Centre for Tax Laws (CTL)

Directorate of Distance Education

NALSAR University of Law, Hyderabad

In collaboration with

TAXMANN

Course Material

M.A. (INTERNATIONAL TAXATION)

1.1.2. INTERPRETATION OF TAX TREATY

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NALSAR University of Law, Hyderabad (Print 2021)
(For private circulation only)

Interpretation of Tax Treaty

Module

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1. **<u>Introduction</u>**

Double Tax Avoidance Agreements are entered into between the countries with the principal purpose of avoiding double taxation and to facilitate trade and investment. The double taxation usually occurs due to following instances:

a) Juridical Double Taxation: Juridical double taxation refers to when the same income is taxed in hands of a person in different countries. It can be due to residence-source conflict or residence-residence conflict.

(i) Residence-Source Conflict: When person's country of residence (the "residence country") as well as the country from which the income is generated (the "source country") claim taxing right on a particular income.

(ii) Residence-Residence Conflict: When a person is resident of two or more countries then each country would claim the taxing right on the global income of that person.

b) Economic Double Taxation: Economic double taxation refers to when the same income is taxed in hands of two different persons. The **example** of economic double taxation is when an enterprise is purchasing goods worth Rs. 1,000 from its foreign associated enterprise. However, the enterprise is allowed deduction of only Rs. 800 as per the Arm's Length Price. Therefore, Rs. 200 would be taxed in India in hands of the Indian enterprise and, it would also be taxed in hands of foreign enterprise, as no corresponding adjustment would be allowed.

The **concerns** in relation to **interpretation of tax treaty** arise mostly due to:

a) Differences in characterisation of income

b) Allocation of taxing rights between the countries

c) Double tax relief by the residence state

For interpreting the Income-tax Act, resort can be made to the Memorandum to Finance Bill, the Finance Minister's Budget Speech and the Notes to the Finance Bill. Further, the Judiciary aids in interpreting the domestic tax law. However, with respect to the international tax, there is not a single court which would interpret the tax treaties from both the countries' perspective. Therefore, every country may interpret the tax treaties differently. Hence, there is a need to understand how to interpret the tax treaty.

2. <u>Principles for Interpreting Tax Treaties</u>

Double Tax Avoidance Agreements are entered into between **two sovereign states**, and therefore, form part of public international law. Before determining how to interpret a tax treaty, it needs to be seen whether a tax treaty is a contract or **agreement** between the two states **or** is it a **statute**. An international agreement cannot be interpreted with general rules of interpretation, while the statute can be. A tax treaty represents the agreement between the sovereign nations to distribute or allocate the taxing rights amongst them and therefore, are agreements. The other view is that the tax treaties are ratified as per the Constitutional procedure and become part of the domestic legislation, therefore, they are also in the nature of statute.

Based on this view, it can be said that the general rules for interpreting any law could be applied for interpreting the tax treaty as well. However, **Supreme Court** in ***Union of India vs. Azadi Bachao Andolan 263 ITR 706 at 751*** has held that principles to be adopted in interpreting treaties are not the same as those employed in the interpretation of — statutory legislation.

Supreme Court in the said case of *Azadi Bachao Andolan* has observed that "An important principle which needs to be kept in mind in the interpretation of the provisions of an international treaty, including one for double taxation relief is that treaties are negotiated and entered into at a political level go ahead and have several considerations as their bases. Commenting on this aspect of the matter, **David R. Davis** in ***Principles of International Double Taxation Relief***, *Pg.4 (London Sweet & Maxwell, 1985)* points out that the main function of a Double Taxation Avoidance Treaty should be seen in the context of aiding commercial relations between treaty partners and as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect of income falling to be taxed in both jurisdictions."

The final Agreement often represents compromises at political level by the countries. The Supreme Court rightly observed that in interpreting double taxation treaties it has to be borne in mind that treaties negotiated are entered into at a political level and have several considerations as their bases. Nevertheless, it is important to refer to principles of interpretation which aid in interpreting the statute, which also play an important role in interpreting the tax treaties.

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.

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 [2005] 276 ITR 306***, the Authority for Advance 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. **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 263 ITR 706*, the Supreme Court of India made the reference to the preamble of the treaty to ascertain the purpose of India-Mauritius Treaty. The Apex Court 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 as **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.

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 [2005] 276 ITR 306*, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material contemporanea exposition, which means that a statute is best explained by **following the construction put upon it by judges at the time it was made, or soon after**".

