APPLICATION AND INTERPRETATION OF TAX TREATIES

LEARNING OUTCOMES

After studying this chapter, you would be able to

- identify the connecting factors of double taxation.
- appreciate the role of Vienna Convention in application and interpretation of tax treaties;
- appreciate the basic principles of interpretation of tax treaties.
- identify the extrinsic aids to interpretation of a tax treaty.
- appreciate the importance of commentaries in interpretation of tax treaties.
7.1. INTRODUCTION

Article 38(1) of the International Court of Justice\(^1\) provides that the court shall apply the following in deciding on a particular matter –

(a) International convention(s) (general or particular) which establishes rules expressly recognised by the contesting states;

(b) International custom; as evidence of general practice accepted as law;

(c) General principles recognised by civilized nations and;

(d) Judicial decisions and teachings of highly qualified publicists of various nations, as subsidiary means for determination of rules of law.

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret the law, one needs to understand the philosophy of law. This is because it is this philosophy which has been kept in mind at the time of passing any law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

Tax has been a consequence of business for several hundreds of years; some of the principles would definitely have their bearing on the manner in which law is passed. International tax law has evolved so that conflict of national interests can be resolved (double taxation being the primary issue).

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. It is to be noted that along with the DTAA, it is the protocols, memorandum of understanding, and exchange of information, etc. forming part of the DTAA which enables interpretation of a DTAA.

(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. Customary international law is the aspect of international law that derives from customs and convention. Along with general principles of law and treaties, custom is considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of the world's governments accept in principle the existence of customary international law, although there are many differing opinions as to what rules are contained therein.

\(^1\) http://www.icj-cij.org/en/statute#CHAPTER_II
7.2 DOUBLE TAXATION AND CONNECTING FACTORS

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”. It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business with another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business in a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link.

- **Jurisdictional double taxation**
  
  Accordingly, when source rules overlap, double taxation may arise i.e. 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”.

  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 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.

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.

- **Economic double taxation**
  
  ‘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)
7.4 INTERNATIONAL TAXATION

Example

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.

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.

7.3 OTHER IMPORTANT CONCEPTS

The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force. In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness**: Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) **Neutrality and efficiency**: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

   (a) Capital export neutrality and

   (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**: In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country’s overall economic growth and development.
### 7.4 APPLICATION OF TAX TREATIES


“Treaty” means an international **agreement** concluded between States **in written form and governed by international law**, whether embodied in a **single instrument or in two or more related instruments** and whatever its particular designation.

In home country, tax is an obligation, while in the host country, tax is a cost. Therefore, there is need to achieve tax efficiency. Double Tax Avoidance Agreements come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned states on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

DTAAs can be of two types, limited or comprehensive. 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.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

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.

It is pertinent to note that entries 10 and 14 of List I of the seventh schedule confer the power on Parliament to legislate treaties with foreign countries. Further, this power of Parliament has been delegated to the Central Government vide section 90 and 90A of the Act.

Section 90(4) provides that the non-resident to whom the DTAA in section 90(1) applies, shall be allowed to claim the relief under such DTAA if a Tax Residency Certificate (TRC) obtained from the Government of that country or specified territory is furnished declaring his residence of the country outside India or the specified territory outside India, as the case may be.

#### (1) Role of Vienna Convention in application and interpretation of Tax Treaties

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. It came into force in the year 1980. Further, in April, 2014, it was ratified by 114 Countries.

Since tax treaty is a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty). Therefore, it would be worthy to understand some of the articles of the Vienna Convention of Law of Treaties which are useful in understanding application and interpretation of tax treaties.

**Vienna Convention on Law of Treaties**

The principles are as under –

**Article 26 – Pacta Sunt Servanda (in good faith)**

Every treaty in force is binding upon the parties and must be followed by them in good faith.

**Article 28 – Non-retroactivity of treaties**

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

In other words, unless otherwise provided, treaties cannot have retrospective application.

**Article 29 – Territorial Scope of Treaties**

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

**Article 31 – General Rule of Interpretation**

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

- The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure
  
  (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 thereto.

- The following shall be taken into account, together with the context in that:

  (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 to relation between the parties.

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

**Article 32 – Supplementary means of interpretation**

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

(a) Leaves the meaning ambiguous or obscure; or

(b) Leads to a result which is manifestly absurd or unreasonable.

