

## Chapter VI

# Reflections on the Principle of ‘Good Faith’ as a Source of Normative Content for the Application and Interpretation of Double Taxation Conventions

*“For not only is every state sustained by good faith, as Cicero declares, but also the greater society of states. Aristotle truly says that if good faith has been taken away, all intercourse among men ceases to exist”* (Hugo Grotius, *De Iure Belli ac Pacis Libri Tres* – 1625)

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### 1. Introduction

One can scarcely find a principle more fundamental to the law of treaties than the requirement of observing treaty obligations in good faith. Not only is “good faith” mentioned five times in the Vienna Convention on the Law of Treaties<sup>622</sup>, and enshrined in the UN Charter<sup>623</sup>, it has repeatedly been invoked before and acknowledged by the international courts<sup>624</sup> and tribunals<sup>625</sup>, to say nothing of the international literature

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<sup>622</sup> Hereafter “VCLT”. References to ‘good faith’ are found in the Preamble, art. 26 (*pacta sunt servanda*), art. 31 (general rules of interpretation), art. 41 (provisions of internal law) and art. 69 (consequences of invalidity).

<sup>623</sup> Art. 2 par 2 Charter of the United Nations; Markovic, M., *Fulfillment in Good Faith of Obligations Assumed in Accordance with the UN Charter*, in *Principles of International Law Concerning Friendly Relations and Cooperation*, ed. by Milan Sahovil’C, 1972, p. 375-383.; The principle is also mentioned in art. 1.7 of the UNIDROIT Principles of International Commercial Contracts (as well as in various other articles of the same document) and in art. 7(1) of the UN Convention on Contracts for the International Sale of Goods.

<sup>624</sup> *Treatment of Polish Nationals case*, PCIJ 1932 A/B, n. 44, p. 28.; *Minority Schools in Albania case*, PCIJ, 1935 A/B, n. 64, p. 19-20.; *Rights of Foreign Nationals in Morocco case*, ICJ Reports 1952, p. 212.; *North Sea Continental Shelf cases*, 1969 ICJ Reports 3 p. 47 par. 85.; *Nuclear Tests cases*, 1974 ICJ Reports 253, p. 268 par. 46.; *WHO/Egypt Agreement Advisory Opinion*, 1980 ICJ Reports 73, p. 95-8 (par. 48-51).; *Military and Paramilitary Activities in and against Nicaragua case* (jurisdiction and admissibility) 1984 ICJ Reports 392, p. 418 par. 60.; *Border and Transborder Armed Actions Nicaragua-Honduras* (jurisdiction and admissibility) 1988 ICJ Reports 396, p. 69 par. 105.; About the reference in these cases to the principle of good faith, see below.

<sup>625</sup> *Samoa Claims case*, Arbitral award of 14 October 1902 by King Oscar II of Sweden, IX RIAA 15, 25.; 95 *BFSP* 169, 164, 168 (The arbitrator referred to Germany, Great Britain and the United States as ‘bound by the principles of good faith’ to maintain the existing security situation in Samoa until negotiations would

dedicated to this topic<sup>626</sup>. Indeed, as Lord McNair noted, “the performance of treaties is subject to an overriding obligation of mutual good faith”<sup>627</sup>.

Of course tax treaties are, just as any other treaty, subject to the requirement of being observed and avoidance “in good faith”<sup>628</sup>. However, it is fair to say that the actual implications of the principle of good faith have not received that much particular notice in the field of international taxation<sup>629</sup>, although it has been called upon to examine the issue of taxpayers’ abuse of rights and tax avoidance in matters of double

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provide otherwise); *North Atlantic Coast Fisheries case*, Award by the Permanent Court of Arbitration, XI RIAA 167, 186-8.; 103 BFSP 86, 102, 105 *Guinea-Bissau Maritime Frontier Delimitation* arbitration award of 14 February 1985, par 46, 89 *RGDIP* 484, 508 1985 (underlining the importance of good faith in treaty interpretation); *Air Service Agreement* arbitration Award of 9 December 1978, XVIII RIAA 415, p. 445.

<sup>626</sup> The author mainly consulted the following doctrine on good faith in international law for this text: Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals*, Stevens and Sons, 1953.; Cavare, L., “La notion de bonne foi et quelques-unes de ses applications en droit international public”, *Cours de l’Institut de Hautes Etudes Internationales*, p. 1963-1964.; Kahn, P., “Les principes généraux du droit devant les arbitres du commerce international”, *J.D.I.*, 1989, p. 116.; Kolb R., *La Bonne Foi en Droit International Public*, PU France, 2000.; O’Connor *Good Faith in International Law*, Dartmouth, 1991.; Rosenne, S., *Developments in the Law of Treaties 1945-1986* (Chapter 3- Good faith in the codified law of treaties), Cambridge UP, p. 135-179.; Mani V.S. *Basic Principles of Modern International Law*, Lancers Books, 1993, p. 200-220.; Stuyt A.M., “Good faith and bad faith”, *N.I.L.J.*, vol. 28, 1981.; Zoller, E., *La Bonne Foi en Droit International Public*, ed. A. Pedone, Paris, 1977.; Virally M., “Review Essay: Good faith in public international law”, *AJIL*, 1983, p. 130-134.; in addition to the general works and doctrine on treaty interpretation quoted throughout this article.

<sup>627</sup> McNair, A.D., *The Law of Treaties*, Oxford, 1961, p. 465.

<sup>628</sup> OECD Commentary on art 25, par. 44.5; OECD Report on Tax Treaty Override, par. 9.; Edwardes-Kerr M., *Tax Treaty Interpretation*, Chapter 6.; PIJL, H., “The theory of the interpretation of tax treaties, with reference to the Dutch practice”, *Bull. I.F.D.*, 1997, 540.; Vogel, K. *On Double Taxation Conventions*, 3<sup>rd</sup> edition, p. 66; Almost no tax treaties actually mention ‘good faith’ literally. Some might, as a standard formula, mention it at the very end of the treaty (“Done in two duplicates in good faith...”) such as the double taxation agreement between Mauritius and Madagascar of 30 August 1994.

<sup>629</sup> The OECD Report on Tax Treaty Override, par. 10, has a rather restrictive idea of the principle of good faith in international public law (“It must be performed in good faith means that international law requires States to implement the provision of a treaty”), although the examples given at the end of the Report are illustrations of the wider scope of the principle. Actually, Virally notes the same lack of elaborations on the actual operation of the principle in general international public law (Virally, M., “Review essay: good faith in international public law, *AJIL*, 1983, p. 130).

taxation conventions<sup>630</sup>. Traditionally, tax scholars have mainly referred to the notion of good faith in the context of ‘tax treaty override’<sup>631</sup>, but that says little on the difference between observing a tax treaty and observing it ‘in good faith’<sup>632</sup>. What is the difference between an interpretation and an interpretation ‘in good faith’? Can, in the case of double taxation conventions, the principle of good faith be the source of actual legal obligations or rights beyond the text of the treaty itself? In other words, does ‘good faith’ really mean something for tax treaties? And if so, can it affect the position of the taxpayer or is good faith only legally relevant to the contracting states themselves?

## 2. Definition, Elements and Function of Good Faith

### 2.1 Defining ‘Good Faith’?

Good faith has traditionally been associated with the observance of conventional agreements or ‘*pacta sunt servanda*’<sup>633</sup>. Clearly, there are so many important common elements between the two notions that they can

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<sup>630</sup> Ward, D., “Abuse of tax treaties”, in Essays on International Taxation To Sidney I. Roberts, Alpert H. and Van Raad, K (eds.), p. 403.; See also below, where good faith in international public law is distinguished from domestic anti-tax avoidance statutes and doctrines.

<sup>631</sup> See, among others: Baker Double Taxation Agreements and International Tax Law, 2 nd ed, Sweet & Maxwell, London, 1994, p. 51.; Vogel, Double Taxation Conventions, p. 67-71.; Becker, H., and Wurm “Double taxation conventions and the conflict between international agreements and subsequent domestic laws”, Intertax, 1988, p. 261. (“Each state is obliged to observe the tax treaty in good faith, i.e. must do its utmost to meet the obligations it has assumed”); Critchfield, R., Honson and Mendelowitz, M., “Passthrough Entities, Income Tax Treaties, and Treaty Overrides”, *Tax Notes International*, February 8 1999, p. 587.; Doernberg, R.L., “Selective Termination or Suspension of Income Tax Treaty Provisions”, *T.N.I.*, Nov. 1990, 1130-1135. Rezek., J.F., Luthi, D. et al, Tax Treaties and Domestic Legislation, IFA Seminar Series, 1989.

<sup>632</sup> O’ Connor, Ibid, ft. 626, p. 108: “The difficulty about good faith and the law of treaties does not lie in the basic obligation that treaties must be kept, but in the meaning, the scope and the function of the principle of good faith in relation to the making and the performance of treaties generally”; Because I have chosen this approach, this article is more concerned with the depth of the principle of good faith or if you will the less obvious implications it has for tax treaty observance, than with clear instances of “treaty override”.

<sup>633</sup> Kunz, J., The meaning and the range of the norm *pacta sunt servanda*, *AJIL*, 1945, p. 180-197. On good faith as one of the general principles of international law, Cherif Bassiouni, “A fundamental approach to ‘general principles of international law’”, 11 *Mich.J.Int.L.*, 768.; Schaffer, E. and Snyder, J., Contemporary Practice of Public International Law, Oceana, 1997, p. 44.

hardly be distinguished in some respects. Nevertheless, they are not identical<sup>634</sup>. One might say that *pacta sunt servanda* is actually based on good faith, as the ICJ noted in its decision on the *Nuclear Tests case*<sup>635</sup>. Therefore, observing one's treaty obligations may be seen as one of the main elements of good faith conduct<sup>636</sup>. On the other hand, however, the scope of the legal obligations derived from good faith is wider than *pacta sunt servanda* alone. This is illustrated by the existence of international obligations on states *preceding* the actual conclusion of a treaty<sup>637</sup>, and by the application of good faith to obligations arising from not only treaties but also to those emanating from other sources of law<sup>638</sup>.

Neither the World Court nor the VCLT has actually defined 'good faith'. In fact, the ILC agreed with the Special Rapporteur that "the concept of good faith, being difficult to express, had better left undefined<sup>639</sup>". Likewise, Prof. Bin Cheng, in his classic study of the general principles of international law, quotes Lord Hobhouse to point out that good faith may be too difficult to define: "Such rudimentary terms applicable to human conduct as 'good faith', 'honesty' or 'malice' elude *a priori* definition. They can be illustrated but not defined<sup>640</sup>".

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<sup>634</sup> Zoller, *ibid.*, ft. 626, p. 47.; Chaumont, C., *Cours de Droit International Public, RCADI*, 1970, I (129), p. 381.

<sup>635</sup> *ICJ Reports* 1974, 253 par. 46.

<sup>636</sup> O'Connor pointed out (*ibid.*, ft. 626 p. 107) that it is not really relevant whether good faith developed from *pacta sunt servanda*, or that *pacta sunt servanda* is 'but an expression of the principle of good faith which above all signifies the keeping of faith'; In the meantime, the ICJ (see previous footnote) decided that, in fact, *pacta sunt servanda* is based on the principle of good faith, and not the other way around.

<sup>637</sup> Hassan, T., "Good faith in treaty formation", 21 *Virginia J.I.L.* 1981, p. 443 (450).; Elias, T.O., *The Modern Law of Treaties*, New York, 1974, p. 26.; *ALI*, Restatement of the Law Third, vol. I, 1987, p. 174.; See also Resolution 53/101 adopted by the General Assembly on 8 December 1998 entitled "Principles and Guidelines for International Negotiations", par. 2 a); The *German Interests in Polish Upper Silesia case* (*CPIJ ser. A no. 7*, p. 29-30) is often quoted as a landmark case in this respect although the Court did not decide on this matter explicitly. On the implications of good faith for tax treaty negotiations, see below at 7.2.

<sup>638</sup> See for example the statement of delegate Darwin (UK) Doc. A/AC.125/SR.46, p. 11.

<sup>639</sup> 772<sup>nd</sup> Meeting par. 2-5.; An earlier attempt to define good faith in the course of the Draft Declaration on the Rights and Duties of States (art. 13) had not resulted in anything but, in the words of Slomanson, W.R., (*Fundamental Perspectives on International Law*, 1990, p. 258) "something so generally acceptable that it was virtually useless as a functional device for resolving treaty disputes".

<sup>640</sup> *Russell v. Russell* [1897] A.C. p. 395 ad p. 436 as in Cheng, *ibid.*, ft. 626 p. 105; on good faith in the perspective of (other) general principles of international law, see Brownlie, I., *Principles of Public International Law*, Oxford University Press, 2003, p. 18-19.

Although a precise definition of the principle may be elusive, there is no doubt that its contents must be associated with moral values such as fairness, honesty, reasonableness, consistency, sincerity, good conscience, etcetera.

This is apparent from the statements of the delegates of states in the meetings leading to the VCLT<sup>641</sup>, and from the doctrinal literature devoted to this subject<sup>642</sup>. The decisions of international courts and tribunals that Cheng examined also refer to the moral notions of honesty, fairness, equity, and reasonableness<sup>643</sup>, and the author therefore notes that:

“The enforcement of the principle of good faith may be considered as the enforcement of that degree of morality which is necessary for the functioning of the legal system”<sup>644</sup>

O’Connor does come up with a definition that, to say the least, has the merit of making it possible to picture the principle of good faith in our minds. His definition also puts the moral values of fairness, honesty and reasonableness center-stage:

“The principle of good faith in international law is a fundamental principle from which the rule *pacta sunt servanda* and other legal rules distinctively and directly related to honesty, fairness and reasonableness are derived, and the application of these rules is determined at any particular time by compelling standards of honesty, fairness and reasonableness prevailing in the international community at that time”<sup>645</sup>

It must nevertheless be noted that however moral the undertones to good faith, the days are long gone when the principle was only the source of moral rules, not legal ones. Failure to meet the standard of good faith is not only a moral failure, but also a legal one<sup>646</sup>. As Rosenne notes:

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<sup>641</sup> See the useful overview of those statements by the delegates in the chapter “What is good faith” in Mani, V.S. *Basic Principles of Modern International Law*, Lancers Books, 1993, p. 204-206.

<sup>642</sup> *Ibid*, ft. 626.

<sup>643</sup> Cheng, *ibid*, ft. 626, *inter alia*, p. 111, 115, 118, 123, 125, 127.

<sup>644</sup> Cheng, *ibid*, ft. 626, p. 118.

<sup>645</sup> O’Connor, *ibid*, ft. 626, p. 124.

<sup>646</sup> Joint Dissenting Opinion of Basdevant, Winiarski, McNair and Read to the *Admissions case* (Advisory Opinion), *ICJ Reports*, 1947-48, p. 57.

“...from the manner in which the expression ‘good faith’ was included in the codified law of treaties, it emerges that alongside its non-judicial content –its possible moral content- ... the expression possesses and was intended to possess some normative content.”<sup>647</sup>

## 2.2 Good faith as a yardstick for obligations

The ICJ has pointed out in the *Border and Transborder Armed Actions Nicaragua-Honduras* (jurisdiction and admissibility) case that good faith is not a legal obligation onto itself<sup>648</sup>. As authoritative scholars have also noted, good faith is a *yardstick*, a measuring rod for *existing* legal obligations<sup>649</sup>. A treaty rule needs to be observed, but there are always many ways of observing a treaty rule. The function of good faith is to be the standard for how the treaty must be observed, say the depth and degree of the legal obligation.

