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Sergio André Rocha

Interpretation of Double Taxation Conventions

General Theory and Brazilian Perspective

Series on International Taxation

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Interpretation of Double Taxation Conventions

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To my wife Fernanda and Family

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Foreword

It is surprising and, at the same time, highly gratifying to observe that my doctor's thesis on the '*Interpretation and Application of International Double Taxation Agreements*', defended (and approved!) nearly 30 years ago in the University of São Paulo Law Faculty, continues to be consulted and cited by Brazilian tax specialists, who venture to explore such a complex topic in what is already the difficult area of Revenue Law. And now I have the added pleasure of writing the preface to the brilliant thesis submitted by tax lawyer Sergio André Rocha at Gama Filho University in Rio de Janeiro on the same subject-matter.

The work of Sergio André, based on a vast national and international bibliography, constitutes a systematic study of international double taxation agreements and their interpretation. He begins his exposition with the historical evolution, juridical nature, hierarchic position and objects of these international agreements, which the author prefers to call 'Double Taxation Conventions', the initials for which (DTCs) I shall adopt in this preface. With clarity and confidence, the author examines the concepts involved and the divergences existing in relation to the matter, while at the same time putting forward his personal opinion, duly backed by legal authority.

After setting out the propaedeutic notions, the author embarks on the study of the interpretation of DTCs with its specific problems: the rules of interpretation, the qualifications, the concept of 'context', the commentaries on the OECD Model Convention, the parallel treaties, the new approach and other questions related to the interpretation and application of DTCs. In view of the divergences existing among jurists, the author adopts a coherent approach, even when this is contrary to the prevailing opinion.

This work therefore serves both as an introduction to those starting out in this area of the law, and at the same time stimulates reflection in those who are familiar with it. For me personally, it constituted an incentive to reexamine my own conclusions regarding the 'old and always new' problems surrounding DTCs and the

more recent questions and statements thereon. By way of illustration, I should like to put forward a few examples of controversial issues, to which my attention has been drawn.

1. Juridical nature and hierarchic position of DTCs

In spite of the doctrinal evolution that has taken place, I continue of the opinion that DTCs belong to two distinct juridical orders: the *international*, as a mutual agreement between two sovereign states, limiting their fiscal sovereignty, and the *national*, when, in each of the states, the international agreement is 'incorporated' by the competent legislative power.

However, such '*incorporation*' does not involve the '*transformation*' of the international convention into law, as defended in my doctor's thesis, influenced by German law. The *legislative decree*, which approves the international convention (and not the presidential decree promulgating the convention), incorporates the convention as such, making it applicable internally.

This conclusion is based on the rules of the National Revenue Code ('CTN') which, in Article 96, states that the term '*tax legislation*' comprises the laws and treaties and international conventions. If these had been 'transformed' into *law*, it would not make sense to cite them separately as a kind of rule that forms part of the Brazilian tax legislation.

The recognition of two distinct juridical orders is also made clear by the provision of Article 98 of the CTN, when it establishes, albeit in an inappropriate manner, that '*international treaties and conventions revoke or modify internal tax legislation, and shall be observed by subsequent legislation*'.

As may be seen, the CTN places treaties and international conventions on a higher level than the domestic tax law, admitting their application in the internal juridical order, in a position hierarchically superior. The CTN adopts, therefore, *juridical dualism*, without 'transformation' of treaties and international conventions into internal law. If they had been transformed into internal law, evidently they could not have primacy in relation to the other internal laws, unless by the criterion of speciality, enjoyed by treaties and international conventions, and by the chronological criterion.

As 'internal law', the prevalence of the international convention could only be founded on the principle 'lex posterior derogat legi priori' or on the principle 'lex specialis derogat legi priori'. A conflict between norms which are of equal hierarchy could still be resolved by the rule 'lex posterior generalis non derogat legi priori specialis'.

As it happens, these are the rules that apply under German law, where the DTC occupies the same position as ordinary laws, in spite of the fact that paragraph 2 of the German Tax Code (*'Abgabenordnung'* – *'AO'*) *establishes the primacy of agreements under international law*, in the following terms:

'Treaties with other States, in the sense of Article 59, item II, period 1, of the Fundamental Law, that deal with taxation prevail over tax laws, provided that they have become internal law of immediate application.'

