.], UN: Protecting Tax Base of Developing Countries, p. 28.
[60] *Elliffe*, Lesser of Two Evils: DTT Override or Treaty Abuse?, British Tax Rev 2016, p. 79.
[61] OECD Report on Tax treaty override, p. 13.
[62] *Elliffe*, Lesser of Two Evils: DTT Override or Treaty Abuse?, British Tax Rev 2016, p. 64. Although some scholar consider to this categorization as "oversimplified", it still provides a clear distinction about the interaction of international and national law.
[63] *Vogel*, K., "The Domestic Law Perspective" in *Maisto*, G. (ed.), Tax Treaties and Domestic Law (The Netherlands: IBFD, 2006), as cited by *Elliffe*, Lesser of Two Evils: DTT Override or Treaty Abuse?, British Tax Rev 2016, p. 66.
[64] Art. 238(7) CR.
[65] Art. 202(9) CR.
[66] Art. 137 CR in relation with Art. 141 CR.
[67] For some scholars, the origins of the law and economics dates back to Jeremy Bentham's and John Stuart Mill's utilitarism ideas. *Hylton*, Law & Economics vs Economic Analysis of Law, Eur J Law Econ (2017), p. 2

century by the hand of distinguished scholars such as Calabresi, Coase, Posner, and Shavell, among others, who contributed to the analysis of legal rules and normative models in an exponential way. This model of thought postulates that legal decisions should be based on the economic efficiency[68] and optimality of their consequences and on their ability to contribute to the improvement of the law.[69] "Effeciency" is the keyword when law and economics are to be put into place when a certain legal decision is needed.[70] Although law and economics (and the Economic Analysis of Law) aim at juridical relations governed by private law,[71] their principles are nonetheless applicable when extrapolated into the relations between sovereign states,[72] or among individuals and states. However the particularities of state relationships poses a challenge for economically analyzing treaty obligations, due to the difficulty of finding accurate numbers of transaction costs and externalities.[73]

This is the line of thought that will be tried to be achieved by scattering the *effectiveness* and *optimality* approach to decisions with international law implications. For this purpose, the system of economic normative analysis and legal positive analysis (EN/LP) argued by Hylton*[74]* will be adopted for the purposes of determining the most effective way to solve the issue raised at the beginning, i.e. which decision would result as "optimum" when put into practice: Unconditional termination of DTC when a tax treaty override occur, or continue its application despite the constitutional compulsion to terminate when no reciprocity is in place? According to the mentioned author, the focus of the EN/LP analysis is directed to shape an optimal system based

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[68] However, this approach has been subject to sharp criticism by certain scholars. For example: *Backhaus*, Lawyers' Economics versus Economic Analysis of Law, critique to Posner's approach, 43 Eur J Law Econ (2017), p. 519; and *Haugh*, Richard Posner's pragmatic jurisprudence, 9 Irish Stud L Rev (2001).

[69] *Posner*, Review of *Shavell's Foundations of Economic Analysis of Law*, XLIV J of Econ Lit (2006), p. 413.

[70] *Raskolnikov*, Limits of Tax Law and Economics, 98 Cornell L Rev (2013), pp. 527 f.

[71] For example: *Cooter*, Contracts and Economics Dev., 59 Alabama L Rev (2008), p. 1109; *Dunoff/Trachtman*, Econ. Analysis of Intl. Law, 24 Yale J. Int'l L (1999), p. 19: "*The international market for power is different from the market for private goods…*"; *Calabresi/Melamed*, One View of the Cathedral, 85 Harvard L Rev (1972), p.1105 f.

[72] "*In the international society, the equivalent of the market is simply the place where states interact to cooperate on particular issues-to trade in power-in order to maximize their baskets of preferences.*" *Dunoff/Trachtman*, Econ. Analysis of Intl. Law, 24 Yale J. Int'l L (1999), p. 13.

[73] In the sense given to these terms by Calabresi and Melamed in "One View of the Cathedral", as cited by Dunoff and Trachtman. *Dunoff/Trachtman*, Econ. Analysis of Intl. Law, 24 Yale J. Int'l L (1999), p. 29: "*property rules may be used to promote efficient exchange where transaction costs are low, while liability rules may be appropriate where transaction costs are high*". The difficulty of enforcing "property" or "liability" rules in the international law arena is another great challenge for the law & economic analysis of international law, especially international tax law.