The role of good faith as a yardstick is eloquently explained by the Harvard Draft on the Law of Treaties:

“Good faith has reference rather to the manner or spirit in which the obligation is to be performed –the degree of fidelity, strictness and conscientiousness manifested in the fulfillment of the promise made. The obligation to fulfill in good faith a treaty engagement requires that its stipulations be observed in their spirit as well as according to their letter and that what has been promised be performed without evasion or subterfuge, honestly, and to the best of the ability of the party which made the promise”<sup>650</sup>.

It follows from the above that good faith must be used as a yardstick to the treaty obligations articulated in the text of the treaty, a yardstick for the actual conduct of the contracting states. If that conduct is in fact reasonable, fair, and honest, so it seems, necessarily depends on the actual circumstances of the case. What is contrary to good faith in one particular situation, is not necessarily so in another. That does not mean however that, based on the body of case law of international courts and tribunals,

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<sup>647</sup> Rosenne, S., *ibid.*, ft. 626, p. 136.

<sup>648</sup> O’Connor, *ibid.*, ft. 626, p. 113.

<sup>649</sup> Schwarzenberger, “The fundamental principles of international law”, *RCADI*, 1955-I, p. 132 (“The purpose is to exclude arbitrariness, capriciousness, contradiction, unreasonableness and absurdity. Good faith serves as the measuring rod...”); Virally, M., Review Essay: Good Faith in Public International Law, *A.J.I.L.*, 1983, p. 132.; O’Connor, *ibid.*, ft. 626, p. 108.; Kolb, R., *ibid.*, ft. 626, p. 265.

<sup>650</sup> Harvard Draft on the Law of Treaties, *A.J.I.L.*, 1935, 29, p. 981.

no valid lessons and conclusions can be drawn for future good faith assessments, including those in matters of double taxation conventions.

### 2.3 Abuse of rights

Good faith becomes particularly important when one of the contracting states finds itself in a position of power to determine the depth or manner of observing its own treaty obligations, as is often the case. Even when a state has a (conventionally) explicit right to do so, such discretion is never absolute. It is subject to the requirement of good faith<sup>651</sup>, and examples of this assertion with respect to double taxation conventions can be found throughout this article. As the same applies to the interpretation of a treaty by one of the contracting states, this issue addresses also the application of art. 3(2) OECD Model<sup>652</sup>.

### 2.4 The principle of effectiveness

The principle of effectiveness includes according to some authors two distinguishable rules<sup>653</sup>. The first is that all provisions of the treaty must be supposed to have been intended to have significance<sup>654</sup>. The second is that the treaty as a whole must be taken to have been concluded to achieve some intended effect, a consideration closely related to the “object and purpose” of the treaty<sup>655</sup>. The latter rule is also commonly referred to with the adagio *ut regis magis valeat quam pereat*, by Schwarzenberger described as “the battle-cry of functional treaty interpretation”<sup>656</sup>. The World Court has held that a state is obliged to take all measures, including those of a legislative or regulatory nature, to ensure the effective application of a treaty<sup>657</sup>. Performance of a treaty in good faith requires that a contracting state abstains from any action that

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<sup>651</sup> *North Atlantic Fisheries Arbitration*, Award by the Permanent Court of Arbitration, XI RIAA 167, 186-8.

<sup>652</sup> Also Chapter 9 “Unless the Vienna Convention Otherwise Requires”.

<sup>653</sup> Berlia, Contribution a l’interprétation des traités, *Receuil des Cours*, 114 (1965-1) p. 306.

<sup>654</sup> *Corfu channel case*, ICJ reports, 1949, p. 24; *Anglo-Iranian oil case*, ICJ Reports, 1952, p. 105.; Thirlway H., *The Law and Procedure of the International Court of Justice*, BYIL, 1991, Vol. 62, p. 44.

<sup>655</sup> *Interpretation of the peace treaties case*, ICJ reports, 1950, p. 229; *Ambatielos case*, ICJ reports, 1952, p. 45.

<sup>656</sup> Schwarzenberger, *International Law*, I, 3<sup>rd</sup> ed., Stevens, 1945, p. 520.

<sup>657</sup> Advisory opinion on *Exchange of Greek and Turkish populations*, PCIJ Reports, Series B, n 10, p. 20.; Zemnek, in Neuhold/Hummer/Schreuer/, p. 65.; Harris, D.J., *Cases and Materials on International Law*, 5 th ed., Sweet & Maxwell, 1998, p. 71-72.

impedes the effective realization of the object and purpose of the treaty<sup>658</sup>. In other words, “enabling the provisions of the treaty to work and to have their appropriate effects”<sup>659</sup>. If a state’s internal law is such as to prevent it from fulfilling its international obligations, that failure may constitute a breach of international law for which the state may be held responsible<sup>660</sup>.

The principle predominantly applies with regard to the interpretation of treaties, because “an interpretation which would make [a provision] no more than an empty gesture must for that reason be regarded as of dubious validity”<sup>661</sup>. It was included in Fitzmaurices’ principles of interpretation, but is not as such mentioned in art. 31 or 32 VCLT. The ILC found that the implications of this principle are actually included in the principle of good faith, which is mentioned explicitly, and a statement to that effect was made in the ILC Explanation<sup>662</sup>.

The ICJ refused to repair a fault in the mechanics of a treaty even though this meant that the treaty could not have the effect the drafters intended<sup>663</sup>. This dictum by the ICJ illustrates the “organic defects” Brownlie sees in the principle of effectiveness<sup>664</sup>. It is, as Stone noted, difficult to balance the common intent of the contracting states on the one hand and giving the treaty an unforeseen operation on the other hand<sup>665</sup>. Treaty provisions must be given their full, real effect by states but an oversight or a fault in the treaty should not be repaired on the basis of the principle of effectiveness.

It follows from the principle of effectiveness and more specifically from the maxim *ut regis magis valeat quam pereat*, that the contracting states of a tax treaty must, among other things, take all reasonable measures to ensure that the protection the treaty intended to bestow on the taxpayers is

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<sup>658</sup> *Rights of nationals in Morocco case*, ICJ reports, 1952, p. 212.; *North Atlantic fisheries case*, *RIAA*, vol. XI, p. 188.

<sup>659</sup> Starke, *Introduction to International Law*, 10 th ed, Butterworths, 1989, p. 480.

<sup>660</sup> Van der Bruggen, E., “State Responsibility under Customary International Law in Matters of Taxation and Tax Competition”, *Intertax*, 2001, p. 115-138.; Jennings, R. and Watts, A., *Oppenheim’s international law*, Longman, 1992, p. 84.

<sup>661</sup> Thirlway, H., *ibid*, ft. 659, p. 44.

<sup>662</sup> *Yearbook ILC 1966*, II, par 6.

<sup>663</sup> The principle of effectiveness could not be used by the ICJ to attribute to the provisions of the Peace Treaties a meaning which would be contrary to their letter and spirit (*Interpretation of peace treaties case*, *ICJ Reports*, 1950, pp 221, 17 ILR, p. 318; Shaw, *International Law*, p. 658).

<sup>664</sup> Brownlie, I., *ibid*, ft. 639, p. 636.

<sup>665</sup> Julius Stone, *Of Law and Nations Between Power Politics and Human Hopes*, William S. Hein & Co., Inc., 1974, p. 180-181.

actually available to them. How they go about doing that is normally not the concern of international law, as long as the obligations and rights established by the treaty are indeed realized<sup>666</sup>. This has implications with respect to the conducting of the mutual agreement procedure<sup>667</sup>, the practical aspects of granting relief for double taxation<sup>668</sup> and procedural rules.

## 2.5 Legitimate expectations

In my view, and this is an argument that will repeatedly be revisited in the analysis below, there is support for associating the principle of good faith with honoring the internationally prevailing standards and practice<sup>669</sup> by the community of nations in the application and interpretation of double taxation agreements. This is the effect of the principle of legitimate expectations.

As good faith must necessarily be a yardstick that is universal<sup>670</sup>, this implies, as O'Connor indicates<sup>671</sup>, that there may be circumstances where a contracting state is bound by good faith to honor that prevailing practice, because the other state could reasonably expect it to do so. In other words, good faith observance and interpretation of treaties can also be seen from the perspective of the *legitimate expectations of the contracting states at the time of the conclusion of the treaty*. Put in the words of De Visscher: “Le principe, valable pour l’interprétation comme pour l’exécution, est celui de la bonne foi: pacta sunt servanda, ‘pivot moral du jeu des volontés autonomes’. Ce principe doit éclairer et guider toute interprétation. Celle-ci ne peut trahir la *confiance légitime* que les déclarants ont placée dans l’emploi des termes sur lesquels ils se sont mis d’accord (emphasis added)”<sup>672</sup>

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<sup>666</sup> Jennings, R. and Watts, A., *Oppenheim’s International Law*, Longman, 1992, p.83-85.

<sup>667</sup> see below, part 4.

<sup>668</sup> see below, points 6.2 and 6.3.

<sup>669</sup> What exactly may constitute state practice in this respect is not further discussed at present, but reference is made to Villiger M.E., *Customary International Law and Treaties*, Martinus Nijhof, 1985, p. 4-10.

<sup>670</sup> If the principle of good faith is to function at all, observing a treaty in good faith in France may not have a different meaning than observing a treaty in good faith in Germany, for example.

<sup>671</sup> O’Connor *ibid.*, ft. 626, p. 124.

<sup>672</sup> De Visscher, p. 50.

There is much authority to associate the principle of the legitimate or reasonable expectations of the parties with good faith in municipal law<sup>673</sup>, in international private law<sup>674</sup>, and in European law<sup>675</sup>, and there are in my view convincing arguments and suggestions to do the same in international public law<sup>676</sup>. In the meetings of the delegates to the Special Committee formed while drafting the VCLT, member Reuter clearly established a link between the principle of good faith and legitimate expectations by noting that:

“[...] when a state definitively expressed its will to be bound, it created a certain expectation in its partners and that it was the non-fulfillment of that expectation that was incompatible with good faith”<sup>677</sup>.

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<sup>673</sup> Wightman, J., “Good faith and pluralism in the law of contract”, in *Good Faith and Contract*, Brownsword, R., (ed) Darmouth, 1998, p. 42.; Patterson, J.M., “Duty of good faith- Does it have a place in contract law?”, *LIJ*, 2000, 47.; Brownsword, R., “Positive, Negative, Neutral: The reception of good faith in English contract law”, in *Good Faith and Contract*, Brownsword, R., (ed) Darmouth, 1998, p. 33.; Slawson, W.D., “Standard form contracts and the democratic control of lawmaking power”, *HARV. L. Review*, 1971, p. 529.; Slawson, W.D., *Binding Promises*, Princeton U.P., 1996, p. 44-73.; Waddams, S.M., “Good faith, unconscionability and reasonable expectations”, *J.C.L.*, 1995, p. 55.

<sup>674</sup> Art. 7(1) of the Convention for the International Sale of Goods requires the observance of good faith in international trade, which has been interpreted as meaning “conduct that is *normal* among tradesmen (emphasis added)” by Maskow On the Interpretation of the Uniform Rules of the UN Convention for the International Sale of Goods, Report for the Twelfth Congress of the International Academy of Comparative Law, Sydney, 1986, p. 18.; Enderlein, F., “Uniform law and its application by judges and arbitrators”, in *Unidroit, International Uniform Law in Practice*, Rome, 1988, p. 342.

<sup>675</sup> See the overview of case law by the European Court of Justice referring to the principle of legitimate expectations by Brown, L.N., and Kennedy, T., *The Court of Justice of the European Communities*, 4<sup>th</sup> ed., Sweet and Maxwell, London, 1994, p. 329.; Charney, J.I., “Is international law threatened by multiple international tribunals?”, 271 *Hague Recueil*, 1998, p. 203 (who associates this principle with estoppel).

<sup>676</sup> Byers, M. *Custom, Power and the Power of Rules*, Cambridge UP, 1999, p. 106-125.; McDougal, M, Lasswell, H., and Miller, J., *The Interpretation of International Agreements and World Public Order*, New Haven Press/ Martinus Nijhof, 1994, p. 6, 8, 11-13 (emphasizing the importance of the genuine expectations of the parties for the interpretation and application of treaties).; Tridimas, T., *The General Principles of EC Law*, Oxford UP, 1999, p. 169-170 (on the principle of legitimate expectation in EC law).; Villiger, M.E., *Customary International Law and Treaties*, Martinus Nijhof, 1985, p. 29-31, par.77-79 (on the protection of good faith and the expectations which one state’s conduct has raised in other states) with further references.

<sup>677</sup> Yearbook of the ILC, 1965, p. 91 (par. 41).

Similar statements, supporting the association between good faith and legitimate expectations of states were made in the meetings leading to the VCLT by delegates Tammes<sup>678</sup> and Diaconescu<sup>679</sup>. Also Villiger notes that:

“Art. 18 of the VCLT gives concrete meaning to the principle of good faith by protecting legitimate expectations which relations of this type generate among states”<sup>680</sup>.

Finally, the principle of legitimate expectations was explicitly recognized by the WTO Dispute Settlement Body<sup>681</sup>, and included in the considerations of the ICJ in its judgment on the *Fisheries Jurisdiction case*<sup>682</sup>.

After all, as mentioned above, the world of tax treaties is highly standardized<sup>683</sup>, and a pre-condition to the achievement of their object and purpose, even for the actual conclusion of a tax treaty, is that contracting states adhere in a certain degree to the fundamental international tax rules on which double taxation conventions are based<sup>684</sup>. The conclusion of a

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<sup>678</sup> Tammes (Netherlands), GAOR, 20<sup>th</sup> session, 6<sup>th</sup> Cmtee, 974<sup>th</sup> mtg, p. 199 (referring to good faith and the expectations that parties make while drafting an instrument, as noted by Mani, V.S. *Basic Principles of Modern International Law*, Lancers Books, 1993, p. 205).

<sup>679</sup> Diaconescu (Romania), GAOR, 21<sup>th</sup> session, 6<sup>th</sup> Cmtee, 932<sup>nd</sup> mtg., p. 201.

<sup>680</sup> Villiger, M.E., *Customary International Law and Treaties*, Martinus Nijhof, 1985, p.321, par. 469.

<sup>681</sup> *India- Patent Protection for Pharmaceutical and Agricultural Chemical Products*, WTO Doc No. WT/DS50/R at 47-49 par. 7.18-7.22, 10 *World Trade and Arb. Mat.*, 35, 84 (1998).

<sup>682</sup> “In consequence, the exercise of jurisdiction by the Court to entertain the present application would fall within the terms of the compromissory clause and correspond exactly to the intentions and *expectations* of both parties when they discussed and consented to that clause” *Fisheries Jurisdiction*, Judgment, *ICJ Reports*, 1973, p. 57-58, par. 22-23 (emphasis added).

<sup>683</sup> To such extent that the ALI study notes that one could (almost) see the OECD Model as a multilateral convention; *ALI, Federal Income Tax Project*, II, p. 3.

<sup>684</sup> It has for example been pointed out that the main reason for developing countries to conclude tax treaties may be the “signal-function” to foreign investors that the state adopts these internationally accepted rules: Vann, R.J., “International tax aspects of income tax”, in Thuronyi, V. (ed), *Tax Law Design and Drafting*, IMF, 1998, p. 986 et seq. (“Most important, tax treaties signal to foreign investors the country’s intention to play by the generally accepted rules of international taxation and not to discriminate against foreign investors...”); see also (concurring) Van Overbeeke, M.P., and Prast-Ragetli, J.C., “Taxation and economic development”, in De Waart, P, Peters, P and Denters, E., (ed.), *International Law and Development*, Martinus Nijhof, 1988, p. 268-269.

tax treaty always creates expectations in the eyes of the treaty partners<sup>685</sup>, but not all expectations are “legitimate” and have to be honored by the other state, including in my view the expectation that what is not taxed in the one state will be taxed in the other state<sup>686</sup>. Depending on the circumstances, therefore, it may be contrary to good faith for a state to on the one hand conclude those highly standardized and uniform tax treaties with other states, but on the other hand bluntly ignore a practice on tax treaty-related matters or an interpretation of a treaty term that the international community of nations has come to see as prevailing and expects to be honored. It follows that in the absence of particular agreements between the parties on a tax treaty issue the conclusion of the treaty, the contracting states may reasonably assume that each will not significantly deviate from the international practice they are both familiar with, and this becomes thus a part of the common intent.