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. 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.

3. Role of Vienna Convention on Law of Treaties

Vienna Convention on Law of Treaties (VCLT) embodies the **customary rules of interpretation governing international agreement**. The International Law Commission initiated the work on VCLT in 1949 and the same got completed in 1969. VCLT finally came into force in **1980**. VCLT is universally accepted as authoritatively laying down the principles governing the law of treaties. It is an open treaty whereby any country who wishes to be part of it can sign and ratify it. **India** is **not a signatory to VCLT**.

Since, tax treaties are public international law, VCLT can be resorted to interpret the tax treaty as it provides rules of interpretation for any international agreement. The VCLT codifies the principles of interpretation laid down by usage, customs and courts over years.

Though, India is not a signatory to VCLT, Courts have resorted to it time and again as an aid to interpret the tax treaties. Therefore, it is important to understand the various principles of interpretation embodied under VCLT. In *Ram Jethmalani v. Union of India [2011] 12 taxmann.com 27*, the Supreme Court pointed out that though India is not a party to the Convention, it contains many principles of customary international law. Since the principles of customary international law, could always be invoked, the Courts have drawn inspiration from the said Convention, whenever it was necessitated. Following are the important principles of VCLT, which assist in treaty interpretation.

- **Article 26 - Pacta Sunt Servanda:** This principle lays down that **every treaty in force** is **binding upon the parties and must be followed by them in good faith**. The parties to the treaty should not dishonour their international commitments with each other by retrospectively amending their domestic tax laws or by not abiding the treaty terms. **Madras High Court** in ***T. Rajkumar V. Union of India [2016] 68 taxmann.com 182 (Madras)*** had referred to this principle while interpreting India-Cyprus tax treaty in context of Section 94A of the Income-tax Act. The question before the Court was whether Section 94A was against principle of Pacta Sunt Servanda contained in Article 26 of Vienna Convention as it obliged both contracting parties to perform their obligations in good faith and if one party to treaty failed to provide necessary information, then such a party would be in breach of obligation under Article 26. The Court held that Section 94A was not against the principle of Article 26 as Cyprus failed to provide the necessary information to India. One of the four purposes for which, an agreement could be entered into by the Central Government under section 90(1), is for the exchange of information. If one of the parties to the treaty fails to provide necessary information, then such a party is in breach of the obligation under article 26 of the Vienna Convention. The beneficiary of such a breach of obligation by one of the contracting parties cannot invoke the Vienna Convention to prevent the other contracting party (India in this case) from taking recourse to internal law, to address the issue.

- **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**. In ***DCIT v. ITC Ltd. (2002) 82 ITD 239 (Kol.) (Trib.)*** it was held that notification of Central Government amending the treaty cannot affect the right of taxpayers with retrospective effect. Similarly, in ***Tata Iron Steel & Co. Ltd. v. DCIT (1998) 69 ITD 292 (Mum.) (Trib.)***, it was held that Protocol notified in year 1985-86 for amending the Indo-German Tax Treaty of 1959 will not affect the contract entered prior to assessment year 1985-86 even if it provides for 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:** This is a very important principle for interpreting the treaties.

  - 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**. This is a basic principle. It states that treaties should be interpreted by first giving the ordinary meaning to the language. It is only if the ordinary meaning is ambiguous or leads to illogical results, that the purpose may be considered.

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

    - Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

    - 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:

    - Any **subsequent agreement** between the parties regarding the interpretation of the treaty or the application of its provisions;

    - Any **subsequent practice** in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

    - 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.

Mumbai Tribunal in ***Hindalco Industries Ltd. v. Asstt. CIT [2005] 94 ITD 242 (Mum.)*** had held that

"A tax treaty is to required to be interpreted as a whole, which essentially implies that the provisions of the treaty are required to be construed in harmony with each other", that "the words employed in the tax treaties …… need not be examined in precise grammatical sense or in literal sense" and "even departure from plain meaning of the language is permissible whenever context so requires, to avoid the absurdities and to interpret the treaty **ut res magis valeat quam pereat**. i.e., in such a manner as to make it workable rather than redundant".

Therefore, a treaty shall be interpreted in good faith by both the states 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 shall include preamble, annexure and any subsequent agreements by the parties.

- **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.

