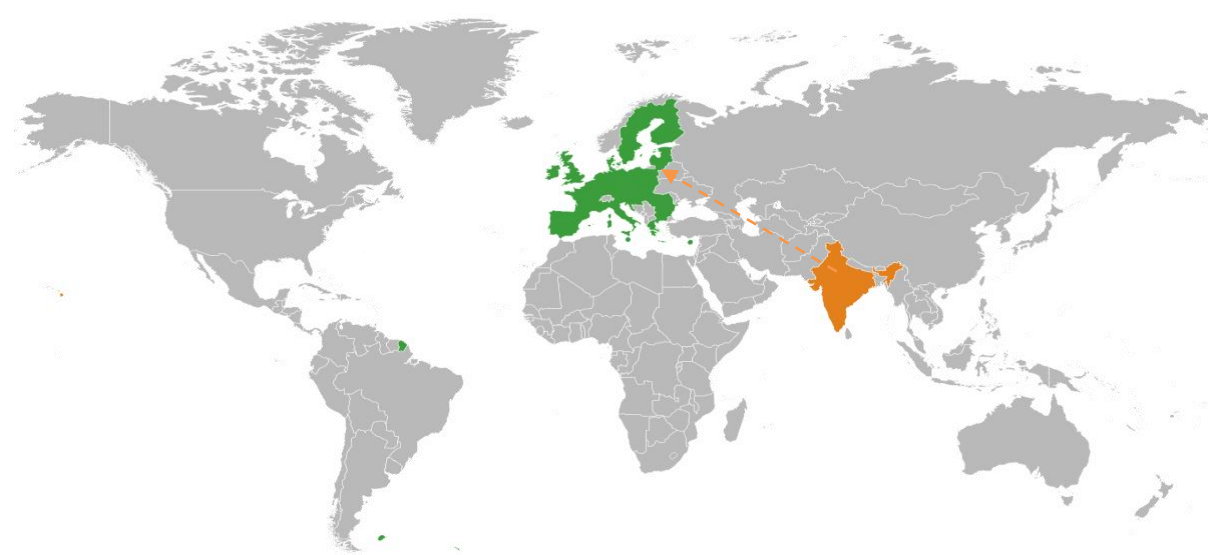


## Application and Interpretation of Tax Treaties



### **Guideline by International court of Justice before deciding on particular matter**

one needs to understand the philosophy of law. This gives rise to the principles of public international law

**Article 38(1) of the International Court of Justice<sup>1</sup>** provides that the court shall apply the following in deciding on a particular matter –

- (a) International convention(s)
- (b) International custom;
- (c) principles recognised by civilized nations and;
- (d) Judicial decisions

### **Directive Issued to Indian State with regards to International agreement**

In the Indian context, **Article 51 of the Indian Constitution** has inter-alia set out some directive principles which must be followed by the State in the context of International agreements and relationships. It has been provided that-

"The State shall endeavor to -

- (a) **Promote international peace and security;**
- (b) **Maintain just and honourable relations** amongst nations;
- (c) Foster **respect for international law** and treaty obligations in the dealings of organised people with one another; and
- (d) Encourage **settlement of international disputes** by arbitration.

## How International tax law originates

International tax law originates from the following –

- (i) **Multilateral international agreements** (example – The Vienna Convention on Law of Treaties- VCLT)
- (ii) **Double Tax Avoidance Agreement (DTAA)** which may be comprehensive or otherwise.
- (iii) **Customary international law and general principles of law.** For example, principles of law recognised by civilized nations in their national legal systems, customary law and judicial decisions and the practices of international organizations.

## Meaning of Double taxation and connecting Factor which leads to Double Taxation

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business

- **with that country** or
- **in that country.**

Internationally, the term used to determine the jurisdiction for taxation is “connecting factors”. There are two types of connecting factors, namely,

- **“Residence”** and
- **“Source”.**

### Jurisdictional double taxation

#### How It Arise

Tax is imposed by two or more countries as per their domestic laws in respect of the same transaction, income arises or is deemed to arise in their respective jurisdictions. This is known as “jurisdictional double taxation”.

#### What Company Do to avoid double Tax

In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or Double Taxation Convention– DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 91, providing unilateral relief in the event of double taxation.

