

Interpretation of International Tax Treaties

Jacques Sasseville
Head, Tax Treaty Unit
OECD

9th International Tax Planning Conference
December 5 and 6, 2003
Mumbai

Summary

- Substantive issues
 - general remarks on interpretation of treaties
 - treaty interpretation issues related to time
 - distinguishing real interpretation issues from other treaty disputes
- Process issues
 - dispute resolution mechanisms:
 - recourse to domestic courts
 - mutual agreement procedure
 - arbitration
 - the role of the OECD Model Tax Convention

Interpretation of tax treaties versus interpretation of domestic laws

- intentions of 2 countries involved
- addressed to broader audience
- treaties are exclusively relieving
- treaties often use terms not used in domestic law
- treaties are more generally worded
- international experience with treaties
- influence of Models

Vienna Convention

Article 31

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

Vienna Convention on the Law of treaties

(2) The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty

Vienna Convention Article 31

(3) There shall be taken into account together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties

Vienna Convention Article 31

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

Vienna Convention Article 32

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

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

Supplementary Means of Interpretation ?

1. U.S. Technical Explanations
2. Competent authority agreements
3. OECD Commentary
4. Foreign court decisions
5. Administrative pronouncements
6. Books and articles

OECD Model Treaty Article 3(2)

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

1. Is the term defined in the treaty?
2. What is the meaning of the term for domestic tax purposes? For other legal purposes?
3. Does the context require that the term have a different meaning?

OECD Model Treaty Article 25(3)

- The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

Treaty interpretation issues related to time

- Time is relative, as established by Albert Einstein:
 - Astronaut travels from earth to a star located at 500 light-years
 - 99.995% of the speed of light
 - Once there, astronaut makes a u-turn and heads home at the same speed
 - Journey takes 1,000 years for earthlings and 10 years for astronaut

Time and tax treaties: the ambulatory or static issue

- Two different interpretation issues:
 - 1) Treaty references to domestic law
 - 2) References to later Commentaries for purposes of interpreting a previously-concluded treaty

Treaty references to domestic law

Paragraph 3 of Article 2:

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

The Queen v. Melford Developments

- 1982, Canadian Supreme Court
- Guarantee fees paid by a Canadian resident to a German bank
- Canada-Germany treaty had been incorporated into Canadian law by a specific law ("*The Canada-Germany Income Tax Agreement Act*") adopted by the Canadian Parliament in 1956

Melford (cont.)

- In 1956, not clear whether or not guarantee fees are interest under Canadian law
- A 1974 amendment expressly deems the payment of a guarantee fee to be a payment of interest for purposes of the Canadian withholding tax

Income Tax Convention Interpretation Act

- "3. Notwithstanding the provisions of a convention or the Act giving the convention the force of law in Canada, it is hereby declared that the law of Canada is that, to the extent that a term in the convention is
- (a) not defined in the convention,
 - (b) not fully defined in the convention, or
 - (c) to be defined by reference to the laws of Canada,
- that term has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the Income Tax Act, as amended from time to time, if, after that date, its meaning for the purposes of the *Income Tax Act* has changed."

Article 2 ambulatory rule

- "The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes..."

Article 10

- "The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares" by the laws of the State of which the company making the distribution is a resident."

Using later Commentaries when interpreting a previous treaty

- 2001 OECD-IFA seminar (San Francisco)
- Conclusions:
 - recourse to previous Commentary is possible
 - real issue is an issue of weight

When do treaty provisions apply?

- Last sentence of paragraph 1 of Article VII of the Canada-United States treaty :
 - “If the resident carries on, *or has carried on*, business as aforesaid, the business profits of the resident may be taxed in the other State but only so much of them as is attributable to that permanent establishment” [emphasis added].

Reason

- The United States Treasury Technical Explanations:
 - “The reference to a prior permanent establishment (“or has carried on”) makes clear that a Contracting State in which a permanent establishment existed has the right to tax the business profits attributable to that permanent establishment, even if there is a delay in the receipt or accrual of such profits until after the permanent establishment has been terminated.”