[74] *Hylton*, Law & Economics vs Economic Analysis of Law, Eur J Law Econ (2017), p. 7.

on the rule of the written and existing law.[75]

Contrary to the optimality perspective, Raskolnikov specifically examines the relationship between tax law and economics and brings up the Marginal Efficiency Cost of Funds approach (MECF) as example of the benefits from economic analysis of taxation.[76] The author continues stating that the MECF approach's goal does not consist in reaching 'optimality' of a determined system. It focuses on incremental (marginal) changes instead[77] by contrasting revenue changes resulting from incremental reforms.[78] Despite Raskolnikov's scrutiny of the MECF approach aims at the efficiency analysis of enactment of new tax regulations or reforms, if it were to be applied for conducting an economic analysis of which tax policy should be applied when facing tax treaty overrides, the formula would consist of analyzing the projected tax revenue *losses*, provided that unconditional termination is opted before milder alternatives. This chapter is intended to identify the potential losses of revenue that termination of Double Taxation Treaties could entail; and from this basis, assess the most effective legal alternative. The fundamentals of requiring an effectiveness and optimality purpose test to legal decisions relies on the negative effects that would arise, when lack of reciprocity from a tax treaty-overriding partner would lead to a DTC termination.

This analysis will consider two economic dimensions: on the one hand, the foreign taxpayers' perspective investing in Paraguay due to the existence of the DTC between Paraguay and their residence State; and on the other hand, the Paraguayan perspective, where the potential loss of FDI would be at stake. Additionally, the costs and efforts that lead to the conclusion of tax treaties would be also accounted.

I. The investor's perspective

1. Financial viewpoint: monetary losses and capital flight

Multinational Enterprises (MNEs) and individuals have the right to pursue legal,

[75] *Raskolnikov*, Limits of Tax Law and Economics, 98 Cornell L Rev (2013), pp. 527 f.
[76] *Raskolnikov*, Limits of Tax Law and Economics, 98 Cornell L Rev (2013), p. 582.
[77] *Raskolnikov*, Limits of Tax Law and Economics, 98 Cornell L Rev (2013), p. 583: "*In order to perform this comparison, an analyst must know what reforms are possible and how taxpayers are likely to respond to them.*".
[78] *Raskolnikov*, Limits of Tax Law and Economics, 98 Cornell L Rev (2013), p. 585.

non-abusive and non-agressive planning of their business strategies, being the tax factor one of the main pillars in the formation of cross-border investment schemes. And I emphasize non-abusive and non-aggressive tax planning schemes,[79] because if states are compelled to interpret and apply international agreements in good faith[80], so are the taxpayers.[81]

In this vein, it is common to see that foreign investors choose one jurisdiction over another to maximize profits. From a tax perspective, the existence of a DTC captivates the attention of those looking forward to legally minimize the tax burden and reduce operative costs even more.

Once the double taxation element is excluded, the movement of capital between borders becomes more fluent. Therefore, increased creation of value and and tax substract can be kept by the source country.

Now, let us imagine that Paraguay celebrates a DTC with a potential treaty-overrider partner and several MNEs and individuals decide to set up new industries and businesses due to the benefits[82] of the DTC. And let us further imagine that Paraguay's treaty partner enacts or amends, for example, domestic legislation that taxes foreign-sourced profits from a Permanent Establishment (PE) located in Paraguay that would otherwise be only taxable in Paraguay (Art. 7(1) OECD-MC) and thus, overhauling a treaty provision. Although such an extreme situation is hard to imagine, it is not completely impossible and Paraguay would have no power over legislative decisions of its treaty partner.

Such override may be seen as a substantial or material breach of the DTC, of articles 26 and 27 VCLT and henceforth a rupture of the reciprocity principle. Following Art. 180 CR, the inexistence of reciprocity, as it will be seen in Section C below, must be punished with termination.

What would happen in such context with the lingering investments? The benefits that once motivated and convinced foreign investors to venture into the Paraguayan market will vanish in front of their eyes. Most likely, several industries

[79] A difference between tax evasion, tax avoidance and tax planning is to be found at *Knuutinen*, CSR, Taxation & Aggressive Tax Planning, Nordic Tax J 2014, pp. 59-60.
[80] Art. 26 VCLT.
[81] *Avi-Yonah*, R., Tax Treaty Overrides, in: *Maisto*, G., EC and Intl. Tax Law Series (2006).
[82] For example, taxation of business profits from a PE located in Paraguay (Art. 7(1) OECD-MC), where direct and indirect taxes are lower than in the residence state, and the possibility to use income taxes paid in Paraguay as credit (Art. 23B OECD-MC) in the residence country; or reduced withholding tax rates when paying dividends, interest or royalties (Arts. 10, 11 and 12 OECD-MC) to the principal, among others.

would lose their economic appeal when no DTC is in place and a capital flight might happen. Enormous amounts of technology, jobs and indirect taxation could be at stake in such scenario.