**Article 33 – Interpretation of Treaties Authenticated in two or more languages**

- 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.

- A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.

- The terms of the treaty are presumed to have the same meaning in each authentic text.

- Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

**Article 34 – General Rule regarding third states**

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

**Article 42 – Validity and Continuance in force of treaties**

- The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention.

- The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty.

---

3 Article 3 of the Model tax convention (UN and OECD model)
Article 60 – Termination or Suspension of the operation of a treaty as a consequence of a breach

- 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.
- A material breach of a multilateral treaty by one of the parties entitles:
  (a) The other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations amongst themselves and the defaulting State, or (ii) As between all the parties;
  (b) A party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State;
  (c) Any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty.
- A material breach of a treaty, for the purposes of this article, consists in:
  (a) A repudiation of the treaty not sanctioned by the Convention; or
  (b) The violation of a provision essential to the accomplishment of the object or purpose of the treaty.
- The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.

Article 61 – Supervening impossibility of performance

- 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. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation.
- Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party thereto.

Article 62 – Fundamental change of circumstances

- A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless –
(a) The existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and

(b) The effect of the change is radically to transform the extent of obligations still to be performed under the treaty.

- A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty –
  
  (a) If the treaty establishes a boundary; or
  
  (b) If the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.

- If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation.

**Article 64 – Emergence of new peremptory norm of general international law**

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

**(2) Anti-Avoidance measures**

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. These differences include taxpayers to resort to tax arbitrage strategies. This frustrates Government’s objective and results in unintended tax benefits. Therefore, in specified circumstances, treaty benefits are denied. Some of the circumstances in the Indian context induce (i) General Anti-Avoidance Rules (GAAR)\(^4\) (ii) Targeted anti avoidance rules (transfer pricing), etc. (iii) Beneficial Ownership Conditions (iv) Limitation of Benefits Clause/ Articles, etc.

Recently, India has re-negotiated DTAA with countries like Mauritius, Singapore, etc. to prevent fiscal evasion with respect to taxes on income and capital gains of the investor\(^5\).

**Article 4 of DTAA – Gateway to avail tax benefits**

It is a well-accepted proposition in a tax treaty scenario that a person shall be entitled to a tax treaty only if he is a resident of one of the contracting states.

This provision aims at curbing the ‘treaty shopping’ practices. It must be noted that though ‘Article 4’ of the tax treaty deals with residential status of a person, it does not provide rules for

---

\(^4\) GAAR provisions in India are applicable from Assessment Year 2018-19

\(^5\) Effective from 01 April 2017
determination of the residence. Instead, it refers to the determination in accordance with the provisions of domestic tax law of the respective contracting state. This is clear from the language which provides that “the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature............”. Therefore, the primary requirement is for a person to qualify as a resident under the law of the concerned contracting state.

Determination of residential status of a person is crucial since it is ultimately the country of residence that may have full right to tax the worldwide income of its resident. Further, in addition to taxing the global income, the country of residence would grant relief in respect of tax paid in the country of source.

Place of effective management is an important criterion for availing treaty benefits by a corporate. India – U.A.E DTAA (as revised) further limits the application of treaty by providing that the treaty would be applicable to U.A.E company only if it is incorporated in U.A.E and is controlled wholly in U.A.E. Only such company would be regarded as resident of U.A.E. Further the India – U.A.E DTAA provides that if a person other than an individual is resident of both the States, then it should be deemed to be resident of the State in which its Place of effective management is situated.

(3) Computation of income liable for the purpose of taxation

The provisions of tax treaty *inter alia* allocates taxing rights between the treaty partners, provides relief or reduce or eliminate the harmful effects of double taxation. However, it is to be noted that except for the provisions under ‘Article 7 i.e. Business Profits taxation’, generally the treaty does not provide rules for computation of income. It would depend upon the domestic tax law provisions. Treaties at best distribute the taxing rights between two states. It may limit the rate of tax (generally in the state of source) or provide the upper limit up to which taxes can be levied. Certain treaties do reduce the incidence of tax by providing or restricting the scope of the subject matter of taxation.

(4) 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. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

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 and if the state in whose favour right to tax is devolved, chooses not to tax such income, then it may result into double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, it takes care of future liability of 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.”