It can therefore in my view be said that even when a tax treaty refers to the domestic law of one state, or is applied subject to the provisions of its domestic law<sup>687</sup>, there may be situations where the other state may legitimately expect that state to align itself with the prevailing practice on that particular issue or interpretation of a treaty term<sup>688</sup> in the international community of nations. In more than one way, the principle of good faith will protect the reasonable or legitimate expectations of states, but problems will arise when the expectations of states diverge, as they occasionally do<sup>689</sup>.

### **3. Good Faith and Tax Treaty Interpretation.**

#### **3.1. Bona fide interpretation of treaties in general**

Treaty interpretation is obviously a complicated issue, and the impact of certain fundamental principles of international public law on tax treaty interpretation certainly merits more time than can be consecrated here.

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<sup>685</sup> Kingson, C.I., “The Coherence of international taxation”, *Col.Law.Rev.*, 1981, p. 1153 (“Coherence means, then, that each country must take into account how the others tax international income. In fact, each country’s statutes and treaties reflect how it *expects* the others to tax” –emphasis added).

<sup>686</sup> Van Weeghel, S., *ibid.* p. 105.; Van Der Bruggen, E., “State Responsibility under Customary International Law in Matters of Taxation and Tax Competition”, *Intertax*, 2001, p. 115-138.

<sup>687</sup> See below, part 6.

<sup>688</sup> See above, point 2 e).

<sup>689</sup> Brownsword, in *Good Faith and Contract*, Brownsword, R., (ed), Dartmouth, 1998, p. 35.

What is more, as was mentioned above, interpretation ‘in good faith’ is sometimes hard to distinguish from pure principles of interpretation, which muddies the water even further in what follows below. It is nevertheless undisputed that good faith must play an important part in the interpretation of treaties<sup>690</sup>, although good faith is not by everybody regarded as a genuine interpretation-rule<sup>691</sup>. Indeed, in what follows, it is not always obvious where lies the distinction between the principle of good faith and general rules of interpretation of treaties<sup>692</sup>. The fact remains however that the principle of good faith has its own impact, crucial and distinguishable in certain situations.

Art. 31 of the VCLT on treaty interpretation starts by referring to the principle of good faith: “A treaty shall be interpreted in good faith...”. Before this codification of international law, Prof. Bin Cheng summarized the need for good faith to be implicated in treaty interpretation as follows:

“Performance of a treaty obligation in good faith means carrying out the substance of this mutual understanding honestly and loyally. As the ascertainment of this mutual understanding, i.e. the real and common intention of the parties, is a matter of interpretation, it is also said that treaty interpretation is governed by the principle of good faith”<sup>693</sup>

It is not easy to determine exactly what good faith contributes to treaty interpretation beyond the other elements of art. 31 and 32 VCLT. The doctrine and jurisprudence on this matter is somewhat confusing because a certain interpretation of a text can be an application of good faith to some and a pure interpretative canon to others. Sometimes, interpretation

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<sup>690</sup> Art. 31 VCLT (see in detail below); *Guinea-Bissau Maritime Frontier Delimitation* arbitration award of 14 February 1985, par 46, 89 *RGDIP* 484, 508 1985.; Jokl, M., *De l’interprétation des traits normatifs d’après la doctrine et la jurisprudence internationales*, Paris, 1935, p. 104.; Cheng, *ibid.*, ft. 627, p. 115.; Voicu, p. 45.; Kolb, *ibid.*, ft. 626, p. 273.; Lauterpacht, H., *Annuaire de l’Institut de Droit International*, vol. 43, I, 1950, p. 413.

<sup>691</sup> Kock (p. 85), for example points out that good faith in treaty interpretation goes without saying, and should be regarded as only a quasi-interpretative rule. In the discussions leading to the VCLT, on the other hand, it was suggested by some that good faith alone is a sufficient rule for interpretation, encompassing i.e. the duty to establish the true intent of a treaty provision (quoted by Kock, p. 85-86).

<sup>692</sup> However, see Bernardez’s Separate Opinion in the *Land, Island and Maritime Frontier case*, *ICJ Reports*, 1992, p. 351, par. 190.

<sup>693</sup> Cheng, *ibid.*, ft. 627, p. 115.; Along the same lines Voicu notes: “Guidée par la bonne foi, l’interprétation d’une norme contribuera à son application correcte”, p. 18.

in good faith is associated with viewing the text of the agreement in the light of its spirit, the intention of the parties, or as a complement to it<sup>694</sup>. On other occasions, interpretation in good faith implies reasonableness<sup>695</sup>. Also, it may be required under good faith to look at all the language versions of a treaty<sup>696</sup>. In addition, according to the ILC, the principle of good faith also governs the so-called inter-temporal issue of treaty interpretation<sup>697</sup>

It may not be forgotten, however, that a clear text must be deemed to be the expression of the intention if the parties<sup>698</sup>, and that “good faith first requires that “a tribunal shall have regard to the actual text or plain meaning of the treaty (...) It might be said that this is in accordance with the basic rule of good faith- parties must observe what they have actually agreed to observe”<sup>699</sup>. On the other hand, it is true that even a clear treaty text must be seen in the light of the different materials and circumstances that are relevant to it, each of those materials and circumstances having a different relative weight or value<sup>700</sup>.

When the plain meaning of a treaty is not beyond doubt, the “wider function of the principle of good faith is called into service”<sup>701</sup>. Good faith does not allow, for one, that what is directly forbidden by a treaty, would be allowed indirectly<sup>702</sup>. In other words, the text of the treaty may not be read in such a manner that it leads to a result which is contrary to

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<sup>694</sup> Kolb, *ibid*, ft. 626, p. 274 (“En cas d’absence d’une volonté commune effective sur un point donné, la bonne foi peut combler la lacune”).

<sup>695</sup> Jennings, R and Watts A., *Oppenheim’s International Law*, Longman, 1992, p. 1272 (with further references).

<sup>696</sup> Enderlein, F., “Uniform law and its application by judges and arbitrators”, in *Unidroit, International Uniform Law in Practice*, Rome, 1988, p. 342.

<sup>697</sup> See below, point 3.2 c).

<sup>698</sup> Art. 31 VCLT; *Interpretation of Peace Treaties case* (second phase), *ICJ Reports*, 1950, p. 221; *US Nationals in Morocco case*, *ICJ Reports*, 1952, p. 196.; *Certain Expenses of the UN case*, *ICJ Reports*, 1962, p. 159.; Kolb p. 263 and 275.; Lauterpacht H., “Restrictive interpretation and the principle of effectiveness in the interpretation of treaties,” 26 *BYIL* 1949, p. 67.

<sup>699</sup> O’Connor *ibid*, ft. 626, p. 109.

<sup>700</sup> Sinclair I., *The Vienna Convention on the Law of Treaties*, Manchester UP, p. 72-73.

<sup>701</sup> O’Connor *ibid*, ft. 626, p. 109.; Lauterpacht H., *Annuaire de l’Institut de Droit International*, vol. 43, I, 1950, p. 413.; Hull, C., in *Repertoire des Questions de Droit des Lois*, I, Brussels, 1924, p. 194.; Voicu, *ibid*, p. 38.; Yasseen, *ibid*, p. 23 (“...dans le cas d’un doute continu ou d’une ambiguïté persistante [le principe de la bonne foi pourrait] peut-être justifier plus de recherches et inciter à plus d’efforts”).

<sup>702</sup> M. Marcq in *Diversion of Water from the river Meuse case*, *CPIJ* 1937 series C, no. 81, p. 466.

its object and purpose<sup>703</sup>. The intent of a treaty is always a common intent, an agreed intent. It can never be what only one party understood to be the (common) intent. In the words of the *Franco-Venezuelan Mixed Claims Commission*:

“A treaty is a solemn compact between nations. To be valid, it imports a mutual assent, and in order that there may be such mutual assent there must be what both parties understood to be the matters involved. It can never be what only one party understands, but it always must be what both parties understood to be the matters agreed upon and what in fact was the agreement concerning the matters now in dispute”<sup>704</sup>.

In 1992, in a noted separate opinion of Judge Bernardez the ICJ had the opportunity to render its views on the implications of the principles of “good faith” and “object and purpose” for treaty interpretation, which are more than relevant to this discussion:

“To determine objectively the intentions of the Parties as reflected in the Special Agreement, one must certainly start as provided for in the Vienna Convention, namely from the “ordinary meaning” of the terms used in the provision of the Special Agreement which is the subject of the interpretation, that is, paragraph 2 of Article 2 in the instant case. But not in isolation. For treaty interpretation rules there is no “ordinary meaning” in the absolute or in the abstract. *That is why Article 31 of the Vienna Convention refers to “good faith” and to the ordinary meaning “to be given” to the terms of the treaty “in their context and in the light of its object and purpose”. It is, therefore, a fully qualified “ordinary meaning”.* In addition to the said “good faith” “context” and “object and purpose”, account may be taken, together with the “context”, of the other interpretative elements mentioned in Article 31, including “subsequent practice” of the parties to the treaty and the “rules of international law” applicable between them. Furthermore, recourse to “supplementary means of interpretation” (preparatory work; circumstances of conclusion) is allowed for the purposes defined in

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<sup>703</sup> *Competence of the ILO to Regulate Agricultural Labour case*, PCIJ 1922, Series B, No. 2 and 3, p. 23.; *Free Zones case*, PCIJ, series a/b, no. 46, p. 140.; Lauterpacht, H., Individual Opinion *Admissibility South-West Africa case*, Advisory Opinion, ICJ Reports, 1950, p. 128.; *Air transport Services Agreement Arbitration*, 1963, ILR, 45, p. 393.; Jennings, R and Watts, A., *Oppenheim’s International Law*, Longman, 1992, p. 1273.; Kolb, *ibid*, ft. 627, p. 268; See also art. 31(1) of the VCLT.

<sup>704</sup> *Maninat case* 1905 Ralston’s Report, p. 44 at p. 73.; Cheng, *ibid*, ft.626, p. 115.

Article 32. The elucidation of the "ordinary meaning" of terms used in the treaty to be interpreted requires, therefore, that due account be taken of those various interpretative principles and elements, and not only of words or expressions used in the interpreted provision taken in isolation" (emphasis added)<sup>705</sup>.

Moreover, there are numerous decisions and awards that approach the duty to interpret a treaty in good faith from the perspective of the prohibition of abuse of rights, a principle closely associated with good faith<sup>706</sup>. When a contracting state has the discretion to interpret the provisions of a treaty, it does so subject to the general requirement of good faith. The function of good faith is here to temper the state's discretion to exercise that right<sup>707</sup>. According to Villiger, this is even the primary function of good faith in treaty interpretation<sup>708</sup>. It is not necessary that the treaty would explicitly state so<sup>709</sup>.

In summary, it is fair to say that interpretation 'in good faith', while not easily reducible to compact rules<sup>710</sup>, generally means "in accordance with the common, real intent of the treaty"<sup>711</sup>. It means that a literal application of the text of the treaty may not become a pretext for one of the contracting states to be unreasonable, unfair or dishonest. A text never "has" an "ordinary meaning", the ordinary meaning *is given to it*<sup>712</sup>, and

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<sup>705</sup> *Land, Island and Maritime Frontier Dispute case*, ICJ Reports 1992, p. 351, par. 190.

<sup>706</sup> *North Atlantic Fisheries Arbitration*, Award by the Permanent Court of Arbitration, XI RIAA 167, 186-8; *US nationals in Morocco case*, ICJ Reports, 1952, p. 176.; *Rainbow Warrior*, RGDIP 1990 94, p. 843, Group dissenting opinion Lauterpacht, Wellington Koo and Spender, *Aerial incident case* (preliminary objections), ICJ Report, 1959, p. 189.

<sup>707</sup> Kolb, *ibid*, ft. 627, p. 269.; Zoller, *ibid*, ft. 627, p. 88-89.; Cheng, *ibid*, ft. 627, p. 114-115.; Yasseen, L' *Interprétation des traités d'après la Convention de Vienne sur le droit des traités*, *Recueil des cours*, 151 (1976-III), p. 23.

<sup>708</sup> Villiger, M.E., *ibid*, ft.626, p. 343.

<sup>709</sup> McNair, *ibid*, ft. 628, p. 466.

<sup>710</sup> Tamello, I., (Treaty Interpretation and Practical Reason, Sydney, 1967, p. 22) observed during the Vienna Conference that the articles drafted have adopted the standard of good faith as an overworked idea because it is expected to do that otherwise canons of interpretation would have done. See also O'Connor, *ibid*, ft. 627, p. 109-110.

<sup>711</sup> Lauterpacht, H., *International Law –Collected Papers*, vol. IV, Cambridge, 1978, p. 437 ("The principle of good faith impels the assumption of a common purpose")

<sup>712</sup> The emphasis on the words "to be given to it" in art. 31(1) VCLT, was emphasized by the ICJ in the *Land, Island and Maritime Frontier Dispute case*, ICJ Reports 1992, p. 351, par. 190.

this given meaning must be *a fully qualified one, not an isolated one*<sup>713</sup>. The principle of good faith is, together with i.e. the “object and purpose” and the “context” of a treaty, operative in the elucidation of the “ordinary meaning” of the treaty text. It puts the treaty text in the light of the mutual intent of the treaty partners, and lends support to a search for the real intent of the contracting states. In the international law of treaties, the common intent of the contracting states is always emphasized, and room for one-sided interpretations is downplayed. As a consequence it may be noted that, in more than one way, good faith plays a particular role in treaty interpretation when a contracting state interprets its own treaty obligations. There is sufficient evidence in international law that a contracting state may only do so subject to the requirement of good faith<sup>714</sup>.

### 3.2. Bona fide interpretation of double taxation conventions

#### *a) Introductory remark*

My attention here primarily goes out to the particular implications of good faith in the interpretation of double taxation conventions, while fully recognizing that the complexity of treaty interpretation involves many more aspects (some of which can also be derived from the principle of good faith).

Among other things, the principle of good faith in matters of interpretation requires that the contracting states follow their common, real understanding of the terms of the double taxation agreement. As Judge Bernardez pointed out in the *Land, Island and Maritime Frontier Dispute case*<sup>715</sup>, the principle of good faith is operative in qualifying the “ordinary meaning” of treaty terms, and that qualification must be carried out with the context and the object and purpose of the tax treaty in mind. Edwardes-Ker associates the principle of good faith with appealing to supplementary means of interpretation for clarification and confirmation<sup>716</sup>. This does not mean that the –supposed- intent of the contracting states can replace the text of the agreement as an independent, alternative means of interpretation<sup>717</sup>, a rule that is reflected in the

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<sup>713</sup> ICJ Reports 1992, p. 351, par. 190, see also above.

<sup>714</sup> Kolb, *ibid*, ft. 627, p. 264.

<sup>715</sup> *Land, Island and Maritime Frontier Dispute case*, ICJ Reports 1992, p. 351, par. 190.

<sup>716</sup> Edwardes-Ker, M., *Tax Treaty Interpretation*, 21.03.

<sup>717</sup> BFH 9 October 1985, E.T., 1986, p.120.; Edwardes-Ker, Chapter 6 p. 7.

decisions of the ICJ as well<sup>718</sup>. In tax matters the often quoted tax case *Maximov v. US*, just to name one example. Justice Goldberg stated:

“It is particularly inappropriate for a court to sanction a deviation from the clear import of a solemn treaty between this nation and a foreign sovereign when, as here, there is no indication that application of the words of the treaty according to their obvious meaning effects a result inconsistent with the expectations of its signatories”<sup>719</sup>

In the UK *Commerzbank*-case, a similar reluctance was noted to prefer the supposed intention behind a tax treaty article above the clear text of the provision<sup>720</sup>.