Under these circumstances, would it be optimal to terminate a DTC under a strict interpretation of Art. 180 CR? At this stage it seems difficult to quantify monetary amounts, since we are dealing with hypothetical situations. Until now, no treaty override occurred between Paraguay its two DTC Partners, namely Chile and Taiwan, and Paraguay does not have any potential treaty overrider partner for future DTC at sight.[83] However, it is better to prevent the course of legal actions based on optimatlity before mishaps occur.

2. Reputational perspective: legal certainty

Provided that Paraguay applies a policy of strict interpretation of Art. 180's "all or nothing" reciprocity principle, and thus terminates DTC withour further discussion upon the first override, regardless of the partner's intentions or periodicity of the same, the country would lose its attractiveness as treaty partner. Other jurisdictions would find hard to initiate bilateral negotiations if the country is known in the international arena as too severe with its treaty partners. The provision of legal certainty and security is a higher value to be preserved, if Paraguay is willing to continue expanding its DTC network.

It does not seem fair for Paraguay to be the one carrying the bad reputation's burden for standing for its rights against cheating treaty partners. But in the end, the measures the country ought to take in override situations should not be misguided by upright legal protectionism but by economic effectiveness of its actions.

II. The Paraguayan State's perspective

1. Potential economic losses

[83] The current versions of the Constitutions from Chile (1980) and Taiwan (1947) do not expressly contemplate the hierarchy between national legislation and bilateral conventions. A constitutional analysis of the normative hierarchy is found in: for Chile, *Nogueira*, Tratados, Ius et Praxis 1997, p. 19; and for Taiwan *Chiu*/*Fa*, Taiwan's Legal System, Contemporary Asian Studies 1994, p. 26.

Capital flight might be a harmful consequence of direct treaty termination, provided that the termination has not been caused by unilateral anti-abuse legislation of the treaty partner, i.e. the legislature overrode the treaty irrespective of the taxpayer's conduct towards the application of the DTC. As mentioned before, abusive practice of taxpayers' does not justify the breach of internationally assumed obligations from the signatory states, but in this context, it would make no sense to discontinue treaty benefits and the resulting spillover effect due to a handful of unlawful taxpayers.

Moreover, the economic effect of the overriding statute is crucial to determine if the same would deprive Paraguay from essential taxation sources.[84] This could be a measure to ascertain whether the breach is fundamental or not. However, if terminating the treaty would result in Paraguay potentially losing – or at least having a drastical reduction of – the existing or future FDI in the country, the termination could be more detrimental than the override. This would be absurd and should be avoided by all means possible. The American scholar Townsend referring to the US' perspective of treaty termination exclaims:

> "*Termination of a treaty, however, may have very detrimental economic consequences to the flow of trade between the United States and the treaty partner, a result that a treaty partner will not invoke unless the alleged breach is so fundamental that it justifies giving up the other benefits of the treaty*."[85]

2. Diplomatic costs

The signature, ratification and entering into force of bilateral tax conventions is preceded by long procedures and complex negotiations.[86] Firstly, the need for a Double Tax Treaty has to be identified, especially considering the future economic relations between both countries and the interrelation between their tax systems,

[84] *"…termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future*" as cited by *Avi-Yonah*, R., Tax Treaty Overrides, in: *Maisto*, G., EC and Intl. Tax Law Series (2006).
[85] *Townsend*, Tax Treaty Interpretation, 55 Tax Law (2001), p. 272.
[86] *Vogel*, DTT Interpretation, Berkeley J of Intl' Law 1986, p. 16.

which may be inhibiting economic relations due to excessive or double taxation.[87]

Once this need for a DTC is identified, the initial contacts towards negotiations begin through diplomatic channels. The countries negotiate DTC article by article, because their taxing rights are at stake, and usually every party looks forward to keeping most of them possible.[88]

As mentioned before, the UN-MC already include certain provisions favoring source states (normally LDC) against residence states (usually developed economies). But if the parties cannot agree on a determined Model Convention, the discussions could last several months, or even years, before final agreements on the DTC redaction are reached.[89] And negotiations are not only time-consuming, but also require state investment in hiring highly qualified international tax attorneys, tax consultants and advisors, economy technicians and political negotiatiors.[90]

These individuals are often required to be technically prepared for the negotiation rounds, which includes overall knowledge of the foreign country's tax system and their treaty network, particularities of their DTC in place, and familiarity with Model Conventions.[91]

Preliminary meetings between the countries' teams and negotiations often take place in both signatory states, which require travel and accommodation expenses of the delegations to be covered during each negotiation round. Moreover, once the negotiations come to an end and the copies of the DTC are initialed by the leaders of the negotiation teams,[92] the Executive's work is done and it is time for the Legislature

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[87] UN Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, Department of Economic and Social Affairs, Division for Public Administration and Development Management, New York 2003, p. 220.