#### **Example**

Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch

	<p>of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.</p> <p>If, instead of UK, ICO has a branch in Hong Kong, then it can claim unilateral relief under section 91 of the Act, 1961 in respect of taxes paid by its Hong Kong branch as India does not have a tax treaty with Hong Kong as the tax treaty with China does not apply to Hong Kong</p>
<p><b>Economic double taxation</b></p>	<p><b><u>How It Arise</u></b></p> <p>'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different person (because of lack of subject identity)</p> <p><b>Example</b></p> <p>When one state attributes an income/capital to its legal owner whereas the tax law of other state attributes it in the hands of the person in possession or having economic control over the income, it leads to economic double taxation.</p> <p>Yet another classic example is tax on distributed surplus by a company which is taxed in the hands of the company distributing such surplus, while the other jurisdiction taxes the said income from distribution in the hands of the shareholder.</p>

<p><b>Q1. Other Consideration While Entering into Tax Treaty</b>  <b>Q2. Explain the concept of Neutrality in DTAA</b></p>	
<p>There are various other important considerations as mentioned below:</p> <ul style="list-style-type: none"> <li>• <b>Ensuring non-discrimination between residents and non-residents</b></li> <li>• <b>Resolution of disputes</b> arising on account of different interpretation of tax treaty by the treaty partner.</li> <li>• <b>Providing assistance in the collection of the fair and legitimate share of tax.</b></li> </ul> <p>Further, in addition to above, there are some other principles which must be considered by countries in their tax system –</p> <p>(i) <b>Equity and fairness:</b> Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.</p> <p>(ii) <b>Neutrality and efficiency:</b> Neutrality factor provides that economic processes should not be affected by external factors such as taxation.  <b>Neutrality is two-fold.</b>  <b>(a) Capital export neutrality and</b></p>	

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) **Promotion of mutual economic relation, trade and investment:**



International Law Commission

Drafted the Model on Tax treaty between Various Countries and put it before the committee meeting to be Held in Austria Vienna



<b>Vienna Convention on Law of Treaties, 1969</b>	
<b>History</b>	<p>The International Law Commission initiated the work on the Vienna Convention on Law of Treaties in the year 1949 which was completed in the year 1969.</p> <p>It came into force in the year 1980. Further, in April, 2014, it was ratified by 114 Countries.</p>
Role of Vienna Convention in application and Interpretation of Tax Treaty	<p><b>The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty).</b></p>
<b>Article 2</b> of Vienna Convention on Law of Treaties, 1969 defines Treaty[How Agreement Will be Made]	<ul style="list-style-type: none"> <li>✓ “Treaty” means an international <b>agreement</b></li> <li>✓ concluded between States</li> <li>✓ <b>in written form</b> and</li> <li>✓ <b>governed by international law,</b></li> <li>✓ whether embodied in a <b>single instrument or in two or more related instruments</b> and</li> <li>✓ whatever its particular designation.</li> </ul>
Implication of above definition	<p><b>In home country, tax is an obligation, while in the host country, tax is a cost.</b></p> <p>Therefore, there is need to achieve tax efficiency.</p>
<b>Type of DTAA</b>	<p>DTAAs can be of two types,</p> <ol style="list-style-type: none"> <li>1. limited or</li> <li>2. comprehensive.</li> </ol> <p>Limited DTAAs are those which are limited to certain types of incomes only. e.g., DTAA between India and Pakistan is limited to shipping and aircraft profits only</p> <p>Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention.</p>

Clauses in Vienna Convention		
Article	Particulars	Provisions
26	<b>Pacta Sunt Servanda (in good faith)</b>	Every treaty in force is binding upon the parties and must be followed by them in good faith
27	<b>Internal law and observation of treaties.</b>	A party may not invoke the provision of its internal law as justification for its failure to perform a treaty . This rule is without pre justice to article 46.
28	Non-retroactivity of treaties	Unless a different intention appears , treaties cannot have retrospective application.
29	Territorial Scope of Treaties	Unless a different intention appears, a treaty is binding upon each party in respect of its entire territory.
31	General Rule of Interpretation	<ul style="list-style-type: none"> <li>• A treaty shall be interpreted in good faith</li> <li>• The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure</li> <li>• A special meaning shall be given to a term if it is established that the parties so intended</li> </ul>
32	Supplementary means of interpretation	Recourse may be had to supplementary means of interpretation, <ul style="list-style-type: none"> <li>→ Leaves the meaning ambiguous or obscure; or</li> <li>→ Leads to a result which is manifestly absurd or unreasonable</li> </ul>
33	<b>Interpretation of Treaties Authenticated in two or more languages</b>	<p>☞ 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.</p> <p>☞ The terms of the treaty are presumed to have the same meaning in each authentic text.</p>
34	<b>General Rule regarding third states</b>	A treaty does not create either obligations or rights for a third State without its consent .
42	<b>Validity and Continuance in force of treaties</b>	The termination of a treaty, or the withdrawal of a party, may take place only upon the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty Suo Moto Withdrawal of treaty not allowed

