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Tax Treaty Interpretation in Portugal

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Resumo

A interpretação das convenções fiscais é uma matéria complexa, exigindo a conjugação do Direito interno, internacional e da Comunidade Europeia. Adicionalmente, permanece controversa a relevância da Convenção de Viena sobre o Direito dos Tratados e em especial a do Modelo de Convenção Fiscal sobre o Rendimento e o Património da OCDE e respectivo Comentário, embora este último seja o guia geralmente aceite de interpretação das convenções fiscais. Este artigo limita-se, no essencial, a resumir doutrina portuguesa sobre estas questões, dado não existir praticamente qualquer jurisprudência, entendimentos administrativos ou procedimentos amigáveis relevantes envolvendo as autoridades fiscais portuguesas quanto ao assunto.

Abstract

Tax treaty interpretation is a complex matter, requiring the interplay of domestic, international and European Community Law . Additionally, the relevance of the Vienna Convention on the Law of Treaties and specially that of the OECD Model Income Tax Convention on Income and on Capital and its Commentary remains controversial, although the latter is the general accepted guide on the interpretation of tax treaties. This article essentially summarises the Portuguese doctrine on these issues, as there is barely no relevant case law, administrative rulings or mutual agreement procedures involving the Portuguese tax authorities on the subject.

I. TAX TREATY LAW AND DOMESTIC LAW

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Tax treaty law and domestic law

Tax treaties,[1] as international conventions, shall be subject to the same principles, methods and rules applied to them.[2] Therefore, we should clarify which different types of relations may appear when we are in the presence of internal and international law. In fact, either we understand that they are two independent legal systems or, on the contrary, we believe that law forms a single order and both international and internal law consist of two different forms of its expression.

The procedure required to bind the Portuguese State to an international convention is governed by internal and international law while European Union (EU) Community law also restricts the autonomy of the State's binding power.

Unlike what happened until the last Portuguese Republic Constitution (*Constituição da República Portuguesa* (CRP)) Amendment of 1997, where tax treaties were mandatorily subject to the parliamentary (*Assembleia da República*) approval,[3] there is currently no direct constitutional obligation of a tax treaty adopting the form of solemn treaty (*tratado em forma solene*) instead of an executive agreement in a simplified form (*acordo em forma simplificada*).

Nonetheless, after the said amendment, the ancient binding procedure was maintained, and even though the government is now apparently free to choose between solemn or simplified form[4] as far as tax

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[1] By means of "tax treaty" we shall designate throughout the text the "Conventions for the avoidance of Double Taxation and Prevention of Fiscal Evasion with respect to Taxes on Income and Capital".

[2] See, among others, Xavier, *Direito Tributário Internacional – Tributação das Operações Internacionais* (hereafter '*Direito Tributário Internacional'*) (1993) p 131, Prokisch, A Interpretação dos Tratados de Dupla Tributação, *Fisco* 1994, Ano VI, no. 68, p 22, Mesquita, *Convenções sobre Dupla Tributação* (hereafter '*Convenções sobre Dupla Tributação'*) (1998) p 38, and Pires, Portugal – National Report, *Cahiers de Droit Fiscal International*, Vol. LXXVIII (a) (hereafter '*National Report'*) (1993) p 522.

[3] See Xavier, *Direito Tributário Internacional*, p 104. This was due to the former Art. 168 (i) of the CRP, which granted Parliament the authority to approve treaties on matters within its legislative competence, which is the case with the creation of taxes and the tax system.

[4] See Loureiro Basto, O Procedimento de Vinculação Internacional do Estado Português após a Revisão Constitucional de 1997, *Revista da Faculdade de Direito da Universidade de Lisboa* 1998, Vol. XXXIX, no. 1, pp 32 et seq. However, in

treaties are concerned, the former has been consistently adopted as a *de facto* customary practice.

As in other jurisdictions, the basic binding procedure governed by international law and completed by internal law is therefore divided into five different phases: (1) negotiations; (2) signing; (3) internal approval; (4) ratification, and (5) publication (internal or international).[5]

1. The negotiation, which is a government's competence according to Art. 197 (1) (b) of the CRP, has two distinct moments, the decision to initiate negotiation and, as a consequence, the negotiation itself.

   During this phase, the intervention of our Autonomous Regions (Azores and Madeira) may be required if the convention directly concerns them, as per Art. 227 (1) (t). Although this is a controversial matter,[6] we believe that there are some instances where it might be justified to have an Autonomous Region intervention in the negotiation of a tax treaty. This would be the case where the tax treaty to be signed has specific provisions regarding these Autonomous Regions' Free Zones or their ultra-peripheral status. Additionally, on this phase, the type of binding procedure must be chosen (agreement in a simplified form or treaty in a solemn form). As already mentioned, the latter has been adopted so far with regard to tax treaties.

2. The signature is also a government competence according to Art. 197 (1) (b) of the CRP. It is the act that binds the Portuguese State in an executive agreement, but only an interim act towards the definitive consent in the case of solemn treaties,[7] such as those concerning taxes.

3. According to Articles 161 (i) and 197 (1) (c) of the CRP, internal approval is above all an internal phase whose competence belongs to parliament or to the government. In the case of tax treaties, since there has been an option to consider them as solemn treaties, the approval power lies with parliament.

4. The President is responsible for the ratification of solemn treaties - therefore, of tax treaties - as laid down in Art. 135 (b) of the CRP. The President will receive the parliament's resolution of approval and may require its constitutional appreciation before deciding whether or not to ratify it.

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our opinion, there is no direct obligation of adopting the form of a solemn treaty and there is an apparent freedom because one might say that indirectly only that form is adequate to bind the Portuguese State, given the internal principle of parliamentary reserve of law as per tax matters. Mesquita, *Convenções sobre Dupla Tributação*, p 52 explicitly considers that government agreements in a simplified form can only address subjects that are not included in that parliamentary reserve. See also Xavier, *Direito Tributário Internacional*, p 107, although this was written before the constitutional amendment of 1997.

[5] We adopt Loureiro Basto, *Revista da Faculdade de Direito da Universidade de Lisboa* 1998, p 25 proposed schedule of phases. Xavier, *Direito Tributário Internacional*, pp 103 et seq, distinguishes between the *negotiation* phase (which encompasses (1) and (2)), and the *celebration* phase, which includes all other (that is, (3), (4) and (5)). See also, for a summary, Mesquita, *Convenções sobre Dupla Tributação*, pp 51 et seq.

[6] See Loureiro Basto, *Revista da Faculdade de Direito da Universidade de Lisboa* 1998, pp 31 et seq, and Gonçalves Pereira/Fausto de Quadros, *Manual de Direito Internacional Público* (hereafter '*Direito Internacional Público*') (1993) pp 190 et seq, with further references.

[7] See Loureiro Basto, *Revista da Faculdade de Direito da Universidade de Lisboa* 1998, p 38, and Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, pp 195 et seq.

5. Finally, the publication of the tax treaty in the *Diário da República,* the Official Journal, is a condition for its effectiveness and closes the process. It is nevertheless important to note that tax treaties only become a part of domestic law when they are internationally binding. It was normal for the Portuguese tax authorities to publicise the entry into force and regime of each and every tax treaty,[8] but after tax authority's ruling (*Circular*) no. 18/99, of 7 October 1999, which revoked the former tax treaties' individual and specific rulings and set uniform guidelines for all of them, this has ceased to take place.

With regard to the relations between internal and international law, two problems arise: the relevance of conventions and the hierarchical place of these conventions in the Portuguese law, and several positions have been adopted regarding this particular issue.

In Portugal, a significant part of the doctrine supports the idea according to which both international and internal legal systems are part of a larger one and, as for the relevance of conventions, most authors believe that under the Portuguese system international conventional law - and this can include the tax treaties - is not subject to transformation and incorporation into internal law. Tax treaties are automatically accepted, and valid as such, but their coming into force depends on their publication in the Official Journal, pursuant to Art. 8 (2) of the CRP.[9]

As far as the hierarchy of tax treaties in the Portuguese internal system is concerned and in the absence of an absolutely clear legal base, at least two different positions have been adopted. In fact, for some authors, tax treaties should take preference not only over domestic legislative tax law but also over constitutional law.[10] However, for the majority doctrine, tax treaties only prevail over domestic tax law and not over constitutional law.[11] This last view is apparently also taken by the tax authorities' circulatory ruling (*Ofício-circulado*) no. 31.051, of 28 May 1998. Consequently, if there is a violation of a tax treaty by domestic legislative law, and the latter cannot be interpreted in conformity with the former, then it will be considered ineffective, inapplicable or derogated.[12] Treaty override is not acceptable, due to Art. 8 (2) of the CRP and Art 27 of the Vienna Convention on the Law of Treaties (VCLT).[13]

Since the conventions are neither transformed nor incorporated into internal law, one can say that the tax treaty is received in its own capacity, and such automatic and full reception method directly points to an interpretation of the treaty under international principles.[14]

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[8] See Mesquita, *Convenções sobre Dupla Tributação*, p 52.

