Interpretation of Treaties for the Avoidance of Double Taxation with Practical Examples

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Abstract

This contribution deals with the problem of interpretation of treaties for the avoidance of double taxation from the point of interpretative models theory. The main aim of the contribution is to confirm or disprove the hypothesis that the continental interpretative canon or Anglo–Saxon one should be used during the procedure of interpretation of the legal concept of treaties.

Keywords

tax; interpretation of treaties for the avoidance of double taxation

1 Introduction

The paper aims to discuss the specific forms of interpretation in tax law with practical examples of the interpretational path used in the recent judgment of the Supreme Administrative Court.[2] The judgement deals with the interpretation of treaties for the avoidance of double taxation (hereinafter: double taxation treaties). In the Anglo–Saxon legal system and continental legal environment, there have been developed sophisticated interpretative guidelines for interpretation of the tax law. The rules outlined in these guidelines are general. The hypothesis of the article is to verify, which of the interpretational paths is the correct one for interpretation of double taxation treaties for the Czech legal system.

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[2] Judgment of the Supreme Administrative Court from 25 May 2018, file No. 7 Afs 265 / 2017 (hereinafter: the Judgment).

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From the point of view of the 100th Anniversary of the Founding of Czechoslovakia, it is necessary to say that international double taxation treaties have played in the past years (decades) a significant role in national jurisdictions, because double taxation of income resulting from the very existence of an international element is world-widely an undesirable phenomenon in tax law. The interpretation of double taxation treaties should therefore be given real attention.

The interpretation of international treaties, including, of course, double taxation treaties is, to a certain extent, a specific legal area. It is necessary to take account, *inter alia,* of Arts. 31, 32 and 33 of the Vienna Convention on the Law of Treaties. According to the rules, international treaties must be interpreted in good faith, in accordance with the usual meaning given to the terms in the contract in their overall context, and also taking into account the subject matter and purpose of the contracts. Account must also be taken of the different language versions of contracts and additional means of interpretation (OECD model contracts and commentary on these model contracts).

As mentioned above, the following text will deal with the recent Supreme Administrative Court ruling on the interpretation of double taxation treaty; in particular the Convention between the Czechoslovak Socialist Republic and the Kingdom of the Netherlands for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital (hereinafter: Convention) was the subject of legal interpretation of the court. This contract shows many relatively atypical signs, especially because of its "age". It was negotiated in 1974, and it is the oldest applicable Czech double taxation treaty (the reason the authors use it as an example).

The interpretation of the text of double taxation treaties is the subject of several publications.[3] However, the Czech academic environment lacks literature dealing with methods of interpretations and its basic rules.

To confirm or disprove the hypothesis, the authors will use scientific methods such as analysis, implementation of premises for the purpose of testing it in the legal approach of the Czech legal order and others.

2 Methods of Legal Interpretation

The doctrinal and interpretative rules of the tax law are summed up by the President of the Supreme Administrative Court of Poland, M. Zirk-Sadowski,[4] in the so-called canon of interpretation based on four key points:

a) The preference of grammatical interpretation – the grammatical interpretation is always a key one, however, when the Czech Constitutional Court already confirmed the impossibility of a purely grammatical interpretation as the only

[3] See Sojka, 2017; Vyškovská, 2010; Wassermeyer et al., 2010.
[4] See Zirk-Sadowski, 2004: 9–20.

and always just enough interpretation.[5] The use of teleological interpretation in the field of public law, in view of the *nullum tributum sine lege* principle, is confirmed, even for the area of criminal law, which is *ultima ratio* and the standard of legal protection is the highest.

b) In a situation of interpretational doubts, decision should favour the taxpayer – the principle *in dubio pro mitius* reflects the attempt to protect against ambiguity of provisions of the law. The principle *in dubio pro mitius* is based on Art. 4 par. 4 of the Charter of the Fundamental Rights and Freedoms of the Czech Republic.

c) Strict interpretation (narrow construction) of the tax exemptions – this is the reaction on the abuse of rights.

d) Prohibition of analogy – of course, to the detriment of the taxpayer.