		take permission of Commission.
60	<b>Termination or Suspension of the operation of a treaty as a consequence of a breach</b>	<ul style="list-style-type: none"> <li>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.</li> </ul>
61	<b>Supervening impossibility of performance</b>	<p>✍ A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty.</p> <p>✍ If the impossibility is temporary, it may be invoked only as a ground for suspending its operation.</p>
62	<b>Fundamental change of circumstances</b>	<ul style="list-style-type: none"> <li>A fundamental change which was not foreseen by the parties, cannot be a ground for terminating or withdrawing from the treaty unless –             <ol style="list-style-type: none"> <li>The existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and</li> <li>The effect of the change is radically to transform the extent of obligations still to be performed under the treaty.</li> </ol> </li> </ul>
64	<b>Emergence of new norm of general international law</b>	If a new norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated

<b>ANTI-AVOIDANCE MEASURES</b>	
<p><b>ANTI-AVOIDANCE MEASURES</b></p> <p><b>[Measures taken by India for Avoidance of Tax]</b></p>	<p>In various countries, unless the context otherwise requires, the provisions of the DTAA shall prevail over the domestic tax provisions. No two treaties between the countries are alike. DTAA signed by India with USA is different in comparison to the DTAA signed with other countries like Netherlands.</p> <p>Therefore, in specified circumstances, treaty benefits are denied. Some of the circumstances in the Indian context induce</p> <p>(i) General Anti-Avoidance Rules (GAAR)</p> <p>(ii) Targeted anti avoidance rules (transfer pricing), etc.</p>

	<p>(iii) Beneficial Ownership Conditions (iv) Limitation of Benefits Clause/ Articles, etc.</p> <p>Recently, India has re-negotiated DTAA's with countries like Mauritius, Singapore, etc. to prevent fiscal evasion with respect to taxes on income and capital gains of the investor</p>
Computation of income liable for the purpose of taxation	<ul style="list-style-type: none"> <li>✦ generally the treaty does not provide rules for computation of income.</li> <li>✦ It would depend upon the domestic tax law provisions.</li> <li>✦ Treaties at best distribute the taxing rights between two states.</li> </ul>

### DISTRIBUTIVE RULE

- ✓ **Tax treaties only distribute or assign taxing jurisdiction. It does not impose tax.**
- ✓ **Having assigned the jurisdiction of tax between the State of Residence and State of Source, the domestic tax laws of the respective State determine taxing rules.**
- ✓ **English lawyers called it “Classification and Assignment Rule”, whereas German jurists called it the “Distributive Rule”.**

**According to this principle, “to the extent that an exemption is agreed to, its effect is in principle independent of both whether the Contracting States imposes a tax, in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax”.**

**The point here is that having agreed to part the right of tax with the other state, that state may or may not levy tax**

**Prof. Klaus Vogel, commenting on US – German DTAA observed: “Thus, it is said that the treaty prevents not only ‘current’ but also merely ‘potential’ double taxation.”**

### INTERPRETATION OF TAX TREATIES

**1. Monist vs. Dualist Views**

**MONIST VIEW :** Monist accept that the internal and international legal system form a unity .The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAA's which are applicable to the taxpayers, then, the provisions of the Act shall apply to the extent they are more beneficial to the taxpayer. Internationally, this situation is known as **“Monist View”**

**DUALIST VIEW :** The other prevalent view is known as “Dualistic View” wherein International Law and National Law are separate systems and DTAA becomes part of the national legal system by specific incorporation/legislation. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

## 2 Basic Principles of Interpretation of a Treaty

If words are clear or unambiguous, then there is no need to resort to different rules for interpretation.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

**a) Golden Rule - Objective Interpretation:**

Ideally any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind i.e. according to their plain and natural meaning.

However, if the grammatical interpretation would result in an absurdity, it should not be adopted

**b) Subjective Interpretation**

Under this approach, the terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

**c) Teleological or Purposive Interpretation**

In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the ‘objects and purpose’ method.

