Interpretation of Tax Treaties

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Introduction

• Are tax treaties contractual or legislative in nature?
  o Treaties are contracts which are given legislative effect;
  o Therefore they are both contractual and legislative in nature.

• Do treaty interpretation principles differ from legislative interpretation principles?
  o Some rules clearly overlap, so to that extent there is no difference;
  o Other rules only apply in a tax treaty context, so therefore there is a difference.

• Traditional view of overseas courts: there are particular tax treaty interpretation rules;

• For purposes of, or in interests of, uniformity, tax treaty interpretation should not be rigidly controlled by domestic rules of construction (Stag Line Ltd v Foscolo, Mango and co [1932] AC 328 at 517 (“the Mango case”):
  o Conventions are apt to be more loosely worded;
  o Do not interpret strictly.
Introduction cont.

- While tax treaties are agreements and should be interpreted as such, often domestic statutory interpretation principles are applied to them (Union Texas Petroleum Corp v Critchley (Inspector of Taxes) [1998] BTC 405 and Whitney v IRC (1942-26) 10 TC 88);

- Which domestic statutory interpretation principles will apply to a tax treaty?
  - Literal meaning/cardinal rule must be circumspectly applied;
  - Contra fiscum rule may possibly apply;
  - Ejusdem generis rule should apply;
  - Lex poterior non derogant rule should apply;
  - Other rules? UK: special definition in domestic tax law of “special relationship” for tax treaty purposes.

- If domestic statutory interpretation principles should be applied, does one follow the literalist approach, or the teleological approach?
The domestic South African approach toward statutory interpretation has been either ‘literalist’ or ‘teleological’;

- In the “literalist” approach, the bias is towards a ‘strict’ construction of the statute, placing emphasis on the words used;
- The second approach (“purposive”) is teleological – it is more concerned with the purpose for which the legislation was enacted;

Neither approach has been consistently followed by South African Courts, although in tax cases there has historically been a more “literalist” approach, with a more purposive approach being followed very recently.

In this context, the question arises as to how tax treaties should be interpreted, especially to the extent that domestic statutory principles apply;

The answer to the latter question should be sought in the legal nature of, and in the context of the status of, tax treaties in South African law;

Thereafter, international interpretative principles should be applied.
Legal Nature of Tax Treaties

• In international law a tax treaty is a contract between two States. *Vienna Convention on the Law of Treaties, Article 2*:
  - A treaty is an international agreement (in one or more instruments, whatever called) concluded between states and governed by international law;

• International agreements generally create rights and obligations only for the States, not for third parties, but tax treaties are unusual in that certain third parties (e.g. taxpayers) obtain rights;

• In Canada and Australia, tax treaties are also enacted as statutes, while in South Africa they are simply deemed to be the same as statutory law;

• Once enacted, tax treaties create rights for taxpayers as well as certain indirect obligations (e.g. the provision of information).
Legal Nature of Tax Treaties cont.

- Various types of tax conventions exist:
  - Bilateral tax treaties (e.g. OECD Model Tax Convention and the United Nations Model Double Taxation Convention);
  - Multilateral tax treaties e.g. EU Tax Directives.
- Treaties do not impose tax;
- Treaties limit the taxing power of each state;
- Treaties do not displace domestic law – e.g. dual residents.
Legal Nature of Tax Treaties:
Differences between Tax Treaties and Domestic Tax Legislation

- Tax treaties are agreements between States: only the two States and their taxpayers are affected;
- Treaty drafting style is different from statutory drafting style;
- Treaty language differs from domestic tax language;
- Tax treaties are virtually all modeled on the OECD Model Tax Convention;
- Tax treaties are relieving:
  - fundamental purpose is to eliminate double taxation, hence the need for common interpretation.
Section 108 of the Income Tax Act

- S108 provides for the prevention of or relief from, double taxation, as follows:

  1. The National Executive may enter into an agreement with the Government of any other country, whereby arrangements are made with such Government with a view to the prevention, mitigation or discontinuance of the levying, under the laws of the Republic and of such other country, of tax in respect of the same income, profits or gains, or gains, or donations, or to the rendering of reciprocal assistance in the administration of and the collection of taxes under the said laws of the Republic and of such other country.