But what is the common intent of tax treaty partners? To double taxation plays an important role in answering this question. But with which interpretations is this to be achieved? The conclusion of double taxation agreements is characterized by a high degree of international integration and standardization<sup>721</sup>. As with many treaties, but this is particularly true for double taxation agreements, they typically cover a very large scope of situations, rights and obligations. In many cases, as Schwarzenberger noted in general terms<sup>722</sup>, an issue which subsequently may become controversial, may never have occurred to treaty negotiators. Or, in order not to jeopardize the success of the negotiations, negotiators may deliberately have left the point open. What is, in that frequent case, the “common intent of the parties”?

This issue, and the other implications of the principle of good faith for treaty interpretation, is further illustrated and explored below with respect to the conventional referral to domestic law for the interpretation of treaty terms and the issue of changing circumstances.

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<sup>718</sup> As noted by Kock, *Vertragsinterpretation und Vertragskonvention*, p. 92, *inter alia* referring to the *Maritime Safety Committee membership case*, *ICJ Reports*, 1960, p. 159.

<sup>719</sup> A decision on the question whether a trust may invoke the provisions of a double taxation convention, this was quoted by Yambrusic, E.S., *Treaty Interpretation*, University Press of America, p. 25-26; See also Kerr, *ibid*, ft.628, Chapter 6, p. 7.

<sup>720</sup> *I.R.C. vs. Commerzbank and Banco do Brazil*, 1990, S.T.C., 305; Comments on these cases by Avery Jones in “More on treaty interpretation”, *B.T.R.*, 1990, p. 388-392.

<sup>721</sup> See above, point 2 d).

<sup>722</sup> Schwarzenberger, G., *ibid*, ft. 656, p. 495.

b) *Good faith and tax treaty interpretation with reference to domestic tax law*<sup>723</sup>

The issue of tax treaty interpretation is in part dominated by the debate surrounding the referral to domestic law in art. 3(2) of the OECD Model Tax Convention and in other places of the double taxation convention<sup>724</sup>. Art. 3(2) of the OECD Model tax convention reads (in its current version):

“As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State”

Bearing this system in mind<sup>725</sup>, it is obvious that a contracting state may use domestic laws or regulations, intentionally or not, to escape from its international obligations. The system of referral to domestic law for treaty interpretation and application makes double taxation conventions vulnerable to unilateral intentional dodging and unintentional hollowing

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<sup>723</sup> See Chapter 9, “Unless the Vienna Convention Otherwise Requires”, p.277-322.

<sup>724</sup> Vogel, IFA, p. 77.; The OECD Model also refers to domestic tax law in other provisions, including art. 6(2) and 10(3).

<sup>725</sup> According to Avery Jones, this reference is unique to double taxation conventions (in “Art. 3(2) of the OECD Model Convention and the commentary to it: treaty interpretation”, E.T. 1993, p. 252). Such a wording is indeed quite rare (see Blix, H. and Emerson, J., *The Treaty Makers Handbook*, Oceana, 1973, p. 117-131) but international treaties sometimes do refer to domestic law and international law, the latter having priority over the former. (see on the role of domestic law in the ICSID-Convention: Broches, “The Convention on the settlement of investment disputes”, *Selected Essays*, 1965, p. 200-208); It may be noted that other types of treaties and conventions have adopted different mechanisms for treaty interpretation, mechanisms that guarantee a higher degree of uniformity. Art. 17 of the 1964 Convention on the Uniform Laws on the International Sale of Goods, for example, states that matters governed by the Convention, but not expressly provided for, shall be decided in conformity with the general principles on which the Convention is based. Another technique is to grant some international body the exclusive right to interpret treaty provisions, such as the 1971 Protocol to the Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Criminal Matters of 27 September 1968 (see Van Der Bruggen, Edwin, “The European Court of Justice and the Free Movement of Tax Treaty Judgments”, *EC Tax Review* 2002, Vol. 11, Issue 2, p. 52-64) or art. 24 par 3 and 4 of the OECD/COE Convention on the Mutual Administrative Assistance in Tax Matters.

out of tax treaty obligations by the contracting states, as was already pointed out above<sup>726</sup>. That concern is also expressed, to mention but one source, in the OECD Commentary with respect to art. 3(2) of the Model Tax Convention:

“A state should not be allowed to empty a convention of some of its substance by amending afterwards in its domestic law the scope of terms not defined in the Convention”<sup>727</sup>.

As Vogel and Prokisch noted in their general IFA-report on tax treaty interpretation, there are basically two schools of thought regarding the extent of domestic referral on the treaty-level<sup>728</sup>. One opinion is that domestic definitions are only a last resort, and every effort must be made to find a more or less common interpretation *first*. Another opinion is that the domestic definition should normally be used, unless the context really “demands” otherwise<sup>729</sup>.

There is much evidence in international case law that the duty to interpret a treaty in good faith may be approached from the perspective of the prohibition of abuse of rights, which is actually an application of the principle of good faith<sup>730</sup>. It must be kept in mind that except in quite exceptional circumstances, the subjects of international law actually create law, as no real supranational authority exists. States must also

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<sup>726</sup> With respect to unilateral interpretations, Voicu, *ibid*, (on p. 118) draws the interesting distinction between unilateral treaty interpretation before and after the conclusion of a treaty. He points out, among other things, that unilateral treaty interpretations in the course of concluding the treaty may, under certain circumstances, become authentic.

<sup>727</sup> Commentary on art 3, par. 13 (added in 1992); The legal basis for this assertion in the OECD Commentary, or if you will its proper denomination under international law, can in my opinion only be the principle of good faith. The application of a referral to domestic law is subject to the requirement of good faith, which sanctions states that abuse the discretion given to them under art. 3(2), as is argued below. See also the comments of Bartlett, *ibid*, p. 83 (“In recent years, however, concern has been expressed about a worrying development whereby changes in the terms of a treaty have been made unilaterally through new tax legislation in the partner country”)

<sup>728</sup> Vogel, K., and Prokisch, R., “General Report on the Interpretation of Tax Treaties”, *Cah. Dr. Fisc. Int.*, 1993, p. 81-82.

<sup>729</sup> Vogel, K., and Prokisch, R., *ibid*, ft. 728, p. 77.

<sup>730</sup> *North Atlantic Fisheries Arbitration*, Award by the Permanent Court of Arbitration, XI RIAA 167, p. 186-8.; *US nationals in Morocco case*, *ICJ Reports*, 1952, p. 176.; *Rainbow Warrior*, *RGDIP* 1990 94, p. 843, Group dissenting opinion Lauterpacht, Wellington Koo and Spender, *Aerial incident case* (preliminary objections), *ICJ* 1959, p. 189.

interpret the treaties they conclude themselves<sup>731</sup>. This helps explain why as a general principle in international law, treaty terms may not be deemed to have the meaning they have under domestic law of one or both states without good reason<sup>732</sup>. Normally, an international court or tribunal will only refer to the domestic law of one of the contracting states in case no “international meaning” can be established. This principle was recalled, for example, by the Exchange of Greek and Turkish Populations case<sup>733</sup>, where it had been suggested that the term “etablis” must be interpreted in the light of the relevant Turkish and Greek legislation respectively. The PCIJ rejected this contention, stating that it could find no indication of that at all. Domestic courts should, as a point of international law, resist the temptation to interpret treaties “guided by nationalistic concerns or corresponding exclusively to legal concepts of its legal system”<sup>734</sup>. Furthermore, when a contracting state has the discretion to interpret the provisions of a treaty, it does so subject to the general requirement of good faith. A state may not unilaterally change the treaty by giving its terms a different meaning<sup>735</sup>. The function of good faith is here thus to temper the state’s discretion to exercise that right<sup>736</sup>. According to Villiger, this is even the primary function of good faith in treaty interpretation<sup>737</sup>. The principle of good faith always favors common intent above divergence, especially when domestic law is called upon to give contents to international obligations in treaties<sup>738</sup>. The principle of abuse of rights may also be invoked to temper the discretion states exercise while unilaterally interpreting the terms of a double taxation convention<sup>739</sup>.

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<sup>731</sup> Verhoeven, J., *Droit International Public*, p. 420.

<sup>732</sup> Conforti, B., p. 105.; Verhoeven, J., *Ibid*, ft.730, p. 424 (“Les interprétations effectuées unilatéralement par chacun des états contractants sont en revanche sans autorité quelconque”);

<sup>733</sup> *Exchange of Greek and Turkish Populations case*, Series B, no 10 at p. 20 and 26.

<sup>734</sup> Conforti, B., *ibid*, p. 105.

<sup>735</sup> Nicaragua, Costa Rica, Honduras, *ICJ Reports*, 1988, par. 29-41.

<sup>736</sup> Kolb, *ibid*, ft. 627, p. 269.; Zoller, *ibid*, ft. 627, p. 88-89.; Cheng, *ibid*, ft. 627, p. 114-115.; Yasseen, *ibid*, ft. 708, p. 23.

<sup>737</sup> Villiger, M.E., *ibid*, ft. 676, p. 343.

<sup>738</sup> See above; *Barcelona Traction case*, (second phase), *ICJ Reports* 1970, p. 33 and 37.; Raible Claim (about the notion of ‘mandate’ and ‘trust’) *ILR* 1964, 40, p. 260.; Jennings, R and Watts, A., *Oppenheim’s International Law*, Longman, 1992, p. 83 (“international law may itself incorporate a concept of municipal law, in which case international law, *in the absence of any corresponding concept of its own*, will refer to the relevant rules generally accepted by municipal legal systems which recognize the concept in question” –emphasis added);

<sup>739</sup> In the same sense see Critchfield, R., Honson N., and Mendelowitz, M., “Passthrough Entities, Income Tax Treaties, and Treaty Overrides”, *Tax Notes International*, February 8, 1999, p. 587.

Emphasizing the common intent of a tax treaty may also be achieved by giving a wide meaning to term “context” in art. 3(2). In that case, it would *prima facie* seem unnecessary to resort to the principle of good faith. Apart from the question whether attaching such an interpretation to “context” in art 3(2) is in fact compatible with the text of the treaty, that reasoning should in fact be reversed in my view. In certain circumstances, the principle of good faith may require that “the context” is given a wide meaning and thus serves to give precedence to the common intent of the contracting states<sup>740</sup>. Moreover, it should be noted that even without any mitigation of the referral to domestic law in the treaty text –as is arguably the function of “context” in art. 3(2)- such as in art. 6 and art. 10 of the OECD Model, the discretion of the contracting state that carries out the interpretation and application is *still* subject to the principle of good faith in the ways already described. In any event, it may thus be concluded, the principle of good faith has a proper function and only in some instances, other rules of international law (for example those relating to interpretation) may have partly the same operation.

It may be noted, however, that as tax treaties do not aim to create new tax laws, but mainly just limit the application of domestic tax laws in certain situations, a referral to the definitions of the domestic tax law it has set out to limit, is to a certain extent unavoidable<sup>741</sup>. It can happen that changes in domestic law lead to an unforeseen, possibly unintended impact on the “equilibre” of the treaty, and such is not necessarily contrary to good faith<sup>742</sup>. In other words, not every explanation of treaty terms along the lines of domestic tax law will be contrary to the principle of good faith. As is by definition the case with respect to good faith, much will depend on the circumstances. In any event, it can be said that a state (including its courts) that first consecrates every effort to determine what *both* contracting states could reasonably have meant with a certain term in the treaty, before choosing to settle the matter by referring to his own internal law, is acting in good faith<sup>743</sup>. On the contrary, a state that simply settles questions on the interpretation and the application of a double taxation convention with regard only for its internal law, without

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<sup>740</sup> Kolb (“Bonne foi et texte ou contexte du traite”), p. 272-273.

<sup>741</sup> Avery Jones, J.F. , “Art. 3(2) of the OECD Model Convention and the commentary to it: treaty interpretation”, *E.T.* 1993, p. 252.

<sup>742</sup> Good faith forbids that an interpretation of a treaty should only lead to a foreseen result. Unforeseen results are possible: Cafilisch, L., “La pratique Suisse en matière de droit international public”, *ASDI* 1982, p. 81.; Lalive, J.F. “The first World Bank Arbitration- Some legal problems, *BYIL*, 1980, p. 154.

<sup>743</sup> A similar argument is made by Critchfield, R., Honson N., and Mendelowitz, M., *ibid.*, ft. 739, p. 587.

bothering to examine if a common interpretation can be found, is not acting in accordance with its duty to observe and interpret the double taxation convention in good faith, even when it acts within a conventionally accorded authority to apply domestic law.

In summary, it is clear that the principle of good faith sheds a rather restrictive light on the interpretation and application of 3(2) OECD Model. The duty to apply and interpret the duty in good faith is an all-overriding legal obligation upon the contracting states of a DTA. It is the sole element mentioned in art. 31 that seems to be independent from ordinary meaning of the terms in dispute. Put another way, states cannot “contract-out” the duty of one or more treaty partners to observe and interpret the treaty in good faith.

*c) Changing circumstances and unforeseen results*

By its very nature, the principle of good faith comes into play when a treaty text is confronted with new, unforeseen circumstances. On the one hand, *pacta sunt servanda* requires that the treaty is observed, regardless of the fact that an unforeseen situation has presented itself within the scope of the treaty. On the other hand, the principle dictates that within certain circumstances, invoking a treaty to cover cases which could not reasonably have been in the contemplation of the parties at the time of the conclusion, may not be in accordance with good faith<sup>744</sup>. A contracting state that takes advantage of an unforeseen situation by applying treaty provisions to it in a way that can never have been the common intent, may, again depending on the circumstances, be acting contrary to good faith<sup>745</sup>.

It is clear that this issue is closely related to the intertemporal element in treaty interpretation. Unless the treaty itself would explicitly or implicitly provide otherwise, treaty terms are to be interpreted according to their meaning at the time the treaty was concluded, as the ICJ held in the Rights of US Nationals in Morocco Case<sup>746</sup>. The OECD Model was revised in 1995 to reflect the opposite position, namely an ambulatory interpretation at least with respect to undefined terms<sup>747</sup>.

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<sup>744</sup> *Free Zones case*, 1932, PCIJ, Series A/B, 46, p. 156; *Abu Dhabi Oil Arbitration*, 1951, 1 *ICLQ* 1952, p. 253.; McNair, *The Law of Treaties – British Practice and Opinions*, 1938, p. 191.

<sup>745</sup> *Franco-Greek Phares Islands arbitration*, RSA, vol. XII, p. 226.

<sup>746</sup> *ICJ Reports*, 1952, p. 176 ad 189.

<sup>747</sup> See OECD Comm. 3/11.

A balance (between performing what was agreed and keeping the treaty flexible enough to be practical) was struck in the *clausula rebus sic stantibus*, which must be deemed to be a part of every treaty relationship as prescribed by art. 62 of the VCLT. Not every change of circumstance means a possible end to the treaty. Only a *fundamental* change of circumstances may be invoked by a contracting state if it was not foreseen by the parties, if the existence of those circumstances constituted an essential basis of the consent of the parties and if the effect of the change is radically to transform the extent of obligations still to be performed under the treaty<sup>748</sup>.

