

**FOURTH NLSIR SYMPOSIUM
INDIA'S TAXATION REGIME: PERSPECTIVES ON
THE PROPOSED CHANGES**

**INTERPRETATION OF TAX TREATIES: AN ART YET
TO BE MASTERED!**

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ABSTRACT

Well-founded norms of treaty interpretation are imperative to understanding legislation. Through this piece, the author provides a detailed study of norms relating to the interpretation of tax treaties. In this light, the author provides an overview of the general principles enshrined in the Vienna Convention, as confirmed by judicial decisions, as well as of the model tax conventions developed by organizations such as the OECD, the League of Nations, the UN, and individual states such as the US. The author finally details the Indian perspective on the interpretation of tax treaties, as evinced in judicial decisions, arguing that Indian jurisprudence currently lacks established norms for interpreting tax treaties although a broad adherence to the Vienna Convention is discernable.

"It would be idle to expect every statutory provision to be drafted with divine prescience and perfect clarity"

-Lord Denning

The interpretation of law has always been a subject matter for international adjudication. Today, the increasing number and significance of treaties have added importance to the art of their interpretation. Further, when two countries are involved, there is a great chance that for the same term, people from the two countries will have different meanings. It is in this background that the art and study of interpretation has developed and gained importance.

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I. HISTORICAL PERSPECTIVE

The reference to the concept of 'Treaty Interpretation' dates back to the classical Greco-Roman era. In those times, there was a developed practice of framing treaties and developing rules of interpretation. Later, during the 10th-18th centuries, renowned jurisprudential thinkers like Grotius, Pufendorf and Vattel identified rules for interpretation of treaties and made efforts to shape them into codes. Grotius while publishing his work on the law of war and peace in 1625 noted that "*the interpretation of treaties is sufficiently important to warrant a complete chapter.*"

Increasing resort to arbitration from the late 19th century onwards and encouragement by Hague Conferences resulted in a growing repository of decisions on interpreting treaties. A landmark in the progression towards codification of the principles of interpretation of treaties was the publication of the fruits of research conducted at Harvard in the form of draft conventions.

These elements of the history of interpretation of treaties have led towards modern treaty interpretation, and serve as an introduction to the work of the International Law Commission and the Vienna Conference.

The art of interpretation of treaties has remained unsettled. This was sought to be resolved by the Vienna Convention on Law of Treaties [Hereinafter, "Vienna Convention"] signed at Vienna on May 23, 1969. Today, 45 and 111 countries are signatories and parties, respectively, to the Vienna Convention.

II. VIENNA CONVENTION

The Vienna Convention was signed considering the pivotal role of treaties in the history of international relations, thereby recognizing the escalating significance of treaties as a source of international law and as a means of developing peaceful cooperation among nations.

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In the realm of public international law, the three main approaches to treaty interpretation which have been traditionally recognized are as under:

- The 'textual' (or 'ordinary meaning of the words') approach analyses the actual words in the text of the treaty to ascertain its meaning.
- The 'intentions of the parties' (or 'founding fathers') approach ascertains the parties' intentions. The treaty is then construed to give effect to such intentions.
- The 'aims and objects' (or 'technological') approach ascertains the treaty's aims and objects. The treaty is then construed to give effect to these aims and objects.

However, complex commercial relations and the growing uncertainty with respect to the traditional approach posed two major issues: which approach is the most appropriate, and what materials (apart from the treaty text itself) a court may consider.

The Vienna Convention, especially in terms of Arts. 31 to 33, provides insight into these two major aspects of treaty interpretation.

Art. 31(1) of the Vienna Convention provides guidance on which approach is most appropriate by adopting the 'textual' or 'ordinary meaning of the words' approach as the beginning for the general rule of interpretation.

Art. 32 of the Vienna Convention provides that in interpreting the terms of a treaty, the preparatory work and the circumstances of its conclusion should be taken into account if the application of the textual rule creates ambiguity. This is called the '*travaux préparatoires*' rule.