  2. As soon as may be after the approval by Parliament of any such agreement, as contemplated in Section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act.

- Consequently, Section 108 is a deeming provision which gives a tax treaty the same status as domestic statutory tax law when the provisions of Section 231 of the Constitution have been met;

- Olivier & Honiball: International Tax: A South African Perspective, suggest that:
  
  - the provisions of a DTA and the ITA should be interpreted so as to be consistent with each other;
  
  - If there is a conflict then the DTA would prevail. Should that not be the case, the provisions in the DTA providing for the prevention, mitigation or discontinuance of the liability for tax would be nullified.

- When interpreting a tax treaty the court will in reality be interpreting a bilateral agreement and therefore the intention of the parties (States) ought to be examined closely.

- One should always have regard to the objectives or purposes of a tax treaty including as set out in s108 of the ITA, namely (1) the avoidance of double taxation and (2) to provide reciprocal assistance in the administration and collection of taxes;

- Objectives or purposes of a tax treaty must therefore feature prominently its interpretation;

- From an interpretative point of view, and on the basis of the wording of section 108 of the Income Tax Act, we may say that a DTA has primarily two objectives:
  - The avoidance of international juridical double taxation;
  - Reciprocal assistance in the administration and collection of taxes through the exchange of information.
Tax Treaty Interpretation Rules:
Objectives of a Tax Treaty

- Although these two purposes are the main purposes of DTAs they do not constitute their only purposes (see next slide);

- A DTA itself may set out its objectives, which are not always the same per treaty (e.g. Mauritius/SA DTA).

- Direct objectives
  - Eliminate double taxation;
  - Prevent tax evasion and avoidance;
  - Non-discrimination;
  - Division of tax revenues;
  - Administrative aspects;
  - Information sharing;
Tax Treaty Interpretation Rules:
Objectives of a Tax Treaty, cont.

- Indirect objectives;
  - Provide tax certainty;
  - Remove barriers to cross-border investment flows;

- Sometimes bilateral agreements are concluded which have as their sole objective the sharing of information for anti-tax avoidance purposes (e.g. treaty between The Isle of Man and The Netherlands).
Tax Treaty Interpretation Rules: Unique Features

- A treaty contains reciprocal obligations entered into by the contracting states which are found in domestic tax legislation;

- Although belonging to the law of nations, tax treaties have a purpose substantially different from that of normal political or economic treaties. They are primarily intended to avoid simultaneous taxation in both countries.

- In South Africa, once the treaties are ratified, they have the same effect as the statutory tax law of the country.

- However, tax treaties have the following unique features:
  - The treaties are not multinational conventions but bilateral international agreements;
  - A treaty can modify the domestic tax principles only in so far as it exempts or reduces the domestic tax burden;
  - The wording used is generally of a wider, more general application, written with the intention of remaining in place for a long period;
Tax Treaty Interpretation Rules: Unique Features cont.

- Treaties do not impose nor levy tax.

- It would therefore seem that treaty provisions should be interpreted in a more liberal way than statutory domestic tax provisions, i.e. a less strict application. Furthermore, the emphasis should be placed on the common intention of the parties, which in this case are the Contracting States;

- On this basis, can one therefore conclude that the ordinary rules of construction applicable to the interpretation of statutory instruments apply to the DTAs? According to some foreign case law, domestic interpretation rules should not apply to tax treaty interpretation (Memec PLC v IRC and IR v Commerzbank AG);

- Schwarz: UK domestic interpretation rules do apply but only to the extent that the rules are the same. It is submitted that this is also the position in South Africa, but for the wider, more purposive approach which should be followed.
Tax Treaty Interpretation Rules:
The Vienna Convention

- This is an international multilateral convention on the law of treaties and does not only apply to tax treaties;

- Countries that have signed and ratified the Convention have an international obligation to interpret future treaties in accordance with the Convention (*Fothergill v Monarch Airlines Ltd* [1981] AC 251 HL);

- South Africa is not a signatory to the Convention;

- There is therefore a debate about the extent to which the Convention’s interpretation principles must be applied in South Africa;

- Strictly speaking, the Vienna Convention does not at all apply in South Africa;

- The Vienna Convention also does not apply in those countries which are signatories to the Convention in respect of tax treaties signed before they ratified the Convention. For example, in the UK the Convention entered into force on 27 January 1980;

- However, the Vienna Convention is regarded as reflecting or codifying ‘International Customary Law’. So even though South Africa is not a signatory to the Vienna Convention, it is arguable that South Africa is bound to apply its provisions in so far as they reflect International Customary Law (*Fothergill* case at 282).
Tax Treaty Interpretation Rules:
The Vienna Convention cont.