The unresolved residence-residence conundrum

- Employee is a resident of State R1 (which, like Belgium, taxes options at the time of grant) in year 2002
- He works 180 days in State S during 2002. During the same year, an option is granted to the employee.
- He works and resides in State R2 (which, like most States, taxes stock-options at the time of exercise) throughout 2003.
- On 31 December 2003, the option vests and the employee exercises it.

Distinguishing real treaty interpretation issues from other conflicts

- Conflicts of qualification
- Conflicts concerning the interpretation of the facts
- Conflicts concerning the interpretation of relevant provisions of domestic law
- Conflicts of allocation
- Conflicts of source

Conflict of qualification

- Given the same facts, the residence and source countries would apply different articles of the convention on the basis of differences in their domestic law

Conflict concerning the interpretation of the facts

- countries take different views as to the facts on the basis of which tax is assessed

Conflict concerning the interpretation of relevant provisions of domestic law

- cases where the two Contracting States do not agree on how relevant provisions of the domestic law of one State, typically the State of source, should be interpreted.

Conflict of allocation

- the two Contracting States tax different taxpayers on the same income
- Will often result in a conflict of interpretation

Conflict of source

- Situation where one of the parties to a Convention considers that income of a non-resident is derived from its territory and may therefore be taxed by it under the provisions of the convention while the other State, on the basis of its own source rules, consider that the income does not arise from the former State
- Between residence and source country: could be a conflict of facts, a conflict of interpretation or a conflict of qualification
- Between two source states: could also arise from a triangular case (e.g. paragraph 11(4))

Real conflicts of interpretation of the treaty provisions

- Contracting States agree on all the facts relating to a particular case but disagree on how the provisions of a convention should be applied to them

Example of conflict: Pierre Boulez

- Boulez was a resident of Germany and a world-renowned music director and conductor.
- In 1969 entered into a contract with CBS Records
- Conducted various performances with the Cleveland Orchestra, the New York Philharmonic, and others in the recording of musical compositions for CBS Records. None of these recordings were from "live" performances

Provisions of the contract

- We [CBS Records] hereby agree to engage and you [the petitioner] agree to render your services exclusively for us as a producer and/or performer for the recording of musical and/or literary compositions for the purpose of making phonograph records.
- All master recordings recorded hereunder and all matrices and phonograph records manufactured therefrom, together with the performances embodied thereon, shall be entirely CBS Records property, free from any claims whatsoever by you or any person deriving any rights or interests from you.

And...

- CBS shall have the unlimited right, from time to time, to manufacture, by any method now or hereafter known, phonograph records and other reproductions, on any mediums or devices now or hereafter known, of the master recordings made hereunder, and to sell transfer or otherwise deal in the same throughout the world under any trademark, trade names and labels or to refrain from such manufacture, sale and dealing;
- Under paragraph 7a of the contract, it was provided "For your services rendered hereunder and for the rights granted to us herein we will pay you the following royalties." There then followed an elaborate formula by which the petitioner was to be paid, based upon a percentage of the retail price derived by CBS Records from the sale of its phonograph records

Interpretation issues related to the design of tax treaties

- Schedular nature of tax treaties
- Focus on income
- Independence of treaty concept of residence
- Brevity of treaty provisions
- Relative immutability of treaties

The schedular nature of tax treaties

- Basket approach
- Conflicts of classification
- Baskets are not mutually exclusive
- Existing conflict rules

Basket approach

- Tax treaty rules vary depending on the nature of the income
- Many (most?) categories of income are not mutually exclusive, e.g.
 - interest and income from immovable property
 - royalties and business profits
 - interest and dividends
 - income from international transport and business profits

Conflicts of classification

- Already dealt with
- Provisions that refer to domestic law classification
- Residence and source State have different domestic laws
- Example:
 - interest paid by a partnership to a partner

Conflict rules

- Examples
 - Paragraph 4 of Article 6
 - Paragraph 7 of Article 7
 - Paragraph 1 of Article 15
 - Article 21

The focus on income

- Treaties apply to persons who are residents of either State (Article 1)

BUT

- Treaty provisions refer to income regardless of who is the taxpayer under domestic law (see various Articles)

Independence of the treaty concept of residence

- Treaty /domestic law dual resident
 - resident of State A under tie breaker rule
 - remain resident of State B under State B law
 - legislative solution
- Treaty/treaty dual resident
 - resident of States A and B
 - resident of State A for purposes of the A-B treaty
 - can he claim to be a resident of State B for purposes of the B-C treaty ?