[88] *Cooper*, G., in United Nations Handbook on Selected Issues, *Protecting the Tax Base of Developing Countries*, 2nd Edition, New York 2017, p. 364.

[89] "*The more troublesome issue presented by reliance on negotiating history is the use of unilaterally prepared documents. For example, the treaty negotiators may keep journals, memoranda, rough notes or other writings reflecting their thoughts about the dynamics of the negotiation of the treaty text.*" *Townsend*, Tax Treaty Interpretation, 55 Tax Law (2001), pp. 219-307, p. 287.

[90] According to the UN Manual for Negotiation of Bilateral Tax Treaties, p. 221: "*The members of the delegation should be individuals who, among them, combine most or all of the following skills:*
(a) Familiarity with the administrative aspects of tax treaties and with the administration of the international aspects of internal law. An individual having such familiarity would represent, in effect, the competent authority function on the delegation;
(b) A lawyer who is familiar with domestic tax law and able to draft treaty provisions;
(c) An economist or other individual with an understanding of the economic relationships between the two countries and an ability to assess the economic impact of the decisions being made in the course of the negotiations."

[91] *Townsend*, Tax Treaty Interpretation, 55 Tax Law (2001), pp. 221-222.

[92] *Vogel*, DTT Interpretation, Berkeley J of Intl' Law 1986, p. 17.

to play their part. Ratification procedures are in many dualist jurisdictions required for DTC to enter into force[93], like any other international agreements.

These procedures usually do not happen swiftly and sometimes during signature, ratification and exchange or deposit of the ratification instruments a decade may pass. The DTC Paraguay-Taiwan is a clear example: 14 years between signature and entering into force in Paraguay.[94]

Aside from negotiation and ratification, termination procedures of international conventions require resorting to the diplomatic channels and their associated procedures and costs, including time and monetary and human resources.[95]

C. Third Chapter: Legal alternatives to optimally overcome tax treaty overrides

This Section intents to analyze which legal alternative would be suitable to reach economical optimality, based on the cost variables set forth above. Furthermore, the constitutional feasibility to conclude DTC with potential treaty-overriders will be also considered.

I. Brief overview of the basic Paraguayan constitutional principles on taxation

1. Supremacy clause of the Paraguayan Constitution

Article 137 CR[96] incorporates the so-called Kelsen's Pyramide[97], which represents a very determined order of legal norms. According to Hans Kelsen's theory, treaty overrides in Paraguay should be *prima facie* unconstitutional, because simple

[93] It is important to notice that Art. 31(1) of the 2017 OECD-MC requires ratification of DTC: "*This Convention shall be ratified and the instruments of ratification shall be exchanged…*".
[94] See Section A. above.
[95] A very detailed analysis of DTC Termination is to be found in: *Zembala*, K., Article 31 OECD-MC (Termination), in: *Reimer* & *Rust* (Ed.), *Klaus Vogel on Double Taxation Conventions*, 4. Edition (2015), Article 31, Rn. 19 ff.
[96] "*The highest Law of the Republic is the Constitution. The latter one, along with the adopted and ratified international treaties and conventions, the laws enacted by Congress and other legal regulations with lower hierarchy […] form the national positive Law in the mentioned order.*".
[97] It is said that the expression "*pyramide*" is not attributable to Kelsen, but to a French translator of Kelsen's work. Instead, the Austrian author used "*Stufenbautheorie*" or "stepped theory" for referring to the different levels of norms and their descending hierarchy, being the Constitution at the top step and the remaining on the lower levels. *Kelsen*, Reine Rechtslehre, pp. 228 ff.

laws do not bear normative hierarchy over ratified international treaties.[98] Therefore, Paraguay's tax legislative sovereignty finds its limits before international conventions, when the same are introduced into domestic legislation and the ratification instruments are deposited or exchanged.