By this provision, paragraph 2 of the AO appears to consider the international agreement as a 'lex superior', in the same way as Article 98 of the CTN. This, however, is refuted unanimously by German jurists and German court decisions, due to the nature of the AO. Unlike the CTN, which has the nature of a law complementary to the Federal Constitution, hierarchically superior to the ordinary law, the AO is a mere ordinary law, which cannot accord to another ordinary law, namely the agreement, any superior hierarchic position or primacy.

It should be explained that Article 59 of the German Constitution, to which paragraph 2 of the AO refers, deals with the power of international representation conferred on the President of the Federation and provides, in item 2, that treaties involving matters of federal legislation require the approval or the intervention of the competent federal legislative authorities, in the form of a *federal law*.

Under the German Constitution, DTCs are therefore mere federal laws, since Article 25 of the Constitution does not apply to them, as this refers only to the general norms of public international law rather than to treaties and international conventions. In accordance with the said article, 'the general norms of public international law constitute an integral part of federal law. They prevail over the laws and constitute a direct source of rights and obligations for the inhabitants of the federal territory'.

With the warning that this is a minority position, Sergio André takes the view that, under Brazilian law also, DTCs 'occupy the same hierarchic position as internal ordinary laws, any conflict between such treaties and the domestic tax laws being resolved through the application of the criteria of chronology and speciality', since he does not recognize the competence of the CTN to regulate this matter, which would render its Article 98 unconstitutional.

Notwithstanding the arguments of Sergio André, I remain steadfast in my view that Article 98 of the CTN is in perfect conformity with constitutional principles, which lead to recognition of the prevalence of applicability of the international norms. Accordingly I agree with the arguments put forward by authors such as Alberto Xavier and Heleno Tôrres.

The fact that both Alberto Xavier and Heleno Tôrres have defended the supremacy of international treaties shows clearly that the dichotomy between *monism* and *dualism* of the juridical orders has ceased to be relevant. Monism with the primacy of international law leads to the same result as the dualism of Heleno Tôrres, which is no longer characterized by the '*transformation*' of international conventions into internal law with the same content, but by their *reception* as a norm of international law. And, under the Federal Constitution, this international norm has the nature of a '*lex superior*', which prevails over internal laws.

As from the moment that it is recognized that an international agreement is not transformed into *internal law*, but continues as a norm of international law, strictly speaking it becomes irrelevant whether the CTN confers on it the position of a 'lex superior' or not. This is because in the event of conflict with an internal law, due to the special nature of the subject-matter of the international agreements, the principle already mentioned of 'lex specialis derogat legi priori' is applied. Accordingly, the international agreement prevails. And even without the command

contained in article 98 of the CTN, the international agreement cannot be revoked by a subsequent internal law, but only by an instrument of the same kind; in other words, as stated by Alberto Xavier, by an act of the joint competence of the head of state and the National Congress.

Hence we may conclude that, in essence, the discussions regarding juridical dualism and monism, primacy of the international agreement or parity with the internal law, constitutionality or otherwise of Article 98 of the CTN, have practically become irrelevant, in view of the procedure of entering into treaties stipulated in the Federal Constitution, from which it is clear that there is no '*transformation*' but complete *reception* of the treaties, which are treated internally as *international norms of a special nature* and not as federal ordinary laws. And accordingly cases of conflict between these two orders of norms are resolved by the application of the principles of speciality and legislative competence, without the need to have recourse to the principle of the 'lex superior'.

Recognition of the non-existence of the 'transformation' of the DTC into an internal law has also forced me to review my position regarding its interpretation. Differently from what I had concluded in my doctor's thesis, *DTCs*, as a general rule, are interpreted in accordance with the *rules of interpretation of treaties*, since they are mutual agreements between states and limit their fiscal sovereignty. Only if the DTCs themselves make *renvoi* to the 'lex fori', in other words remit to the *internal legislation* of the contracting states, will the *rules of interpretation of laws* be applied to such law.

2. Objectives of DTCs and their relevance for the interpretation thereof

DTCs represent one of the kinds of measures for eliminating or attenuating international double taxation. However, the same end can also be achieved by unilateral measures, under the domestic law of the states. What is the advantage then of entering into bilateral international agreements?

