Tax Treaty Override

(adopted by the OECD Council on 2 October 1989)

R (8)

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I. THE PROBLEM

1. Double taxation agreements (tax treaties)[1] are an essential element in facilitating economic relations between States and encouraging flows of capital and labour. They form a firm and reliable basis for tax relations between States. They limit and regulate the taxing jurisdiction of the States entering into them so as to ensure the orderly application of the domestic tax laws of what are often quite different systems. Their importance is underlined by the large numbers that are currently in force and the fact that international organisations and the business community repeatedly recommend the enlargement and improvement of the treaty network.

2. The certainty that tax treaties bring to international tax matters has, in the past few years, been called into question, and to some extent undermined, by the tendency in certain States for domestic legislation to be passed or proposed which may override provisions of tax treaties. In this note, which looks at the consequences of such action by national legislatures, the term "treaty override" refers to a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State. Legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (*e.g.* in cases of treaty shopping or other forms of abuse). Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice. Some hypothetical examples of treaty override are given in Section IV of this note.

3. This note proceeds to analyse treaty override from three different points of view. First, it examines the relevant rules of international and domestic law and the relationship between them. Secondly, it considers the possible legal remedies when override occurs. Thirdly, it analyses different practical cases, including the motivation for treaty override in any given situation. The note then presents the position of the Committee on Fiscal Affairs on the question and makes suggestions for action at the international and domestic levels including ways in which particular situations which States have tried to resolve by treaty override can be dealt with.

4. At the outset, however, the kind of treaty override primarily addressed in this note should be distinguished from other situations, which either involve or are similar to treaty override and may have the same effects. Three of these situations are described below and comments are made on them either below or later in this note.

a) A State may legislate to reverse the effect of a court decision which deviates from the common interpretation, explicitly accepted or tacitly implied by the treaty partners, of a provision based on the text of the treaty. In this case, it is not considered that any injury is done to the basis of international tax relations if the competent legislative and administrative organs of the States concerned are in agreement that the court decision is contrary to their intentions. Indeed it is the Court's decision in the first place which may be seen as overriding the treaty;

b) A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2, of the 1977 OECD Model Double Taxation Convention which provides that, as regards the application of a treaty by a Contracting State, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty;

c) Finally, newly adopted domestic legislation may be incompatible with a treaty provision, without the competent organs intending, or even being aware of, such an effect.

5. In summary, the type of treaty override primarily addressed in this note is the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.

II. THE LEGAL ANALYSIS OF TREATY OVERRIDE

i) Preliminary remarks

6. The legal effect of a treaty override has to be examined both in the light of international and of domestic law.

7. Under a treaty the Contracting States mutually undertake the obligation to respect and apply the treaty provisions. This is the principle of "*pacta sunt servanda*". Treaty override implies that a State by legislative action gives preference to domestic law over international law, and thus refuses to fulfil certain obligations arising out of the contractual nexus on grounds that the treaty obligations conflict with domestic law. When a treaty override occurs there is, therefore, a breach of the treaty. It should be noted that a breach of the treaty occurs when the overriding legislation is passed by the legislature

and not only when it is applied to actual cases. Any breach of a treaty has an effect on the international relationships of the State concerned with other States, and the rights and obligations arising out of such action have to be determined under the rules of international law.

ii) The obligation to perform treaties under international law

8. Tax treaties are international agreements concluded between States in written form and governed by international law. The *Vienna Convention on the Law of Treaties*, which came into force on 27th January 1980, contains the rules applicable to treaties concluded after it came into force between States that are parties to the Convention. As at 31st December 1988, 56 States were parties to it, including the following OECD member countries: Australia, Austria, Canada, Denmark, Finland, Germany, Greece, Italy, Japan, the Netherlands, New Zealand, Spain, Sweden and the United Kingdom. Luxembourg and the United States have signed, but not ratified, the Vienna Convention. As concerns States which are not parties to the Vienna Convention, or as concerns treaties concluded before its entry into force, the principles applicable are those of customary international law. However, since most of the principles embodied in the Vienna Convention have been derived from customary international law, it is the principles set out in that Convention to which this note will refer.

9. The obligation "*pacta sunt servanda*" is one of the fundamental, universally recognised principles of the law of treaties, which has been codified in the preamble and in Article 26 of the Vienna Convention, which reads as follows: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith".