2. Observance of economic and development-fostering policies

In turn, Article 176 CR[99] could be understood as legitimation basis for promoting economic growth through economic or rather tax policies. Furthermore, Articles 179 and 181 CR deal, *inter alia*, with the purposes of Paraguayan taxes and the tax system itself. In this vein, if economic policies materialize as tax policies aimed to foster and promote the introduction of FDI into Paraguay attending fair economic and social principles, development-friendly policies and the general conditions of the economy, these policies would benefit from the constitutional protection of Article 176 CR in connection with Articles 179 and 181 CR even if the entrance into force of DTC would presuppose relinquishing certain taxing rights for the better good.[100]

3. Prohibition of double taxation

Article 180 CR[101] prohibits the same *subject matter* or tax event from being object of taxation twice. Although it does not provide the classical OECD's definition of international juridical double taxation, i.e. the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods,[102] the constitutional prohibition to tax the same subject matter could

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[98] In other words, an uncoordinated relation between international treaties and domestic law is not constitutionally possible to happen, due to the prevalence of treaties over statutory norms. De Pietro says "*the relationship between international and national law must not be taken into consideration merely in terms of prevalence of one over the other but rather in terms of coordination*". See *De Pietro*, Tax Treaty Override and Need for Coordination, WTJ 2015, p. 77.

[99] "*The fundamental purposes of the economic policy shall be fostering the economic, social and cultural development. The State shall promote economic development through rational usage of the available resources, with the purpose of boosting an orderly and continuous economic growth, creating new work and wealth sources…".*

[100] *Andic*, Taxation in LDC, p. 25.

[101] "*The same subject matter shall not be object to double taxation. On its international relationships, the State can conclude conventions that avoid double taxation, on the base of reciprocity.".*

[102] OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, p. 9.

still be sufficient for avoiding both economical *and* juridical double taxation.[103] The Paraguayan Supreme Court shared this hypothesis in the past by stating that "*according to Art. 180 CR economic double taxation should be understood as a juridical double taxation in the broad sense*".[104]

4. Principle of reciprocity: an ambivalent nature

The same Art. 180 CR incorporates an essential principle of international contractual law[105] into the Paraguayan legal order and deals with one of the core problems analyzed in this paper: Paraguay's mandatory reciprocity of DTC.

On the one hand, this exigency as *condictio sine qua non* for the validity of international treaties could become a showstopper of bilateral retations rather than a safeguarding mechanism (especially for DTC[106]), due to the economic aftermath it could cause if a strict interpretation of Art. 180 CR is put into place as state policy.

On the contrary, it can serve as a tailored solution for the distribution of taxing rights between states and simplify the avoidance of qualification conflicts and the atributtion of profits,[107] as well as promoting the increase of FDI and strengthen the cooperation between tax authorities.[108]

Additionally, it internalized the principle of *pacta sunt servanda* as interpretation standard for international agreements. Curiously, the reciprocity principle is not usually incorporated as constitutional "standard" for the fulfillment of double tax treaties.[109]

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[103] A difference between economic and juridical double taxation can be found in *Haase*, Intl. EU StR, Rn. 34.
[104] CSJ Decision Nr. 216 dated 26.04.2013 ("*Acuerdo y Sentencia CSJ Nr. 216/13"*).
[105] *Stein/v. Buttlar/Kotzur,* VölkerR, Rn. 11.
[106] German *Bundesfinanzhof*'s Decision dated 19.05.1993, I-R-80/92, BStBl. II 1993, p. 656: "*As a matter of fact, the object and purpose of DTC have to be respected. They provide tax reliefs for avoiding double taxation, i.e. the local tax relief corresponds to an obligation abroad, and viceversa.*" (*Im Übrigen sind Sinn und Zweck der DBA zu beachten. Diese sehen Steuerbefreiungen zur Vermeidung der Doppelbesteuerung vor, d.h. die Steuerbefreiung im Inland korrespondiert mit einer Steuerpflicht im Ausland und umgekehrt.*) The translation belongs to the author.
[107] *Reimer*, E., Internationales Finanzrecht, in: *Isensee/Kirchhof* [Ed.], HStR XI, ^{3}2013, § 250, Rn. 47.
[108] *Valta,* Intl. StR, p. 328.
[109] This specific requirement for DTC is not provided in the Constitutions of other MERCOSUR and South American countries (e.g. Argentina, Brazil, Bolivia, Chile, Ecuador, Peru, Uruguay and Venezuela). The same applies for North American countries (Canada, Mexico and the U.S.). In continental Europe, the reciprocity requirement for the entry into force of DTC cannot be found in the Fundamental Laws of France, Germany, Italy, Spain or The Netherlands. Regarding the African continent, reciprocity clauses for the validity of DTC have not been found in the Constitutions of Algeria, Arab Republic of Egypt, Botswana and South Africa, Finally, the Constitutions of selected Asian and Oceanian countries do not provide a reciprocity clause for DTC (Australia, India, Indonesia, Israel, Japan, South Korea, United Arab Emirates and New Zealand). However, the Constitutions of Taiwan

Perhaps because the *pacta sunt servanda* principle is sufficiently deep-rooted as a general principle that it does not require additional anchorage into individual constitutions.