Art. 33 states that 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, the text in one language will prevail.

These rules are not step-by-step formulae for producing an irrefutable interpretation in each and every case. There is in these rules a definite innate logical succession but these rules are not of use every time. Nor can they always be sequentially applied.

The principles of free consent, good faith and *pacta sunt servanda* (i.e. a treaty obligation must be respected) form the basic pillars and foundation of the Vienna Convention.

The unreserved recognition and endorsement of the rules of interpretation as contained in the Vienna Convention are now well evidenced in the judgments and opinions of the International Court of Justice, [Hereinafter, "ICJ"] and in the arbitral awards and decisions of national courts.

The ICJ, which is the principal judicial organ of the United Nations, has pronounced that the Vienna Convention is in principle applicable to the interpretations of all treaties. This proposition now constitutes a statement of customary international law, with the effect that the rules apply to the interpretation of any treaty, whether the states involved are parties to the Vienna Convention or not. The view of the ICJ has been shared by several other international organisations, courts and tribunals like the World Trade Organization, the Permanent Court of Arbitration, etc.

III. ORIGIN AND GROWTH OF INTERNATIONAL TAX TREATIES

With the growth in cross-border investment, in order to ensure that the commercial interests of the investing country are not seriously impeded through the returns on such investment being taxed twice, renowned world organizations like the League of Nations, the United Nations [Hereinafter, "UN"] and the Organization for Economic Co-operation and Development [Hereinafter, "OECD"] sought to provide a basic framework for developing bilateral tax treaties.

The League of Nations first commenced work in this regard in 1921 and produced the first Model Bilateral Convention in 1928.

The OECD first published a Draft Double Taxation Convention on Income and Capital in 1963, followed by the Model Tax Convention on Income and Capital in 1977. The OECD Model Convention is accompanied by an extensive commentary, prepared by the OECD Committee on Fiscal Affairs.

In the first decades of its existence, the UN did not occupy itself with the development of any such Model Tax Conventions. So, when the OECD published its 1963 Model Convention and later the 1977 Model Convention, they quickly became the worldwide standard for tax treaty negotiations.

It was seen that the OECD model was more appropriate for negotiations between developed countries rather than capital-importing or developing countries. Therefore, pressure was put on the UN to set up an independent working group of tax treaty experts nominated by governments but acting in

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their personal capacity. This led to the creation, by the UN Secretary-General, of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries in 1968.

It was only in 1980 that the first UN Model Double Taxation Convention between Developed and Developing countries was published. There are major differences between the two Model Tax Conventions in terms of the provisions dealing with Permanent Establishment (Art. 5), Business Profits (Art. 7), Associated Enterprises (Art. 9), Dividends (Art. 10), Interest (Art. 11), Royalties (Art. 12), Capital Gains (Art. 13) and Other Income (Art. 21).

The UN Model was quickly embraced, mostly by developing nations. The OECD Model Convention and the commentaries relating to it, though primarily meant for use by the OECD countries, are often referred to and applied in interpreting agreements between non-OECD countries also.

Predictably, the United States wanted to have its own Model Convention and published the US Model Treaty in 1976. It is accompanied by a most exhaustive technical explanation commenting on the various articles in the Model Convention. Whenever the United States enters into a Double Taxation Avoidance Agreement, [Hereinafter, "DTAA"] it also releases a detailed write-up explaining the US view concerning each of the articles in the Agreement entitled "The Treasury Department Technical Explanation". Thus, far more 'official' literature is available in respect of agreements concluded by the US.

The provisions of these Model Conventions are not binding and should not be construed as formal recommendations. They are intended primarily to point the way towards feasible approaches to the resolution of the issues involved that both the potential contracting parties are likely to find acceptable.