10. "Binding on the parties" means that the treaty is binding on the subject of international law as such, *i.e.* the State as a whole. It does not matter which organ represented the State when entering into treaty commitments, nor whether the procedure by which the State became bound involved parliamentary approval or not. The State is bound even if its consent in that respect was expressed by an organ beyond its competence or under violation of constitutional procedures, unless this violation was evident to the other parties (*cf.* Article 46 of the Vienna Convention). It "must be performed in good faith" means that international law requires States to implement the provisions of a treaty. It depends on each individual State the particularities of its constitutional and legal system, and the nature of the treaty itself how such implementation takes place. International law, however, is not concerned with the ways and means by which performance is obtained, but exclusively with the result.

11. Article 27, stressing that internal law cannot serve as justification for non-compliance with treaty obligations, reiterates a principle which might be seen as already implicit under Article 26. This can apply to the case where national legislative or administrative organs adopt measures contrary to existing treaty obligations. According to Article 27, such internal difficulties or even impossibilities may not be presented as a legally valid excuse in relations between States, *i.e.* under international law.

12. In summary, it can be said that under international law treaties have to be observed by the parties as long as they are valid, and unless they have been formally denounced. Domestic legislation (whether subsequent to signature or otherwise) or other reasons in no way affect the continuing existence of that international obligation. All other parties to a treaty are entitled to insist on compliance by a party not performing its obligations.

iii) The rank of treaty obligations under domestic law

13. Under the provisions of Article 1, the Vienna Convention has effect only *between States*. The source for rights and obligations for individuals and organs *within a State* is its domestic law. While Article 27 of the Vienna Convention does not admit provisions of domestic law as an excuse for not complying between States, it implicitly admits that conflicting domestic law may exist. This is in accordance with the two main doctrines explaining the relationship between international and domestic law: while the "dualist" doctrine believes that international and domestic law are two completely independent systems, each governing different relations and having different sources, the "moderate monist" doctrine sees international and domestic law as part of one overall system, but admits nevertheless the valid existence of domestic law in conflict with international law.

14. It depends on each State's legal system how, and at what level, international law (treaties, customary law and general principles) is given effect domestically. The level attributed to treaty obligations, as incorporated in domestic law, determines whether derogations therefrom are unconstitutional or not. In the end, the choice is between giving priority either to a State's international obligations, or to the sovereignty of decision of a country's elected representatives. "Treaty override" under domestic law can be automatically avoided if, under a State's Constitution, a higher value is attributed to a treaty obligation than to domestic law or if a State regards treaty law as "*lex specialis*" to which priority is to be given in domestic law. If treaty obligations are considered as having – at most – the same rank as that of domestic law, they may, within some national legal systems be subject to the rule "*lex posterior derogat legi priori*" (*i.e.* later law overrides prior law). However, the situation is less simple to determine in practice since this principle applies only when inconsistencies arise between the new law and

the prior law and it is well known that courts are reluctant to construe treaties as inconsistent with domestic law (and vice versa).

15. In this respect, OECD member countries find themselves in different positions. For example, Article 55 of the French Constitution of 1958 provides that treaties regularly ratified or accepted shall possess, from the moment of publication, superiority over ordinary laws.[2] A similar principle is embodied in Article 94 of the Dutch Constitution. Here, the treaty obligations prevail, also under domestic law, over any conflicting provisions of prior and posterior laws. On the other hand, the United States has chosen, in accordance with Article VI, paragraph 2, of its Constitution, to give treaty obligations equal rank with domestic law and thus to make such obligations subject to the "*lex posterior*" rule in the case of irreconcilable conflicts. In the Federal Republic of Germany Article 59, paragraph 2, of the Fundamental Law provides for the transformation of the treaty into domestic law and treaties so transformed normally have precedence over national law. In the United Kingdom domestic legislation implementing treaty obligations is subject to amendment or repeal by later legislation. Under the Constitution of Finland, treaties which may conflict with prior domestic law require approval by Act of Parliament and after such approval will have the same rank as that Act.

16. Mention should also be made in this context of the fact that many OECD member countries are also member States of the European Community. For them, European Community law adopted on the basis of the EEC Treaty, the ECSC Treaty, the EURATOM Treaty and the other Community treaties occupies a special place in the legal hierarchy. Directly applicable EC provisions are, in effect, law which operates directly in the domestic legal system and overrides conflicting domestic law. It should however be noted that the European Communities themselves, in their regulatory activities, are bound by the rules of international law.