Another and, at some points, a contradictory interpretative canon has been provided by the representative of the Anglo–Saxon legal environment Lord Donovan in the case of IRC v. Mangin.[6] The Anglo–Saxon Legal World has created basic interpretative rules.

First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices.[7]

Secondly, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[8]

Thirdly, regarding the object of the construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.[9]

Fourthly, the history of an enactment and the reasons which led to its being passed may be used as an aid to its construction.[10]

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5 The Constitutional Court in its plenary decision from 17 December 1997, file No. Pl.US 33/97 stated that: "Language interpretation is only an initial approximation to the legal norm. It is only a starting point for clarifying its meaning and purpose (which also serves a number of other procedures, such as logical and systematic interpretation, interpretation *e ratione legis,* etc.). Mechanical application abstracting from, resp. knowingly, either intentionally or as a result of ignorance, the meaning and purpose of the legal norm, makes the law a tool of alienation and absurdity."

6 IRC v. Mangin AC 739, 746; 1971 1 All ER 179, 192.

7 Turner, J. added in his (albeit dissenting) judgment in *Marx* v. *Commr. of I. R. (N.Z.)* (1970) N.Z.L.R. 208 at p. 208, moral precepts are not applicable to the interpretation of Revenue Statutes.

8 See also Rowlatt, J. in *Cape Brandy Syndicate* v. *I.R. Commrs.* (1921) 1 K. B. 64 at p. 71, approved by Viscount Simons, L.C. in *Canadian Eagle Oil Co. Ltd.* v. *R.* (1946) A.C. 119.

9 It is the very essence of the case (ratio).

10 Lord Mackay, concurring with his brethren in allowing the taxpayers' appeals, did so on the basis that the taxpayers' interpretation was at least one of two possible constructions, and any ambiguity should be resolved in favour of the taxpayer. He did not believe that parliamentary materials should be allowed to be used as aids to statutory interpretation, largely because of the practical difficulties in

The last rule has been precised in time. Lord Braune-Wilkinson formulated three conditions under which the exclusionary rule could be relaxed so as to permit reference to parliamentary materials:

a) where legislation is ambiguous or obscure;
b) where the material relied upon consists of one or more statements by a minister or other promoter of the Bill together if necessary with such other parliamentary material as is necessary to understand such statements and their effect; and
c) the statements relied upon are clear.[11]

Professor Brzeziński[12] softly summarises *An Interpretation Strategy for Taxes in the Anglo–Saxon Environment* into these simple rules:

1. The words are to be given their ordinary meaning. They should not be given another meaning because it leads to tax avoidance.
2. In the interpretation of tax regulations, moral rules do not apply.
3. Pay attention to only what has been clearly stated in the text of the provision.
4. There is no equality in taxation and should not be sought for.
5. Do not fill any gaps in the law by implication or by "adding" a text.
6. When interpreting a legal norm, it should be assumed that the legislator did not intend to produce absurd or unjust results. If, within the limits of a grammatical interpretation, it is possible to omit such results, it should be done.
7. The history of legal works on the draft and the reasons for its adoption may be used as auxiliary source of arguments for interpretation (its result).

From these canons of interpretation, it is clear that grammatical interpretation plays a decisive role and law-making ("courtislation") is forbidden. In addition to these two "contact points", however, canons differ from each other. One introduces non-equity and lack of moral rules in the tax law, the other underlines the principle of *in dubio pro libertate* (*in dubio pro mitius* or *in dubio contra fiscum*).

What, however, do these tax rules show in the field of international double tax treaties and whether the Polish interpretational canon – in favour of the taxpayers – or Anglo–Saxon theories – rather textual (for the benefit of the state) prevails in the Czech legal order? To disprove or confirm the hypothesis, the exemplification of the Czech judicial approach will be the subject matter of the next analysis.

terms of the expense and time that would be taken on research by advisers and lawyers. He considers the permissibility to relax the exclusionary rule – for more details see Re, 2014.