[9] See Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, pp 110 et seq, and Xavier, *Direito Tributário Internacional*, pp 105 et seq, with further references, as well as Pires, *National Report*, p 522.

[10] See Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, pp 119 et seq.

[11] See Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, pp 119 et seq, and Xavier, *Direito Tributário Internacional*, pp 107 et seq, with further references, as well as Pires, *National Report*, p 522.

[12] See Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, p 123, and Xavier, *Direito Tributário Internacional*, pp 110 et seq.

[13] See Xavier, *Direito Tributário Internacional*, pp 109 et seq.

[14] See Xavier, *Direito Tributário Internacional*, p 108.

The relevance of Community law for the interpretation of tax treaty law

Portugal has been a Member State of the EU since 1986, being therefore subject to Community law. The principle of primacy of Community law, which has been applied by the EU Court of Justice on various cases, is viewed generally as a condition for its own existence because if an internal rule could prevail over it, the latter's subsistence, as a common legal system, would become impossible. Consequently, in the presence of international conventions, such as tax treaties, we not only have to consider internal and international law but also Community rules.[15]

As far as tax issues are concerned, Articles 90 to 93 of the European Community (EC) Treaty only give a certain number of guidelines that must be respected according to the above-mentioned principle of primacy. As a matter of fact, Member States have not transferred their power to enter into tax treaties to the Community and no harmonisation has yet taken place in this area. The EU does not have the power to conclude tax treaties, however Member States cannot as well enter into agreements that violate Community rules.

In addition, Art. 293 of the EC Treaty provides that Member States should enter into negotiations in order to abolish double taxation within the Community. This, according to *Ana Paula Dourado*, means that such power is not only recognised nor invited to be exerted, but in fact even imposed on the Member States - and in spite of the absence of a material principle applicable in the elimination of double taxation (which is not forbidden), and the fact that the Community intervention is limited to the Commission's incentive to the negotiations - these are bound by the parameters of efficiency and non-discrimination, for the benefit of the nationals of all other EU Member States.[16]

Fernando Loureiro Basto points out that one of the limitations in the capacity of internationally binding the States derives from the activity of the EU Member States in the community field, but he does not seem to consider tax treaties to be included in this last concept.[17]

Nevertheless, the fact that Member States have an exclusive competence on these subjects does not prevent them from the obligation of respecting the EC Treaty freedoms, as stated in the EU Court of Justice jurisprudence, and recently clarified by the *Saint Gobain* case.

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[15] For a recent example of the relations between Community law and international tax law see Dourado, The EC draft directive on interest from savings from a perspective of International Tax Law, *EC Tax Review* 2000, Vol. 9, Issue 3, where the author analyses the regime of the EU Savings Draft Directive, compares it with the solutions of the OECD Model Convention and anticipates some problems on the application of the Directive together with tax treaties. She states the opinion that the result would certainly be more consistent if some kind of EC Model was adopted and that the regime proposed in the Savings Draft Directive and subsequent technical and political discussions may be an example that the European Community may not isolate tax harmonisation from tax measures with third countries.

[16] See Dourado, *Tributação dos Rendimentos de Capitais: A Harmonização na Comunidade Europeia* (hereafter '*Tributação dos Rendimentos de Capitais*') (1996) pp 12, 21, 27 et seq, and mainly 216 et seq.

[17] See Loureiro Basto, *Revista da Faculdade de Direito da Universidade de Lisboa* 1998, pp 20 et seq, 37, 41 et seq, 47 et seq.

Articles 43 to 48 of the EC Treaty provide for the freedom of establishment, which means that no restrictions should be opposed to nationals of a Member State who wish to pursue activities in the territory of another Member State, unless these restrictions comply with public policy, security or health purposes. As a consequence, nationals of a Member State are free to set up branches, agencies or subsidiaries in the territory of another Member State. This freedom also benefits companies and firms that were formed in accordance with the law of a Member State and have their registered office, central administration or principal place of business within the Community ("deemed nationality"). Therefore, permanent establishments of EU national companies should be granted the same tax treatment given to resident companies, according to the *Saint Gobain* case, if their tax base is approximately the same, and they are in a comparable situation with respect to the same category of income.[18]

In this regard, long before the *Saint Gobain* case, and taking into account the a*voir fiscal* case, some authors had argued that the Portuguese dividend participation privilege granted under the Corporate Income Tax (*Imposto sobre o Rendimento das Pessoas Colectivas* (IRC)) Code to Portuguese resident companies on qualifying holdings (25% of the capital, two-year holding period, in general) on other resident companies is discriminatory and should be applicable to the dividends received by permanent establishments of EU residents set in the Portuguese territory to which shareholdings in companies have been allocated.[19]

Furthermore, the EC Treaty contains a certain number of general principles, namely the one relating to non-discrimination, that should be seriously taken into account during the interpretation process.

A significant number of Portuguese authors believe that some internal tax law provisions may be considered to be in conflict with the principles in the EU Treaty, namely the one of non-discrimination. As a matter of fact, the compatibility with the EC Treaty and with the tax treaties of Articles 57-B and C of the IRC Code (Controlled Foreign Company (CFC) and Thin Capitalisation rules, respectively), for example, has been intensely discussed lately.[20]

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[18] See Offermanns/Romano, Treaty Benefits for Permanent Establishments: The Saint-Gobain Case, *European Taxation* 2000, Vol. 40, No. 5, p 187.

[19] See, among others, Xavier, *Direito Tributário Internacional*, pp 187, 237 and 348, Dourado, *Tributação dos Rendimentos de Capitais*, pp 190 et seq, and Impact of non-discrimination principle on Portuguese income tax law, *EC Tax Review* 1997, Vol. 6, Issue 1, pp 11 et seq, Passos/Brito da Mana, (Fundamental Freedoms for Citizens, Fundamental Restrictions on National Tax Law) Country Reports – Portugal, *European Taxation* 2000, Vol. 40, No. 1 / 2, p 72.

[20] Passos/Brito da Mana, *European Taxation* 2000, pp 71-2 consider that Art. 57 B may constitute a violation of the EU freedom of establishment principle, and Art. 57-C may be viewed as a violation of the non-discrimination principle, in regard of the freedom of movement of capital and payments.
Silveira da Cunha, A Subcapitalização no Direito Português – Apreciação face ao Direito Comunitário in: *Estudos em homenagem ao Professor Doutor Pedro Soares Martínez*, Vol. II – Ciências Jurídico Económicas (2000) p 546, after a thorough analysis, concludes that Article 57-C is a discriminatory measure, deprived of an objective justification, creating obstacles to the EC free movement of capital, freedom to provide services and freedom of establishment, that also violates the non-discrimination principle set forth in Art. 24 of the OECD Model Convention.

Fernandes, As Recentes Medidas Anti-Abuso do Código do IRC, *Fisco* 1996*,* Ano VIII, no. 74 - 75, pp 11 et seq, discusses the applicability of the Portuguese CFC rule to a Dublin IFSC company, but does only analyse the issue with reference to this being an EU authorised regime.

Ana Paula Dourado says that the absence of specific anti-abuse provisions does not imply the acceptance of a literal interpretation of tax treaties or EU directives, open to fraudulent behaviour. She takes a common approach whereby she assimilates, in some way, the internal, international and EU Community interests on international tax avoidance, admitting the enforcement of domestic provisions on cases where the legal form used to obtain liable to tax results is disregarded,[21] as in spite of international commitments no State can demand those provisions not to apply. Notwithstanding, on the subject of elision of the tax treaties or Community law rules', domestic norms on tax evasion can only apply if they do not violate international or Community law.[22]

If the inadequacy of a unilateral criteria for evasion results from the interpretation of a tax treaty or a directive, a universal principle (or at least a Community principle) of evasion that simultaneously attacks the abusive utilisation of international or Community law by the States and by the taxpayers must be found.[23] The definition, by each internal legislation, of the limit situations that determine evasion results in the re-nationalisation of international or Community law, a result that does not seem acceptable.[24] The author believes that the evasion criterion set forth in Directive 90/434/EEC might be assimilated with the concepts of substance over form, abuse of legal forms or legal circumvention.[25]

Sousa da Câmara/Ayala, Portugal - CFC Taxation, *Fisco* 1996, Ano VIII, no. 78-79, p 85 also mention that Luxembourg Soparfis may not be treated as CFC for Portuguese tax purposes, but believe that CFC rules are not included in the scope of the tax treaties, being therefore admissible.

Menezes Leitão, A introdução na legislação portuguesa de medidas destinadas a reprimir a evasão fiscal internacional: o Decreto-lei no. 37/95, de 14 de Fevereiro, *Ciência e Técnica Fiscal* 1995, no. 377, p 103, expresses some doubts on this, and shows preference to the mechanism of reservations to the tax treaty.