With respect to tax treaties, this issue was well noted by Acting Secretary Barr in an exchange of notes concerning the US-Brazilian double taxation convention of 1967:

“As with other treaties, it is our expectation that this one will remain in force for many years to come. But we must recognize that this treaty is a product of our times, and that if the prevailing conditions change we must be alert to make whatever modifications become appropriate under new conditions.”<sup>749</sup>

It must be pointed out that it would be rather exceptional for circumstances to have changed so drastically that it would be contrary to good faith to insist on applying the provisions of a double taxation convention regardless<sup>750</sup>. It is widely accepted that a good faith-interpretation of a treaty text does not, in principle, preclude unforeseen results<sup>751</sup>. In an environment where economical, social, legal and other circumstances are in constant movement, treaty provisions may not be cast aside lightly, especially provisions of tax treaties, which are drafted in broad terms to withstand the test of time<sup>752</sup>. Good faith may for example in my view not be invoked to argue that established tax treaty rules should no longer apply due to progress in science and technology and the legal developments related to that progress, such as e-commerce

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<sup>748</sup> Art. 62 VCLT.

<sup>749</sup> Exchange of Notes 13 march 1967 (The Secretary’s expectation proved unjustified. The treaty never entered into force); See also the Exchange of Notes between The Netherlands and the US of 18 December 1992.

<sup>750</sup> Kolb, *ibid*, ft. 626, p. 283 (“Des obligations exceptionnelles de s’abstenir de tirer indument profit du cocontractant”).

<sup>751</sup> See above, point c).

<sup>752</sup> In his separate opinion concerning the *Gabckovo-Nagymaros Project case*, (ICJ Reports 1997, p. 113-114) Judge Weeramantry took the period a treaty was meant to be operative into account to interpret its provisions and to decide whether it had been breached.

and the Internet. Such developments are unlikely to constitute a fundamental change in circumstances, or can in other words probably not be considered entirely unforeseen in a day and age where new technical accomplishments are achieved on a daily basis<sup>753</sup>.

The principle of good faith has above been described as the basis for turning legitimate expectations of one contracting state into international obligations for the other contracting state. Principally, the same process should work with respect to the interpretation of treaties. Insofar a treaty term has been given a meaning that has generally been accepted as prevailing by the international community of nations, it would be contrary to the principle of legitimate expectations for a state to conclude a treaty with such term, but consequently argue that it is by no means bound by the relevant prevailing interpretation. The content and direction given to the principle of legitimate expectations is in this case by the effect of treaties *in pari materi*. Tax treaties are based on a common model, and states deviate only slightly (but not insignificantly) from the widespread model texts. In view of this fact, it is recalled that there is much authority for interpreting treaties with reference to so-called “similar treaties”. Without wishing to discuss this interesting matter in depth, it may in any event be said that there is much authority in the jurisprudence of the World Court to refer to similar treaties for the purpose of treaty interpretation<sup>754</sup>. In the *Oder case*, the *Venezuelan bond case* and the *Decision regarding interest on awards* (British Venzualean claims commission), to name but a few examples from the classics of international jurisprudence, the disputed terms were interpreted in conformity with principles and practices followed by nations in similar treaties<sup>755</sup>. In addition, it can be said that a pre-condition to the achievement of the object and purpose of a tax treaty is that contracting states adhere in a high degree to the fundamental international tax rules on which double taxation conventions are based<sup>756</sup>. Could it not be argued that the object and purpose of a tax treaty is as much the avoidance of

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<sup>753</sup> To support my contention I refer to a dictum of the ICJ regarding the law of treaties (*Gabckovo-Nagymaros Projec case*, *ICJ Reports* 1997, p. 62-68, par. 103) which indicates that technical progress and the law related to it must nowadays be expected: “The Court does not consider that new developments in the state of environmental knowledge and of environmental law can be said to have been completely unforeseen”.

<sup>754</sup> Matscher, F., *Vertragsauslegung durch Vertragsrechtsvergleichung in der Judikatur internationaler Gerichte*, in *Festschrift für Hermann Mosler*, 1983, p. 545.

<sup>755</sup> Cheng, *ibid*, ft. 626, p. 74.

<sup>756</sup> See above, part 2.

international double taxation as the one that can occur in a bilateral relationship?

Based on the combined operation of legitimate expectations and the interpretation of treaties *in pari materi*, it is fair to say that the principle of good faith may be able to play a role in creating enforceable, ‘uniform’ or ‘international’ interpretations of treaty terms, even when those treaties are in theory purely bilateral. This consideration may have implications for the value (under international public law) of the OECD Commentary for tax treaty interpretation, but this issue certainly merits further study than can be consecrated in this contribution.

#### **4. Good Faith in the Mutual Agreement Procedure and in Other Instances of Negotiation Between the Contracting States**

##### **4.1. The mutual agreement procedure**

One of the instances where the implications of the principle of good faith are quite significant in tax treaty matters is the mutual agreement procedure. Art. 25 of the OECD Model provides in an obligation upon the contracting states to “endeavor” to resolve cases where a taxpayer’s taxation is not in accordance with the provisions of the treaty<sup>757</sup>. The same goes for difficulties or doubts arising as to the interpretation or application of the treaty<sup>758</sup>. According to the OECD Commentary, the title of the article and the terms employed suggest that:

“Par. 2 no doubt entails a duty to negotiate: but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavors and not to achieve a result”<sup>759</sup>

That contracting states only have a duty to negotiate, and there is therefore no guaranteed solution, has frequently been described as a significant flaw in the procedure<sup>760</sup>. The discretion the contracting states

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<sup>757</sup> Art. 25(2) OECD Model.

<sup>758</sup> Art. 25(3) OECD Model.

<sup>759</sup> Commentary on art. 25, par. 25-26.

<sup>760</sup> OECD Report on Corresponding adjustments, par. 34 (describes it as an “important limitation”); Bricker convincingly sums up several major disadvantages about the mutual agreement procedure, mainly that the authorities are not required to reach a result, that the taxpayer is not guaranteed to be heard, and the lack of time limit.; Bricker, M.P., “Arbitration Procedures in Tax Treaties”, *Intertax*, 1998, p. 97.;

enjoy in the mutual agreement procedure is enhanced by its additional authority to assess whether a presented claim is justified and susceptible of being put forward to the other state in the context said procedure. The tax authorities to which a case is presented may, so it seems, consider that the matter will not be presented to the other contracting state<sup>761</sup>, for example because there is little chance of success anyway<sup>762</sup>.

The mutual agreement procedure can be associated with two general obligations found in international law, which both relate to the principle of good faith. First, international law obliges states to settle their disputes by peaceful means<sup>763</sup>. States must cooperate in the application and interpretation of the treaty between them, and should resolve treaty conflicts as a matter of good faith<sup>764</sup>. As Sir Robert Jenkins notes: “A refusal to consider means of settlement must be a breach of that obligation”<sup>765</sup>. Secondly, as the OECD Commentary already suggests<sup>766</sup>, the mutual agreement procedure can be seen from the perspective of the notion “*pactum in contrahendo*” in international public law.

With respect to the lack of any obligation to reach a solution in the event of a mutual agreement procedure, it may be noted that there is ample evidence in international case law that the principle of good faith nevertheless has important implications upon the way a party conducts its negotiations<sup>767</sup>. The depth of the obligation “to endeavor” resolving the case of the taxpayer by mutual agreement, or to resolve any difficulties or doubts arising as to the interpretation or application of the convention, is

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See also Avery Jones, J.F. et al, *The Legal Nature of the Mutual Agreement Procedure under the OECD-Model Convention*, *B.T.R.*, 1979, 333 and 1980, p. 13.

<sup>761</sup> As was pointed out by Baker, there may be circumstances where the competent authority indeed has such a right: Baker, Ph., *ibid*, ft.631, p. 416-417.; IFA General Report, *Cahiers Dr. Fisc. I.*, 1981, p. 109-112.

<sup>762</sup> IFA General Report, *Cahiers Dr. Fisc. I* 1981, p. 109-112.

<sup>763</sup> Art. 2(3) Charter of the United Nations; 1982 Manila Declaration on the Peaceful Settlement of International Disputes, G.A. Resn. 37/10, G.A.O.R., 37<sup>th</sup> Session, Supp. 51, p. 261.; *Military and Paramilitary Activities case* (Merits), *I.C.J.Reports*, 1986, p. 14.

<sup>764</sup> *Case A 15 Iran vs. US*, 20 august 1986, *US Claims Tribunal Reports*, vol. 12 p. 61 (on the duty to cooperate and resolve difficulties while implementing the treaty); *Air Service Agreement arbitration Award* of 9 December 1978, XVIII RIAA 415, 445 (the duty to resolve treaty disputes).

<sup>765</sup> *Collected Writings of Sir Robert Jennings*, Vol. 1, Kluwer, 1998, p. 252.

<sup>766</sup> The OECD Commentary explicitly refers to the term “*pactum de contrahendo*”.

<sup>767</sup> *Lake of Lanoux case*, *RGDIP*, 1958, p. 106.; *Continental Shelf case*, *ICJ Reports*, 1969, p. 47.; *Fisheries case (merits)*, *ICJ Reports*, 1974, p. 32 and 201.; *Arbiral Award on Certain German external loans*, *A.F.D.I.*, 1973, p. 535.; Zoller, *ibid*, ft.626, p. 60-68.

determined by the principle of good faith<sup>768</sup>. The competent authorities are not free to conduct themselves how they please in the context of the mutual agreement procedure. Their discretion only exists within the constraints of the requirement of good faith.

As Zoller notes:

“La bonne foi dans les négociations suppose que les Etats parties a celles-ci fassent preuve d’une certaine bonne volonté et que s’instaure entre eux un climat de loyauté et de confiance réciproque. Les parties doivent adopter des positions suffisamment souples en vue d’aboutir, par des concessions réciproques, à un compromis qui les satisfasse l’une et l’autre.”<sup>769</sup>

Conducting a mutual agreement procedure in good faith has several practical implications. The competent authorities must take the mutual agreement procedure in a tax treaty seriously<sup>770</sup>. Not showing up for scheduled talks, a failure to nominate representatives<sup>771</sup> or unreasonable delays in setting meetings<sup>772</sup>, for example, may be conduct that is not in accordance with the principle of good faith<sup>773</sup>. It may be recalled that in various decisions, the ICJ has opposed arbitrariness and lack of due process<sup>774</sup>.

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<sup>768</sup> Federal Income Tax Project, International Aspects of US Income Taxation II, Proposals on US Income Tax Treaties, *A.L.I.*, 1992, p. 101.

<sup>769</sup> Zoller, *ibid.*, ft. 626, p. 60.

<sup>770</sup> Guyomar, G., “Tribunal d’arbitrage de l’accord sur les dettes extérieures allemandes”, *A.F.D.I.*, 1973, p. 535 (“The promise to negotiate does not necessarily imply the obligation to reach an agreement, but it does entail making serious efforts to try doing so”); See also the OECD Report on Corresponding Adjustments, par. 29: “The Committee considers that tax authorities should therefore be encouraged to do this whenever it is appropriate and possible, and to do all they can in such circumstances to reach such agreement in order to eliminate double taxation as far as possible”; See also (about the slow character of the mutual agreement procedure) Federal Income Tax Project, International Aspects of US Income Taxation II, Proposals on US Income Tax Treaties, *ALI*, 1992, p. 107.

<sup>771</sup> *Peace Treaties with Bulgaria, Hungary and Romania case* (Advisory Opinion) of 18 July 1950, *ICJ Reports*, 1950, p. 222.

<sup>772</sup> OECD Report on Corresponding Adjustments, par. 91: “Nevertheless, the Committee agreed that every effort should be made to seek to avoid delays in these matters, and to improve their practice insofar as their resources permit”. The principle of good faith offers a legal basis for these statements.

<sup>773</sup> *Lake of Lanoux case*, *RGDIP*, 1958, 106.

<sup>774</sup> *Elettronica Sicula S.p.A. (ELSI) case*, *ICJ Reports* 1989, p. 15 (“Arbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law. This idea was expressed by the Court in the *Asylum* case, when it spoke of

One of the often voiced complaints about the mutual agreement procedure is that it is so time-consuming that it may become completely ineffective at times. The principle of good faith requires in my view that the contracting states provide to each other all necessary or relevant information to reach a decision in a timely manner. In the absence of conventionally determined time limits, this issue is governed by the principle of good faith<sup>775</sup>. The problem is to determine in practice how long a period must pass before a lack of good faith performance may be assumed. It is doubtful whether the passing of any length of time for a negotiation between states can ipso facto be seen as evidence of bad faith. It must be established if the lapse of time can be attributed to abusive behavior on the part of one treaty state. The issue of time is thus actually largely a question of genuine willingness by the contracting states to find a solution. Unjustifiable delays, lack of answer to proposals in any reasonable period of time, inexplicable changes in the position of a state that will prolong the procedure, are all indications that there is no genuine will to reach an agreement. That way, it can be established that the contracting state has infringed upon its duty to perform the tax treaty provision on the mutual agreement procedure in good faith.

It is furthermore required that the parties are each willing to make sacrifices in the course of the procedure. A good faith performance of the duty to negotiate in the course of a mutual agreement procedure implies flexibility and compromise. Bluntly refusing to give in to any case presented by the other party is not in accordance with good faith<sup>776</sup>. In this respect the willingness to compromise may be seen in the perspective of the whole body of cases between the two states, rather than for one individual case.

In short, it can be said that the yardstick of good faith excludes that a state should treat the mutual agreement procedure as a mere formality, and is not genuinely committed to finding a timely solution. As Virally noted: “Good faith excludes any separation between reality and appearances”<sup>777</sup>.

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“arbitrary action” being “substituted for the rule of law” (*Asylum, Judgment, I.C.J. Reports 1950*, p. 284) It is a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety”).

<sup>775</sup> *Gabckovo-Nagymaros Project case, ICJ Reports 1997*, p. 7: “Precisely what periods of time may be involved in the observance of the duties to consult and negotiate, [...] are matters which necessarily vary according to the requirements of the particular case. In principle, therefore, it is for the parties in each case to determine the length of those periods by consultation and negotiation in good faith”.

<sup>776</sup> *Continental Shelf case, ICJ Reports 1969*, p. 47.

<sup>777</sup> Virally, M., “Review essay: good faith in international public law, *AJIL*, 1983, p. 131.

#### 4.2. Tax treaties with “most favored nation”-arrangements

Another obligation to negotiate often found in tax treaties is embedded in a “most favored nation”-clause. Such clause can either be formulated as an obligation of conduct or as an obligation of result. In the Thai-US double taxation agreement of 1996, for instance, the US is obliged (if it alters its policy with regard to tax sparing credits or if it reaches a double taxation agreement including a tax sparing credit with another country) to “agree to reopen negotiations with Thailand”<sup>778</sup>. This is an obligation of conduct that can, according to the letter of the agreement, only be breached by the US if it refuses to enter into any renegotiation concerning the tax sparing credit at all. The requirement of good faith adds however, that the negotiations should be genuine, and not just a formality. Both parties must, if the occasion arises, be willing to compromise for these negotiations to be called “genuine”. It may be noted that other clauses on the same subject have a different normative content. The most favored nation-clause in the China-US treaty, for example, does constitute an obligation of result:

“The Agreement shall be promptly amended to incorporate a tax sparing credit provision if the US hereafter amends its laws concerning tax sparing or if it reaches a double taxation agreement including a tax sparing credit with another country”<sup>779</sup>.

#### 4.3. Other instances with a duty to negotiate in good faith

Protocols to double taxation conventions often provide in some duty to negotiate or consult in case of a particular event. In my view, the reasoning that was developed above also applies to those instances. In the Protocol of the double taxation agreement between India and Italy, for example, the two contracting states agreed to, with reference to art. 7(3), “consult each other for purposes of amending this paragraph” in case future changes to their domestic tax laws should further restrict the deduction of executive and general administrative expenses<sup>780</sup>. The same can be said for an agreement that is to be negotiated between the US and

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<sup>778</sup> Thai-US DTA, 26<sup>th</sup> November 1996, Exchange of Notes.; See also the Exchange of Notes between the US and Cyprus of 19 March 1984.