Taxation of residents

- Exemption with progression
- Are treaties intended to restrict a State's right to tax its own residents?
 - Principle and exceptions
 - Examples of difficulties
 - partnerships
 - CFC rules
 - savings clause of U.S. treaties

U.S. savings clause

Except as provided in paragraph 3, nothing in the Convention shall be construed as preventing a Contracting State from taxing its residents (as determined under Article 4) and, in the case of the United States, its citizens (including a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of ten years following such loss) and companies electing to be treated as domestic corporations, as if there were no convention between the United States and with respect to taxes on income and on capital.

Should treaties be longer?

- Compare tax treaties to domestic tax laws
- “Word-inflation” of tax treaties
- Longer means harder to negotiate
- Longer means more frequent changes to adapt to changing circumstances
- Longer means less flexibility
- BUT Longer means more certainty

Relative immutability

- Average life of tax treaties is 15 years
- Requires more interpretation
- Model tax Convention
 - OECD Model is regularly updated but little changes to the Articles
 - UN Model partially updated after 21 years

Problems related to immutability of tax treaties

- Several important recent developments not expressly dealt with require interpretation:
 - controlled foreign companies
 - thin capitalization
 - foreign exchange issues
 - cross-border reorganizations
 - derivative financial instruments
 - employee stock-options
 - e-commerce
 - ageing of populations

Resolution of tax treaty interpretation disputes

- The provisions of tax treaties leave considerable scope for interpretation
- Disputes between
 - taxpayers and tax administrations
 - treaty partners
- Process for solving the disputes

Process for solving conflicts

- Recourse to domestic courts
- Mutual agreement procedure
- Arbitration?
- Expanding the Commentary?

Dispute resolution

- PE, royalties and transfer pricing disputes are a major concern
- The traditional dispute resolution mechanism of tax treaties (the MAP) is only a consultation process
- Current OECD project:
 - improve working of MAP; co-operation between authorities
 - supplementary dispute resolution mechanisms (mediation and arbitration).
 - not confined just to transfer pricing issues

Arbitration ?

- Pros and cons
- Situation of developing countries
- To what extent does Article 25 already allow arbitration?
- A possible practical solution

Role of the OECD

- OECD has been working on tax treaties for close to 50 years
- The OECD Model Tax Convention is the basic document on tax treaties
 - originally designed for treaty negotiations (in order to expand the treaty network)
 - now primarily used for treaty application and interpretation

A short history of model tax conventions

- 1958 Fiscal Committee of OEEC starts its work on tax treaties
- 1963 Draft OECD double taxation convention on income and on capital
- 1977 OECD model double taxation convention on income and on capital
- 1980 United Nations Ad Hoc Group of Experts model convention for developed and developing countries

A short history of model tax conventions

- 1992 OECD model tax convention on income and on capital
- 1994 First update to OECD Model Convention
- 1995 Second update to OECD Model Convention
- 1997 Third update (inclusion of non-member country positions)
- 2000 Fourth update
- 2001 Revised UN Model
- 2003 Fifth OECD update

Role of the OECD Model Tax Convention

- Follow a standard format
- Based on the OECD Model and UN Model
- OECD Model was developed to facilitate the extension of the tax treaty network in OECD countries in the late 1950s-60s
- The Model is now used primarily to apply and interpret tax treaties

OECD Model Tax Convention

- Unusual instrument
 - has legal standing through its recognition by courts even though not technically a legal instrument
 - goes around the OECD consensus rule through observations and reservations
 - applies to OECD and non-OECD countries
 - UN Group of Experts Model is 80% OECD Model
 - 24 non-OECD countries have formally endorsed it subject to their comments

OECD Model Tax Convention

- Some difficulties:
 - "far-reaching" interpretations
 - retrospective application
 - participation of non-OECD countries
- An imperfect instrument that is perfect for an imperfect tax world?

Importance of OECD Commentary

- Facilitates uniformity of interpretation
- Illustrates and interprets provisions
- Widely followed
- Primary secondary source
- Often referred to by courts