II. Two opposing ways: Unconditional termination or continuity of DTC?

The constitutional recognition that reciprocity is specially[110] needed for DTC could be understood as an instrument for interpretation of double tax treaties,[111] as well as a justification of the Paraguayan state to restrict its own sovereignty;[112] however, in practical terms, Article 180 CR could represent, in itself, an impediment which would inevitably lead to termination of the DTC without further discussion. The constitutional text is pretty clear: no DTC without reciprocity, regardless of the scope or significance of the breach.[113]

Alternatively to unconditional termination, the general principles of Public International Law enshrined in the VCLT provide milder alternatives to unconditional termination, due to the fact that Art. 60(1) VCLT subjugates the suspension or termination of international agreements to material breaches from one party. Furthermore, the same article typifies what "material breaches" are, i.e. repudiation of the treaty not sanctioned by the VCLT[114] and violation of a provision essential to the accomplishment of the object or purpose of the treaty[115].

Now, this "tug-of-war" between the Paraguayan Constitution and the VCLT will be addressed in order to suggest a solution which could break the tension between the opposing alternatives at stake: the *unconditional termination* of Art. 180 CR versus the *continuity* of Art. 60 VCLT in connection with Art. 176 CR.

1. Unconditional termination

(Art. 141) and of Colombia (Art. 150(16) and Art. 226) provide that their treaty relations shall be based on reciprocity, despite no particular provisions regarding to double tax conventions are foreseen.

[110] Because the CR does not provide the same requirement for other international agreements, including on human rights matters.

[111] *Simma*, Das Reziprozitätselement, pp. 55, 57, 73.

[112] *Lampert*, Doppelbesteuerungsrecht, p. 238.

[113] Art. 180 CR. Moreover, the Constitution of Paraguay provides only two other circumstances in which international or bilateral reciprocity is required: for the admission of multiple nationality (Art. 149 CR) and regarding the suspension of the right to citizenship, Art. 153(1). In all cases, the reciprocity principle is expressly mentioned. This is not provided for other international agreements.

[114] Art. 60(3)(a) VCLT.

[115] Art. 60(3)(b) VCLT.

The Constitution is the country's supreme law and its text should be interpreted according to its language. If it clearly states that reciprocity is the *raison d'être* for double tax conventions, then if this element is absent, no DTC can exist. If the essence of DTC vanishes, the rejection of the country's own sovereignty will be unjustified. Reciprocity thus has the power to enhance or restrict the country's own normative universum,[116] and if DTC are concluded under this premise and later on unilaterally disrespected, the sovereignty concession will be in vain.

That notwithstanding, would this approach be in accordance with the Paraguayan Constitution? Or would it necessarily imply a violation of Art. 180 CR? Although the redaction of Art. 180 CR is clear, taking a "more royal than the king"-position could be in detriment of the country's policies to foster economic and social growth, which are a substantial element of DTC and their relation with the inflow of FDI.

The suggestion to consider the economic perspective of unconditional termination of DTC against any kind of reciprocity breach, i.e. even if they are not fundamental and/or intentional, would possibily induce the policy maker or governmental decision taker to carefully reconsider the strictness of Art. 180 CR and seek for more benign alternatives along with a systematic approach of the constitutional text.

Finally, the continuity of DTC even when fundamental and material breaches occur, provided that they do not continue in time, should be in accordance with the Constitution, due to the fact that this protects a greater good, namely the economic welfare by protecting foreign investments and honest investors.

2. Continuity

a. The OECD approach

The Report of the Committee on fiscal Affairs of 29 June 1989 on Tax Treaty

[116] "*Thanks to the Principle of Sovereignty the State constructs with its legal order a normative Universum.*" See *von Bogdandy*, A., Prinzipien from Staat und Organisationen, in: *Isensee/Kirchhof* [Ed.], HStR XI, [3]2013, § 232, Rn. 9. The translation belongs to the author.

Override[117] strongly condemns treaty overrides, even when they are aimed at tackling abusive practices from individual taxpayers and disregarding the legitimacy of the objective pursued by such legislation.[118]

Alternatively, the states should deploy diplomatic strategies to counteract treaty overrides through negotiation of appropriate ammendments to tax treaties.[119] If the diplomatic negotiations fail, the OECD suggest suspension or termination of the international convention, according to Art. 60 VCLT. Furthermore, the Organization stresses that the breach must be "material" to retaliate with termination. Otherwise, the termination could be deemed as unproportionate.[120]

Again, termination of DTC is regarded as the least desirable solution, applicable when diplomatic efforts do not influence the treaty partner's decisions.