Mesquita, O artigo 57º-B do Código do IRC, as convenções sobre a dupla tributação e o Tratado da Comunidade Europeia, *Ciência e Técnica Fiscal* 1996*,* no. 382, pp 63 et seq, believed that the Art. 57-B of the IRC Code as compatible with the tax treaties and with EU Law, quoting in its favour, with regard to the former, Vogel *Double Taxation Conventions – A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital* (1991) and the OECD, *International Tax Avoidance and Evasion, Four Related Studies* (hereafter '*International Tax Avoidance'*) (1987). In this regard, Mesquita and Prazeres Lousa in: Ministério das Finanças (eds), Relatório da Comissão de Reforma da Fiscalidade Internacional Portuguesa, *Ciência e Técnica Fiscal* 1999, no. 395, pp 143 and 173, say it will be difficult to limit the applicability of foreign domestic CFC rules against the Portuguese Madeira Free Zone, and they do not consider such rules as incompatible with the tax treaties.

However, Mesquita, Aplicação das convenções sobre dupla tributação a empresas instaladas nas zonas francas da Madeira e de Santa Maria, *Direito e Justiça* 1997, Vol. XI, Tomo 2, p 76, also quoting Vogel, *Double Taxation Conventions – A Commentary to the OECD, UN and US Model Conventions for the Avoidance of Double Taxation of Income and Capital* (hereafter '*Double Taxation Conventions'*) (1997) and the OECD Committee on Fiscal Affairs, states that in the Portuguese legal order, given the position of the treaties in the hierarchy of tax norms, domestic anti-abuse rules cannot be applied to the situations encompassed by the treaty. Additionally, Mesquita, *Convenções sobre Dupla Tributação*, pp 31 et seq, quoting again Vogel, *Double Taxation Conventions* (1997), the OECD, *International Tax Avoidance*, and Baker, *Double Taxation Conventions and International Tax Law* (1994), shows preference for limitation on benefits clauses, and says domestic anti-abuse norms cannot be applied in the absence of explicit treaty rules allowing so.

[21] Dourado, *Tributação dos Rendimentos de Capitais*, p 137.

[22] Dourado, *Tributação dos Rendimentos de Capitais*, p 138.

[23] Dourado, *Tributação dos Rendimentos de Capitais*, p 138.

[24] Dourado, *Tributação dos Rendimentos de Capitais*, p 138.

[25] Dourado, *Tributação dos Rendimentos de Capitais*, p 138.

Reading *Ana Paula Dourado*, one seems to get the idea that a single legal (internal, international or Community) approach must be taken on the interpretation of tax rules as per the issue of tax evasion.

According to *Gabriela Pinheiro*[26], through the latter community cases, namely *Schumacker* and *Wielocks*, one can notice that efforts have been made in order to reconcile Community and international tax law (including the OECD Model Tax Convention). Thus, the author attempts to analyse the compatibility of tax treaties and international tax law in general with Community law, namely with the EU Court of Justice jurisprudence, under the following topics: the principle of primacy of Community law, the most favoured nation clause, the non-discrimination principle and the residence criteria, the imputation method and the State of residence neutrality principle, and the principle of bilateral coherence.[27]

Under the principle of primacy laid down by the a*voir fiscal* case*,* tax treaties must respect Community law; this may prevent Member States from regulating through those treaties matters which are the object of community measures (parent-subsidiary affiliation, for example), in view of the uniform application and non-discrimination envisaged for the common market.[28] The author is ambiguous as per the application of the most favoured nation clause,[29] whereupon no State should accord benefits to another State's nationals with which it has entered a treaty without extending them to all the States in the EU.[30] She first states that under Community law it seems a discriminating practice and a source of economic distortion not to grant an equal treatment to all EU nationals or to grant a more favourable treatment to third States' nationals.[31] Subsequently, she concludes that the bilateral coherence concept of *Schumacker* and *Wielockx* is not compatible with the multilateralisation of privileges.[32]

On the other hand, although tax issues are the States' competence, their action has to respect the principles of non-discrimination and the criteria of residence as conceived in Community law cases such as *Schumacker*, *Commission* vs. *Luxembourg*, *Wielockx* and *Asscher*, and the author summarises the compromise of the EU Court of Justice with the international tax law as follows:[33]

- The Court of Justice adheres to international tax law when it *admits the residence criteria as fundament for a different treatment*;

[26] Pinheiro, *A Fiscalidade Directa na União Europeia* (hereafter '*A Fiscalidade na União Europeia'*) (1998) p 153.

[27] Pinheiro, *A Fiscalidade na União Europeia*, p 159.

[28] Pinheiro, *A Fiscalidade na União Europeia*, pp 161 et seq.

[29] Mesquita, *Convenções sobre Dupla Tributação*, p 37, argues that the fact that each treaty, individually, translates a different compromise of advantages and disadvantages to the residents of each contracting State, prevents the application of more favourable treaties entered into with other Member States, on the basis of Community law.

[30] Pinheiro, *A Fiscalidade na União Europeia*, p 163.

[31] Pinheiro, *A Fiscalidade na União Europeia*, p 163.

[32] Pinheiro, *A Fiscalidade na União Europeia*, p 165.

[33] Mesquita, *Convenções sobre Dupla Tributação*, p 309, points out that EU Member States residents benefit from the non-discrimination regime of both tax treaties and Community Law. See also Adonino, Il principio di non discriminazione nella fiscalità internazionale, in: Associação Fiscal Portuguesa/Instituto Latino-Americano de Direito Tributário (eds), *Actas das XIX Jornadas Latino-Americanas de Direito Tributário*, *Livro 4 - A Criminalização das Infracções Fiscais & O Enquadramento Fiscal da Subcapitalização das Empresas - Relatórios Gerais. Conferências Científicas* (1998).

- The Court of Justice goes beyond international tax law when it issues the thesis that *a difference in treatment between residents and non-residents may be qualified as a discrimination when no objective difference of a situation capable of justifying the differences in treatment between the two categories of taxpayers exists.*[34]

As per this jurisprudence, the author believes that the national treatment by the source Member State when the mentioned objective difference does not exist, should be viewed under the general principle of residence State neutrality and deemed compatible with the imputation method giving rise to world-wide income taxation at the latter's level.[35] Following *Wielockx*, she thinks that tax treaties are relevant for evaluating the argument of the coherence of the tax system and the existence of discrimination between residents and non-residents in view of the fundamental freedoms.[36]

As for *Nuno de Sampayo Ribeiro*, he defends that the neutralisation by the State of residence of the useful effect of a EU State aid in the form of an authorised tax incentive granted by a source State would make the first mentioned State the beneficiary of the exemption underlying the aid, and this would constitute a violation of the negative and positive obligations deriving from the Community law.[37]

We also believe that the useful effect of a EU allowed State aid binds the tax treaties entered into between the EU States, derogating the regimes set therein that are incompatible with the tax protection demanded by that aid.[38]

Two provisions of the recently signed treaty with the Netherlands exemplify the relevance of Community law in the interpretation of Portuguese tax treaty law.

Firstly, point II – ad Art. 4 of the Protocol in appendix to the Convention between Portugal and the Netherlands, concerning the definition of the term "resident", establishes in its paragraph 3 that "*Residents of a Contracting State which benefit from a favourable tax treatment shall not be entitled to the benefits of the chapter III of this Convention* (Taxation of income) *in so far as domestic transactions comparable to the transactions to which this favourable tax treatment is applicable are excluded from this favourable tax treatment (ring fenced)*".

Moreover, according to paragraph 4 of this same point "*Residents of a Contracting State which benefit from tax measures which are harmful within the meaning of the EC-Code of conduct for business*

[34] Pinheiro, *A Fiscalidade na União Europeia*, pp 171 et seq.

[35] Pinheiro, *A Fiscalidade na União Europeia*, p 178.

[36] Pinheiro, *A Fiscalidade na União Europeia*, p 179.

[37] Sampayo Ribeiro, *"Tax Havens", "Offshore" and "IFSCs" within the EC: a turntable phenomenon between European Law and International Tax Law ?** some thoughts * (1998), pp 50 et seq.

[38] Ministério das Finanças, *Relatório da Comissão de Reforma*, p 143, considers that the "precedent effect" of the exclusion of the Portuguese Madeira Free Zone from the scope of tax treaties entered into by Portugal might create serious issues with regard to the most favoured nation clause, in particular with respect to the extension to the European partners of a clause eventually negotiated with a non-EU country. On this most favoured nation clause, see Offermanns/Romano, *European Taxation* 2000, p 188, with more references.

taxation, as agreed by the ECOFIN-meeting of 1 December 1997, shall not be entitled to the benefits of chapter III of this Convention".

"*However, tax measures referred to in paragraphs 3 and 4 above shall not be considered harmful if they are accepted and to the extent they are authorised by the European Community as an appropriate support for the economic development of a particular area and do not undermine the integrity and coherence of the Community legal order, including the internal market and common policies*", as per paragraph 5.