11 Pepper v. Hart, AC 593; HL 1992, 65 TC 421; [1992] STC 898.

12 See Brzeziński, 2016: 255–272.

3 Exemplary Judgement of the Supreme Administrative Court; General Background

The judgment of the seventh senate of the Supreme Administrative Court dealt with the interpretation of the Convention, which came into force on 5 November 1974 (see also Decree of the Ministry of Foreign Affairs No. 138/1974 Coll.).

In the present case, it has become questionable, according to which article of the Convention, the silent partner is to tax the income from his silent (limited) partnership.

It is therefore necessary to at least generally explain the Czech legal institute of silent partnership.

Under a silent partnership contract, the silent partner undertakes to make a certain investment contribution to an entrepreneur's business and thereby to participate in it, while the entrepreneur undertakes to pay him a part of the profits proportionate to the silent partner's share in such business (trading result) after the entrepreneur deducts the proportionate mandatory allocation of money transferred to a reserve fund if such fund must be created. The extent of the silent partner's share in a profit and loss must be equal.[13]

An important circumstance is that the rights and obligations towards third parties from business come only to entrepreneurs. This is why they are in "silent" partnership. However, it must be added that a silent partner is, however, responsible for the obligations of the entrepreneur if his name is included in the business name of the entrepreneur or he declares to the person with whom the entrepreneur negotiates the conclusion that he is doing business together with the entrepreneur.

Likewise, it is extremely important that a silent partner has a legal position with respect to his or her contribution, which the creditor has in respect of his claim, but is not entitled to demand the return of his investment contribution before the termination of the contract.

4 Facts of the Case

The petitioner in the Judgment was Dutch company A, established in the Kingdom of the Netherlands (hereinafter: the applicant). On 21 April 2004, the petitioner concluded with the Czech company B (hereinafter: the taxpayer) under Art. 673 of the Commercial Code, a silent partnership contract, under which he provided investment contribution of 425,101 EUR. Due to the contract, the applicant as a silent partner was entitled to 66% of the net profit of the company. On 22 April 2013, the parties agreed to end the silent partnership. According to this agreement, an amount of 5,408,890 EUR was to be paid

[13] See Art. 673 par. 1 of the law No. 513/1991 Coll., the Commercial Code, as amended (the law in force at the relevant time).

to the petitioner as a silent partner. The tax in the amount of 10% from the 5,408,890 EUR has been assessed by the tax administrator.

The applicant disagreed with the tax administrator decision. Therefore, he filed a lawsuit against the tax administrator to the administrative court.

The administrative court dismissed the appeal. According to this court, in the case, Art. 10 (3) of the Double Taxation Treaty cannot be applied because the applicant did not own at least 25% of the capital[14] of the company paying the dividends. The silent partner has a creditor position towards the company. The creditor is not the owner of the debtor's assets. The court further added that Art. 23 of the Treaty cannot be applied to the case, since the income is not an income explicitly mentioned in the Convention, but is income from the profit-sharing debts under Art. 10 par. 6 of the Convention.

Cassation complaint has been filed. In this, he argued that the tax administrators and the municipal court misinterpreted the text of the Convention. According to the applicant's opinion either Art. 23 of the Convention or Art. 10 par. 3 of the Convention must be applied to his situation, as the complainant fulfilled the condition of direct ownership of at least 25% of the taxpayer's capital. From the point of view of the applicant, the notion (concept) of "capital" cannot be narrowly (strictly) defined as "registered capital"; pursuant to Art. 6 par. 2 of the Commercial Code, the capital is the aggregate of all the entity's business property and liabilities.[15]

5 The Judgement

The Supreme Administrative Court considered first the review of the income of the silent partner, and later dealt with the notion (concept) of "capital".