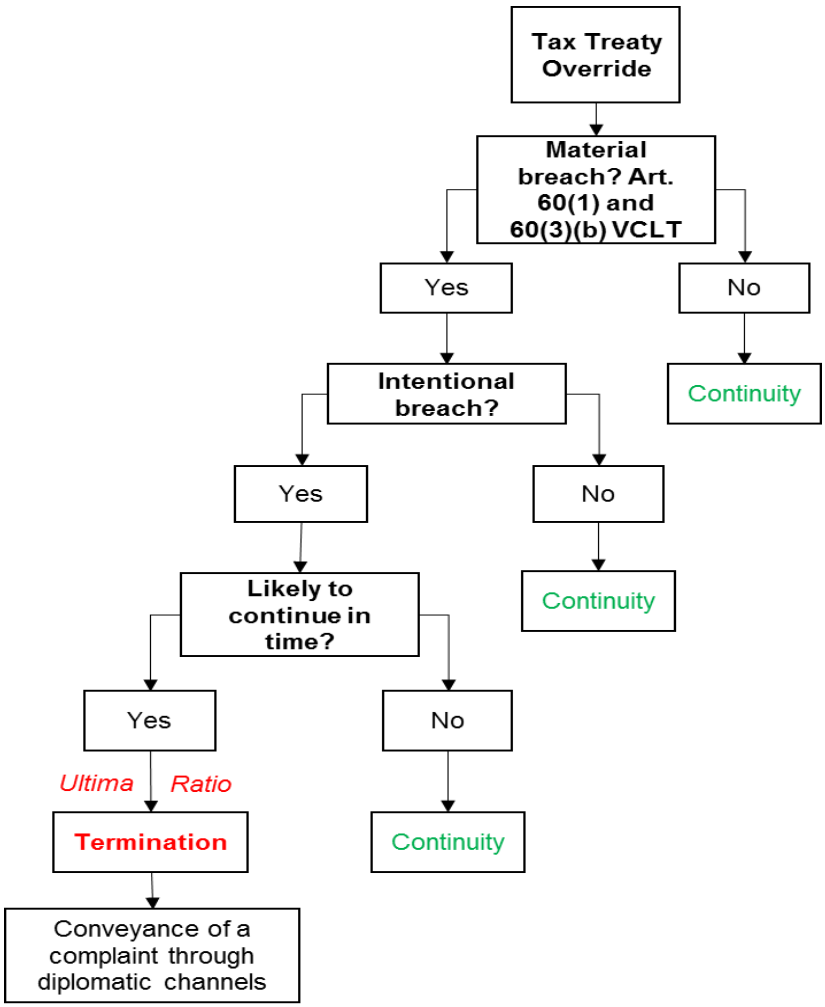
b. Art. 60 VCLT in connection with Art. 176 CR

An interpretation of of Art. 60(1) and Art. 60(3)(b) of the Vienna Convention on the Law of Treaties indicates that treaty termination shall be understood as the *ultima ratio* solution.[121] The pacific continuation of the treaty should be the guiding principle for the interpretation of conventions and the signpost when analyzing treaty violations.

Along with the VCLT's perspective, the interpretation of the Constitution should not be rigid, and further aspects should be brought into analysis before taking a final decision involving a treaty partner. Domestic taxes and the overall taxation system shall respond to fair economic and social principles as well as favourable policies to national development. Paraguay's Supreme Court of Justice ruled in 2012 that tax laws must be flexible enough to adapt to different situations, whenever the economic and social development of the country is at stake.**[122]** The economic focus of state policies into social development and economic welfare reflects the Constitution's social state based on the rule of law,[123] which in turn incorporates the idea of state

[117] DAFFE/CFA/89.13 (2nd Revision). See: https://legalinstruments.oecd.org/en/instruments/83.
[118] OECD Report on Tax treaty override, p. 10. Notwithstanding the OECD's position, Elliffe suggests that treaty override could be 'acceptable' under certain circumstances, including for instance, non-intentional legislative overrides. *Elliffe*, Lesser of Two Evils: DTT Override or Treaty Abuse?, British Tax Rev 2016, p. 73.
[119] *Elliffe*, Lesser of Two Evils: DTT Override or Treaty Abuse?, British Tax Rev 2016, p. 77.
[120] OECD Report on Tax treaty override, p. 8.
[121] *Lehner*, M., Grundlangen, in: *Vogel/Lehner* [Ed.], DBA, Rn. 198.
[122] CSJ Decision Nr. 410 from 30.05.2012 (*Acuerdo y Sentencia CSJ Nr. 410/12*).
[123] Article 1 CR.