  Therefore, whenever, the treaty terms are not clear, recourse can be made to the preparatory work to determine the intention of the parties. In *Azadi Bachao Andolan Case*, the Supreme Court emphasized on the preamble to tax treaties to gauge the intention of the Contracting States, which was to promote mutual trade and investment.

- **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**.

In **India**, the **treaties are notified in English and Hindi** and it provides that "all texts are authentic. In case of divergence of text, English text shall be operative one."

4. Reliance on OECD and UN Model Commentaries for Interpreting Tax Treaties

League of Nations first started the work on international taxation in 1921. The Fiscal Committee of the League of Nations invited the United Nations (UN) to review the early models developed. However, the work lapsed in the mid-1950s, and the Organisation for European Economic Cooperation ('OEEC'), the precursor organisation to the OECD, started the work on model convention. In 1963, the Fiscal Committee submitted its final report titled 'Draft Double Taxation Convention on Income and Capital'. Thereafter, revisions were made to the 1963 Draft Convention, which ultimately resulted in the publication of a new Model Convention and Commentary titled Model Double Taxation Convention on Income and Capital, OECD (OECD Model and OECD Commentary) in 1977. This OECD Model has been updated with increasing regularity since 1977, with the latest version being the 2017 version.

Based on the 1977 OECD Model, the UN also adopted a draft Model in late 1979, which was published in 1980 as the United Nations Model Convention (UN Model).

OECD and UN have framed its model tax convention and commentaries to assist the countries to negotiate and enter into the tax treaties. The OECD and UN model commentary represents the views of the Experts from different countries on the interpretation of tax treaties. Though India is not a member of the OECD, yet the model conventions and commentaries on OECD have been used as guidance in interpretation of tax treaties signed by India. The model commentaries can fall within Article 32 of VCLT - 'supplementary means of interpretation' There are divergent views of Indian Courts as to whether OECD Commentary can be used to interpret the tax treaties.

- **View 1: OECD Commentary cannot be relied upon for treaty interpretation**

SC in ***CIT V. P. V. A. L. Kulandagan Chettiar [2004] 137 Taxman 460 (SC)*** had observed that *"Taxation policy is within the power of the Government. Section 90 of the Income-tax Act enables the Government to formulate its policy through treaties entered into by it and* *even such treaty treats the fiscal domicile in one State or the other and thus prevails over the other provisions of the Income-tax Act, it would be unnecessary to refer to the terms addressed in the OECD or in any of the decisions of foreign jurisdiction or in any other agreements."*

Gracemac Corpn. V. Asstt. DIT, International Tax Division [2010] 42 Sot 550 (Delhi) *"We would like to mention that OECD Commentary contains the views of the authors. The commentary cannot be equated with the decision of the apex court or the law enacted by the Parliament. Therefore, while interpreting the provisions of the Income-tax Act and Indo-US DTAA, reliance cannot be placed on OECD Commentary. Though the developed countries are following OECD model convention, but a large number of them had reservation in following the OECD Commentary. Therefore, in all humility we decline to agree with the proposition of the ld. counsel for the assessee to rely on the OECD Commentary, particularly in view of the fact that India has clear reservations on OECD Commentary".*

- **View 2: OECD Commentary can be relied upon for treaty interpretation**

CIT vs. Visakhapatnam Port Trust (1983) 144 ITR 146 is one of the first judgements in India wherein the general principles applicable in the case of Double Taxation Avoidance Agreement were exhaustively considered. In this case, reference was made therein to the OECD Commentaries and the view was expressed that in interpreting a Double Taxation Avoidance Agreement the Court must have regard to the decisions and rulings of Courts in foreign countries. In ***Asia Satellite Telecommunications Co. Ltd. V. DIT [2010] 332 ITR 340 (Delhi)***, it was held that "*The Tribunal has discarded the aforesaid commentary of OECD as well as Klaus Vogel only on the ground that it is not safe to rely upon the same. However, what is ignored is that when the technical terms used in the DTAA are the same which appear in section 9(1)(vi), for better understanding all these very terms, OECD Commentary can always be relied upon."*

Similarly, in ***Metchem Canada Inc. V. Dy. CIT [2006] 100 Itd 251 (Mum.)***, it was held that "*When an expression or a clause is picked up from the OECD Model Convention, the normal presumption is that the persons using the said clause or expression are also aware about the meanings assigned to the said clause or expression by the OECD and have used it in the same sense and for the same purpose. Unless a contrary intention is specifically expressed, say by a protocol attached to the DTAA, it is only axiomatic that the clause or the expression will have the same meaning as normally assigned in the tax literature by the OECD. Therefore, when an expression or a clause from the OECD Model Convention is used even in a bilateral tax treaty involving a non-OECD country, one has to proceed on the basis that it is used in the same meaning and with the same connotations as assigned to it by the OECD Model Convention Commentary."*