5.1 The income of the silent partner; Art. 10 or 23 of the Convention?

Under Art. 23 of the Convention, the income of resident or domiciled person in one of the states (the Czech Republic or Netherlands) not expressly mentioned in the preceding articles is subject to tax only in that state. Therefore, if the applicant's income would fall under the scope of any article of the Convention, it would not have to be taxed in the Czech Republic, but it would have to be taxed in the Kingdom of the Netherlands. It was therefore necessary to find out whether the income could be subordinated to any other article of the contract or not.

The Supreme Administrative Court held that the income falls under Art. 10 par. 6 of the Convention. The court underlined that the agreement on silent partnership was

[14] In Czech, capital can be understood as the (registered) capital of the company, asset, property or estate, it is an ambiguous legal concept.

[15] Capital in the meaning of business assets.

concluded in accordance with the Czech Commercial Code, and its contracting parties agreed that the contract and legal relations resulting from it will come under the Czech legal system. Based on Czech private law, the silent partner has the same legal position regarding the investment contribution as the creditor to his claim.[16]

Therefore the silent partner is a creditor with a claim to the company (he deposited the claim).[17] The Court further pointed out that the contribution was conjunct with the profit (even due to the agreement).

5.2 Theoretical approach of the interpretation of income

The court reached the first of four steps of the Zirk-Sadowski canon and concluded that the income of the silent partner has the same legal nature (basis) as dividends. The court proceeding differs from the theoretical approach.

On the one hand, the court asserts that the nature of the income from silent partnership is, according to the law, similar to a dividend, on the other hand, it points out that this nature of income also arises from the contract between parties. There is a difference between the application of "the will criterion" and "the private law rule" and the "subordination of the facts of the case under some legal provision". Since the establishment of the Supreme Administrative Court, its case law has formed the rule that in tax law, the factual state of the matter is the only criterion for application of the tax rule (legal provision).[18] Unlike private law, public law regulations do not give recipients the choice of how income from a legal relationship can be taxed. The silent partner and company A (parties to the contract) behaved according to the contract, which no one interfered, if it were otherwise, the actual situation will prevail and the proper assessment would be connected to this factual state.

5.3 The income of the silent partner (the applicant) and Art. 10 of the Convention

In the next procedural step, the court had to answer the question whether the complainant's income fell under the second paragraph of Art. 10 of the Convention or under the third paragraph of the article.[19] It is noteworthy that if the income under consideration had to be assessed under the third paragraph of the Convention, the applicant should not have been taxed by the Czech tax administrator.

16 See Art. 681 of the Commercial Code.

17 See Pokorná et al., 2009: 822.

18 See the judgment of the Supreme Administrative Court from 31 March 2004, file No. 5 Afs 22/2003.

19 Due to Art. 10 par. 3 of the Convention "[n]*otwithstanding the provision of paragraph 2 the State of which the company is a resident shall not levy a tax on dividends paid by that company to a company the capital of which is wholly or partly divided into shares and which is a resident of the other State and holds directly at least 25 per cent of the capital of the company paying the dividends.*"

As aforementioned, the problem occurred in relation to the interpretation of the word "capital".

Whereas the concept of "capital" is not defined by the Convention, its interpretation must be made in accordance with Art. 3 par. 2 of the Convention. According to that provision, a term which is not otherwise defined has, for the purposes of the application of the Convention, the meaning which it derives from the law of the state which assess the taxes which are the subject matter of the Convention unless the circumstances of the case requires a different interpretation.

The Supreme Administration Court emphasised that for the interpretation of the terms contained in the Convention, the importance of ordinary legal concepts (meanings) at the time of the negotiations of the Convention must be taken into account. At that time, the meaning of "capital" has been used for a legal institute later named as "registered capital". The same conclusion appears from another two language versions of the Convention (Dutch and English).

The Supreme Administrative Court also applied Art. 32 of the Vienna Convention on the Law of Treaties and admitted the commentary on the OECD model contract as an "additional tool" for interpretation.