<sup>779</sup> China-US DTA, 30<sup>th</sup> April 1984, Exchange of Notes.

<sup>780</sup> Protocol dated 29 January 1996, point 1.

Denmark, not to deny treaty benefits to taxpayers without the other contracting states' consent<sup>781</sup>.

## **5. Good Faith and the International Exchange of Information (Art. 26 OECD Model)**

One of the provisions of the OECD-model where the principle of good faith makes another significant contribution to the normative content of the international legal obligations on the contracting states, is the article on the exchange on information. As was mentioned above, good faith is an all-overriding fundamental principle of international law, which is associated with moral values of reasonableness, honesty and fairness, and is used as a yardstick for observing treaty obligations. The principle of good faith becomes particularly important when one contracting state finds itself in a position of power to determine the extent of the treaty obligation on that state, and such is indeed the case with the exchange of information-article.

### **5.1. Rights and reasons to refuse the supply of information**

In several important ways, the treaty provision for the exchange of information offers the state on which the obligation rests, the right to refuse the supply of the requested information. Most importantly, the state has a right to refuse if it considers that the exchange would require administrative measures at variance with its laws and administrative practice, if the information is not available under its law or in the normal course of the administration, or if that information would disclose any trade, business, industrial, commercial or professional secret or trade process or information the disclosure of which would be contrary to public policy<sup>782</sup>.

There may be different reasons why a contracting state may try to escape from its treaty obligation to supply information. One of the main considerations involved may be that the contracting state has the impression that the requesting state is not supplying enough information either. Although it is true that reciprocity is a corner-stone of treaty law, relying on this kind of argument leads a contracting state down a slippery slope. The exchange of information-article is not the only provision in a

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<sup>781</sup> Point 1 of the Exchange of Notes of August 23, 1983 regarding the double taxation agreement between the US and Denmark.

<sup>782</sup> Art. 26(2) OECD Model.

tax treaty, and states are not at liberty to select treaty provisions for performance in function of their preferences of the moment<sup>783</sup>.

Besides the pretext of reciprocity, there are many situations where a state might be less than forthcoming with requested information. Perhaps, the possibilities for disclosure of information from tax records are not clearly regulated in internal law, and government officials are reluctant to expose themselves to criticism or sanctions. Officials in certain countries may also be wary of cooperating in the case of requests concerning state enterprises or political figures. Finally, the reluctance to cooperate may simply be due to an already high workload of the tax administration.

## 5.2. Implications of the principle of good faith on handling information requests

The text of the treaty does not explicitly subject the right of refusal to any requirement of good faith but under international law, an explicit reference is by no means a condition for the principle to apply<sup>784</sup>.

One contribution of good faith to art. 26 OECD Model DTC is the aspect of timeliness. No time limit is provided for supplying the information in the treaty. The Commentary simply states that “the manner in which the exchange of information agreed to in the Convention will finally be effected can be decided upon by the competent authorities of the contracting states”<sup>785</sup>. Although neither the text of the article, nor the Commentary indicate any obligation on the state to supply the requested information before a certain time has passed, this aspect of the treaty obligation is in my view addressed by the requirement of good faith. As Kolb notes: “When no timeframe has explicitly been provided, the question is answered by good faith”<sup>786</sup>. More precisely, the supply of information must take place within a reasonable timeframe, given the particular circumstances of the case. It is true that this requirement of good faith falls short of imposing a clear period in amount of days, months or years. Instead, because the principle of good faith is associated with the notion of legitimate expectations entertained by the international community of tax treaty concluding states<sup>787</sup>, it seems that a reasonable

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<sup>783</sup> *Qui habet commoda ferre debet onera; Plateau Continental de la mer Egee, ICJ Reports, 1978, p. 3ss.*

<sup>784</sup> See above, part 2.

<sup>785</sup> OECD Commentary, art. 26, par. 10.

<sup>786</sup> Kolb, *ibid.*, ft. 626, p. 280.

<sup>787</sup> See above, part 2.; O’Connor, *ibid.*, ft. 626, p. 124.

time may be determined in accordance with the time a regular tax administrative agency can be expected to verify the request, locate the information and supply the results to the other state. After all, in the absence of particular agreements between the parties on this matter during the conclusion of the treaty, the contracting states may reasonably assume that each will not significantly deviate from the international practice they are both familiar with, and this becomes thus a part of the common intent.

Factors such as type of request (special request or automatic), type of information (already available in the records or requiring special audit) and taxpayer (multinational, industry-wide, natural person)<sup>788</sup>, may all be taken into account. It may also be taken into account that the requesting state has been less than forthcoming with details necessary to locate the information<sup>789</sup>.

Good faith also commands that a refusal to supply information should be motivated, and should be handled with regard for the rules of due process, and not arbitrarily<sup>790</sup>. A blunt refusal to supply the requested information, without any explanation, is not in accordance with good faith<sup>791</sup>. A failure to respond at all is in any event a failure of a state's duty to perform its treaty obligations in good faith.

Another obligation that can be derived from the principle of good faith with respect to the international exchange of information, is that a contracting state must take responsibility for inaccurate information that was supplied, and must immediately notify the requesting state as soon as it has ascertained its inaccurate nature<sup>792</sup>.

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<sup>788</sup> Commentary, art. 26, par. 9.1.

<sup>789</sup> This can be derived from the obligation of cooperation between the contracting states, which does not have to be explicitly inscribed in the treaty: *Case A 15, Iran vs. United States*, 20 August 1986, Iran/US Claims Tribunal Reports, vol. 12, p. 61.; *Rainbow Warrior*, 1990, (94) p. 843.; Kolb *ibid*, ft. 626, p. 278.; on the same duty to cooperate in French civil law see Picod, "L'obligation de coopération dans l'exécution du contrat," *JCP*, 1999, 900.

<sup>790</sup> The ICJ has opposed arbitrary behavior and spoken out for due process in the *Asylum case, Judgment, ICJ Reports 1950*, p. 284.; See also the *Elettronica Sicula S.p.A. (ELSI) case ICJ Reports 1989*, p. 15.

<sup>791</sup> See also art. 20(2) of the OECD/COE Convention on Mutual Administrative Assistance in Tax Matters.

<sup>792</sup> See for example point 8 of the Final Protocol to the German-Vietnamese double taxation convention of 16 November 1995.

### 5.3. The “normal course of administration”

Art. 26(2) b) provides that no obligation exists to exchange information when such information is not available in the “normal course of the administration”. Even though the treaty does not define what “normal” is in this context, the state confronted with the request for the request for information cannot interpret “normal” at its own discretion. What is normal and what is not, is not entirely up to the state that has to fulfill the obligation. It may certainly not, for example, invoke this provision as a matter of standard practice in order to dodge its treaty obligations. Is it contrary to good faith for a state to regard certain information as not available in the normal course of administration, when in fact, generally tax authorities around the world can ordinarily be expected to have such information available in the normal course of administration? The yardstick of reasonableness must set the threshold in this respect quite high. All facts and circumstances must be taken into account, including the fact that a contracting state may be a developing country and has only limited resources available. Still, good faith must be allowed to curb contracting states abusing their discretion with respect to the notion of “normal course of administration” to escape their treaty obligations.

### 5.4. The exception for trade secrets and public policy

Another ground for refusal to supply information is the exception for trade secrets and matters of public policy. Based on 26 (2) c), a contracting state is not bound by the treaty to supply information if that would disclose trade information contrary to public policy. No definition or explanation is given in the treaty text, and the Commentary merely states that “secrets mentioned in this sub-paragraph should not be taken in too wide a sense”<sup>793</sup>. Along the same lines, the Commentary notes that the exception for public policy must concern “the vital interests of the state itself”<sup>794</sup>. What is public policy lies thus *prima facie* within the discretion of the contracting state confronted with the request. But again, the discretion given to the contracting states may not be seen as absolute, even when there is no provision in the tax treaty that explicitly says so. Good faith imposes a restriction on the right to invoke the grounds for refusal, which may not be abused or exercised in an unreasonable, dishonest or unfair manner. It may be contrary to good faith, for example, to supply certain information at one time, but to invoke the exception for public policy to identical information the next time. International case law

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<sup>793</sup> Commentary, art. 26, par. 19.

<sup>794</sup> Ibid.

supports that states may not blow hot and cold at the same time without good reason<sup>795</sup>.

## **6. Good Faith and the Application of Double Taxation Conventions Subject to Domestic Tax Law**

### **6.1. General remarks**

Discussing the relationship between domestic law and treaty law is largely an issue of precedence of international law<sup>796</sup>, but general principles of international law such as good faith may still play a part here as well.

It is noteworthy in this respect that the jurisdiction to tax is under international customary law an attribute of the sovereignty of the state<sup>797</sup>,

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<sup>795</sup> Inconsistency was sanctioned by the ICJ i.e. the *Temple of Preah Vihear case*, ICJ Reports 1962, p. 6.

<sup>796</sup> Under the VCLT (art. 27), a party to a treaty may not invoke the provisions of its internal law as justification for its failure to perform a treaty. Within the ILC itself, there were three different attitudes apparent at various times during the conference on the issue of the relationship between international law and national law. The first was that of Sir Lauterpacht who believed that municipal law prevailed over international law. The opposite view was that of Sir Fitzmaurice. A third view was gradually accepted, namely that international law overrides national law unless there was a manifest violation of international law that invalidates the consent of the state to the treaty (art. 46).; See Sinclair *The Vienna Convention on the Law of Treaties*, p. 45.; See also Starke, J.G., *Introduction to International Law*, p. 71-91.; Sinclair, *Vienna Convention on the Law of Treaties*, p. 42; With respect to tax treaties and domestic tax law see, *inter alia*, Baker, p. 51.; Edwardes-ker, M., *ibid*, Chapter 44.; Vogel, *Double Taxation Conventions*, p. 67-71.; Rezek, J.F., Luthii D. *et al*, *Tax Treaties and Domestic Legislation*, IFA Seminar Series, 1989.; Becker, H., and Wurm “Double taxation conventions and the conflict between international agreements and subsequent domestic laws, *Intertax*, 1988, p. 257.; Tan How Teck, “Do Singapore’s domestic tax laws constitute a tax treaty override?”, *I.T.J.*, summer 2000, p. 51.

<sup>797</sup> *Free Zones Case*, P.C.I.J., 1930, Ser. A, nr. 24, 10; *Prince von Pless Case*, P.C.I.J., 1933, Ser. A/B, nr. 59, p.194.; *Customs Union Case*, P.C.I.J.,1931, Ser. A/B, nr. 46, 96 (also Ser. A nr. 22, 5 and 24 p.4 ), *Foreign Nationals in Morocco Case*, *I.C.J. Reports*, 1952, p. 176.; *Cook v Mexico* 4 RIAA, 1926, p. 593.; *Santa Clara Estates Claim*, 9 RIAA, 1903, p.455.; *Commission Euratom v. UK Atomic Energy Authority*, 25 February 1967, *I.L.R.*, 1972, p. 409-413.; Albrecht, A.R., “The Enforcement of Taxation under International Law”, *B.Y.I.L.*, 1953, p. 455.; Norr, M., “Jurisdiction to tax and international income”, *T.L.R.*, 1962, p. 431.; Martha, R.S.J., *The Jurisdiction to Tax in International Law*, Kluwer Law and Tax Publ., 1989, p. 43-54.; Quereshi, A.H., “The Freedom of a State to Legislate in Fiscal Matters under General International Law”, *Bull.I.F.D.*, 1987, p.14.; Mann F., “The Doctrine of International

and is hardly the subject of any customary limitations<sup>798</sup>. In the absence of a clear restriction of that sovereign right to tax, for example in a treaty, it may thus be noted that a state does not have to take any international obligations into account in these matters<sup>799</sup>.

Once a state has consented to treaty-restrictions upon its sovereign right to tax, however, but then adopts legislation that is incompatible with its treaty obligations, it infringes upon its duty to observe the treaty in good faith<sup>800</sup>. In addition, good faith precludes a contracting state from enacting legislation in view of rendering the treaty *in fact* inoperative even though the domestic legislation is not literally and directly contrary to the treaty<sup>801</sup>. Sir Lauterpacht already noted that states might try to encroach on their treaty obligations by touching upon related areas<sup>802</sup>. The World Court has also held, without explicitly referring to the notion of good faith, that a state is obliged to take all measures, including those of a legislative or regulatory nature, to ensure the effective application of a treaty<sup>803</sup>. A state may legitimately be expected to arrange its internal affairs in order, so that the treaty can have effect<sup>804</sup>. Sometimes double

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Jurisdiction Revisited after 20 years” *Receuil des Cours*, 1984, vol. 111 , p. 98.; Van Der Bruggen, E., “State responsibility under customary international law in matters of taxation and tax competition”, *Intertax*, 2001, p. 120-122.

<sup>798</sup> Quereshi, A.H., *ibid*, ft. 796, p. 14.

<sup>799</sup> Van Der Bruggen, E., “State responsibility under customary international law in matters of taxation and tax competition”, *Intertax*, 2001, p. 122 (with further references).

<sup>800</sup> Kolb, *ibid*, ft. 627, p. 292.; Zoller, *ibid*, ft. 627, p. 91 (who points out that the main issue in this respect is not ‘good faith’ but the precedence of international law over domestic law); Brownlie, I., *System*, p. 142.; Van Der Bruggen, E., “State responsibility under customary international law in matters of taxation and tax competition”, *Intertax*, 2001, p.130-132.; Mann, F. A., “Treaties before Municipal Courts”, in *Notes and Comments on Cases in International Law, Commercial Law and Arbitration*, 1992, p.131.

<sup>801</sup> *Treaty of 1902 on Minors*, ICJ Reports 1958 , p. 55; *German Interests in Polish Upper Silezia case* (merits) PCIJ, Ser. A no. 7, p. 29-30.; See the proposal by Luxembourg that was deemed unnecessary: A/Conf. 39/L.15; A/Conf. 39/11 add 1 p. 52; The International Law Commission further remarked “That an obligation of good faith to refrain from acts calculated to frustrate the object of the treaty attaches to a State which has signed a treaty subject to ratification appears to be generally accepted.”(Yearbook of the International Law Commission, 1966, Vol. II, p. 202.)

<sup>802</sup> SO Lauterpacht, ICJ Reports 1958, 81-82.

<sup>803</sup> Advisory opinion on *Exchange of Greek and Turkish populations*, PCIJ Reports, Series B, n 10, p. 20.; Zemanek, in *Neuhold/Hummer/Schreuer/*, p. 65.; Harris, D.J., *Cases and Materials on International Law*, p. 71-72.

<sup>804</sup> See above, part 2.

taxation conventions explicitly require that certain measures are taken by a contracting state in its domestic law<sup>805</sup>, but that is not common practice.

Furthermore, the relationship between domestic laws and regulations and rights bestowed by treaty provisions is governed by good faith in a sense that a contracting state may not abuse those rights, namely to use those rights in an unreasonable, dishonest or unfair manner<sup>806</sup>.

Turning our attention to tax treaties, the starting point must remain that the contracting states of a double taxation convention did not wish to freeze their respective national tax laws. Even so, it follows from the above that a contracting state may be violating the principle of good faith if it introduces legislation that results in a hollowing out of its tax treaty obligations<sup>807</sup>, or that is manifestly at odds with the treaty object and purpose. This is explicitly acknowledged in the Exchange of Notes relating to the Dutch-US tax treaty of 1992 by the US State Department to The Netherlands, that reads as follows:

“Both Governments confirm that their respective countries recognize the principle that the Convention, once in force, is binding upon both parties and must be performed by them in good faith and in accordance with generally accepted rules of international law. The Governments further confirm their recognition that they should avoid enactment or interpretation of legislation or other domestic measures that would prevent the performance of their obligations under the Convention”<sup>808</sup>.