The provision of point I - ad Art. 2 (2) of the above-mentioned Protocol is another example for the importance of Community law; it states that "*It is understood that this Convention shall also apply to any tax that for the purpose of an EC–directive, - regulation or - convention is considered to be a tax on income, on capital or elements of capital*".

In conclusion, the generally accepted Portuguese view is that Community law takes precedence over domestic tax provisions and over tax treaties concluded between Member States. As for tax treaties concluded with third countries, the EC Treaty recognises their effects, under Art. 307, when these treaties were entered before it,[39] something that does not prevent Member States to take all necessary measures in order to remove existing incompatibilities between them. Moreover, domestic provisions should always be interpreted in conformity with Community law and its fundamental principles.

The relevance of Articles 31 and 32 of the Vienna Convention on the Law of Treaties

The VCLT, as signed on 25 May 1969, and especially its Articles 31 and 32[40], provide for rules on the interpretation of treaties. As referred to above, tax treaties are international treaties and therefore they

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[39] The EC Treaty does not consider the case of subsequent tax treaties with third countries, but according to Mesquita, *Convenções sobre Dupla Tributação*, p 36, these may conflict with Community law either by binding the State to a behaviour contrary to it, or by binding or authorising the third State to act in the Community territory in a way contrary to it.

[40] *Article 31:*

General rule of interpretation

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

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

(a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

should be interpreted in accordance with the VLCT, as any other convention. In fact, the general definition of "treaty" given by Art. 2 of the VLCT does not exclude from its scope any type of international treaties. The general rule of interpretation is given by Art. 31 (1) which states that "a *treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*".

In an article published in Portuguese, *Rainer Prokisch* gives particular relevance to the principle of mutual and common agreement on interpretation of the tax treaty provisions by the contracting States, quoting the resolution of the 1993 IFA's Congress in Florence, the OECD Committee on Fiscal Affairs Recommendation of 23 July 1992, and Art. 33 (4) of the VCLT.[41]

In a recent tax article published in a Portuguese magazine, *Philip Baker* explains the British broad liberal approach to the interpretation of tax treaties, consistent with their purpose.[42] He adds that "It is often said that in interpreting a tax treaty one should seek the intention of the Contracting States when they entered into the tax treaty".[43] Nevertheless, this author believes that the focusing on the two States concerned seems to ignore the general international interest in the correct interpretation of tax treaties.[44] "The decisions of the courts in one country on the interpretation of a treaty are relevant not just to that country but also to all other countries that have concluded treaties using similar wording. With the increasing dominance of the OECD Model, most decisions of courts around the world are on the wording of treaties, which are identical with virtually all of the other treaties in the world".[45] Therefore, the courts should be looking at a truly international or pan-national fiscal meaning to the wording of the treaty, consistent with the position of all countries, the principles of international tax law as a whole and the international environment of tax treaties, rather than reflecting or depending just on the intentions of the two parties.[46]

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

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.*

[41] Prokisch, *Fisco* 1994, pp 21 et seq.

[42] Baker, Recent Developments in the Interpretation and Application of Double Taxation Conventions, *Fiscalidade – Revista de Direito e Gestão Fiscal* 2000, no. 4, p 17.

[43] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 17.

[44] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, pp 26 et seq.

[45] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, pp 26 et seq.

[46] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, pp 27.

Based on the "object and purpose" of tax treaties, as per Art. 31 (1) of the VCLT, one may take into account the peculiarities of tax treaty law, as that concept grants the necessary flexibility in the application of the VCLT to those treaties.[47]

Tax treaties have several purposes, such as the allocation of taxable income among the contracting States, the avoidance of double taxation, the removal of tax obstacles to trade, the promotion of foreign investment, the prevention of discrimination and tax evasion, the enabling of exchange of information.[48] These special purposes may guide the interpretation of the expressions and concepts used in particular rules.[49] However, as far as the interpretation of the allocation provisions are concerned, those purposes may not be fulfilled, because such provisions put into practice the aim of the general agreement, the avoidance of double taxation, which invalidates any interpretation that intends to fill a gap or complete an agreement, even if in this regard a double taxation not otherwise envisaged by the treaty is avoided.[50]

Tax treaties have a double legal character, being at the same time normative agreements enforced as laws by tax authorities and courts, and agreements negotiated by two contracting parties on the basis of reciprocity and in their own interests; consequently, in the absence of a legislator, the interpretation of a concept should take into account the understanding of both parties, and that of tax treaties the said double dimension.[51]

Philip Baker points out that with regard to Art. 33 of the VCLT there will possibly be an increasing number of problems arising over dual language texts, namely getting hold of the foreign language text and finding someone who understands its meaning.[52]

The VCLT is not binding in Portugal as an international treaty since it has never been ratified. However, this does not necessarily mean that its interpretation rules are not to be taken into account. As a matter of fact, authors consider the Convention to be customary law or general / common international law and binding for that reason.[53]

As far as the relevance of international public law in the interpretation of tax treaty law is concerned, one should note that Art. 3 (1) (a) of the Convention between Portugal and Belgium, pursuant to the amendment introduced by the additional Convention signed on 6 March 1995, establishes a new definition of the expression "territory" by stating that the term "Belgium" means the territory of the Kingdom of Belgium, the respective territorial sea, and any other zone over which, in accordance with the laws of Belgium and international law, the Kingdom of Belgium exerts its sovereign rights or

[47] Prokisch, *Fisco* 1994, p 26.

[48] Prokisch, *Fisco* 1994, p 26.

[49] Prokisch, *Fisco* 1994, p 26.

[50] Prokisch, *Fisco* 1994, p 26.

[51] Prokisch, *Fisco* 1994, pp 27 et seq.

[52] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 24.

[53] See Gonçalves Pereira/Fausto de Quadros, *Direito Internacional Público*, pp 120 et seq, p 172, Prokisch, *Fisco* 1994, p 2, and Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 19. See, apparently against this reasoning, Pires, *National Report*, pp 530 et seq, which considers VCLT "(...) to a great extent a poisoned gift for international tax law not only by reason of the general nature of its rules but also of some difficulties connected with its understanding".

jurisdiction. Moreover, point 2 - ad Art. 3 (1) of the Protocol in appendix to the above-mentioned Convention, pursuant to the amendments of the additional Convention, states that in case of conflict between the internal law of a contracting State and international law, the latter should prevail.

The relevance of the OECD Model and the OECD Commentary

Since its original version in 1963 until its publication in the actual form, the OECD Model has considerably inspired the negotiation, the application and interpretation of tax treaties. The OECD Model is undoubtedly a fundamental reference for most of the treaties entered into by Portugal on this matter. The Commentary is normally analysed in Portuguese by the Portuguese tax authorities and tax professionals, although doctrine and private practice also use the English version consistently.

For *Inês Batalha Mendes*, the exact relation between the OECD Commentary and tax treaties based on the OECD Model does not congregate the doctrine. Although no one contests the fact that the OECD Commentary is a highly recognised guide for interpretation and application of tax treaties, the question of the exact place it occupies in the process of interpretation is much more controversial.[54]

The OECD Commentary has been written by representative specialists of the Member States and some reservations or observations were made by the States that do not always agree with the proposed interpretation.[55] However, the above-mentioned observations do not intend to deviate from the meaning of the Model Convention but rather give a precious indication of how the States will apply its provisions.[56] The introduction of the OECD Commentary clearly explains its function as being extremely useful for the application and interpretation of conventions, namely for the settling of disputes, and although the intention of the drafters of the Commentary was to be significant in the process of interpretation of tax treaties, it is not considered to be binding.[57]

Given the restrictive understanding of "context" as per Art. 31 of the VCLT,[58] *Inês Batalha Mendes* finds it hard to reconcile the fundamental role of the OECD Model with the general rules of

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[54] Batalha Mendes, A Importância dos Comentários ao Modelo de Convenção Fiscal da OCDE na Interpretação de Acordos de Dupla Tributação, *Revista Jurídica* 1999, Nova série, no. 23, p 463.

[55] Batalha Mendes, *Revista Jurídica* 1999, p 467.

[56] Batalha Mendes, *Revista Jurídica* 1999, p 467.

[57] Batalha Mendes, *Revista Jurídica* 1999, p 468.

[58] As for Batalha Mendes, *Revista Jurídica* 1999, pp 465 et seq, the term "context" as used in Art. 31 of the VCLT involves several particularities. In fact, for some authors this term has two sides, an internal and an external one. The so-called internal context concerns only the facts directly and immediately related to the treaty. The external elements such as the circumstances surrounding the negotiation and conclusion of the treaty and the preparatory works are included in the external context. According to Art. 31 (2) of the VCLT the context is defined as the internal context. Additionally, paragraph (3) of the referred Article broadens the context to include the agreements on the interpretation or application of the treaty as well as the subsequent practice on this matter. The general means of interpretation of the general rule of Art. 31 point to a restrictive understanding of "context", equivalent to the internal one.