- This is also clear from Section 232 of the Constitution which provides that customary international law is law in South Africa unless it is inconsistent with the Constitution or an Act of Parliament.

- Article 31 of the Vienna Convention: General rule of interpretation:

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

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

     a) any 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 relation between the parties.

  3. A special meaning shall be given to a term if it is established that the parties so intended.
Tax Treaty Interpretation Rules: The Vienna Convention, cont.

- This general rule contained in Article 31 is arguably a codification of the interpretation rules of customary international law (Lord Diplock in the *Fothergill* case). However, note that not all the Articles of the Convention are regarded as such a codification.

- Article 32: Supplementary means of interpretation:
  - According to 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.
The Ordinary Meaning

- Article 31 of the Vienna Convention provides that the ordinary meaning of tax treaty wording must first be ascertained;

- In *Padmore v IRC*, the court rejected Revenue’s argument that the general scheme of the treaty was relevant in determining the meaning of the words “profits of a Jersey enterprise”. Rather, the “proper starting point” was the ordinary language of the relevant article;

- Similar words used in different sentences in a treaty may even mean different things (*IRC v Exxon Corp* [1982] BTC 182);

- In *Trevor Smallwood Trust v R&C Com*, the court held that the words “taxable only” means precisely that and therefore there was no scope for any basis of taxation in the non-treaty residence state.
Article 32 of the Vienna Convention: Supplementary Means of Interpretation

- History of treaty provisions;
- Expert evidence;
- OECD Model and Commentary;
- OECD Studies;
- Legislative history of treaty;
- Foreign court decisions;
- Tax Department’s administrative pronouncements;
- Authors and Academics.
Relevance, admissibility and weight of supplementary materials related to the treaty

- The OECD Commentary: generally regarded as very important;
- An interpretation in the OECD Commentary that is included after the treaty was signed that clarifies an issue previously not addressed;
- An interpretation in the OECD Commentary that is included after the treaty was signed that changes a previous interpretation of the Commentary;
- An observation that an OECD country has lodged in relation to the OECD Model Commentaries.
Relevance, admissibility and weight of supplementary materials related to the treaty cont.

- A technical explanation of a tax treaty unilaterally issued by the tax administration of that country;
- An agreed technical explanation of a tax treaty issued by the tax administrations of the two countries;
- A decision of a foreign court on a tax treaty matter;
- Written transcripts of treaty negotiation prepared by one of the parties;
- A note outlining an understanding agreed to by both parties at the time of the negotiation that is not made public;
- A note outlining an understanding agreed to by both parties at the time of the negotiation that is made public;
- All the above supplementary materials are not listed in weighted order (see Memec and Commerzbank cases).
OECD Model Tax Convention

- 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;

- This is the so-called Renvoi-clause which is found in the common law of some countries;

- There are various problems with Article 3(2), e.g. : What is the relevant weighting of this clause? Is it prescriptive? What about terms which have an international tax meaning different from the relevant domestic law meaning (e.g. beneficial ownership)? (see next slide).
Problems with the application of Article 3(2) of the OECD Model

- What are undefined terms?
- What if there are multiple domestic meanings?
  - Static v ambulatory interpretation;
- Undefined terms used in treaty definitions?
- Inclusive definitions;
- When does a State apply the treaty?
- What does “context” mean?
  - Pierre Boulez 83 TC 584 (1984);
- German resident conducted an orchestra/recordings in US;
- Income from personal services/royalties;
- Article 3(2) : Source State priority to classify.
Problems with the application of Article 3(2) of the OECD Model, cont.