(A) Treaties are entered into for “Mutual Benefits”

Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally.

Treaties are negotiated and entered into at a political level and have several considerations as their basis. Thus, treaties should be seen in the context of aiding commercial relations between treaty partners.

(B) A tax treaty provision may have an unequal effect

State A imposes tax but state B does not impose a tax, yet wordings of the treaty are reciprocal – so that if and when State ‘B’ does introduce such a tax, the treaty rates would be operative in State ‘B’. Until such time there would be an unequal effect.

Moreover, State ‘A’ may make a distributive rule operative upon fulfilment of certain condition or comparable feature. E.g., Indo-Jordan DTAA provides that a capital gain on sale of shares arising to a resident of Jordan is taxed only in Jordan. However, if Jordan does not tax such a gain, then the right to tax reverts to India.

7.5 INTERPRETATION OF TAX TREATIES

(1) Introduction: Monist vs. Dualist Views

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the Vienna Convention on Law of Treaties (VCLT). These rules of interpretation are not restricted to tax treaties but also apply to any treaty between two countries. So any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD/UN Model Conventions has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation.

---

6 David R. Davis in Principles of International Double Taxation Relief (London, Sweet and Maxwell, 1995)
7 Tax Treaty Interpretation – The International Tax Treaties Service
In India, even before insertion of Section 90(2) by the Finance (No.2) Act, 1991, with retrospective effect from 1-4-1972, CBDT had clarified vide Circular No. 333 dated 2-4-1982 that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income.

The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAAs 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” wherein International and National laws are part of the same system of law, where DTAA overrides domestic law. Some other countries which follow such a system are: Argentina, Italy, the Netherlands, Belgium and Brazil.

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. In case of Dualistic View, DTAAs may be made subject to provisions of the National Law. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

Interpretation of any statute, more so international tax treaties requires that we follow some rules of interpretation. In subsequent paragraphs, we shall deal with rules of interpretation of tax treaties.

(2) Basic Principles of Interpretation of a Treaty

Principles or rules of interpretation of a tax treaty would be relevant only where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible. 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. Just as each country’s legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law. We have already discussed, the some of the rules of interpretation of Vienna Convention on law of Treaties.

Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) **Golden Rule - Objective Interpretation:** Ideally any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. The term has to be interpreted contextually.

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the
intention of the parties, it should not be adopted\(^8\).

(ii) **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.

In *Abdul Razak A. Meman’s case*\(^9\), the Authority for Advanced Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

(iii) **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.

In case of *Union of India v. Azadi Bachao Andolan*\(^10\), the Supreme Court of India observed that “the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases.”

The Apex Court also agreed with the contention of the Appellant that “the preamble to the Indo-Mauritius DTAA recites that it is for ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty”.

(iv) **The Principle of Effectiveness:** According to this principle, a treaty should be interpreted in a manner to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which ‘on the whole’ will render the treaty ‘most effective and useful’, in other words, enabling the provisions of the treaty to work and to have their appropriate effects\(^11\).

(v) **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.

In *Abdul Razak A. Meman’s case*\(^12\), the AAR observed that “there can be little doubt that while interpreting treaties, regard should be had to material *contemporanea expositio*. This proposition is embodied in article 32 of the Vienna Convention, referred to above, and is also referred to in the decision of the Hon’ble Supreme Court in *K. P. Varghese v. ITO [1981] 131 ITR 597.*"

---

\(^8\) Prof. J. G. Starke in Introduction to International Law 10\(^{th}\) Edition
\(^9\) [2005] 276 ITR 306 the AAR
\(^10\) 263 ITR 706 (SC)
\(^11\) Prof. J. G. Starke in Introduction to International Law 10\(^{th}\) Edition
\(^12\) [2005] 276 ITR 306, the AAR
(vi) **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.

In John N. Gladden v. Her Majesty the Queen\(^{13}\), the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed: “Contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be defeated or frustrated in so far as the particular item under consideration is concerned.”

The Court further recognised that “we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms.”

(vii) **Treaty as a Whole – Integrated Approach:** A treaty should be construed as a whole and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

(viii) **Reasonableness and consistency\(^{14}\):** 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.