IV. INDIA'S PERSPECTIVE: TAX TREATIES

The increase of DTAA's entered into by India with numerous foreign countries has led to the creation of a new discipline in tax law. These agreements come into play when a resident of one state has income sourced in another state. For the purpose of such agreements, income is regarded as sourced in a state if the payer is based there.

A DTAA may effectively provide for avoidance of tax or for relief against double taxation by providing for grant of credit by the state of residence of the tax paid in the source state.

The first concrete step for providing relief against double taxation in India was taken in 1939 with the coming into force of the Income Tax (Double Taxation Relief) (Indian States) Rules. Currently, the Central Government has been authorised under ¶ 90, The Income Tax Act, 1961 [Hereinafter, "the Act"] to enter into DTAAAs with other countries.

India became a member of the UN on 30th October, 1945. It also places reliance on the UN Model in the interpretation of treaties. Though India is currently not a part of the OECD (India is currently an Enhanced Observer at the OECD), it may soon join ranks with top world economies by becoming a member of the OECD. It may speed up its efforts to trace black money in foreign shores and tighten anti-money laundering regulations.

India has entered into DTAAAs with over 90 countries - some of them of limited application but most of them being comprehensive agreements. These treaties are based on the general principles laid down in the model draft of the UN and the OECD with suitable modifications as agreed to by the other contracting countries.

The OECD Model Convention requires one to have regard to the definition of a term in the agreement in any local law but preference is to be given to the meaning, if any, under the local tax law. However, as per the US and UN Models as well as the agreements generally entered into by India, it is only the meaning in the local tax law (and not any other local law) which has to be taken into account.

From the increasing treaty network of India as well as the recent amendment to the India-Switzerland treaty on the aspect of exchange of information, the signals India is seeking to send are clear - that India has been working towards building a model for itself which is suitable to its environment, like the US has built the US Model for itself. However, till the same has been concretized, the issues of interpretation of the tax treaties will persist in India.

V. TREATY INTERPRETATION: INDIAN APPROACH

Tax treaties are international agreements under public international law and thus subject to interpretation according to international law principles. Rules for the interpretation of international agreements laid down in the Vienna Convention dealing with the "interpretation of treaties" thus provide the framework for assessing the international tax treaties as well. India is not a party to the Vienna Convention. However, as the rules laid down in the Vienna Convention are

regarded as a principle of customary international law, to that extent they would be equally applicable in interpreting DTAA's entered into by India.

The first and the primary premise according to the Vienna Convention is '*pacta sunt servanda*' i.e., observe all treaty obligations. In this regard, the supreme law of the land in India i.e. Art. 51(c), The Constitution of India, 1950, provides that all international obligations must be respected.

Further, § 90(2), the Act makes it clear that where a treaty for avoidance of double taxation has been entered into, then in relation to the taxpayer to whom such treaty applies, the provisions of the Act, to the extent that they are more beneficial as compared to the provisions of the DTAA, would have to be applied and vice versa. Given this provision, coupled with the charging provisions of the Act which begins with a clause stating "*subject to other provisions of the Act*", it can be suggested that in India, the tax treaties are interpreted so as to foster adherence to the international obligations that have been entered into.

Naturally, such beneficial provisions would lead to treaty shopping. When such is the position of law, the immediate query that comes to mind is why the benefits under the beneficial tax treaties are being denied to taxpayers on the pretext of the doctrine of economic substance.

The Supreme Court of India has dealt with this aspect exhaustively in *Union of India v. Azadi Bachao Andolan*.¹ [Hereinafter, "*Azadi Bachao Andolan*"] According to the Supreme Court, it was for Parliament to take appropriate action in the matter and in the absence of a prohibition, one could not deny the benefits of a treaty on the basis of the belief that treaty shopping was not permissible. An anti-treaty shopping provision is normally inserted in a DTAA, where intended, in the form of a 'limitation on benefits' clause. Therefore, according to the view of the Supreme Court and the general principles of respecting treaty obligation, merely because a tax benefit is obtained, the treaty should not be regarded as not being applicable.