- Use of domestic law for undefined terms;
- Goes against the need for common interpretation;
- May lead to double taxation or double non-taxation;
- Is there a preference for domestic or treaty meaning?
- Ambulatory, not static, unless context requires?
The Impact of the South African Constitution

- Section 232 provides as follows:

  232 Customary International Law
  Customary international law is law in the Republic unless it is inconsistent with the Constitution or an Act of Parliament.

- Is a DTA not part of ‘customary international law’? What about the OECD Commentary?

- The effect of this section is that the principles regarding the interpretation of international agreements, like certain articles of the Vienna Convention, will apply to tax treaties. For example, articles 31 and 32 of the Vienna Convention are generally accepted to be a codification of customary international law.

- Section 233 of the Constitution provides as follows:

  233 Application of international law

  When interpreting any legislation, every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law;
The term ‘any legislation’ would include in its ambit the provisions set out in the South African Income Tax Act;

Furthermore, to the extent that a tax treaty constitutes ‘international law’ then we must endeavour to interpret the ITA in such a way as to be consistent with the tax treaty;

SIR v Downing 1975 SA 518 (A);

This case considered the meaning of the DTA. There were no questions raised relating to the meaning of the ITA or how one reads the ITA and the DTA together;

The Court did not expressly delineate any specific principles relating to the interpretation of DTAs;

Nevertheless, commentators have said that there are a number of inferences that may be drawn from this decision relating to the interpretation of treaties. (See David Clegg article) Is this correct?
SIR v Downing 1975 SA 518 (A)

- The treaty provisions cannot be interpreted as creating or increasing a tax liability;
- The model convention adopted by the OECD has served as the basis for the more modern treaties signed by South Africa. In this context it is interesting to note that a passage of the OECD commentary was advanced as an argument by one of the parties and dealt with by the lower court, although the AD did not base its judgment on the commentary;
- Treaty definitions were used by the court and translated into language appropriate to the facts of the case;
- The words included in the definition of the treaty provision in question were ascribed their natural meaning;
- Reference made to the intention of the contracting parties in drafting the treaty provisions whose meaning the court tried to establish;
- The existence of an ‘international tax language’ of which the treaty makes use was acknowledged by the court.
Foreign Case Law Precedents

- Strong English case law influence on interpretation principles e.g. Capital vs Revenue *(Californian Copper Syndicate v IR)*;

- Australian case law influence (New South Wales Act);

- US case law influence *(Cohen v CIR 1962(2) SA367(A))*;

- Meyerowitz 3.26 : If the statutory provision is not similar, the foreign decision cannot be applied *(Bailey v CIR)* and 3.28 if the whole basis of taxation is different, the foreign decision cannot be applied *(Pyott Ltd v CIR)*;

- Meyerowitz 3.30 : a foreign decision will never have binding force;

- All above cases heard prior to Article 233 of the South African Constitution;

- Although the basic approach is that a domestic court should not only apply domestic rules of interpretation when it is called to interpret a treaty, foreign courts differ on which interpretation rules should be used;

- In the UK the House of Lords held in *Forthergill v Monarch Airlines* 3 WLD 209 that in interpreting treaties a court should not be constrained by English legal precedent, but should base its interpretation on the principle of general acceptation.
Foreign Case Law Precedents cont.

- On similar lines it was held in *CIR v Commerzbank AG* 235-236 that:

  1. It is necessary to first establish the clear meaning of the words used in the relevant article and a strict literal approach should not be followed. Where provisions are ambiguous, a purposive construction should be followed.

  2. Narrow domestic rules of interpretation should not be applied to establishing the meaning of a treaty as its wording is addressed to a much wider and more varied judiciary. The ordinary meaning should be given to its terms in the light of its object and purpose;

  3. Where the above interpretation rules lead to a result which is manifestly absurd or unreasonable, recourse may be made to supplementary rules of interpretation;

  4. Subsequent commentaries on a treaty have persuasive authority only. Similarly, the use of decisions of foreign courts on the interpretation of a treaty depends on the reputation and status of the court in question;
Foreign Case Law Precedents cont.

- In Commerzbank, the court also held that aids to the interpretation of a treaty such as international case law and legal writings is discretionary and depends on, for example, the relevance of such material and the weight to be attached to it.

- The Fothergill-case related to a pre-Vienna Convention UK tax treaty and is therefore particularly persuasive to a South African court. Similarly, the Commerzbank AG case tax treaty was not governed by the Vienna Convention, so would also be particularly persuasive.