One thing may be noted regarding the rules of interpretation, that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act.

### (3) 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:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

---

\(^{13}\) 85 D.T.C. 5188 at 5190, Source: UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)

\(^{14}\) Prof. J. G. Starke in Introduction to International Law 10\(^{th}\) Edition

© The Institute of Chartered Accountants of India
(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

**Provisions in Parallel Tax Treaties**

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y?

However, the views of the Indian Judiciary are not consistent in this respect. There are contradictory judgments by Indian courts/tribunal in this regard.

**International Articles/Essays/Reports**

International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained “useful material” through international articles.

**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. Cahiers were relied upon in case of *Azadi Bachao Andolan’s (supra) case* by the SC.

**Protocol**

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to the India-US tax treaty provides many examples to elucidate the meaning of the term “make available”. Protocol to India France treaty contains the Most Favoured Nation Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

**MFN clause**

*MFN clause is usually found in Protocols and Exchange of Notes to DTCs. Under this clause a country agrees to extend the benefits to the residents of the other country, which it had (first country) promised to the residents of third country. It tries to avoid discrimination between residents of different countries.*

*Normally the benefit under this clause is restricted to a specific group like OECD countries or developing countries. The nature of benefits under MFN clause could either be application of lower rate of tax or narrowing the scope of the income liable to tax or allowing higher deduction in respect of executive and general administrative expenses of head office.*

**Preamble**

Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of *Azadi Bachao
Andolan, the Apex Court observed that ‘the preamble to the Indo-Mauritius Double Tax Avoidance Convention (DTAC) recites that it is for the ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty’. These observations are very significant whereby the Apex Court has upheld ‘economic considerations’ as one of the objectives of a Tax Treaty.

Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. 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. Successful MAPs also serve as precedence in case of subsequent applications.

(4) Commentaries on OECD/UN Models

OECD Model Commentary has been widely used in interpretation of tax treaties. The Commentary on the OECD Model Convention states that: “the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge’s deliberations.”

In CIT v. Vishakhapatnam Port Trust’s case\textsuperscript{15}, the Andhra Pradesh High Court observed that “the OECD provided its own commentaries on the technical expressions and the clauses in the Model Convention.

OECD has framed a model convention to guide countries to draft DTAA. In the Azadi Bachao Andolan case\textsuperscript{16}, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

UN Commentary reproduces significant part of the OECD Model Commentary and thus, OECD plays a greater role in providing standardized or systematized approach in interpretation of tax treaties.

(5) Foreign Courts’ Decisions

In CIT v. Vishakhapatnam Port Trust’s case\textsuperscript{17}, the Andhra Pradesh High Court observed that, “in view of the standard OECD Models which are being used in various countries, a new area of genuine ‘international tax law’ is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in

\textsuperscript{15} [1983] 144 ITR 146,
\textsuperscript{16} [2003] 263 ITR 706
\textsuperscript{17} [1983] 144 ITR 146,
other countries or rulings given by other tax authorities would be relevant."

In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

*Union of India v. Azadi Bachao Andolan*¹⁸

*CIT v. Vishakhapatnam Port Trust*¹⁹

*Abdul Razak A. Meman’s case*²⁰

(6) Ambulatory v. Static Approach

Whenever a reference is made in a treaty to the provisions of domestic tax laws for assigning meaning to a particular term, 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.

**Static**

Static approach looks at the meaning at the time when the treaty was signed.

**Ambulatory**

Ambulatory approach provides that one looks to the meaning of the term at the time of application of treaty provisions. All Model Commentaries²¹ including the Technical Explanation on US Model Tax Convention favors ambulatory approach, however with one caution and that is ambulatory approach cannot be applied when there is a radical amendment in the domestic law thereby changing the sum and substance of the term.

India-Australia Treaty, in Article 3(2) adds the expression “from time to time in force” to provide for an “ambulatory” interpretation.

(7) Ambulatory Approach subject to Contextual Interpretation

Article 3(2) of the OECD Model Convention provides that meaning of the term not defined in the treaty shall be interpreted in accordance with the provisions of the tax laws of the Contracting State that may be applying the Convention. 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. For example, India-US treaty provides that assignment of meaning under the domestic law to any term not defined in the treaty shall be according to the common meaning agreed by the Competent Authorities pursuant to the provisions of Article 27 (Mutual Agreement Procedure). And if it is not so agreed, only then, the meaning would be assigned from the domestic tax law and that too, provided the context does not require otherwise.