The external context includes the confirmation of a particular meaning, pursuant to Art. 31 (4), and the supplementary means of interpretation: the circumstances surrounding the conclusion of the treaty and the preparatory works. The author tends to think that only documents capable of revealing the intention of both parties, and not unilateral documents to the treaty, are considered as complementary means of interpretation. However, one can only appeal to such supplementary

interpretation of the VCLT, namely with Art. 31, as *Kees Van Raad*[59], *Klaus Vogel/Rainer Prokisch*[60], and the case of the Supreme Court of Western Australia *Thiel* vs. *FCT* state.[61]

To assume that, insofar as a certain tax treaty is based on the OECD Model, the Commentaries are also included in its context is quite a tempting construction, but it is no more than to annex those to the tax treaties to be concluded, something which was not intended by the specialists from the OECD Committee on Fiscal Affairs, as stated on paragraph 29 of the introduction to the Model.[62]

Contrary to the opinion that there might be a conflict between the duty to adopt OECD Model Commentaries and that of limiting the means of interpretation to those stated in Art. 31 of the VCLT,[63] *Inês Batalha Mendes* believes that if tax treaty interpretation presents some specialities towards the VCLT rules, then one should not speak about conflict but rather investigate in which way these specialities (including the Commentary to the OECD Model) differ from the general rules of interpretation.[64]

According to *Inês Batalha Mendes*, those Commentaries cannot as well be considered as preparatory work.[65] In fact, the definition of preparatory work only includes documents drafted towards the preparation and conclusion on concrete terms of a certain treaty, and the OECD Model and Commentaries were written envisaging abstract and hypothetical treaties.[66] However, preparatory work is not the only complementary means of interpretation referred by Art. 32, as the adverb "namely" indicates, therefore there is no need for the Commentaries to be considered as one of the former, just for the purposes of including them in the scope of the above-mentioned Article.[67] Regardless of the formula that might be used to include the Commentaries in the discipline of Art. 32 of the VCLT, this would always imply a limited application and importance.[68]

Inês Batalha Mendes believes that the Commentaries to the OECD Model are considered as subsidiary rules in regard of the tax treaties based on that Model,[69] which means that since the contracting parties

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means when the meaning of the term at stake is not clear enough. See also Xavier, *Direito Tributário Internacional*, pp 131 et seq.

[59] See van Raad, Interpretation of tax treaties, *International Fiscal Association Bulletin* 1986.

[60] See Vogel/Prokisch, Interpretation of the double taxation conventions, *Cahiers de Droit Fiscal International,* Vol. LXXVIII (a) (1993).

[61] Batalha Mendes, *Revista Jurídica* 1999, pp 468 et seq.

[62] Batalha Mendes, *Revista Jurídica* 1999, pp 468 et seq.

[63] See Ault, The role of the OECD commentaries in the interpretation of tax treaties, in: Alpert/van Raad (eds), *Essays on International Taxation* (hereafter '*Essays*') (1993).

[64] Batalha Mendes, *Revista Jurídica* 1999, pp 469 et seq.

[65] Batalha Mendes, *Revista Jurídica* 1999, pp 470-1. See M. Lang, *Doppelbesteuerungsabkommen und innerstaatliches Recht* (1992) and Avery Jones *et al*, The Interpretation of Tax Treaties with Particular Reference to Art. 3 (2) of the OECD Model, I and II, *British Tax Review* 1984, 18-9, pp 14 et seq and pp 90 et seq.

[66] Batalha Mendes, *Revista Jurídica* 1999, p 471.

[67] Batalha Mendes, *Revista Jurídica* 1999, p 471.

[68] Batalha Mendes, *Revista Jurídica* 1999, pp 471 et seq.

[69] See Ault, in: Alpert/van Raad (eds) *Essays*.

are free to make reservations to the text, one should presume that in the absence thereof the intention of the parties is equivalent to that of the Commentaries.[70]

On the contrary,[71] however, she thinks that supplementary means of interpretation, namely the OECD Model, cannot confirm the ordinary meaning of Art. 31 of the VCLT, and except for the cases in which the contracting parts have specifically established something else, the OECD Model and Commentary determine the ordinary meaning given to the treaties.[72] In fact, if the States chose to enter a tax treaty based on the OECD Model, this probably means that their intention was to follow its sense and the interpretation given by its Commentaries, and in this case it is not necessary to search for any particular meaning of the terms.[73]

The problem raised by the introduction of changes to the versions of the OECD Model and its Commentary is one of the most pertinent; in fact, it is quite important to know if the interpretation of tax treaties concluded before the modification will be carried out according to the former or latter Model.

Aware of the density of this problem, *Inês Batalha Mendes* believes that new versions of the Commentary should be taken into account pursuant to Art. 31 (3) (a) of the VCLT and considered as subsequent agreements on the interpretation of the treaty concluded between the contracting parties based on the Model.[74] However, this reasoning only applies because the author understands that the modifications will only introduce clarification and precision to the already existing OECD Model Articles or Commentaries without transforming their meaning.[75] As a matter of fact, when the OECD Member States intend to change the effects of the Model Articles, it would be more coherent, albeit more complex, to review the article of the OECD Model itself and to adapt its Commentary afterwards.[76] Nevertheless, it is extremely important to note that it is sometimes hard to distinguish between comprehensive change and clarification.[77]

Quoting the principle of agreement set forth in the Resolution of the 1993 IFA's Congress in Florence, she concludes that the presumption that the guidance provided by the Commentaries represents the ordinary common meaning in treaties following the OECD Model serves the object and purpose of any tax treaty, the avoidance of double taxation.[78]

For *Prokisch*, the OECD Model is not an "agreement relating to the treaty" (Art. 31 (2)(a)) *vis-à-vis* the VCLT "context" (Art. 31 (2)), or an "instrument which was made by one or more parties in connection

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[70] Batalha Mendes, *Revista Jurídica* 1999, p 473.

[71] See Ault, in: Alpert/van Raad (eds) *Essays*.

[72] Batalha Mendes, *Revista Jurídica* 1999, pp 472 et seq.

[73] Batalha Mendes, *Revista Jurídica* 1999, p 474.

[74] Batalha Mendes, *Revista Jurídica* 1999, p 475. Against, Prokisch, *Fisco* 1994, p 23, considers that they may be relevant through the subsequent practice of the States, under Art. 31, (3) (b) of the VCLT, namely in the case of OECD member countries.

[75] Batalha Mendes, *Revista Jurídica* 1999, pp 475 et seq.

[76] Batalha Mendes, *Revista Jurídica* 1999, p 476.

[77] Batalha Mendes, *Revista Jurídica* 1999, p 476.

[78] Batalha Mendes, *Revista Jurídica* 1999, pp 477 et seq.

with the conclusion of the treaty" (Art. 31 (2) (b)), "any subsequent agreement", "any subsequent practice" or "any relevant rules of international law" (Art. 31 (3)), but he expresses doubts on whether it can be seen as "supplementary means of interpretation" pursuant to Art. 32, or as a "weakened obligation" arising from the OECD Council Recommendations.[79]

Rainer Prokisch believes that the determination of the common understanding of the contracting parties is eased by the existence of model conventions, and that when drafting a treaty they may use the OECD Model, whereby the expressions and concepts will acquire a particular sense arising from the Commentaries and the international jurisprudential practice, or they may deviate from the Model, and only in this case the interpreter is prevented from using the said Model and Commentaries.[80]

The special meaning that shall be given to a term assumes secondary importance[81] in view of the OECD Model and the multiple and universal jurisprudential activity, and requires that it is established according to Art. 31 (4) of the VCLT, subject to a special burden of proof,[82] whereby in case of doubt the OECD Model is deemed to have been followed.[83]

On the issue concerning the role of the OECD Model and Commentaries, *Maria Margarida Mesquita* distinguishes two situations:

- Either the Convention is based on the OECD Model and the interpretation should be carried out according to the latter and its Commentary, in the absence of a reservation or observation to the contrary;

- Or the Convention does not follow the proposed Model and its context suggests otherwise, in which case the Model and the Commentaries are not to be considered.[84]

Maria Margarida Mesquita believes that the Commentaries are not binding but consist in a relevant element for interpreting tax treaties.[85] Regarding the version of the OECD Commentary that should be taken into account when interpreting a tax treaty, the Portuguese legal order leads the author to the conclusion that, when the tax authorities adopt the text of the OECD Model in a treaty they enter into, this means they implicitly accept it the way it was interpreted by the Commentaries existing at that moment.[86]

On this matter, *Philip Baker* too raises a number of difficult questions, the first being of course how to