interventionism in social matters originated in Europe at the end of WWII.[124] Constitutional tax provisions auspicing economic development and social welfare embodied in Articles 176, 179 and 181 CR possess the same hierarchy as the provisions of Article 180 CR. Therefore, Art. 176 CR could lawfully serve as against the provisions of Art. 181 CR. The tension between Art. 180 CR (termination) and Art. 60 VCLT in connection with Art. 176 CR (continuity) should break favoring the greatest economic optimality by avoiding highly costly unproportioned retaliations. Summarizing the foregoing, the following chart is intended to illustrate the suggested course of action Paraguay could undertake provided that a treaty override occur:



III. Constitutionality of the signature of DTC with potential treaty-overriders

[124] *Mendonça*, D., Constitución y Política Económica y Social, in: Comentario a la Constitución, Tomo IV (2012), p. 303.

From the judiciary's perspective, the question of whether Paraguay should conclude DTC with countries where treaty overrides are constitutionally admissible or not is still open for interpretation. This inquiry has not reached the highest judicial instance (CSJ) in Paraguay yet and the likelihood to predict a verdict seems very difficult.[125] However the lack of guiding jurisprudence in Paraguay does not curtail the possibility of exercising hypothetical solutions, being one of them the application of Law and Economics for the constitutional analysis of treaty overrides. Regarding the constitutional conformity of concluding Double Tax Conventions with (plausible) treaty-overriders[126], it will ultimately depend if a unilateral nullification of the treaty in force factually happens. The mere expectation of a hypothetical situation, i.e. rupture of the reciprocity principle, should not tarnish the lawfulness of a bilateral tax agreement or compulsively discard treaty partners due to their past treaty relations.

Treaty overrides must be punished with termination when a material and intentional unilateral breach takes place, which is likely to be prolonged or repeated in the future. Once this happens, the lack of reciprocity would entail sufficient weight to trigger termination due to an infringement of Art. 180 CR.

D. Conclusion

DTC are binding agreements between usually two States and thus are governed by Public International Law. In the majority of jurisdictions, the introduction of DTC into domestic legislation is required for having binding effects. Paraguay follows this legal principle, where ratified treaties are above national law – but below the Constitution – upon exchange of the ratification instruments. Nonetheless, this hierarchical order is not constitutionally binding in all countries, which leaves place for *treaty overriding*. A problem arises for Paraguay and its international DTC network, because the Constitution allows the conclusion of DTC only under the basis of reciprocity. Hence, tax treaty override from a treaty partner would inevitably lead to termination of the treaty due to lack of reciprocity. On the other hand, the Vienna

[125] The lack of specialized judicial bodies in Paraguay which exclusively deal with tax matters is a further challenge. See *Fantozzi*, A., Conclusions, in: *Maisto* [Hrsg.], Courts and Tax Treaty Law, pp. 405 f; *Howard*, Specialized Courts and General Courts, JuSys J 2005, p. 136.

[126] Jurisdictions where international agreements enjoy the same status as domestic legislation, or known to have practiced tax treaty overrides in the past (e.g.: Germany and the U.S.). For a global persective of "treaty overriders" see https://www.lawctopus.com/academike/tax-treaty-overrides-a-global-perspective/ (last access: May 23, 2018).

Convention on the Law of Treaties (VCLT), which governs international conventions, provides milder alternatives to unilateral breaches and sees termination as the *ultima ratio* solution.

Should Paraguay be more royal than the king and terminate DTC when an isolated override occur? The unconditional-termination-policy demonstrates being ineffective from both an economic perspective, as well as from a reputational point of view. The economic analysis has been proved to be of outmost importance for the delimitation of the legal position that could be assumed in case of a tax treaty override. It provides the foundations for which a review of Article 180 CR and the consequent application of the VCLT are necessary for avoiding extensive and expensive damages to individual investors and the Paraguayan State.

The legal pragmatism shows itself as a justified reason to systematic and teleologically interpret the Paraguayan Constitution with the aid of the VCLT. Therefore, the continuity of DTC even when material and intentional overrides occur, or the signature of DTC with potential treaty-overriders are economically and constitutionally justified.

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Abstract

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Keywords

Tax Treaty Override – Double Taxation Conventions – VCLT – Constitutional Law – Tax Law – International Law – Law and Economics – Economic Analysis of Law