With ever-increasing frequency, one hears the provocative question: 'Do we still need double taxation agreements?'. Bearing in mind that the majority of the clauses of an agreement represent concessions that, to a large extent, the states would also grant unilaterally in their internal legislation, in order to guarantee their competitiveness in international relations, it would appear that this question is pertinent.

As Sergio André shows, the United Kingdom adopts unilateral measures to avoid international double taxation, with the result that DTCs have little influence in the achievement of this objective. For this reason, according to David R. Davies, cited very properly by Sergio André, the main objectives of the DTCs entered into by the United Kingdom are the preservation of trade relations and the division of tax revenue between the signatory countries.

Nevertheless, in an article relating to the repudiation of the DTC between Brazil and Germany, after showing the problems that arose from its application and that some benefits of the DTC would, at least partially, be compensated by the internal legislation of the two countries, I reached the conclusion that, even so, it

would be highly convenient for Brazil and Germany to enter into a new DTC. This is because the repudiation of the DTC reduced the *juridical security* of German investors and unilateral measures cannot prevent Germany or Brazil from over-extending their taxation ambitions.

It should also be borne in mind that double taxation is only eliminated by DTCs to the extent of the scope of its application in relation to the persons and the taxes contemplated. In the opinion of Michael Lang, this prevents DTCs from being considered as a generic means of preventing double taxation and accordingly from being applied generically. In order to decide whether the DTC should be applied or not in a given case, the interpreter cannot start from the *maxim of interpretation* in the sense that DTCs must always eliminate the double taxation by any means.

Following this line of reasoning, I cannot accept the description of DTCs as the fulfilment of a '*principle elimination of international double taxation*', which may serve as a generic principle or aprioristic maxim, to be observed on the interpretation of DTCs.

Moreover, I completely agree that the problem of *double non-taxation*, from which Vogel distinguishes double exemption, is not included among the objectives of DTCs, because double non-taxation is not always a consequence of interpretative disharmony in the field of DTCs.

Also according to Michael Lang, cited by Sergio André, the methods of exemption and credit stipulated in the DTCs, combined with the internal legislation of the contracting states, may lead to double non-taxation, without this constituting a violation of the DTCs. Hence Lang concludes that there are no grounds for supposing the existence of a maxim of interpretation to the effect that DTCs must always be interpreted in such a way that income should not be left without taxation.

Vogel also considers it completely normal that a contracting state does not make use of the competence attributed to it by the DTC and thus neither of the two states taxes the income.

If the main purpose of DTCs consists then of juridical security and the division of tax revenues, which unilateral measures of the states, by their nature, cannot attain, this evidently has very important reflexes on their interpretation, which is eminently teleological.

3. Interpretation of international treaties v. the interpretation of domestic laws.

For the reasons set out above, we must start from the following premises when analysing the methods of interpretation of DTCs:

a) International conventions are incorporated internally as such, and are not 'transformed' into internal law.
b) In order to provoke maximum concessions from the other contracting party, while, at the same time, trying to limit their own obligations, states,

on drafting the conventions, frequently use vague and ambiguous terms as well as indeterminate concepts.

c) The use of indeterminate terms leaves international conventions more open to interpretation than internal tax laws.
d) The principal function of DTCs consists of ensuring juridical and tax security and the fair division of revenues between two sovereign states rather than the elimination of international double taxation, which can also be combated by unilateral measures on the part of each state.
e) International agreements must be interpreted in accordance with the interpretation rules of public international law, which are similar to the rules of interpretation of civil law contracts, since they are mutual agreements between two sovereign states.
f) The methods of interpreting the laws apply only to domestic laws and in those cases where the international conventions refer to them expressly (*renvoi* to the 'lex fori').

In view of these premises, I fully agree with Sergio André when he states that international treaties are not interpreted from a domestic standpoint, and that the peculiarities resulting from their nature and from the norms of international law must be observed.

Also in Brazil, although not binding, the rules of interpretation of treaties, contained in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties ('VCLT')*, represent interpretative parameters which are extremely relevant in the interpretation of DTCs.