[79] Prokisch, *Fisco* 1994, pp 23 et seq.
[80] Prokisch, *Fisco* 1994, p 29.
[81] Prokisch, *Fisco* 1994, p 28.
[82] Prokisch, *Fisco* 1994, p 29.
[83] Prokisch, *Fisco* 1994, p 30.
[84] Mesquita, *Convenções sobre Dupla Tributação*, pp 21 et seq.
[85] Mesquita, *Convenções sobre Dupla Tributação*, p 81.
[86] Mesquita, *Convenções sobre Dupla Tributação*, pp 22 et seq.

fit the OECD Commentary into the terms of the VCLT.[87] "The Vienna Convention refers to various extrinsic materials that can be used for the interpretation of treaties. The OECD Commentary does not fit very happily into any of those categories. The categories include any instrument made 'in connection with the conclusion of the tax treaty'. The Commentary does not fit very well into that category. Secondly, the Vienna Convention refers to any subsequent practice regarding the interpretation of tax treaties. Again, it does not fit very well into that category. Finally, the Vienna Convention refers to the *travaux préparatoires*. This is just about possible, but it rather extends the meaning of that expression".[88]

On the question of which of the versions of the OECD Commentary should be taken into account, this author's view is that both the earlier Commentaries and later Commentaries can be helpful in connection with the interpretation of tax treaties.[89]

On numbers 7 and 13, respectively, of the Protocol to the Convention between the Portuguese Republic and the United States of America (USA) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, the contracting States agreed that, with reference to Art. 8 "Shipping and air transport", the term "income from the operation of ships or aircraft in international traffic" will be defined in accordance with paragraphs 5 through 12 of the Commentary on Art. 8, "Shipping, inland waterways transport and air transport", of the 1992 OECD Model Convention, and that with reference to Art. 15 "Independent personal services", the term "fixed base" shall be interpreted according to paragraphs 3 and 4 of the Commentary on Art. 14, "Independent personal services", of the said 1992 Model and to any guidelines that for the application of such term may be developed by such Organisation in the future.[90]

Therefore, the tax treaty with the USA expressly refers to the OECD Commentaries; this reference intends to have the 1992 OECD Model followed statically according to the term "income from the operation of ships or aircraft in international traffic" and in an ambulatory manner with regard to the term "fixed base". Apparently, by using the expression "guidelines" – rather than "Commentaries" – it seems that the parties intended to give relevance to OECD Reports on "Independent personal services", even insofar as these may not lead to changes or amendments of the Commentary itself.

Regarding administrative positions, it is worth noting that the Portuguese tax authority's ruling (*Circular*) no. 18/99 states in its introduction that it would be advisable for States applying the conventions to examine the OECD Model and its Commentaries.

Even if many difficulties may occur to include the Commentaries in the means of interpretation of tax treaties, practice has revealed that they play a major role and more and more references have been made to them by courts and even taxpayers, when interpreting the conventions. As a matter of fact, all the material capable of helping reach an acceptable interpretation for both contracting parties should be seriously taken into account, and the OECD Model and Commentary are therefore of extreme relevance

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[87] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 21.

[88] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 21.

[89] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 22.

[90] See Mesquita, *Convenções sobre Dupla Tributação*, pp 23 et seq.

for the interpretation of tax treaties.

In conclusion, the several versions of OECD Model and Commentary are of great importance in the process of interpretation of Portuguese tax treaties, since they inspire most of them.

The OECD Model may also be relevant for the interpretation of internal law. Art. 4-A of the IRC Code, recently introduced by the Tax Reform Bill (Law no. 30-G/2000, of 29 December), introduced a definition of permanent establishment which clearly appears to be inspired by Art. 5 of the OECD Model. Consequently, in this case, the OECD Model has acted as preparatory work or direct source of the Article of the internal law itself. Although the rule is incorporated into an internal system and subject to its hermeneutic rules, the OECD Model should still be taken into account for its interpretation purposes.

The relevance of Art. 3 (2) of the OECD Model

The provision of the above article is included in all Portuguese tax treaties.

According to *Manuel Pires*, Art. 3 (2) OECD Model contains a provision referring to a term used in the treaty and to the domestic law that governs taxes.[91] However, according to the provision in question, after determining the definition given by the internal element one should submit it to the context, and only if this required a different interpretation should the established rules be removed. In case of doubt, there shall be no reference to context, and if this provides no solution, to internal law.[92]

The author takes the position that whether reference should be made to the domestic law existing at the time the convention was concluded (static or historical interpretation) or to the law in force at the time of its application should be decided on a case-by-case basis. Nonetheless, if no conclusion can be drawn, the latter "actualist" interpretation seems preferable.[93]

As far as the relevance of Art. 3 (2) of the OECD Model is concerned, *Alberto Xavier* does not agree that such article is a *general renvoi clause*, applicable to both interpretation and qualification and legitimising the subsidiary applicability of the domestic law of the State enforcing the treaty.[94]

For him, this provision only relates to interpretation rather than to qualification of terms not defined either in Art. 3 or in other articles of the treaty, pointing solely to the internal tax laws, namely on those specifically regulating income and capital taxes, which is to be excluded if the context suggests a different interpretation.[95]

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[91] Pires, *National Report*, pp 531 et seq.

[92] Pires, *National Report*, p 532.

[93] Pires, *National Report*, p 532. Mesquita, *Convenções sobre Dupla Tributação*, p 81 position is also to choose the law in force on the moment the treaty is being applied, and not the law in force on the moment it was signed, preference being given to tax law.

[94] Xavier, *Direito Tributário Internacional*, p 133.

[95] Xavier, *Direito Tributário Internacional*, pp 133 et seq, 138 et seq, 148.

"Context" is to be interpreted not only as the "internal context" of the VCLT, but also as the intention of the contracting parties when they signed the treaty and as the meaning given to its concepts by the legislation of the other State, whereas the OECD Commentaries are excluded from that expression, particularly on the case of the States that are not part of that organisation.[96]

Article 3 (2) of the OECD Model is therefore used by way of exception, as the context will virtually exclude the applicability of internal law, allowing only a definition of expressions such as "profit" or "direct and indirect control".[97] The reference to domestic tax law also includes the tax treaties that are part of the legal order of that State, unless the context otherwise requires, and should lead to the law in force on the date on which the treaty is being applied, according to a *dynamic* or *evolutionary* conception.[98]

The relevance of other references to domestic law contained in bilateral tax treaties

Alberto Xavier has a thorough theory with regard to the above problem. He believes that the doctrine traditionally conceives three different solutions for the problems of qualification that the treaty does not solve itself:

1. For some authors, each State applying the treaty should qualify its concepts in accordance with its internal law (*lex fori* qualification).

2. For others, both States qualify the terms of the treaty consistently according to the law of the State in which the income originates (qualification by the State of source).

3. Finally, for the last ones, both States should try to issue a consistent qualification from the context of the treaty (autonomous qualification).[99]

The qualification according to the law of the State of residence may be viewed as a fourth hypothesis.[100]

Alberto Xavier does not agree with any of these positions, namely because the treaty may not resolve itself the problem of qualification, which does not concern interpretation, but application.[101]

Firstly, according to this Professor, interpretation and qualification are two distinct problems and not one single operation: interpretation means to define in a general and abstract way the different contents

[96] Xavier, *Direito Tributário Internacional*, p 134.
[97] Xavier, *Direito Tributário Internacional*, p 135.
[98] Xavier, *Direito Tributário Internacional*, pp 135 et seq.
[99] Xavier, *Direito Tributário Internacional*, p 145.
[100] Xavier, *Direito Tributário Internacional*, p 145.
[101] Xavier, *Direito Tributário Internacional*, p 146.

of a concept, while qualification refers to the moment of applying the rule and involves a decision in specie.[102]

Secondly, the autonomous qualification is still a common interpretation of concepts expressed in different national laws, in light of the treaty, but does not solve the true problem of qualification, which is logically subsequent.[103]

Moreover, the cumulative qualifying solution proposed by *lex fori* followers does not satisfy the purpose of the treaty: in fact, if each State has the possibility of qualifying a treaty concept in harmony with its internal law, then situations of conflict of qualification that may be either positive (double taxation) or negative (absence of taxation) will necessarily arise.[104]

Finally, the question of determining if the qualifying competence belongs to the State of residence or to the State of source should not appear as an alternative choice to be made: only exclusive qualifying competencies exist - the only solution in line with the "object and purpose" of those treaties, as per Art. 31 of the VCLT - but these change according to the nature of the questions.[105]

Alberto Xavier distinguishes the concepts referring to the conflicts' rule and describing the different types of income to which the convention applies from the rest of the preconditions for the application of the rule.[106]

As far as the concepts referring to the conflicts' rule are concerned, the exclusive qualifying competence has been attributed to the State of source according to Art. 10 (3) of the OECD Model as for "dividends", according to most Portuguese tax treaties' with reference to interest,[107] and according to Art. 6 (2) of the said Model as for "immovable property".[108] This is not exceptional, and is in line with the general rule according to which the State of residence should accept the qualification made by the State of source and is forced to grant exemption or tax credit, pursuant to Art. 23 of the OECD Model.[109]

