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International Tax Webinar Series

Interpretation of Double Taxation Agreements

Presented by Kristie Schubert, Partner and Jacqueline McGrath, Special Counsel

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International Tax Webinar Series

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Outline

- Double Tax Agreements - Incorporation into Australian law
- Vienna Convention - Interpretation principles
- History of Australian Cases
- *Irish Bank Case*
- Questions

Incorporation into Australian Law

- In Australia, double tax agreements are integrated into Australian domestic law by incorporation as schedules to the *International Tax Agreements Act 1953* (Cth).

- Whilst forming part of Australia's domestic law by Act of Parliament, DTAs are international agreements and because they are international agreements, the interpretative principles applying to the construction of those treaties are governed by Articles 31 to 33 of the Vienna Convention on the Law of Treaties ("Vienna Convention").

Vienna Convention Interpretation Principles

- **Article 31** requires a treaty to 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".
- **Article 32** provides that "[r]ecourse may be had to supplementary means of interpretation to confirm the meaning resulting from the application of Article 31 or to determine the meaning when the interpretation according to Article 31 leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable".
- **Article 33** specifies that "[w]hen a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in the case of divergence, a particular text shall prevail".

Thiel v Commissioner of Taxation (1990) 171 CLR 338

- The central question in the appeal concerned the interpretation to be given by an Australian court to the words "profits of an enterprise of one of the Contracting States" in Art 7 of the Australia and Switzerland DTA.
- “Profits” and “enterprise” were not defined in the Agreement.
- Article 3

  “…any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State relating to the taxes to which this Agreement applies”

- Article 3 was of no assistance since “profits” and “enterprise” were not defined in Australian tax law (the Contracting State).

Thiel v Commissioner of Taxation Cont….

- Mason CJ, Brennan and Gaudron JJ.
  - [9] "The meaning of "enterprise" can then be ascertained from the Agreement construed in the light of such extrinsic materials as may be relevant".
  - Extrinsic material:
    - German translation of DTA
    - OECD Commentary on the Model Convention
- McHugh J
  - [12] "Recourse may also be had to "supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion" to confirm the meaning resulting from the application of Art.31 or to determine the meaning of the treaty when interpretation according to Art.31 leaves its meaning obscure or ambiguous or leads to a result which is manifestly absurd or unreasonable: Art.32."
  - [13] "The Agreement is one "for the avoidance of double taxation with respect to taxes on income". Accordingly, it is necessary to interpret the words of the Agreement with that particular purpose in mind".

Burton v Commissioner of Taxation [2019] FCAFC 141

- Article 22(2) of the DTA between Australia and the United States relevantly allows a credit against Australian tax for the US tax paid:
  - "in respect of income [gains] derived from sources in the United States" but that "[t]he credit shall not exceed the amount of Australian tax payable in respect of the income".
- Was the credit only for the discounted capital gain?
- Steward and Jackson JJ. held that the taxpayer was only entitled to a credit in respect of 50% of the capital gain.
- Logan J. dissented.

Tech Mahindra Limited v Commissioner of Taxation (2018) FCR 502; [2018] FCAFC 172

- Issue
  - Article 7 (the business profits rule) and Article 12 (the royalties provision) of the *Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*.
- Applicant's Arguments
  - Effect of Article 4 & 5 of the Agreement Act was not to incorporate the Agreements Act into the Assessment Acts. The Assessment Acts operated independently.
  - At [26]: The applicant also placed store on the generalised principle that tax treaties are, and can only be, exclusively relieving: that is, they are only ever "shields not swords" and not the grant of a standalone taxing power and independent imposition of taxation.
  - Article 23 gives Australia the right to enact law deeming the income to have Australian source, it is not self-enacting.
- Commissioner's Arguments
  - Accepted that Treaties did not confer taxing rights where none existed (Chevron)
  - The purpose and effect of the "deemed source article" was not to confer taxing rights but to modify the application of Australia's source rules to bring income, in relation to which Australia had been allocated the right to tax, into the scope of the non-resident income provision in section 6-5 (Taxation Ruling – TR 2001/13)
  - Treaty in this regard has a "sword-like effect"

Tech Mahindra Cont…

- The Court held:
  - The text of Article 23(1) was not ambiguous.
  - It was given paramountcy by virtue of the Agreements Act.
  - There was nothing in the context, object or purpose of the DTA or the Agreements Act which permitted it to be read down to confirm with a 'generalised assertion about the 'effect' of tax treaties outside the text of the particular DTA.