17. If a constitutional system does not exclude the adoption of legislation contrary to the State's international obligations, this does not mean that those international obligations are considered as having no importance. If they have such power, the legislative organs must consider carefully whether or not to exercise it. In some States, the outcome of such reflexion may almost always be in favour of respecting those international obligations. In others, legislators may, in occasional cases, consider certain national interests as of such overwhelming importance that the State has no other choice but to override its treaty obligations.

18. In summary, the rank of treaty obligations depends on each State's legal system. The latter may allow for derogation, under domestic law, from those obligations. Such derogation is internally perfectly valid, and binding on a

State's organs and citizens. It does not, however, alter the obligations of the State towards other States under international law.

iv) Interpretation and application of treaties

19. The rules of interpretation embodied in Article 31 of the Vienna Convention[3] are stated in quite general terms and can be applied only on a case-by-case basis. However, some general remarks are called for:

a) First, Article 31 requires States to interpret treaties in the light of their object and purpose. Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between the two Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading to double taxation or to an inappropriate double exemption. However, since double taxation is a result of taxation in two States, the interpretation of the treaty on the basis of its object and purpose requires a high degree of co-ordination between the Contracting States;

b) Secondly, the general rule of interpretation should be based on the terms of the treaty in their context. This corresponds to the approach taken in Article 3, paragraph 2, of the OECD Model Convention where the context of the treaty takes precedence over an interpretation derived from national laws. Interpretation should thus aim at a co-ordinated application in both States in order to avoid double taxation or no taxation;

c) Thirdly, in describing the context, the Vienna Convention refers to agreements, whether prior or subsequent to the treaty, as well as to practices; in the case of tax treaties, these will normally require continuous co-ordination between the tax administrations concerned.

20. All this leads to the conclusion that the interpretative process should, in the case of tax treaties, rely on the co-ordination of approaches by the tax authorities in order to achieve the main objectives, namely the avoidance of double taxation and the prevention of fiscal evasion. For this reason, a mutual agreement procedure between the tax authorities has been incorporated in tax treaties not only to solve specific cases but also to deal with any other difficulties or doubts arising as to the interpretation or application of the treaties.[4] This does not mean that treaties can be interpreted only by formal mutual agreement procedure or by negotiation, since the decisions of courts clearly have an important part to play. Coordination should nevertheless be regarded as the guiding element in the interpretative process.

III. THE REMEDIES UNDER INTERNATIONAL LAW IN CASE OF NON-COMPLIANCE BY A PARTY WITH ITS TREATY OBLIGATIONS

21. If non-compliance consists in one party enacting legislation violating treaty obligations, international law gives the other party the right to require repeal, or at least, non-application of such legislation. The first step which can and should be taken by an injured party is the filing of an official protest in writing, immediately after the government learns of the possibility of treaty override, to the government of the defaulting party stating the details of the treaty override (*i.e.*, the breach of the treaty) and insisting that it complies with its treaty obligations.

22. If this fails, a remedy for non-compliance – termination of the treaty or suspension of its operation by the other party (parties) as a consequence of the breach – is codified in Article 60 of the Vienna Convention. This Article embodies customary international law and practice. It is to be noted that the Article contains separate provisions relating to a bilateral treaty (paragraph 1) and a multilateral treaty (paragraph 2).

23. It is also important to note that the breach of a treaty by one of the parties must be a "material" one as defined in paragraph 3 of Article 60, *i.e.* consisting in the violation of a provision essential to the accomplishment of the object or purpose of the treaty. If one party is in breach of the treaty the other party may respond but only in a way which is proportionate to the breach. The Vienna Convention in fact provides for suspension in whole or in part of the treaty, thus offering various possibilities of dealing with a breach. Whether a "treaty override" by domestic legislation constitutes such a "material breach" depends on the circumstances of each case.

24. It should also be noted that the words "to invoke the breach as a ground for terminating" has been used and not the words "may terminate". Under the Convention, the injured party must follow the procedures set out in Articles 65 to 68 in order to terminate the treaty.