**d) The Principle of Effectiveness**

According to this principle, a treaty should be interpreted in a manner to have effect rather than make it void.

**e) Principle of Contemporanea Expositio**

A treaty’s terms are normally to be interpreted on the basis of their meaning at the time the treaty was concluded. However, this is not a universal principle.”

**f) Liberal Construction**

It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

**g) Treaty as a Whole – Integrated Approach**

A treaty should be construed as a whole and effect should be given to each word

**h) Reasonableness and consistency**

Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. **In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.**

**Extrinsic Aids to Interpretation of a Tax Treaty**

**A wide range of extrinsic material is permitted to be used in interpretation of tax treaties.**

**According to Article 32 of the Vienna Convention the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.**

**According to Prof. Starke one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted: Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;**

**The following secondary aids can be taken for interpretation of tax treaties -**

**Provisions in Parallel Tax Treaties**

**International Articles/Essays/Reports**

International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties.

Cahiers published by International Fiscal Association (IFA), Netherlands

“Cahiers de Droit Fiscal International” is the main publication of the IFA, which is published annually and deals with two major topics each year.

Protocol

Protocol is like a supplement to the treaty.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty.

Mutual Agreement Procedure [MAP]

MAP is more authentic than other aids as officials of both countries are in possession of materials/documents exchanged at the time of signing the tax treaty which would clearly indicate the object or purpose of a particular provision.

<b>OTHER AIDS TO INTERPRETATION OF TAX TREATY</b>	
<b>Commentaries on OECD/UN Models</b>	The Commentary on the OECD Model Convention states that: <b>“the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries.”</b>
<b>Foreign Courts’ Decisions</b>	<ul style="list-style-type: none"> <li>✓ Court cases are useful aid to treaty interpretation,</li> <li>✓ particularly if case is recognized as having international fiscal significance.</li> <li>✓ Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant.”</li> </ul>

<b>Ambulatory v. Static Approach</b>	
Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, <b>a question often arises what meaning to be assigned to the said term the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two views on the subject, namely, Static and Ambulatory.</b>	
<b>Static</b>	Static approach looks <b>at the meaning at the time when the treaty was signed.</b>
<b>Ambulatory</b>	<ul style="list-style-type: none"> <li>❖ Ambulatory approach provides that one looks to the meaning of the term at the time of application of treaty provisions.</li> <li>❖ All Model Commentaries<sup>21</sup> including the Technical Explanation on US Model Tax Convention favors ambulatory approach,</li> <li>❖ however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law</li> </ul>

<p>Ambulatory Approach subject to Contextual Interpretation</p>	<p>Article 3(2) of the OECD Model Convention provides that meaning of the term not defined in the treaty shall be interpreted in accordance to laws of the Domestic Country.</p> <p>However, this provision is subject to one caveat and that is if the context requires interpreting the term 'otherwise', then the meaning should be assigned accordingly. [ We do this Under DTAA as well]</p>
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<p align="center"><b>Difference of Object Between OECD &amp; UN Convention model</b></p>	
<p>OECD and UN Model Conventions have different objectives to achieve.</p>	
<p><b>Objective of OECD Model Conventions for Drafting DTAA</b></p>	<ol style="list-style-type: none"> <li>1. promote, by eliminating international double taxation,</li> <li>2. exchange of goods and services and the movement of capital and persons.</li> <li>3. It is also a purpose of tax conventions to prevent tax avoidance and evasion</li> </ol>
<p><b>Objective of UN Model Conventions for Drafting DTAA</b></p>	<p>The principal objectives of the UN Model Convention are as follows:</p> <ul style="list-style-type: none"> <li>☞ To protect tax payers against double taxation (whether direct or indirect)</li> <li>☞ To encourage free flow of international trade and investment</li> <li>☞ To encourage transfer of technology</li> <li>☞ To prevent discrimination between tax payers</li> <li>☞ To provide a reasonable element of legal and fiscal certainty to investors and traders</li> <li>☞ To arrive at an acceptable basis to share tax revenues between two States</li> <li>☞ F) To improve the co-operation between taxing authorities in carrying out their duties</li> </ul>
<p><b>CONCLUSION</b></p>	<p>Tax Treaties are result of prolonged negotiations between two Contracting States. Ideally, therefore the same should be interpreted keeping in mind the objectives with which they are entered into.</p> <p>Minutes of negotiations, exchange of notes, letters etc. are important material in determining the object of a particular treaty provision.</p>