The Supreme Administrative Court summarised that the applicant's opinion would *ad absurdum* conclude that any large creditor of the corporation (such as a trading partner or even a bank providing a loan company) would meet the above mentioned condition of "ownership of at least 25% of the capital". The share of registered capital is clearly identifiable, essentially stable and publicly verifiable, which can be effectively used to determine the correct tax; this does not apply to the share of assets. The taxpayer also should know his tax regime (forum shopping) in advance.[20]

The interpretation of double taxation treaties is, in practice, quite difficult as we can see. The Supreme Administrative Court chose a grammatical interpretation combined with historical and logical interpretation as classic theory recommends.[21]

5.4 Theoretical approach of the interpretation of double taxation treaties

International law does offer "general rules" for interpreting treaties. These rules are set out in the Vienna Convention on the Law of Treaties and binding on all states. The Vienna Convention on the Law of Treaties offers two main principles of interpreting international law. The first is that treaties must be interpreted "in good faith" in accordance with the "ordinary meaning" of the "terms" or text of the treaty, in their "context", and in light of the treaty's "object and purpose". This summing up of text, context and purpose is described as a holistic, non-hierarchical exercise, albeit one that

[20] See Vyškovská, 2010: 19.
[21] See Knapp, 1993: 170.

starts with the text of the treaty.[22] The second main principle of the Vienna Convention on the Law of Treaties is that the "preparatory work of the treaty and the circumstances of its conclusion" are only secondary sources of interpretation, to confirm meaning established under the first principle or in case the meaning of the treaty remains unclear or leads to an absurd result.[23]

The relationship between two taxpayers cannot influence *forum shopping*. In the present case, the Convention includes direct regulation for forum shopping (Art. 3 par. 2).

The speciality of the interpretation of international treaties generally is that if there are doubts about the meaning of the word, the rule *in dubio pro libertate*[24] does not apply.[25] If a legal norm is incomprehensible or ambiguous, the interpretative rules apply directly from the Vienna Convention on the Law of Treaties. The main rule is the use of grammatical interpretation and the condition that the result of the interpretation cannot be manifestly absurd or unreasonable.[26] In the case under consideration, however, the rules laid down in the contract were used as a *lex specialis* to the Vienna Convention on the Law of Treaties rules.

The court thus ruled correctly.

Professor Brzeziński[27] states that the practical application of tax law focused on the result. A similar "diversion" from interpretive purity to argumentative persuasiveness can also be spotted in the Czech judicial praxis.[28]

6 Conclusion

The interpretation of double taxation treaties is not a classic interpretation of tax law, yet these treaties are part of the legal order of every country.[29] International law, although it is place of "foreorigins" of heyday of human rights, does not favour the *in dubio pro mitius* interpretative principle. Hierarchically, the interpretation of double taxation treaties is the place dedicated to legal purism that protects the ordinary meaning of the words, legal customs and, finally, the reasonability of the interpretation. Legal certainty prevails in international law.

Although the tendencies for the protection and enforcement of human rights standards are generally on the rise, the interpretation of double taxation treaties is an

22 Abi-Saab, 2010.
23 Pauwelyn and Elsig, 2013.
24 This principle originated from the Roman legal principle in dubio pro reo. For more details see The Corpus Iuris of Emperor Justinian (529–533 A.D.), Legal Maximes: Digest Book 50 Chapter 17, Dig.50.17.56, Gaius 3 de legatis ad ed. urb.
25 An opposite opinion maintains Larouer, 2009.
26 The Supreme Administrative Court used argumentum ad absurdum to demonstrate the absurdity of alternative interpretation.
27 Brzeziński, 2016.
28 See Hlouch, 2011.
29 See Malenovský, 2004.

exception. The application of the law deriving from these treaties is without added value in the form of human law protection and interpretation recalls "the good old times" of legal positivism.

The authors hope they gather persuasive arguments for the suitability of the Anglo–Saxon interpretative approach on the field of double taxation treaties. This approach emphasises the detachment of tax law from the classical equality and prevailing of the teleological interpretation searching for the correct meaning between lines over others.

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