Addy v Commissioner of Taxation [2021] HCA 34

- Australia / UK DTA
  - Article 25(1) of the DTA relevantly provides that nationals of the UK shall not be subjected in Australia to "other or more burdensome" taxation than is imposed on Australian nationals "in the same circumstances, in particular with respect to residence".
  - The 'backpacker tax' (amendments to the *Rates Act*) essentially removed the tax-free threshold for Ms Addy (a UK national).
  - Issue for the High Court was whether, in contravention of Article 25(1) of the DTA, the *Rates Act* imposed a more burdensome taxation requirement on Ms Addy.

Addy v Commissioner of Taxation Cont…

- The Court found:
  - At [8]: "The question is whether that more burdensome taxation was imposed on Ms Addy owing to her nationality. The short answer is "yes". When the position of Ms Addy is compared with that of an Australian national, as it must be, that is the only conclusion which may be drawn".
- In terms of DTA interpretation principles, the Court referred to:
  - Commentary that accompanied the OECD Model Convention at the time Australia and the United Kingdom entered into the DTA.
  - *Review of Business Taxation, A Tax System Redesigned: More Certain, Equitable and Durable* (1999) at 678 [22.22].
  - Australia, House of Representatives, International Tax Agreements Amendment Bill 2003, Explanatory Memorandum.

Irish Bank Resolution Corporation Ltd v HM Revenue and Customs [2020] WLR(D) 485; [2020] STC 1946; [2020] EWCA Civ 1128

- In the *Irish Bank Case*, the UK Court of Appeal considered the compatibility of UK domestic tax legislation with Article 8(2) (the business profits Article) of the UK-Ireland DTA.
- **Issue**
  - The UK domestic tax legislation required the deductibility of interest of a permanent establishment (of which the Irish Bank was) for tax purposes to be calculated having regard to the debt and equity capital which the PE could reasonably be expected to have if it were a distinct and separate enterprise operating under specified conditions.
  - The UK-Ireland DTA (so it was argued) that PEs were to be treated for tax purposes as having the ratio of equity to debt that they actually held, rather than this being determined under UK legislation requiring their tax liabilities to be computed by reference to an adjusted amount of capital.

Irish Bank Cont…

- **Irish Bank's Position**
  - The debt financing, as set out in the PE's accounts, was the appropriate measure of debt to be used for tax purposes and that the UK's capital attribution rules were precluded by the UK-Ireland DTA.
- **HMRC'S Position**
  - HMRC argued, broadly, that the PEs were subject to s11AA *Income and Corporation Taxes Act 1988* ('ICTA') (in force during the relevant period), which required the banks to compute their PE taxable profits assuming:
    - the PE had the same amount of equity and loan capital as a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions
    - the PE has the same credit rating as the non-resident entity
    - the PE is a distinct and separate enterprise dealing at 'arm's length' with the non-UK resident company of which it is part.

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Irish Bank Cont…

- **Key interpretation matters arising from Court of Appeal's Judgment**
  - It was accepted that the UK was bound by its treaty obligations and that these were capable *in principle* of overriding domestic law provisions.
  - The Court referred to the absence of evidence of bilateral practice in resolving these issues. It referred to Article 31 of the Vienna Convention, and accepted that evidence of a <u>bilateral</u> practice of the parties to the DTA could assist in support of the construction of the treaty provisions. However, a unilateral practice of one party (here, HMRC) could not.
  - The court cited at length OECD commentaries. The Court rejected the argument for the banks that the revised commentary (in 2008) could not be 'read backwards' into the wording of the 1976 Treaty. It admitted that the wording of the 2010 model treaty, agreed following the 2008 commentary, was more specific than the wording of the 1976 Treaty.

Thank you

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