25. As concerns the overriding party, the so-called "*clausula rebus sic stantibus*" (concept that a fundamental change of circumstances may be invoked as a reason for terminating the treaty) may be mentioned, as it might be relied on in order to justify overriding provisions. This is dealt with in Article 62 of the Vienna Convention. However, it does not justify treaty override as such, in particular not a partial one, but only provides a basis for an extraordinary termination of the treaty as a whole. Treaty override provisions typically do not aim at a complete termination of the tax treaty. On the contrary, they aim at suspending unilaterally the operation of certain treaty provisions in one State while in the other State the treaty would remain applicable in its entirety. Moreover, the "change of circumstances" must be

determined from an objective point of view, *i.e.* a fundamental change of the situation prevailing at the time of conclusion of the treaty, and can not consist in a mere change of national policy. A treaty override, consequently, cannot normally be justified on the basis of the "*clausula rebus sic stantibus*".

26. It should be added that the provisions of Article 61, paragraph 2, on supervening impossibility of performance read as follows: "Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from, or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty."

IV. CASES OF NATIONAL TREATY OVERRIDE

27. It may be useful to give some hypothetical examples to illustrate national overriding legislation. These examples are not intended to reflect specific overriding legislation in member countries but they may bear some resemblance to actual cases.

Case 1

28. State A introduces a new withholding tax on specific items of income such as interest or royalties. State A's tax treaties provide that interest and royalties shall be exempt from tax in the State of source. For internal reasons State A legislates that the new tax will be levied, and that no refund will be provided, notwithstanding its tax treaty obligations to ensure an exemption.

29. This is an outright material breach – not simply because the unilateral action imposes a new tax, but because the effect of the new tax is material – of State A's contractual obligations which would deeply erode the confidence of the international community in State A's trustworthiness in fulfilling its obligations and even in concluding treaties.

30. The breach being a material one, the treaty partners of State A would be justified in terminating their tax treaty relationship with State A. However, termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future. Any wilful treaty override could thus have very serious implications.

Case 2

31. State B taxes gains from the alienation of immovable property. Taxpayers have found a way to avoid paying the tax by interposing, in State B, a company between themselves and the property and by selling the shares in the company rather than the immovable property itself. State B cannot tax the gain from the sale of the shares as its tax treaties follow Article 13 of the OECD

Model Convention. State B legislates that the sale of shares in any real estate company is deemed to be a sale of immovable property for the purpose of the application of its tax treaties.

32. The effect of such legislation is in contravention of State B's tax treaty obligations, even though the overriding measure is clearly designed to put an end to the improper use of its tax treaties. There may be cases where State B could successfully argue that there is such an improper use and deny the treaty benefits but this must be done under existing rules. This type of case might be the object of a mutual agreement procedure but it might also cause State B to give notice of termination[5] of its treaties (at least those with States whose tax laws are such that a double exemption would be achieved).

33. Override of the kind described in paragraph 31 above could justify termination by State B's tax treaty partners under Article 60 of the Vienna Convention. However, as in Case 1, this route may do more harm than good. Partial suspension under that Article (restricted to the provision State B is not respecting) by State B's partners might be an adequate response but it would only leave things as they are. As an alternative, partners of State B could show willingness to solve the problem by an adequate and quick revision of the treaties.

V. THE POSITION OF THE COMMITTEE ON FISCAL AFFAIRS

34. The Committee has considered the arguments that might be put forward to defend the use of overriding legislation and recognised that in a number of cases the legitimacy of the objective pursued – in particular where they aim at counteracting abuse of conventions – is well founded but the Committee remains strongly opposed to overriding legislation. Member countries have so far refrained from taking retaliatory measures (which all agree would not be conducive to better understanding in the international tax field) against overriding legislation but the Committee noted that there is growing dissatisfaction with the continued use of such legislation which could erode confidence in the international tax treaty network as a whole.

35. The Committee cannot agree that breaches of international obligations freely entered into are the proper ways to modify tax treaty obligations and feels that it is becoming urgent to concentrate on other ways to address the problems that overriding legislation aims at solving.

36. When substantial changes are introduced in domestic legislation (for example introduction of new withholding taxes or taxes on capital gains or on wealth) it is to be expected that the new domestic policy will be incorporated in the tax treaty policy of the State concerned. If there is a conflict with that

State's tax treaty obligations the only internationally acceptable way to remove the conflicting provisions is by negotiating appropriate amendments to its tax treaties, not by way of unilateral overriding legislation.