---

¹⁸ [2003] 263 ITR 706 (SC)
¹⁹ [1983] 144 ITR 146,
²⁰ [2005] 276 ITR 306 the AAR
²¹ OECD Model Commentary July 2014 Version

© The Institute of Chartered Accountants of India
In case of *Union of India v. Elphistone Spinning and Weaving Co. Ltd*\(^{22}\), the Supreme Court observed that “when the question arises as to the meaning of a certain provisions in a Statue it is not only legitimate but proper to read that provision in its context. The Context means the statute as a whole, the previous state of law, other statutes in *pari materia*, the general scope of statute and the mischief that it was intended to remedy.”

In *Pandit Ram Narain v. State of Uttar Pradesh*\(^{23}\), the Supreme Court observed that the meaning of words and expressions used in an Act must take their colour from the context in which they appear.

As per section 90(3), any term used but not defined in the Act or in the DTAA, shall, unless the context otherwise requires, and is not inconsistent with the provisions of the Act or the DTAA, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.

Further, in this regard, Finance Act, 2017 has amended the provisions of section 90/90A of the Act by way of insertion of an *Explanation*, according to which, the term not defined in DTAA, but defined in the Act, to be assigned the meaning given in the Act and explanation, if any, given to it by the Central Government.

### (8) Objectives of Tax Treaties

Objectives for signing a tax treaty also play a significant role in its interpretation as they determine the context in which a particular treaty is signed. For example, OECD and UN Model Conventions have different objectives to achieve. The same are as follows:

**(i) OECD Model Conventions:** Principal objectives of the OECD Model Convention are as follows:

The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchange of goods and services and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion\(^{24}\).

**(ii) UN Model Conventions:** The principal objectives of the UN Model Convention are as follows:

- To protect tax payers against double taxation (whether direct or indirect)
- To encourage free flow of international trade and investment
- To encourage transfer of technology
- To prevent discrimination between tax payers
- To provide a reasonable element of legal and fiscal certainty to investors and traders
- To arrive at an acceptable basis to share tax revenues between two States

---

\(^{22}\) [2003] 4 SCC 139,

\(^{23}\) [1956] SCR 664,

\(^{24}\) Paragraph 7 of Article 1 of the Commentary on OECD Model Tax Convention, July 2014 version

© The Institute of Chartered Accountants of India
To improve the co-operation between taxing authorities in carrying out their duties.

(iii) **Indian Tax Treaties**: Section 90 of the Income-tax Act, 1961 contains the objectives of signing tax treaties in general. The same are as follows:

(a) for granting of relief in respect of –

(i) income on which taxes have been paid, both income-tax under this Act and income-tax in that country; or

(ii) income-tax chargeable under this Act and under the corresponding law in force in that country to promote mutual economic relations, trade and investment, or

(b) for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country, or

(c) for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or

(d) for recovery of income-tax under this Act and under the corresponding law in force in that country.

Thus, it can be observed that there are several objectives for entering into tax treaties by the Government of India besides the primary objective of avoidance of double taxation as enumerated above.

(9) **Conclusion**

Determination of intent of parties, prevalent at the time of entering into agreement, after considerable lapse of time is a herculean task in absence of “Travaux Preparatories” i.e. preparatory work.

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. Minutes of negotiations, exchange of notes, letters etc. are important material in determining the object of a particular treaty provision. However, absence of any such document in public domain makes the task of interpretation very difficult.

Interpretation of tax treaties is an evergreen subject of controversy considering the complexities involved. Application of international rules of interpretation while giving effect of provisions under the domestic law creates further confusion. Even courts are not unanimous in their rulings.
Question 1

What do you mean by double taxation? Discuss the connecting factors which lead to Double taxation.

Answer

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”. It means a company can be subject to tax either on its residence link or its source link with a country. Broadly, if a company is doing business with another country (i.e. host/source country), then it would be subject to tax in its home country alone, based on its residence link. However, if a company is doing business in a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link.

- **Jurisdictional double taxation:** Accordingly, when source rules overlap, double taxation may arise i.e. 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”.