As for the other preconditions for the application of the rule, the exclusive qualifying competence lies with a single State (which is not necessarily the State of source): that of *lex situationis* which presents a natural vocation to decide the situation.[110] Therefore, in order to determine if an English trust is a

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[102] Xavier, *Direito Tributário Internacional*, p 138.
[103] Xavier, *Direito Tributário Internacional*, p 146.
[104] Xavier, *Direito Tributário Internacional*, pp 146 et seq.
[105] Xavier, *Direito Tributário Internacional*, pp 146 et seq.
[106] Xavier, *Direito Tributário Internacional*, p 149.
[107]Since the term "interest" includes "income assimilated to income from money lent by the taxation law of the State in which the income arises". Nevertheless, many of the most recent tax treaties entered into by Portugal (Bulgaria, China, Czech Republic, Hungary, India, Macao, Morocco, Netherlands, Poland, Romania, Tunisia and Singapore) do not include that reference.
[108] Xavier, *Direito Tributário Internacional*, p 149.
[109] Xavier, *Direito Tributário Internacional*, p 150.
[110] Xavier, *Direito Tributário Internacional*, pp 150 et seq.

taxable person for purposes of a treaty provision regarding a dividend payment, the English legal order has competence to determine if the trust is such a person and if the recipient is in fact a trust.[111]

Therefore, situations that represent "preconditions" for the applicability of a treaty and that are described by means of legal concepts, should be exclusively qualified by the legal order that presents a straighter connection with it, that connection being revealed by an interpretative effort on the treaty.[112]

Regarding the State of residence, it also has exclusive qualifying competence with regard to the conventional norms that are specifically directed towards it: those inspired by Art. 23A and 23B of the OECD Model, regulating the exemption and imputation methods.[113]

The relevance of mutual agreements

Further to our research, we found no published mutual agreement procedures in Portugal nor tax administration or court decisions regarding the matter. However, some Portuguese scholars discuss the issue.

Maria Margarida Mesquita states that mutual agreements are not binding for the courts, and even if they are mere interpretative agreements they are not to be taken into account according to Art. 31 (3) (a) and (b) of the VCLT, in legal orders similar to the Portuguese system.[114] Even if the VCLT were in force in the legal order at stake, for such agreement to produce effects in relation to the courts – and to the taxpayers, we would add - it would have to follow a procedure identical to the approval of the tax treaty itself.[115]

For *Alberto Xavier*, the binding effect of the mutual agreements is to be discussed only with regard to the taxpayers and the courts and not towards the tax authorities themselves, as their conventional nature should render them binding for the latter.[116] *Philip Baker* also takes the view that decisions of a number of countries, including Belgium and the United Kingdom, reveal that they consider mutual agreements to be binding on the tax authorities themselves, but do not force courts to reach the same result.[117]

In countries like Portugal, the mutual agreements cannot preclude recourse to courts nor be enforced differently after a definitive court decision.[118]

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[111] Xavier, *Direito Tributário Internacional*, pp 151 et seq.

[112] Xavier, *Direito Tributário Internacional*, p 153.

[113] Xavier, *Direito Tributário Internacional*, pp 154 et seq. The author disagrees with paragraph (39) of the OECD Commentaries on Articles 23A and 23B.

[114] Mesquita, *Convenções sobre Dupla Tributação*, pp 319 et seq.

[115] Mesquita, *Convenções sobre Dupla Tributação*, p 320.

[116] Xavier, *Direito Tributário Internacional*, p 177.

[117] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 23.

[118] Xavier, *Direito Tributário Internacional*, p 177.

As far as recourse to courts is concerned, one should note that Art. 205 (2) of the CRP states that the decisions of the courts are mandatory for all public and private entities and prevail over those of any other authorities.

On the enforcement of courts decisions, *Manuel Pires* expresses doubts as to whether an indemnity can be paid by a tax administration of one country regarding certain facts occurred in another country that could not be taken into account by the national court, and if that would amount to a tax incentive, therefore requiring approval by a parliamentary law.[119]

Alberto Xavier distinguishes between *agreements of an interpretative character* and *integrative agreements*, the former including both individual (Art. 25 (1) and (2)) and interpretative agreements (Art. 25 (3), 1st sentence), and the latter resuming to the procedure envisaged in Art. 25 (3), 2nd sentence, of the OECD Model.[120]

He seems to accept that *agreements of an interpretative character* should mandatorily be taken into account by courts as an element of interpretation of the treaty, pursuant to Art. 31 (3) (a) and (b) of the VCLT.[121] As far as *integrative agreements* are concerned, the author considers them to be agreements in a simplified form; they only involve approval by the government, which necessarily implies that they cannot address the zone subject to the constitutional principle of legal reserve and, if they do so, they will not be binding for the taxpayers or the courts.[122]

The oldest Portuguese tax treaties did not include any reference to agreements of an integrative character in order to avoid doubts about their constitutionality,[123] while the more recent ones enable this procedure. Nevertheless, point 37 of the Commentary to Art. 25 of the OECD Model considers that for contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or implicitly dealt with, the Convention could be complemented only by a protocol, like the Convention itself, subject to ratification or approval. According to *Manuel Pires* this point made any reservation unnecessary.[124]

Nevertheless, we believe that although the States did not have to make a reservation to the OECD Model this does not mean that they should not adopt a different position on their tax treaties. The simple fact of being contrary to their internal law and the OECD Model Commentary would not be sufficient to consider as non-written the integrative mutual agreement rule on a tax treaty.

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[119] Pires, Procedimento Arbitral – CEE, *Ciência e Técnica Fiscal* 1990, no. 357, p 15.

[120] Xavier, *Direito Tributário Internacional*, pp 173 et seq, 177.

[121] Xavier, *Direito Tributário Internacional*, pp 177 et seq. He also points out, p 131, that the authentic interpretation of a treaty may only be made by mutual agreement of the parties, and that such agreement is envisaged on Art. 25 (3) of the OECD Model.

[122] Xavier, *Direito Tributário Internacional*, pp 178 et seq. See also Mesquita, *Convenções sobre Dupla Tributação*, p 322.

[123] Pires, *Da Dupla Tributação Jurídica Internacional sobre o Rendimento* (hereafter '*Dupla Tributação Internacional*') (1984) p 801.

[124] Pires, *Dupla Tributação Internacional*, p 801.

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As far as the above-mentioned issue is concerned, we trust that in the case of Portugal two different situations should be analysed.

If the provision enabling the integrative agreements is interpreted restrictively and in conformity with the CRP, it shall not be granted a binding effect towards the taxpayers and the courts, and it will not be liable to challenge for internal law purposes.

On the other hand, if the integrative agreement were considered binding, the tax treaty provision enabling it might be deemed unconstitutional. Nevertheless, under Art. 26, 27 and 42 (1) of the VCLT, the Portuguese State would not be able to invoke such invalidity against another contracting State in order to justify its non-compliance with the treaty. Otherwise, and even if only in theory, it might be considered internationally accountable for such non-compliance. As for the taxpayers, they are not affected by the State commitment and are therefore allowed to question the rule's constitutionality during a court proceeding.

Consequently, we believe that Art. 46 of the VCLT does not apply to this particular case since there does not exist a formal problem of imperfect ratification but rather a substantial situation of incompatibility between the content of the convention itself and the CRP.

Another relevant question that might be raised would be whether we can compare the international approval of a tax treaty containing a clause enabling the government to integrate tax treaties by means of mutual agreements to the internal delegation of powers that the parliament may grant to the government under the principle of limited reserve of law.

Firstly, there is not a specific constitutional authorisation for the government to approve treaties in general. The ratification procedure is established in the CRP and does not refer to the possibility of granting powers to the government to perform it.

As a matter of fact, the delegation of powers granted to the government under the principle of limited reserve of law must include a definition of the object, meaning, extension and duration of this same delegation, which may be extended (Art. 165 (2) of the CRP), being an *ex ante* lien of the legislative powers of the government (Art. 198 (1) (b) of the CRP). The negotiation and adjustment of international conventions is among the government's political attributions (Art. 197 (1) (b) of the CRP), being only susceptible, at most, to approval or refusal by parliament.

On the other hand, the legislative authorisations cannot be used more than once (Art. 165 (3) of the CRP) whereas the government can negotiate and adjust tax treaties at any time.

Furthermore, the legislative authorisations are subject to a double limit. Firstly, they expire with the resignation of the government to whom they were granted, at the end of the legislative period or with the dissolution of parliament (Art. 165 (4) of the CRP). Secondly, those granted to the government in the context of the Budget Law only expire at the end of the fiscal year to which they relate (Art. 165 (5) of the CRP). Therefore, there is nothing in the treaty powers of the government that allows those limits to be applied herein.