States are indeed free to change their domestic tax law, but in more than one way such changes may put them on a collision course with respect to a bona fide- observance of the tax treaty.

The international law of state responsibility teaches us that not only direct breaches of treaties by overriding domestic legislation can entail international responsibility. In tax literature, the example of the US branch profits tax is quoted as a notorious instance of such treaty override. However, less explicit state measures may also be contrary to good faith. It may suffice that the effective operation of a treaty is

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<sup>805</sup> See also the exchange of notes between concerning the double taxation agreement between the US and Cyprus, 19 March 1984.

<sup>806</sup> See above, part 2.

<sup>807</sup> Losinger case, *CPIJ* ser. C n. 78, p. 26 (Swiss pleadings)

<sup>808</sup> Exchange of Notes between The Netherlands and the US of 18 December 1992

impeded in practice<sup>809</sup>. In addition, domestic law may condition the depth and scope of certain international obligations that are provided in the tax treaty.

In my view, the contracting state to whose internal law is referred, is in those cases still not entirely free in exercising the right the treaty bestowed upon it, but exercises that right subject to the principle of good faith. What follows are some tax treaty issues that are explored in the light of this assertion.

## 6.2. Domestic law restricting the scope of foreign tax credits

One of the most important instances where treaty protection is subject to domestic law is with regard to the foreign tax credits. Often, a contracting state will subject the granting of a foreign tax credit to its own relevant laws and regulations among other reasons to safeguard the application of internal anti-abuse measures concerning foreign tax credits. Pursuant to this provision, a contracting state may indeed subject the extension of a foreign tax credit to its domestic laws and regulations, but only insofar such is not contrary to the overriding legal requirement of good faith. In any event, a contracting state may for example not exercise that right in an attempt to escape its treaty obligations. It would be contrary to good faith to create such conditions and exclusions in domestic law that all elimination of double taxation would *in effect* become impossible<sup>810</sup>. Good faith also precludes states from adopting domestic conditions that lead to inconsistent results<sup>811</sup>. Because good faith emphasizes the common agreement between treaty partners, and lends support to the use of mutually accepted standards as opposed to unilateral ones, it can also be said that introducing domestic measures with respect to foreign tax credits after the conclusion of a double taxation agreement that go far beyond what is the prevailing practice in the international community of nations, does not go without saying. One could argue that such would not be in accordance with the legitimate expectations of the treaty partner<sup>812</sup>. At the very least, contracting states should inform one another of a new

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<sup>809</sup> Edwin van der Bruggen, *State Responsibility under Customary International Law in Matters of Taxation and Tax Competition*, *Intertax*, 2001, p. 115-138.; See also below.

<sup>810</sup> The actual result of state measures is the criterion in this respect. See on this issue: *Minority Schools in Albania case*, PCIJ, 1935, Ser. A/B, no. 64, p. 18; *Polish Nationals in Danzig case*, PCIJ, 1932, Ser. A/B, no. 44 p. 28.

<sup>811</sup> A State may not “blow hot and cold at the same time”. See *Temple of Preah Vihear case*, *ICJ Reports* 1962, p. 6.

<sup>812</sup> See above, part 2.

policy on these matters, especially when unusual or far-reaching conditions and exclusions are introduced.

### 6.3. Domestic law enlarging the scope of foreign tax credits

Still with respect to foreign tax credits, the principle of good faith may also play a role in the opposite situation, namely when a foreign tax credit in one state is enlarged by the operation of the domestic law of the other state. This is the case with conventional tax sparing credits in tax treaties between developed and developing countries. The tax sparing credit is in those treaties defined in function of the developing countries' overall corporate income tax rate, in such a way that if the overall rate is increased, the foreign tax credit will increase as well. With that result in mind, the developing country may be tempted to raise the overall corporate income tax rate, in a way that it in fact only affects foreign companies or companies with foreign shareholders. This concern is expressed explicitly in the OECD Report "*Tax Sparing: A Reconsideration*"<sup>813</sup>, together with the apprehension that developing countries might abuse the notion of "tax incentives similar to those currently in force" to expand the scope of conventional tax sparing credits<sup>814</sup>. To a certain extent, as the Report notes, this can be curbed by including explicit references and limitations in the text of the treaty, but it may still safely be said that the yardstick of good faith will continue to play an important role in this respect. Although the starting point remains that a contracting state remains free to change its domestic tax incentives, and that the other contracting state will be obliged to continue extending tax sparing credits (provided no special conventional exception would apply), those changes must remain within reasonable proportions in the light of the prevailing practice on this subject of the international community of nations. One could argue that such would not be in accordance with the legitimate expectation of the treaty partner<sup>815</sup>. In addition, the domestic changes may not be tailor-made to exploit the provision in an unfair manner.

### 6.4. Deductibility of head office expenses

Another example of treaty benefits being subject to domestic tax laws and regulations can sometimes be found with respect to the deductibility of

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<sup>813</sup> OECD, "Tax Sparing – A Reconsideration", Paris, 1997 (included in the OECD Model tax Convention as R-14).

<sup>814</sup> R (14)- p. 28 in the OECD Model Tax Convention, 2000.

<sup>815</sup> See above, part 2.

executive and general administrative expenses. The tax treaty between the US and India provides for example that:

“In the determination of the business profits of a permanent establishment, there shall be allowed those expenses *that are deductible under the laws of the contracting state in which the permanent establishment is situated* and that are incurred for the purposes of that permanent establishment including executive and general administrative expenses, whether incurred in the state in which the permanent establishment is situated or elsewhere” (emphasis added)<sup>816</sup>.

Similar provisions can be found in the Canadian tax treaties with India<sup>817</sup>, and Argentina<sup>818</sup>, as well as certain Indian treaties such as those with Australia<sup>819</sup>, France<sup>820</sup>, Germany<sup>821</sup> and Italy<sup>822</sup>.

In my view, the principle of good faith sheds a particular light on the wording of this text, namely that only the *general* internal provisions on the deduction of expenses are meant. One may think of requirements relating to documents to be submitted as proof, the taxable period expenses may be deducted and general exceptions on the deductibility on certain expenses (such as entertainment expenses). The reservation for domestic law here may in any event be seen as an explicit authorization for subjecting the deductibility to *such general rules of internal law*, rules that in my view might be applied also without such reservation. That is however all which may be deduced from this reservation<sup>823</sup>. The discretion granted in the treaty text to subject the deduction of such expenses to domestic law is not an absolute right. The exercising of that right must be in accordance with the principle of good faith. It would not be in accordance with the principle of good faith to allow the contracting states to subject the deduction to *all* rules of their domestic law, especially not those which impose restrictions to expenses incurred

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<sup>816</sup> DTA US-India, 12 September 1989.

<sup>817</sup> DTA Canada-India, January 11, 1996 (new), art. 7(3).

<sup>818</sup> DTA Canada-Argentina, April 29, 1993, art. 7(3).

<sup>819</sup> DTA India-Australia, July 25, 1991, art. 7(3).

<sup>820</sup> DTA India-France, September 29, 1992, art. 7(3)(a).

<sup>821</sup> DTA Germany-India, art. 7(3) and (4).

<sup>822</sup> Protocol to DTA Italy-India, January 29 1996, point 1 (see also above)

<sup>823</sup> I have argued along the same lines elsewhere, also with reference to the context of the double taxation agreement, namely art. 7(2) and art. 24 (3); “About the Deductibility of Head Office Expenses: A commentary on Art. 7(3) of the OECD Model, the UN Model and Alternative Solutions Adopted in Tax Treaty Practice”, *Intertax*, Vol. 30, August/ September 2002.

abroad by non-resident taxpayers with a permanent establishment in that country, such as art. 100 par. 2 of the Greek Income Tax Code<sup>824</sup> or art. 237 of the Income Tax Code of Belgium<sup>825</sup>. If by applying the domestic rules on this subject, the deduction of head office expenses incurred in the other state would *in fact* become impossible, it would not be in accordance with the principle of good faith for a state to apply those rules in any given situation<sup>826</sup>.

## 7. Changes to Domestic Tax Law During the Negotiation of a Tax Treaty or Before its Entry into Force

One of the major indications that good faith cannot be entirely assimilated with *pacta sunt servanda* (but is actually the basis of it)<sup>827</sup> is the existence of certain international obligations that precede the actual conclusion of the treaty<sup>828</sup>. A contracting state may not, prior to the entry into force of the treaty, enact legislation that voids the treaty provisions of their object and purpose<sup>829</sup>. In tax treaty matters this assertion must be given a special consideration because one of the main objectives of this type of agreement is to achieve the elimination of double taxation. Therefore, if one of the contracting states issues unilateral measures to eliminate international double taxation, or for that matter abolishes income tax altogether, such can hardly be seen as a frustration of the main purpose of the tax treaty<sup>830</sup>. After all, international law is mostly

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<sup>824</sup> “In order to determine the taxable profit of the PE in Greece, general administrative expenses and other expenses regarding the organising or function of the PE that the head office makes can be deducted from the profits of the PE in Greece, but cannot exceed the 5% of the same kind of expenses the PE makes in Greece, as those latter appear in the balance sheet of the PE.” (I am grateful for Katerina Perrou’s translation of this paragraph).

<sup>825</sup> “For deduction as business expenses only expenses are allowed that exclusively concern income referred to in art. 228-231”.; Peeters, B., *Commentaar Dubbelbelastingverdragen*, 1991, p. 103.; Malherbe, J., *Droit Fiscal International*, Larcier, Bruxelles, 1994.

<sup>826</sup> *Minority Schools in Albania case*, PCIJ, 1935, Ser. A/B, no. 64, p. 18.; *Polish Nationals in Danzig case*, PCIJ, 1932, Ser. A/B, no. 44 p. 28.

<sup>827</sup> *Nuclear Test case*, ICJ Reports 1974, 253 par. 46.

<sup>828</sup> *German Interests in Polish Upper Silesia case*, CPIJ, ser. A no. 7, p. 29-30.; Hassan, T., “Good faith in treaty formation”, 21 *Virginia J.I.L.* 1981, p. 443 (450), Elias, T.O., *The Modern Law of Treaties*, New York, 1974, p. 26.; ALI, *Restatement of the Law Third*, vol. I, 1987, p.174.

<sup>829</sup> Kolb, *ibid*, ft. 627, p. 209.; *Samoan Claims case*, Arbitral award of 14 October 1902 by King Oscar II of Sweden, IX RIAA 15, 25; 95 BFSP 169, 164, 168; see also previous also footnote

<sup>830</sup> Although it might constitute a “fundamental change of circumstances”; see below.

unconcerned with the way states implement treaty protection, as long as the result is delivered.

A radical change in a state's tax system may however cause the other state to reconsider concluding a treaty, or even consider terminating an already concluded treaty by reason of a fundamental change of circumstances<sup>831</sup>. It would however clearly be contrary to good faith for a state, wary of its obligations with respect to the exchange of information and mindful of the right to refuse on the basis of domestic law, to enact more strict domestic provisions after having concluded the negotiations but before entry into force of the double taxation convention. Even if that state is not really intending to escape its treaty obligations, but such would in effect be the result of its unilateral conduct, that state is at least obliged under the principle of good faith to timely inform its treaty partner of this turn of events. The same reasoning *mutatis mutandis* applies to changes in domestic tax law (normal corporate income tax rate, scope of tax incentive measures, etc.<sup>832</sup>) after the closing of the negotiations but before the entry into force, which affect the conventional tax sparing credit<sup>833</sup>.

The duty to inform the treaty partner during the negotiation process or before the entry into force of the tax treaty<sup>834</sup> is indeed based on the principle of good faith. Withholding crucial or relevant information from the treaty partner in the course of the conclusion of a treaty is contrary to good faith, and may even affect the validity of the treaty<sup>835</sup>. The scope of the duty to inform is however limited by the concept of "constructive knowledge". As the ICJ recognized in the *Norwegian Fisheries case*,

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<sup>831</sup> See below, part 8.

<sup>832</sup> OECD Report "Tax Sparing A Reconsideration", p. 28-29.; See also OECD Report on Corporate Tax Incentives for Foreign Direct Investment; Ashiabor, H., "Tax sparing: a timeworn mechanism in Australia's bilateral treaties with its trading partners in Southeast Asia?", *I.T.J.*, spring 1998, p. 95-97.

<sup>833</sup> See above.

<sup>834</sup> *Rainbow Warrior case*, *RGDIP*, 1990 p. 843 par. 63 and p. 861 par. 94.; In the pleadings on behalf of the US in the *US Nationals in Morocco case*, the duty to inform was explicitly recognized by the US: *ICJ Reports*, 1952, vol. II, p. 316: ("Good faith on the part of the US required the US to inform the French Government that it might be necessary for it to withdraw its assent to action which it considered in contradiction of its treaty position"); A similar same duty to inform exists during the period the tax treaty is in force.

<sup>835</sup> Art. 48 VCLT (which, among other conditions, requires –for error to invalidate the consent given by the state- that the mistaken fact or situation formed an essential basis of its consent); *Yrbk, ILC*, 1966, II, 243-4.

negligent ignorance may be assimilated with knowledge<sup>836</sup>. It may indeed reasonably be expected from a tax treaty negotiation team of a contracting state to inform itself adequately of the other state's national tax laws<sup>837</sup>, but it is always recommended to point out certain particularities or less known facts to the treaty partner<sup>838</sup>.

## 8. Double Non-Taxation and Tax Exemptions

Is it contrary to the object and purpose of double taxation conventions for a state not to tax income at all? In other words, is it contrary to good faith-observance for a contracting states to introduce laws, regulations or other measures that result in double non-taxation? The following points, which I already made elsewhere<sup>839</sup>, can in this respect be recalled:

### **No restriction in DTA to enact new tax law.**

There is no expressly stipulated or implied international obligation on states to refrain themselves from introducing new tax laws, even tax laws that would create substantial tax privileges. States may definitely issue new laws. Art. 2 par. 4 implicitly admits that states are not limited to do so. As long as they keep exempting or crediting the income they undertook to exempt or credit, as long as they keep giving the promised information, as long as they do not discriminate nationals of the other state, the obligations found in the treaty have not been breached.

### **A DTA does not, as a rule, exclude double relief.**

In double taxation agreements, states undertake the obligation to exempt or to reduce taxation on certain income. It may well be aware that meanwhile, the income concerned is not or not fully taxed by the other state either. This double relief is not uncommon<sup>840</sup>. The OECD Commentary notes that (with regard to the exemption system) the state has to grant exemption whether or

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<sup>836</sup> *ICJ Reports*, 1951, p. 138.

<sup>837</sup> Bartlett, R.T., "The Making of double taxation conventions, *BTR*, p. 78.

<sup>838</sup> Bartlett, *ibid*, ft.837, p. 82 who states that treaty partners are made aware by the UK during the negotiation that only information which is collected for the purposes of UK tax is available for exchange.

<sup>839</sup> Van Der Bruggen, E., "State responsibility under customary international law in matters of taxation and tax competition", *Intertax*, 2001, p.124-126.; Please note that this discussion is based on the OECD Model. Particular provisions in certain non-OECD Model tax treaties may result in other conclusions.

<sup>840</sup> Vogel, K., *Double Taxation Conventions*, 3 rd ed, Kluwer, 1997, Preface to 6-22, par.7, p. 361.

not the right to tax is in effect exercised by the other state. This, according to the OECD, is practical since it relieves the state of residence from undertaking investigations in the other state<sup>841</sup>. In other words, states using the exemption method do so regardless of actual taxation in the other state. If the other state would enact a tax haven regime, and thus exempt certain income that was previously taxed, this cannot be deemed a breach of an international obligation. Even when the state chose for the credit method, double relief is not excluded. As a matter of fact, the credit method would protect the state from much of the possible revenue distribution loss that might be the consequence of the other state enacting a tax haven regime. After all, the state is only obliged to credit tax paid. The tax incentive being adopted in the other state would actually have a neutral effect, thus undermining the claims of the “injured” state with regard to state responsibility. Further support for this may be found in tax sparing provisions in treaties that are (with the notable exception of the US) frequently adopted by states<sup>842</sup>. Finally, in practice, states (including those using the credit method) do accept that certain income may be tax-free in the other state. The US agreed for example to a reduction in withholding taxes on dividend, fully aware that The Netherlands will often exempt dividends from taxation<sup>843</sup>.