Similar conclusion was reached by ***Kolkata Tribunal in ITO v. Right Florists (P.) Ltd***., wherein it was held that "*when an expression or a clause is selected from the OECD Model*

Convention, the normal presumption is that the persons using the said clause or expression are also aware about the meanings assigned to the said clause or expression by the OECD and have used it in the same sense and for the same purpose. In relation to a treaty entered by a non-OECD member, it went on to hold that 'when an expression or a clause from the OECD Model Convention is used even in a bilateral tax treaty involving a non-OECD country, one may generally proceed on the basis that it is used in the same meaning and with the same connotations as assigned to it by the OECD Model Convention Commentary'."

Recently, the Hon'ble Supreme Court recently in ***Engineering Analysis Centre of Excellence (P.) Ltd. v. CIT***, while interpreting the term royalties under the tax treaty, had relied on the OECD Commentary. The Supreme Court had observed that "When the definition of "royalties" is seen in all the DTAAs that we are concerned with, it is found that "royalties" is defined in a manner either identical with or similar to the definition contained in Article 12 of the OECD Model Tax Convention. This being the case, the OECD Commentary on the provisions of the OECD Model Tax Convention then becomes relevant." In other words, the Hon'ble Supreme Court has held that in scenarios where the language of the tax treaty and the OECD Model Tax Convention is the same or similar, the OECD Commentary becomes relevant.

5. Reservation and Observation to the Commentary

OECD member countries may enter reservations on provisions of the OECD Model Convention, which are recorded in the OECD Commentary. By entering a reservation, a member country indicates that it does not intend to follow the OECD Model with regard to a certain provision when concluding double taxation conventions. Member countries entering reservations will thus try to include such modified provisions when negotiating double taxation conventions. If the wording of a provision suggests that a reservation was indeed taken into account, while negotiating the tax treaty, the reservation in the OECD Commentary is relevant for interpretation purposes. Consequently, the OECD Commentary has to be disregarded to the extent that the adopted provision deviates from the OECD Model. If, however, the wording follows the OECD Model despite the fact that a reservation has been entered by a contracting state, it may be assumed that the OECD Model Convention and the OECD Commentary are still relevant.

Member countries may also enter observations on the OECD Commentary. An observation indicates that a member country does not agree with the interpretation given in the OECD Commentary on a certain provision. Unlike a reservation, an observation does not express disagreement with the text of the OECD Model. Consequently, the text of a double taxation convention provides no indication as to whether the contracting states intended a provision to have the meaning expressed in the observation or the OECD Commentary. In such an event, the paragraph of the OECD Commentary commented on by the contracting states loses relevance. Unless the contracting states have made similar observations, one has to rely on additional material (e.g. from the negotiation of the treaty) to determine the content of the treaty provision in question.

Non-OECD member countries express their position, which are essentially disagreements against the views of the OECD Model Commentary. India has been expressing its position against the OECD Model Commentary. However, can such positions expressed in the OECD Model Commentary be relied to interpret the tax treaties.

Mumbai Tribunal in Linklaters case had allowed the treaty benefit to the partners of fiscally transparent entity, despite India's reservation against same in the OECD Model Commentary. Similarly. In ***DIT v. New Skies Satellite BV [2016] 68 taxmann.com 8/28***, Delhi High Court observed that mere positions taken with respect to the OECD Commentary do not alter the DTAA's provisions, unless it is actually amended by way of bilateral re-negotiation. Supreme Court in Engineering Analysis case also rejected the Revenue's reliance on India's position in OECD Commentary to interpret the term royalties under DTAA.

6. Reference to Domestic Tax Laws for Interpreting Tax Treaties

Article 3(2) of the OECD Model provides that "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 or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of the State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax law of that state prevailing over the meaning given to the term under the laws of the other state."

Therefore, if a term is not defined under the tax treaty, can the reference be made to the domestic tax law automatically, to understand that treaty term? The answer to this is no as Article 3(2) provides that reference can be made to the domestic tax law to understand an undefined treaty term, unless the context requires otherwise. For this purpose, it needs to be understood, the meaning of the context. For that purpose, reference can be made to Article 31(2) of VCLT, which spells out that the context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure

- Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
- 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.