37. It might be argued that this is a long process and that some treaty partners may refuse to enter into negotiations. The Committee recognises that treaty negotiations, and renegotiations, are indeed time consuming but this is a factor which is common to all bilateral negotiations where a proper balance of advantage to both sides has to be found. Any unilateral abrogation of specific obligations destroys such balance and must be condemned. The Committee does not subscribe to the argument that member countries are unwilling to renegotiate tax treaties. A number of factors such as manpower shortages, budget limitations, or even a lack of counter-balancing proposals, might give the appearance of some unwillingness to renegotiate but all member countries are committed to avoiding double taxation and do so as evidenced by the large number of tax treaties already in force. Such unwillingness could however develop if a State repeatedly does not respect its international obligations as it would be meaningless to agree on changes which may not be respected.

38. Where, in the situation described in paragraph 4 *a)* above, a court interpretation reverses the intended effect of a specific treaty provision, or where there is abuse of tax treaties, the Committee is of the view that swift action should be taken to redress the situation. This could be achieved through domestic legislation but the State concerned should first ensure that there is a broad consensus that the intended legislation does not injure international tax relations. In the event that there is no such consensus, the Committee considers that only renegotiation of the relevant tax treaties is acceptable. The time consideration referred to above is also relevant in this case but treaty partners are likely to reach agreement more rapidly in this type of situation since the object is essentially to clarify what was already intended.

39. The Committee considers that its Working Party No. 1 on Double Taxation might be used as a forum for early consultations on any effects a member country feels are improper, for the elaboration of adequate interpretation of the treaties and for securing that there is a broad consensus that intended legislation does not injure international tax relations.

VI. SUGGESTIONS FOR ACTION

i) The Committee on Fiscal Affairs strongly urges member countries to avoid any legislation which would constitute a treaty override as defined in section I above.

ii) The motive for enacting legislation that overrides treaties can be less strong if all countries agree that they will promptly undertake bilateral or multilateral consultations to address problems connected with treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties. Working Party No. I of the Committee on Fiscal Affairs is an appropriate forum for facilitating such consultation.

The Committee intends to follow developments closely in domestic legislation of member countries and publicly and forcefully to condemn any action which would constitute a breach of international obligations, including bringing such situations to the attention of the OECD Council.

Notes and References

1. This note is directed primarily at treaty override in the context of income and corporation taxes but the considerations identified in the note and the recommendations to the Council based on them have general application to the taxes and duties covered by the OECD Model Convention on Estates and Inheritances and on Gifts.
2. Subject to application by the other Party, as concerns each treaty.
3. Article 31 of the Vienna Convention reads as follows:
   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 connection with the conclusion of the treaty;
      b) any instrument which was made by one or more parties in connection 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;
      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.
4. See Article 25(3) of the OECD Model Convention.
5. As provided under Article 30 of the OECD Model Convention.

ANNEX A

RECOMMENDATION OF THE COUNCIL CONCERNING TAX TREATY OVERRIDE

(adopted by the OECD Council on 2 October 1989)

THE COUNCIL,

Having regard to Article 5 b) of the Convention of the Organisation for Economic Co-operation and Development of 14th December 1960;

Having regard to the Recommendation of the Council of 11th April 1977 concerning the avoidance of double taxation;

Having regard to the Recommendation of the Council of 3rd June 1982 concerning the avoidance of double taxation with respect to taxes on estates and inheritances and on gifts;

Having regard to the report of the Committee on Fiscal Affairs of 29th June, 1989 on Tax Treaty Override;

Considering that double taxation conventions contribute to the removal of obstacles to the free movement of goods, services, capital and manpower between member countries of the OECD and that the network of conventions brings certainty into international tax matters;

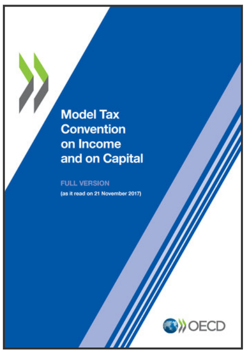
Considering that such certainty has been called into question, and to some extent undermined, by the enactment of legislation which is intended to nullify unilaterally the application of international treaty obligations;

Considering that bilateral or multilateral consultations are the first course of action in dealing with problems arising from conflicts between domestic legislation and treaty provisions;

I. RECOMMENDS member countries:

1. To undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties;
2. To avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations.

II. INSTRUCTS the Committee on Fiscal Affairs to follow developments in this area and to bring to the attention of the Council any action which would constitute a material breach of member countries' international treaty obligations.



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