  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 of the Income-tax Act, 1961, providing unilateral relief in the event of double taxation.

- **Economic double taxation:** ‘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)

Question 2

“In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into tax treaty”. Elucidate.

Answer

In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into a tax treaty, as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
Providing assistance in the collection of the fair and legitimate share of tax.

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness**: Same income earned by different taxpayers must be taxed at the same rate regardless of the source of income.

(ii) **Neutrality and efficiency**: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

   (a) Capital export neutrality and

   (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**: In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country’s overall economic growth and development.

**Question 3**

What is the General Rule of Interpretation under Vienna Convention of Law of Treaties?

**Answer**

Article 31 of Vienna Convention of Law of Treaties contains the General Rule of Interpretation. It lays down that following general rule of interpretation:

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

- The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure

  (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 thereto.

- The following shall be taken into account, together with the context in that:

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

(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 to relation between the parties.

- A special meaning shall be given to a term if it is established that the parties so intended.\(^{25}\)

Question 4

“Treaty prevents not only ‘current’ but also merely ‘potential’ double taxation”. Elucidate.

Answer

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. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

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 and if the state in whose favour right to tax is devolved, chooses not to tax such income, then it may result into double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, it takes care of future liability of 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.”

(A) Treaties are entered into for “Mutual Benefits”

Apart from the allocation of tax between the treaty partners, tax treaties can also help to resolve problems and can obtain benefits which cannot be achieved unilaterally.\(^{26}\)

Treaties are negotiated and entered into at a political level and have several considerations as their basis. Thus, treaties should be seen in the context of aiding commercial relations between treaty partners.

(B) A tax treaty provision may have an unequal effect.\(^{27}\)

State A imposes tax but state B does not impose a tax, yet wordings of the treaty are reciprocal –

\(^{25}\) Article 3 of the Model tax convention (UN and OECD model)

\(^{26}\) David R. Davis in Principles of International Double Taxation Relief (London, Sweet and Maxwell, 1995)

\(^{27}\) Tax Treaty Interpretation – The International Tax Treaties Service
so that if and when State ‘B’ does introduce such a tax, the treaty rates would be operative in State ‘B’. Until such time there would be an unequal effect.

Moreover, State ‘A’ may make a distributive rule operative upon fulfilment of certain condition or comparable feature. E.g., Indo-Jordan DTAA provides that a capital gain on sale of shares arising to a resident of Jordan is taxed only in Jordan. However, if Jordan does not tax such a gain, then the right to tax reverts to India.

**Question 5**

*What is the difference between “Monist Views” and “Dualist Views”?*

**Answer**

The Income-tax Act, 1961 provides that where the Indian Government has entered into DTAAAs 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” wherein International and National laws are part of the same system of law, where DTAA overrides domestic law. Some other countries which follow such a system are: Argentina, Italy, the Netherlands, Belgium and Brazil.

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. In case of Dualistic View, DTAAAs may be made subject to provisions of the National Law. Some of the countries that follow Dualistic View are Australia, Austria, Norway, Germany, Sri Lanka, and the UK.

**Question 6**

*What are the Extrinsic Aids to interpretation of a tax treaty?*

**Answer**

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:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.
Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y?

However, the views of the Indian Judiciary are not consistent in this respect. There are contradictory judgments by Indian courts/tribunal in this regard.

International Articles/Essays/Reports

International Article/Essays/Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP), the High Court obtained “useful material” through international articles.

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. Cahiers were relied upon in case of Azadi Bachao Andolan’s (supra) case by the SC.

Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to the India-US tax treaty provides many examples to elucidate the meaning of the term “make available”. Protocol to India France treaty contains the Most Favoured Nation Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. In case of Azadi Bachao Andolan, the Apex Court observed that ‘the preamble to the Indo-Mauritius Double Tax Avoidance Convention (DTAC) recites that it is for the ‘encouragement of mutual trade and investment’ and this aspect of the matter cannot be lost sight of while interpreting the treaty’. These observations are very significant whereby the Apex Court has upheld ‘economic considerations’ as one of the objectives of a Tax Treaty.

Mutual Agreement Procedure [MAP]

MAP helps to interpret any ambiguous term/provision through bilateral negotiations. 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. Successful MAPs also serve as precedence in case of subsequent applications.