Therefore, the context of the tax treaty reflects the intention of the parties at the time of signing of tax treaties. According to Prof. M. Lang, a solution should be first sought based on the systematic, objective and historical development of the treaty, and only when this fails, one can refer to the domestic tax law.

However, the other question which arises is that whether the source state domestic tax law is to be referred or the residence state domestic tax law is to be referred. There are contradictory views to this. One view is that the source state applies the tax treaty and therefore, the reference should be made to the domestic tax law of the source state. As per this view, the residence state should follow the source state's view. The other view is that even the residence state applies the tax treaty and therefore, the reference can be even made to the domestic tax law of the residence state. However, if each treaty partner applies its own respective definition, it could lead to double taxation or non–taxation of income for both countries. It is pertinent to determine the contracting state that will apply the definition. The general view is to apply the laws of the source state i.e. where the treaty is being applied and the resident state should confirm the applicability of the laws by the source state, so as to avoid any double taxation of income.

Article 3(2) is gaining significance in today's times as more and more countries are trying to place reliance on it to unilaterally define terms in their domestic laws and use the same to override tax treaties, so as to increase their tax base and tax revenues.

Further, Section 90(3) provides that "Any term used but not defined in this Act or in the agreement referred to in sub-section (1) shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the agreement, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf."

Note:

1. Where any term is used in any agreement entered into under sub-section (1) and not defined under the said agreement or the Act, but is assigned a meaning to it in the notification issued under sub-section (3) and the notification issued thereunder being in force, then, the meaning assigned to such term shall be deemed to have effect from the date on which the said agreement came into force.
2. Where any term used in an agreement entered into under sub-section (1) is defined under the said agreement, the said term shall have the same meaning as assigned to it in the agreement; and where the term is not defined in the said agreement, but defined in the Act, it shall have the same meaning as assigned to it in the Act and if any, explanation given to it by the Central Government.

With regard to interpreting the term royalties under the tax treaty, recently Mumbai ITAT [TS-710-ITAT-2019(Mum)] have held that when the expression 'royalty' is a defined expression under the applicable tax treaty, there cannot be any occasion to invoke article 3(2) for further dissecting the issue and explore the domestic law meaning of each expression used in this definition for coming at the conclusions about connotations of royalty.

If countries are allowed to read the domestic tax law interpretation in the tax treaties, that may result in treaty override. The issue which arises is whether Parliament can enact legislation subsequent to the signing of a treaty which would override the provisions of a treaty and if so whether such legislation has to be in any particular form. Depending on the provision in a country's Constitution as to the status of domestic law vis-a-vis provisions in a treaty the conclusion may be different whether a post treaty domestic law can override a provision in an earlier treaty. The French and Dutch Constitutions do not, it appears, permit the overriding of a treaty provision by a subsequent legislation. The position is different in the United States of America and in the United Kingdom. Though Article 51 of our Constitution provides as a directive principle that the state shall endeavour to foster respect for international law and treaty obligations in the dealings of organised peoples with one another the position appears to be that there is no fetter on the power of the Indian Parliament to legislate in a manner which may conflict with or override the provisions of an earlier treaty just as Parliament can over turn or amend an earlier enacted law. An example of such treaty override is provided by the insertion of the Explanation to section 90 of the Act (by the Finance Act, 2001) and subsequently amending the Explanation by the Finance Act (No. 2) Act, 2004.

To understand the context in which the Explanation was added a few facts may be noted. Some Double Taxation Avoidance Agreements provide that tax on a permanent establishment of an enterprise of one of the states in the other state shall not be less favourably levied in such other state than the taxation levied on enterprises of that other state carrying on the same activities.

In India, a higher rate of tax is charged on non-domestic companies compared to domestic companies similarly engaged, with the result that the permanent establishment of an enterprise of a contracting state suffers tax at a higher rate. In some cases, it was judically held that such discrimination was not permissible. The Explanation to section 90 now declares that —the charge of tax in respect of a foreign company at a rate higher than the rate at which a domestic company is chargeable, shall not be regarded as less favourable charge or levy of tax in respect of such foreign company. In other words, the Explanation has ruled that rate discrimination is not to be regarded as a less favourable charge of tax obviously for the purposes of Agreements for Avoidance of Double Taxation as only in the case of persons governed by such Agreement would the issue of less favourable rate of tax arise. Further, Finance Act, 2003 sub-section (3) has empowered the Central Government by notification to provide that any term in the Agreement which is not defined therein or in the

Act shall have the meaning given thereto in the notification so long as such meaning is not inconsistent with the provisions of the Act or the Agreement.