Furthermore, many of the rules of interpretation contained in the VCLT correspond to the methods of interpretation of the laws. Thus, for example, interpretation according to the *context* and in the light of its *objective* and *purpose* corresponds, respectively, to the *systematic interpretation* and to the *teleological interpretation* of the tax law.

Even the *principle of good faith* on the interpretation of international conventions, which, together with the principle '*pacta sunt servanda*', dominates international law, meets its parallel in the interpretation of the tax laws in Brazil, by means of the constitutional principle of the *morality* of the public administration (Article 37 of the Federal Constitution).

As Sergio André astutely observes, the rules of interpretation contained in the VCLT represent a catalogue of topics at the disposal of the interpreter of DTCs, which, nevertheless, do not limit his interpretive alternatives.

This *methodological plurality* frequently leads to conflicts of interpretation between the contracting states, which may affect the juridical security and the fair division of revenues and culminate in undesired double taxation or double non-taxation.

For this reason, the contracting states, in the absence of international tribunals, must find a compromise between the various methods of interpretation, that is to say, they must seek the '*decisive harmony*' to which Sergio André refers. In this connection, in an appeal decision dated 8 July 1998, the Federal Tax Court of

Germany held that the concepts of a DTC must be interpreted, primarily, *in an independent manner*, in other words, on the basis of the international agreement itself. But the Federal Tax Court also observed that evidently the independent interpretation cannot be applied in relation to matters not contemplated by the DTC, but by the internal legislation of each contracting state, such as the elements of the tax obligation and the form of implementing the intended charge to tax, which must be interpreted in accordance with the rules of interpretation of the law.

One may conclude therefore that international conventions and the internal law must be applied and interpreted simultaneously, so as to produce the *useful effect* of the realization of the intended objectives, thereby preventing the clauses from becoming invalid or ineffective. As Sergio André shows, this principle of the useful effect is related to the *principle of good faith.*

4. Paragraph 2 of Article 3 of the OECD Model Convention and *renvoi* to the internal law of the contracting states

There is much discussion regarding the interpretation of paragraph 2 of Article 3 of the OECD Model Convention. After a detailed study of the term '*context*', used in the said provision, Sergio André reaches the following conclusion:

To sum up, the definition of the text on which the interpretative process will occur is determined, in the first place, by the text of the DTC itself. If there is a lacuna in the convention, its context is sought in the manner stipulated in paragraphs 2 and 3 of Article 31 of the VCLT. If the lacuna persists, the issue is remitted to the internal law of the contracting states (legislation referring to the taxes which are the subject of the DTC and that which lends it support). If even after this there is still a lacuna, then a solution will be sought through other elements of interpretation, which may make it possible to create a meaning as from the term utilized.

This procedure differs widely from the investigation scheme for the interpretation of the terms of DTCs suggested by Vogel, who gives priority to the domestic law, when the international convention is silent. However, Vogel also recognizes that *decisive harmony* means that there is no 'German way' of interpretation. On the contrary, that interpretation must be sought that has the greatest possibility of being accepted in both the contracting states.

In other words, the *principles of good faith* and of the *useful effect* must always be respected, since they are fundamental on the interpretation of international conventions.

5. The question of the parallel treaties

In principle, I agree with Sergio André when he states that treaties with other states (parallel treaties) cannot be regarded as internal law for purposes of the *renvoi* referred to in paragraph 2 of Article 3 of the OECD Model Convention. However, authors such as John F. Avery Jones admit that the other agreements, entered into in 'pari materia', may be considered as a supplementary means of interpretation of international conventions.

As shown by Heleno Tôrres, on the interpretation of international conventions, the interpreter may have recourse to the provisions of the others, in accordance with an analogical method, for a uniform comprehension of the provision, provided that the texts in question are *similar*.

In my opinion, there is one case in which the parallel treaties play a special role in interpretation. When the parties to a given convention enter into a subsequent agreement, concerning the interpretation of the convention or the application of its provisions, in accordance with the terms of Article 31, 3 of the VCLT, this agreement must also be taken into consideration on interpretation of the other conventions entered into by the respective states, provided that the clauses thereof are *identical*.