- In *Memec Plc v IRC* 1996 STC 1336 it was held by the UK Court of Appeal (following Commerzbank) that:
  - the approach should be purposive and international;
  - regard should be had to the Vienna Convention;
  - recourse may be had to supplementary means of interpretation;
  - subsequent commentaries and decisions of foreign courts have persuasive value only; and
  - recourse to supplementary means of interpretation, international case law and the writing of jurists is discretionary and not mandatory.
OECD Commentary Recommendations

- The OECD Commentary provides the following general remarks concerning the interpretation of treaties:
  - firstly as per Article 31 of the Vienna Convention, States must interpret treaties in the light of their object and purpose. Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between the two Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading to double taxation or to an inappropriate double exemption;
  - secondly, the general rule of interpretation should be based on the terms of the treaty in their context. The context of the treaty takes precedence over an interpretation derived from national laws.
- Thirdly, reference should be had to other agreements, whether prior or subsequent to the treaty, as well as to practice;
- Fourthly, if there is conflicting anti-avoidance domestic legislation the conflict must be resolved in the terms of, or in the provisions of, a treaty and not in the domestic legislation.

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Treaties in more than one Language

• Most tax treaties are concluded in English;
• Several treaties are concluded in more than one language, especially English and French;
• Tax treaties themselves will generally state which language is authoritative;
• Sometimes, e.g. Canada, both languages are equally authoritative (see Mango case);
• Article 33 of the Vienna Convention addresses this issue – then the terms are presumed to have the same meaning which best reconciles the text having regard to the object and purpose of the treaty shall be adopted.
Summary Comparison of Treaty Interpretation and Statutory Interpretation

• Vogel: tax treaty interpretation is a process regulated by law, not an art like the interpretation of poetry!

• It is accepted that treaties are different:
  o Objective (ordinary use of words);
  o Subjective (intention of parties);
  o Teleological (Treaty’s aim and objectives);

• Taxation statutes often interpreted literally (ie allowance/deduction);

• Aim of domestic law: Impose Tax v Aim of Treaties: Relief double tax & non discrimination & info sharing.
Summary Comparison of Treaty Interpretation and Statutory Interpretation cont.

- Treaties must be interpreted broadly and liberally in most countries;
- But such broad general statements provide little guidance;
- DTA has the same status as the Income Tax Act in terms of section 108(2) and section 231(4) of the South African Constitution;
- A DTA therefore does not automatically override domestic tax law. Consequently, if there is a conflict, it must be interpreted;
- SA: *AM Moola Group Ltd v CSARS* 65 SATC 414 – domestic law takes precedence – is this decision correct?

Relevant rules of interpretation include the object and purpose of the relevant provisions, South African common law rules of interpretation and international rules of interpretation;

- Purpose: Allocate equal taxing rights between Contracting States;
- States should seek the interpretation which is most likely to be accepted in both Contracting States (i.e. goal of “common interpretation”).
Summary Comparison of Treaty Interpretation and Statutory Interpretation cont.

- but note two foreign court cases which state that domestic interpretation rules should not apply;

- The Constitution – a 233 – requires us to interpret international agreements in a manner which is consistent with international law.

- Foreign court cases are only relevant to the extent that they interpret or apply customary international law or interpret a specific DTA or DTA article or are otherwise directly relevant. If not directly applicable, foreign court cases are merely persuasive.
Prescribed and Recommended Reading

- Olivier & Honiball: International Tax: A South African Perspective 2011;
- JR de Ville: Constitutional & Statutory Interpretation;
- GM Cockram: Interpretation of Statutes;
- EA Kellaway: Principles of Legal Interpretation: Statutes, Contracts & Wills;
- Meyerowitz: Meyerowitz on Income Tax 2006-2007 (Chapter 3);
- AM Moola Group Ltd v CSAR 65 SATC 414 (Supreme Court of Appeal);
- Memec Plc v IRC 1996 STC 1336 (UK Court of Appeals);
- CIR v Commerzbank; CIR v Branco Do Brasil 63 TC2;
- OECD Commentary: Introduction and Interpretation;
QUESTIONS?

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