7. Which Version of Commentary should be Referred to?

The model commentary gets revised from time to time. The question arises if the treaty is concluded and the Model Commentary gets revised, whether the updated version of the Model Commentary can be referred for interpretation. Further, the domestic tax law also keeps amending. Also, with passage of time, the definitions and interpretations of terms change under the domestic tax law as well. Therefore, the question arises as to whether the reference should be made to the domestic tax law existing at the time when treaty was signed or at the time when the treaty is being interpreted i.e. whether such amendments affect the interpretation of previously concluded double taxation conventions. There are divergent views on this i.e. static approach vs ambulatory approach.

According to static approach - a tax treaty represents an agreement of mutual understanding between the two countries reached at the time of finalization of the treaty and hence, the interpretation of a tax treaty should be based on the provisions relevant at the time of finalization of the tax treaty.

According to ambulatory approach - changing times and commercial scenarios demand that the tax treaty is interpreted on the basis of meanings prevalent in the current world, i.e. at the time of application of the tax treaty.

The OECD Committee on Fiscal Affairs takes the following position on this issue:

"Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles. However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations."

A view may be taken that, if the amendment in the Model Tax Commentary simply clarifies the earlier existing provisions, then the amended Commentary may be referred for the interpretation of previously concluded tax treaties. However, if the amendment provides for a new meaning or substantially changes the provisions, then the amended commentary may not be of any relevance for previously concluded tax treaties and the earlier version may be referred.

The argument in favour of the 'Static Approach' is that a tax treaty represents an agreement of mutual understanding between the two countries reached at the time of finalization of the treaty and hence, the interpretation of a tax treaty should be based on the provisions relevant at the time of finalization of the tax treaty. On the other hand, the rationale for applying the 'Ambulatory Approach' is that the ever changing times and commercial scenarios demand that the tax treaty is interpreted on the basis of meanings prevalent in the current world, i.e. at the time of application of the tax treaty. The OECD Model Convention and its Commentary support the ambulatory approach for interpretation.

Article 3(2) of certain Indian treaties is worded in a manner to provide for ambulatory approach by use of the words 'at that time', 'from time to time', etc, such as treaties signed with South Africa, Australia, Mexico, Hungary, Saudi Arabia and Kazakstan.

The static approach was upheld by the Indian Court in the case of Siemens to give purposive interpretation to the treaty. In this case, a German company had entered into agreements with Indian companies for provision of certain patents, patent applications, utility models, relevant written material etc. and the question was whether payments for the same qualified as 'royalty'. The term 'royalty' was not defined in the applicable tax treaty (the erstwhile India-Germany tax treaty). For interpretation of an undefined term, the relevant tax treaty gave reference to the meaning of the term under the 'laws in force' of the respective country. The term 'royalty' was not defined in the Indian domestic tax law as well at the time of entering into the tax treaty, though the same had been subsequently defined in the domestic tax law. The Revenue contended that given the expression 'laws in force' in the India–Germany tax treaty, the Court should consider the ambulatory approach of interpretation and not static interpretation and apply the royalty definition existing in the domestic tax law as on the date of application of the treaty, thereby, taxing the payments as royalty. On behalf of the taxpayer, it was submitted that the clauses of the tax treaty and the meaning at the point of time when such treaty was entered into should be considered, thereby ignoring the subsequent amendments. The Court finally held that despite there being a subsequent meaning assigned to the term 'royalty' in the Indian domestic tax law, what was important for determining taxability under the tax treaty was the context in which the term 'royalty' was used in the tax treaty (which was used in a narrow sense with regard to income from operation of a mine, quarry or any other extraction of natural resources) and hence, it did not apply the meaning which was subsequently assigned to 'royalty' in the Act (after the execution of the tax treaty) while interpreting the term under the tax treaty.

It was also held by Mumbai ITAT [TS-710-ITAT-2019(Mum)] that when a domestic tax jurisdiction is allowed to amend settled position with respect to a treaty provision by amendment in domestic law, ambulatory or dynamic interpretation is to be discarded if such approach would patronise and legitimise a unilateral treaty override.