As an example, I may cite the agreement, concluded on 26 February 2003, between the tax authorities of Brazil and Spain, relating to the Brazil-Spain Convention and the fiscal treatment given to royalties and technical services. In this agreement, the interpretation and qualification given to the income resulting from the rendering of services is in perfect conformity with the OECD Commentaries and the best legal doctrine, national and foreign, when dealing with the articles of the OECD Model Convention, adopted by Brazil on entering into its international conventions.

In the international scenario, it would be a serious violation of the principle of good faith, if the Brazilian authorities did not adopt the same attitude in regard to those parallel treaties with absolutely identical clauses.

But also in accordance with *internal Brazilian law* the same attitude must be adopted in relation to the parallel treaties in 'pari materia', based on the OECD Model Convention, in view of the fact that the Secretary of the Treasury, on 21 December 2004, issued *SRF Interpretative Declaratory Act no. 27*. The said administrative act constitutes a *complementary norm* as regards the treaties and international conventions, in accordance with Article 100, I of the CTN, and is therefore *binding* on the administrative authorities, to the extent that:

a) it makes no distinction between technical services or technical assistance *with or without* transfer of technology, including them all correctly in Articles 12 (royalties) or 14 (independent professions) of the Brazil-Spain Convention;
b) it makes it clear that *in no circumstances* does Article 22 ('income not expressly mentioned') apply to technical services;
c) moreover, it states that Article 7 (company profits) does not apply to technical services, since they are covered by more specific articles of the Convention (Articles 12 and 14).

The Interpretative Declaratory Act allows one to conclude that the fiscal authorities take the view that Article 7 of the Brazil-Spain Convention and, consequently, of the Model Convention, is the *general clause* for taxation of business income and therefore that Article 22 of the double taxation agreements only applies to non-business income.

The application of the view of the fiscal authorities to all beneficiaries under the protection of the same type of double taxation agreement as the Brazil-Spain Convention also results from the constitutional principle of equality, which, under Brazilian constitutional law, is specifically contained in Article 150, item II of the Federal Constitution, which prohibits 'the institution of unequal treatment between taxpayers who are in an equivalent situation.'

In accordance with the interpretation contained in SRF Interpretative Declaratory Act no. 27, which was reproduced literally by *Interpretative Declaratory Act no. 4, of 17 March 2006*, which revoked it, it is clear that all business income not mentioned in the subsequent articles, must be classified under Article 7 of the double taxation agreements. Technical services were only not included in Article 7 because the tax authorities, changing their earlier view, included them in Articles 12 and 14, which are more specific.

Accordingly, it is clear that the case referred to by Sergio André in this comprehensive work, namely the remittance for the rendering of services without transfer of technology, must be included in Article 7 of the international conventions, the state of domicile or head office of the beneficiary having the exclusive right to tax, rather than in Article 22, which 'does not apply in any circumstances' to business income. Thus the 'interpretative breach' of the DTCs entered into by Brazil is eliminated.

With these observations, I have intended to give a preliminary idea of the complexity of the subject-matter of this work, while drawing attention to some of the existing doctrinal conflicts and showing to the reader that he has in his hands a systematic study of the interpretation of international double taxation conventions, written in a clear and precise manner, that constitutes a valuable contribution to the development of the subject.

Congratulations, Sergio André!

Presentation

This book comes at a time when tax law has an especially important effect on our society. Over the last few years, we have seen tremendous growth in the number of income tax treaties made by Brazil. Although the influence of this trend on both lawyers and taxpayers has not yet fully emerged, publications like this provide valuable assistance in clarifying some of the many effects of income tax treaties.

Sergio André brings a unique perspective to the need to increase international trade and investment between Brazil and other countries by reducing double taxation of income. Thus, income tax treaties are presented as useful tools in establishing appropriate tax rules for a variety of international trade practices which in the past lacked clear and uniform legislation that would ensure reasonable and efficient taxation.

Sergio André also gives a lucid and very interesting description of the history of income tax treaties, and offers an enlightening discussion of the relationship between income tax treaties and internal Brazilian law.

The integration of the world's economies, and Brazil's increasing reach into many markets so far unexplored by our businesses, gives particular importance to Sergio André's analysis of the mechanisms for interpretation and application of income tax treaties, particularly in connection with the resolution of international tax disputes.

In short, this book is an essential resource for those who seek a better understanding of an international instrument that has acquired growing importance not only for tax specialists, but for the entire legal community.

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