The only two instances where such a benefit can be denied (which should be an exception) is where there is a specific look-through provision in the Act or treaty or where the transaction is a sham and the corporate veil is required to be lifted. The word 'sham', which is used in the context of the economic substance theory, has to be understood in two senses: *First*, where the transaction is *non est* or

1 *Union of India v. Azadi Bachao Andolan*, (2003) 263 ITR 706 (SC) [Supreme Court of India].

fictitious. *Second*, where the transaction is in existence but in its economic sense it is a sham. A mere tax benefit does not make the transaction a sham. Therefore, while Indian tax authorities must respect treaty obligations, look-through provisions and the general rule of lifting of the corporate veil can be used as exceptions to protect the interests of the revenue. This would create a balanced approach in interpreting tax treaties, as suggested by the Supreme Court in *Azadi Bachao Andolan*.

Now, the question that arises is, are treaties to be interpreted literally? In India, there is no strait-jacket rule that is followed by the judiciary while interpreting treaties. The approach of the Indian judiciary is to interpret the law as per the letter of the law and the spirit of the law. Thus, the Indian approach, though in line with the Vienna Convention regarding going by textual interpretation in the first stage, also accords due importance to the purpose of the enactment and the provision.

A classic example of the same can be seen in the judgment of the Madras High Court in *CIT v. V.R.S.R.M. Firm*², wherein the Court, while determining the allocation of taxing rights between two Contracting States in a situation where the expression used was “*may be taxed in the other Contracting State*”, has observed that

“By using the expression “*may be taxed in the other State*”, the contracting parties permitted only the other State i.e. State of income source and by implication, the State of residence was precluded from taxing such income...“*May be taxed*” in the agreement has been liberally used and the same cannot be taken advantage of by the Revenue to bring under the assessment the income taxed in other State”

This view has been followed by several High Courts and Tribunals and has also been endorsed by the Supreme Court of India in *CIT v. Torquise Investment*.³

The next question that arises is what are the materials that one can refer to while interpreting the tax treaty? Since India does not have a model of its own and the Indian tax treaties are largely adaptations of the OECD and UN Model, in *Azadi Bachao Andolan*, the Supreme Court of India observed that the commentaries of these

2 CIT v. V.R.S.R.M. Firm, 208 ITR 400 (Mad) [Madras High Court].

3 CIT v. Torquise Investment, (2008) 300 ITR 1 (SC) [Supreme Court of India].

Model Tax Conventions can be relied on. In contrast, in *CIT v. Kulandagan Chettiar*,⁴ the Supreme Court observed that where the treaty provision is unambiguous, no reference may be made to the international materials and commentaries.

Reading the two judgments of the Supreme Court of India harmoniously, it can be suggested that the Indian courts while interpreting treaties go by the explicit language of the treaties as a general rule first, and then in case of ambiguity, make reference to other materials and the Model Conventions.

Ultimately, in order to arrive at the correct interpretation of tax treaties in India, the Courts, though not explicitly, have in principle been adopting the underlying principles of the Vienna Convention which is regarded as the 'grund norm' in interpreting tax treaties.

VI. CONCLUSION

The taxation policy of a country is within the power of the sovereign and in India, by virtue of § 90, the Act, the Government has been empowered to formulate its policy through treaties entered into by it. Such treaties prevail over the other provisions of the Act.

The general rule in tax law that one has to look merely at what is clearly said and that there is no equity in tax seems to be undergoing a change when interpreting a tax treaty wherein the general rules of international law are being followed.

While it is true that international taxation law has grown by leaps and bounds, the need to have legislation for the implementation of international law is still a prime concern. Thus, in this ever changing world, the only thing that remains constant is 'change'. Even the art of interpretation of treaties will always remain a volatile subject full of uncertainties, thus requiring us to keep pace with the changing business environment.

⁴ *CIT v. Kulandagan Chettiar*, (2004) 267 ITR 654 (SC) [Supreme Court of India].