8. <u>Reliance on Foreign Judicial Rulings</u>

Indian Courts have relied several times on foreign judicial precedents. In case of ***CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 AP (HC)***, it was held that any person interpreting the tax treaty must consider foreign judicial precedents relating to similar treaties. Also Supreme Court in *Azadi Bachao Andolan* case, had relied on several foreign rulings. Tribunal in ***Meera Bhatia v. ITO (2010) 38 SOT 95 (Mum.)(Trib.)*** emphasized the importance of foreign judicial rulings by observing:

"In legal matters like interpretation of the international tax treaties and with a view to ensure consistency in judicial interpretation thereof under different tax regimes, it is desirable that the interpretation given by the foreign courts should also be given due respect and consideration unless, of course, there are any contrary decisions from the binding judicial forums or unless there are any other good reasons to ignore such judicial precedents of other tax regimes."

Reliance on foreign rulings would also ensure consistency in interpretation on the same issue.

9. Significance of Preamble in Tax Treaties

The preamble to the tax treaty describes the scope, object and purpose of the treaty. Preambles can be seen to have both a contextual and a constructive role in statutory interpretation. In historic judgment of ***Kesavanada Bharati v. State of Kerala*** it was held that preamble to the Constitution of India is a part of Constitution and plays a significant role in the interpretation of statues, also in the interpretation of provisions of the Constitution.

Further Article 31(2) of the VCLT for the purpose of interpretation of a treaty it specifies that even the preamble shall be included. The SC has considered the preamble of the India-Mauritius DTAA has one of the factors for its judgement. The relevant text is reproduced below:

"Based on these observations, counsel for the appellants contended that the preamble of the Indo-Mauritius 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" Pursuant to Azadi Bachao Andolan, in the case of Abdul Razak Meman11 the AAR observed that "these recitals12 indicate that purpose of entering into the treaty is to promote mutual economic relations by concluding an agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital".

Therefore, from the above, we could see that the preambles are being relied on for international tax jurisprudence and hence even though the operative portions of the tax treaties are the subject matter, nevertheless the preamble shall be relied in order to verify the entitlement or applicability of a tax treaty at the time of dispute. The apex court's judgement in *Azadi Bacho Andolan* and its reliance on the preamble to India-Mauritius tax treaty has indeed opened up the significance of preamble in tax treaty. Hence it is not only avoidance of double taxation for which the tax treaties are entered, it is also for promotion of mutual economic trade and relations.

However, through BEPS Action Plan 6 and MLI, the text of the preamble is amended to include the following *"Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)"*

The new preamble text is to confirm that the treaties are not only to avoid double taxation but also to avoid double non-taxation through tax evasion or avoidance.

Test Your Knowledge

QUESTIONS	
1.	Explain the meaning of double taxation. What are the factors which lead to double taxation?
2.	Explain the General Rule of Interpretation under Vienna Convention of Law of Treaties.
3.	What are the principles of interpretation of Tax Treaties?

SOLUTIONS	
1.	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 since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods). 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 as the company would be heavily engaged in doing business in the territory of other country (for example, setting up of a branch). • **Juridical double taxation:** 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 "juridical 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. • **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 persons (because of lack of subject identity).
2.	Article 31 of Vienna Convention of Law of Treaties contains the General Rule of Interpretation. It lays down the following general rule of interpretation: a) 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. b) The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure (i) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; (ii) 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.

<table>
<tr><td></td><td>c) The following shall be taken into account, together with the context in that:
(i) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
(ii) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
(iii) Any relevant rules of international law applicable to relation between the parties.
d) A special meaning shall be given to a term if it is established that the parties so intended.</td></tr>
<tr><td>3.</td><td>Following are the six principles of interpretation of tax treaties:

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.

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 [2005] 276 ITR 306, the Authority for Advance 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. 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 263 ITR 706, the Supreme Court of India made the reference to the preamble of the treaty to ascertain the purpose of India-Mauritius Treaty. The Apex Court 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".</td></tr>
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	iv. The Principle of Effectiveness: According to this principle, a treaty should be interpreted in a manner as **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. **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 [2005] 276 ITR 306*, the AAR observed that "there can be little doubt that while interpreting treaties, regard should be had to material contemporanea exposition, which means that a statute is best explained by **following the construction put upon it by judges at the time it was made, or soon after**". **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. 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.