Finally, according to Art. 112 (6) of the CRP, no law can create other categories of legislative acts or grant acts of a different nature the power to interpret, integrate, modify, suspend or revoke externally and bindingly any of its provisions.[125]

In this specific case, from a formal point of view, the delegation is not being operated by a law but by the parliamentary resolution ratifying the tax treaty. Consequently, Art. 112 of the CRP is not directly applicable to this issue. Nevertheless, we should note that the resolution's purpose is to allow the tax treaty to be considered internally as law, and although under the Portuguese system international law is not subject to transformation and incorporation into internal law, but rather to a reception in the terms of Art. 8 (2), the said resolution would still have a normative content.

Therefore, and considering that tax treaties limit the application of internal (tax) law, by granting the government the power to interpret the former, in particular under integrative agreements which involve the drafting of missing rules, we are implicitly allowing it to interpret the relevant internal law concepts underlying the enforcement of the treaty itself.

An interesting provision on this matter is found in Art. 27 (3) of the Convention between Portugal and Canada, signed in 1999 but not yet into force. It establishes a limitation on the application of the treaty to certain entities that are entitled to income tax benefits under the legislation and other measures relating to tax-free zones of a contracting State. Moreover, paragraph 4 of this same Article states that "*For the purposes of paragraph 3 of the article XXII ('Consultation') of the General Agreement on Trade in Services, the contracting States agree that, notwithstanding that paragraph, any dispute between them as to whether a measure falls within the scope of this Convention mentioned may be brought before the Council for Trade in Services, as provided by that paragraph, only with the consent of both Contracting States. Any doubt as to the interpretation of this paragraph shall be resolved under paragraph 3 of article 24* (the provision of the Convention concerning 'Mutual Agreement Procedure') *or, failing agreement under that procedure, pursuant to any other procedure agreed to by both contracting States*".

Regarding this same issue, Art. 29 of the Convention between Portugal and Luxembourg contains a rule excluding certain companies from the scope of said Convention, which previews that the Convention does not apply to the companies that are entitled to income tax benefits under the legislation or administrative practice of any contracting Sate. The governments of the Contracting States will agree periodically on the notion of "*companies that are entitled to income tax benefits under the legislation or administrative practice of one or the other Contracting State*".

In conclusion, and despite all the theoretical reasoning, the only mutual agreement existing so far seems to be the one between taxpayers and the Portuguese tax authorities on not applying the mutual agreement procedure.

The relevance of other contracting State's tax authority practice and law

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[125] See Pires, *Dupla Tributação Internacional*, p 801.

According to *Manuel Pires*, common interpretation involving or resulting from the coherent conduct of the authorities of the States appears to be of greatest interest, being of major importance to consider the interpretations adopted by any other State and to have a procedure leading to the acquaintance with those interpretations.[126]

Furthermore, parallel treaties that result from the treaty practice of the States are also a relevant element of interpretation, even if they deviate from the Model, and it is extremely important to consider changes introduced along the history of the treaty.[127]

For *Alberto Xavier* the setting of an exclusive qualifying competence according to his theory grants relevance to foreign laws (including tax ones) for domestic authorities and leads to the need of knowing the other States' legal systems.[128]

As mentioned above, the State of residence may have to accept the qualification given by the State of source, which acts as a requirement for the applicability of the exemption and imputation method rules, and any State's enforcing authority may have to apply foreign *lege situationis*, regulating one of the requirements for enforcement of the treaty.[129]

There is only strict application of foreign law in the latter case, where the domestic authority applies, for example, Luxembourg's law to determine if a Luxembourg trust is a "person"; in the former case, the power to qualify items of income lies exclusively with the State of source that applies only national domestic laws: accordingly the automatic acceptance of this qualification by the State of residence for purposes of applying a treaty does not involve the enforcement of foreign law, but of a foreign State's administrative or judicial act applying its own national laws.[130]

As far as this matter is concerned, Art. 27 (2) (a) and (b) of the Convention between Portugal and Luxembourg establishes that, in spite of the obligation under which the contracting States should exchange the necessary information to apply the Convention, this could never be understood as forcing the contracting State to act administratively against its or the other State's legislation or administrative practice, nor to give information which, according to its legislation and administrative practice or that of the contracting State, could never be released (see also point VII above).

Another example of the relevance of the other contracting State's tax authority is the provision of ad – Art. 29 of the Protocol in appendix to the above-mentioned Convention that establishes that the term "*companies that are entitled to a special tax regime under the legislation or administrative practise of any contracting Sate means the holding companies as defined by the Luxembourg legislation*".

The applicability of foreign laws, namely tax ones, although relevant for the enforcement of the treaty and, therefore, of domestic laws, does not involve a conflict of sovereignty, because these foreign laws

[126] Pires, *National Report*, p 529 et seq.

[127] Pires, *National Report*, p 530.

[128] Xavier, *Direito Tributário Internacional*, pp 161 et seq. See also Prokisch, *Fisco* 1994, p 24.

[129] Xavier, *Direito Tributário Internacional*, p 162.

[130] Xavier, *Direito Tributário Internacional*, p 162.

cannot give rise to tax obligations whose legal title is attributable to the State they belong to.[131]

A problem addressed by *Alberto Xavier* is whether the relevance of foreign law in qualification problems under international tax law includes only the substantive law or foreign law as a "block" including the conflict of laws rules of that State.[132]

He gives an example whereby the forum (Brazil) is discussing the applicability of a treaty rule under which a foreign company (Portuguese) is deemed to have a permanent establishment in that State (Brazil), when it exerts activity therein through a person acting on its behalf, which is not an independent agent and has authority to conclude contracts pursuant to an agreement entered into in another State (Belgium).[133]

According to his thesis, Brazilian law should qualify the concept of permanent establishment as taxable income (*lex fori*). Nevertheless, the competent law to decide if the person is acting "on behalf", if it is an agent, if such agent is independent or if it has the power to bind the company is the *lex societatis* (Portugal). Portuguese Civil Code conflict of laws rules' would point to the Italian law as the place where the above agreement was concluded to qualify the agent as independent (*transmission of competence*). However, these conflict of laws rules again suggest that it is Brazilian law under which the representative powers are exerted, according to the required existence of binding powers (*remittance or devolution of competence*).

The author notices that the problem of applying foreign law, by reason of the private domestic conflict of laws rules, may arise due to treaty norms, but also due to domestic tax laws.[134]

The relevance of tax authority and court decisions

It is crucial for a harmonious application and interpretation of tax treaties to consider judicial decisions of foreign courts as far as these courts' jurisprudence, in the absence of an International Tax Court, represents the conceptions and perspectives of the international tax community, even if no strong binding effect is recognised therefrom: these decisions represent data sources for other opinions but are as such never a valid source of international law.[135]

As *Philip Baker* said "I believe very strongly that, when courts are called upon to interpret a tax treaty, they should look at any helpful decisions from foreign courts. We should abandon our normal xenophobia when it comes to foreign court cases".[136]

[131] Xavier, *Direito Tributário Internacional*, p 165.

[132] Xavier, *Direito Tributário Internacional*, p 166.

[133] Xavier, *Direito Tributário Internacional*, pp 166 et seq.

[134] Xavier, *Direito Tributário Internacional*, p 168.

[135] Prokisch, *Fisco* 1994, pp 24 et seq.

[136] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 24.

However, Portuguese tax authorities, with the possible exception of the Centre for Fiscal Studies of the Ministry of Finance, or Portuguese courts, normally do not take into account such foreign decisions. Opinion no. 91/91, of 30 July 1991 relating to a permanent establishment issue is an exception. This decision makes indirect reference to a BFH decision of 13 September 1962 on construction work.[137]

Finally, *Philip Baker* directs our attention to expert evidence. He believes it is undesirable that individuals, namely retired Revenue officials, give evidence on what they thought they were meaning when they signed a particular treaty, as this may not necessarily represent their country's view at that moment, and could reflect hindsight and an attempt to legitimise the current government position.[138] On the contrary, he finds it desirable for the courts to receive the evidence of experts – international tax lawyers and academics - in international tax law, and their assistance in the presentation of material.[139]

As international tax lawyers, we therefore join the twenty first century with a deep hope that courts follow *Philip Baker's* suggestion and that there will be an increasing demand for our services in the field of tax treaty interpretation, preferably coming from exotic jurisdictions like the Fiji Islands.[140]

[137] The opinion is authored by Pereira/Lourdes Vale, Parecer no. 91/91, de 30 de Julho de 1991, do Centro de Estudos Fiscais do Ministério das Finanças, *Ciência e Técnica Fiscal* 1991, no. 364. (The quote is made on p 447).

[138] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, pp 25 et seq.

[139] Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 26.

[140] The Fiji Court has indeed received expert evidence from Professor Avery Jones in the case *Commissioner of Inland Revenue* v. *Commonwealth Development Corporation*. See Baker, *Fiscalidade-Revista de Direito e Gestão Fiscal* 2000, p 26.

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