**State expectations with regard to the other states’ tax law do not constitute an international obligation.**

According to Kingson, “when a source country agrees by treaty to give up taxing an item of income, it generally does so because it expects the residence country to tax it. If the residence country does not, the treaty becomes a convention for the avoidance of any taxation”<sup>844</sup>. Van Weeghel agrees that “a general assumption underlying all treaties inspired by the OECD Model Conventions is that an item of income will be taxed at least once in one of the contracting states”<sup>845</sup>. These expectations by the state are however merely general considerations or policy preferences. Based on the analysis offered below and above, they cannot be deemed enforceable international obligations on the state, unless written

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<sup>841</sup> OECD Commentary, art. 23 , par. 34.

<sup>842</sup> Viherkentta, T., *Tax Incentives in Developing Countries and International Taxation*, Kluwer, Deventer, 1991, p. 123.

<sup>843</sup> Van Weeghel, S., *The Improper Use of Tax Treaties*, Kluwer, Deventer, 1998, p. 106.

<sup>844</sup> Kingson, C.I., *The Coherence of International Taxation*”, *C.L.R.*, 1981, 1152.

<sup>845</sup> Van Weeghel, S., *ibid*, ft. 843, p. 105.

explicitly into the DTA, a breach of which may entail state responsibility.

**Treaty partners prevent double relief by explicit treaty provisions.**

States examine the tax system of their prospective tax treaty partners. Sometimes, though certainly not always, they include measures in the DTA to prevent double relief. Such may be the case for states using a strict territorial concept of taxation<sup>846</sup>, or for states that only tax certain income if and when it is remitted to the territory of the state. In Thailand's personal income tax, for instance, all income<sup>847</sup> from abroad is only taxable upon remittance to Thailand<sup>848</sup>. This has caused certain states to reduce their treaty benefits insofar as the income is not actually remitted. Under the Thai-US treaty, the US is allowed to apply the reductions in source taxation to the extent certain income (it only applies to profits, international transport, passive income and other income) is not remitted by the person by the end of the calendar year following the year in which the income was earned<sup>849</sup>. Subject-to-tax clauses may be introduced in the treaty in order to make exemption (or other tax treaty benefits) dependent on having paid tax in the other state<sup>850</sup>. Finally, reversion of taxing rights is possible under some tax treaties if the income is not taxed by the other state<sup>851</sup>. It is clear that double taxation agreements explicitly stipulate a derogation from the principle that double relief may occur, is so desired by the states. Thus, when such explicit provision does not exist, it must be assumed that double relief is tolerated.

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<sup>846</sup> Vogel, K., *Double Taxation Conventions*, 3d ed., Kluwer, 1997, p. 361.

<sup>847</sup> All normally taxable income for natural persons as referred in Sec 40 Revenue Code.: Which is hire of service (1), post or office (2), goodwill, copyright or any other right (3), interest, dividend, other income and gains on securities (4), letting out property (5), liberal professions (6), hire of work (7), income from business, commerce, agriculture, industry not previously specified (8).

<sup>848</sup> Sec. 41 par 2 Revenue Code.

<sup>849</sup> Cfr. Art. 6(5) US-Israel; Art. 4(5) US-Jamaica; Art. 4(5) US-UK.; Dichter, A.J., "The U.S. Thailand Tax Treaty Explained", *Tax Notes International*, 97, p. 484.; The DTCs with Malaysia, Singapore, Australia and The Netherlands contain a similar provision but it applies to all income mentioned in the DTC and there is no mention of a time before which remittance should take place.

<sup>850</sup> OECD Commentary, art. 1, par. 17.

<sup>851</sup> Art. 26 (2), Nordic Multilateral DTA.

## Creating tax incentives is not ‘unreasonable’

Creating tax incentives to compete for investment is hardly unheard of. As a matter of fact, virtually all states in the world do have some kind of tax incentive policy<sup>852</sup>. Suggesting that tax incentives for industrial or manufacturing activities are to be considered lawful but that incentives focusing on highly mobile activities such as finance, headquarters, group services, etc., is not reasonable<sup>853</sup>. That these business activities are so mobile is hardly the fault of any particular state. It would be unreasonable of a developed state to demand that an undeveloped state or one with more difficulties in attracting foreign direct investment, which has little possibility to compete for investment in areas such as technology and industry because of lack of infrastructure, qualified staff, etc., to refrain itself from competing in other areas where the undeveloped state may be more successful, such as finance and group services. Or, as one author puts it not without compassion: “If you take away favorable tax rules, in some cases all you are left with is a nice beach...”<sup>854</sup>. After all, for this category, fiscal policy is relatively more important than for others, which is a consequence of market conditions and business organization, and not of the states’ own tax regime.

It may be so, but this matter certainly merits further study, that the adopting of a new tax haven regime constitutes a fundamental change in circumstances in the sense of art. 62 VCLT, and as such would justify a unilateral termination of the treaty<sup>855</sup>, a question that Luthi seems to

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<sup>852</sup> The fact that most states do indeed have some kind of tax privileges, has a bearing on the principle of reciprocity in international public law, also translated in double taxation agreements. The Belgian government can hardly complain about the Dutch tax privileges relating to financial services, for instance, as Belgian tax law provides a privileged tax regime for coordination centers.

<sup>853</sup> Prof. Vanistendael also questions (with regard to fiscal support measures) this double standard between mobile, finance activities on the one hand and other business sectors: Vanistendael F., *ibid.*, p. 152-161.; OECD Report on Harmful Tax Competition and the OECD Report “Towards Global Cooperation” mainly address tax competition in financial and other services.

<sup>854</sup> Hardesty, D., “Attack on the Havens”, TPI e-commerce, October 2000, p. 16.

<sup>855</sup> If the adoption by the state of the tax haven regime was, among other conditions, not foreseeable and can be deemed to “radically transform the extent of obligations still to be performed by the treaty”. This last condition can be circumvented by the state which adopts the new regime by providing that companies benefiting of the new law do not have tax treaty entitlement.

answer in the negative<sup>856</sup>. It is certainly true that changes in the tax laws of the treaty partners may warrant an amendment of the double taxation agreement between them<sup>857</sup>. Art. 62 VCLT clearly has associations with the principle of good faith, but is now codified and requires no extended discussion in relation to good faith itself<sup>858</sup>.

## 9. Application of Domestic Anti-Avoidance Measures to Tax Treaty Relations

Another rather controversial topic were the principle of good faith may have an impact is the relationship between tax treaty provisions and domestic anti-avoidance measures. The fact that the principle of good faith may play a role in this discussion, is illustrated by a Swiss court decision on this subject which briefly mentions the principle of good faith<sup>859</sup>.

The view of the OECD's Committee on Fiscal Affairs on applying domestic anti-avoidance measures on the treaty level has not always been consistent. Sometimes the Committee appears fairly opposed<sup>860</sup>,

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<sup>856</sup> Luthi, D., in IFA proceedings on 1989 Seminar Tax Treaties and Domestic Legislation, Kluwer, 1991, p. 9.

<sup>857</sup> See for example the exchange of notes dated 13 March 1967 concerning the US-Brazilian double taxation agreement (which, incidentally, never entered into force), where Acting Secretary Barr (US) stated : "I want therefore to take this means to assure you [the Brazilian Minister of Finance] that if such changes occur the United States will be prepared to enter into joint discussions with Brazil promptly with a view to making such modifications as may be needed or appropriate to suit the tax treaty to the new circumstances. For example, within the first three years of the treaty's applications, if the United States corporate income tax rate were to be increased to the extent that the benefit of the rate reductions offered by Brazil under the treaty would no longer accrue to United States investors, we would be agreeable to promptly consulting with Brazil about commensurate modification of those rate reductions. Conversely, should the Brazilian tax rates be increased substantially we would expect Brazil to be prepared to consider commensurate modifications in its treaty rates".

<sup>858</sup> O'Connor, *ibid.*, ft. 626, p. 108.

<sup>859</sup> Swiss BG, 57 ASA 667, 672 (quoted by Vogel, *ibid.*, ft. 846, p. 125).

<sup>860</sup> OECD Report on the Use of Conduit Companies, par. 43.; OECD Report on the Use of Base Companies, par. 40.; OECD Report on Treaty Override, par. 13, 31 and 32 ("The effect of such legislation is in contravention of [...] tax treaty obligations, even though the overriding measure is clearly designed to put an end to improper use of its tax treaties. There may be cases where a state could successfully argue that there is such an improper use and deny the treaty benefits, *but this must be done under existing rules*" -emphasis added ).

sometimes rather permissive<sup>861</sup>, or even without any opinion at all<sup>862</sup>. Recently, however, in the context of the OECD's initiative to combat harmful tax competition, the Committee noted that its "recommendation will help ensure that domestic anti-abuse and judicial doctrines are compatible with tax treaties."<sup>863</sup>

### 9.1 Difference between good faith in international public law and domestic anti-abuse provisions

Ward draws comparisons between good faith (and other general principles of international law) and domestic tax avoidance by taxpayers:

"In light of the fact that the International Court of Justice has already given recognition to the principle of abuse of rights in interpreting treaties generally, that article 26 of the Vienna Convention requires a treaty to be performed in good faith [ ... ] From this, one may argue that a general anti-abuse doctrine should be recognized by tax administrations and courts generally in interpreting tax treaties"<sup>864</sup>

Without addressing Ward's other arguments for applying anti-abuse measures on the treaty level<sup>865</sup>, I share Van Weeghel's view<sup>866</sup> that the principle of good faith (and the notion of abuse of rights, which is based upon the principle of good faith) in the international law of treaties may not be confused with nor seen as legal grounds for countering abusive behavior by a taxpayer in a tax treaty situation<sup>867</sup>. It may namely not be

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<sup>861</sup> OECD Commentary as amended in 1992, par. 24.

<sup>862</sup> OECD Report on the Use of Base Companies, par. 41.

<sup>863</sup> OECD Report on Harmful Tax Competition, par. 121-125.

<sup>864</sup> Ward, D., "Abuse of tax treaties", in Alpert H. and Van Raad K (eds), *Essays on International Taxation To Sidney I. Roberts*, p. 403.

<sup>865</sup> He –as well as Prof. Vogel p. 125- also associates domestic anti-abuse statutes and doctrines that numerous states have, with the "general legal principles recognized by civilized nations" (art. 38 Statute of the International Court of Justice), an argument that is not further discussed here.

<sup>866</sup> Van Weeghel, S., *ibid.*, ft. 843, p. 99.; See, concurring., Lowe, V., *Proceedings of the 1994 IFA Seminar Vol. 19c "How domestic anti-avoidance rules affect double taxation conventions"*, p. 7.

<sup>867</sup> Note however that the proclamation formula of double taxation conventions in the US associates good faith observance with both the US itself *and its subjects*, but this formal passage does in itself not change the heart of the matter. The formula reads as follows: "Now, therefore, be it known that I, [ ], President of the United States of America, do hereby proclaim and make public the aforesaid convention to the end that the said convention and each and every article and clause thereof may be observed and fulfilled with good faith *by the United States of America and by the citizens of the*

forgotten that good faith in the law of treaties and domestic anti-abuse doctrines or statutes emerge from two fundamentally different contexts, although they may have a certain moral background and history<sup>868</sup> in common. Good faith in the law of treaties finds its origin in the agreement between two equal subjects of international law, an agreement that came about by negotiation and mutual compromise. Domestic anti-avoidance statutes and doctrines are acts of the sovereign state, which imposes them on its subjects. Treaties are of a contractual nature, unlike domestic public law. Other principles that are important for the law of treaties, such as ‘reciprocity’, ‘estoppel’ and ‘acquiescence’ are also not appropriate to be transferred to the legal relation between state and taxpayer. Therefore, the international case law that has developed and applied the principle of good faith in the law of treaties may not be invoked in the municipal relationship between state and taxpayer<sup>869</sup>.

## 9.2. Implications of the principle of good faith on the debate

A question central to this debate is whether provisions of internal law that were created to curb tax avoidance, are restricted in any way by tax treaties<sup>870</sup>. In my opinion, the principle of good faith has several implications for this discussion<sup>871</sup>.

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*United States of America and all other persons subject to the jurisdiction thereof* (my emphasis).”

<sup>868</sup> Rosenne has argued that the recent development of good faith in the different municipal civil law systems has not contributed significantly to the concept of good faith in international public law in: *Developments in the Law of Treaties 1945-1986*, Cambridge University Press, p. 165.

<sup>869</sup> Even when a tax treaty itself uses the term ‘good faith’ with respect to taxpayer behavior, this should not be seen as a reference to the principle of good faith in the international law of treaties. See for example art. 10(8) of the Italian-French double taxation agreement of 5 October 1989, art. 12(7) of the Australian-Irish double taxation agreement of 31 May 1983, art. 12(2) of the French-Indian double taxation agreement of 29 September 1992.

<sup>870</sup> It may be noted that municipal courts have often applied general or specific anti-avoidance rules in a treaty situation, such as in France (Conseil d’Etat, March 18<sup>th</sup>, 1994, R.J.F., 5/1994, 317.; Conseil d’Etat., March 3<sup>rd</sup>, 1989, No. 77.581), The Netherlands (H.R., January 8<sup>th</sup>, 1986, *B.N.B.*, 1986/127.; H.R., September 15<sup>th</sup>, 1993, *Vakstudienieuws*, January 6<sup>th</sup>, 1994.; Daniels, T., “Inbound Investment in The Netherlands: Supreme Court rules on abuse of law”, *Intertax*, 1989, 422), the United States (Aiken Industries vs. CIR, 56 Tax Court 925) and in Germany (B.F.H., October 29<sup>th</sup>, 1981, B.S.B., 1982, II, 150.; B.F.H., November 10<sup>th</sup>, 1983, B.S.B., 1984, II, 650.; B.F.H., March 5<sup>th</sup>, 1986, B.S.B., 1986, II, 496); There were however also court decisions to the contrary such as Hoge Raad, B.N.B., 1994, 259.; B.N.B., 1995, 150.; Hofland, D. and Van Raad, K., *Tax Notes International*, 1995, 2121); On this issue see also Van Der Bruggen, E., “May domestic anti-avoidance measures be applied in a treaty-situation?” (in Dutch), *Fiskofoon*, 1994, p. 262-282.; Vogel, K., *ibid*, ft.846, p.

In any event, good faith requires that ‘the curbing of tax avoidance’ is not used by a contracting state as a pretext to escape its international obligations. Internal re-characterization of income under the pretext of combating international tax avoidance, but that is actually meant to shift the balance of taxing power more to the advantage of that state, is clearly contrary to good faith<sup>872</sup>.

Furthermore, it would be contrary to the principle of good faith if internal anti-avoidance measures were allowed to interfere with the common intent of the treaty as a whole, or if you will, *every* object or purpose of the treaty<sup>873</sup> as primarily apparent from the text of the treaty. Domestic anti-avoidance rules have namely sometimes been said to be in line with one of the objectives of tax treaties, namely the prevention of tax avoidance and evasion and that therefore such a treaty should not be seen as an impediment to the application of internal anti-avoidance rules<sup>874</sup>. Furthermore, it may be recalled that contracting states do not have the freedom to select which part or purpose of the treaty they wish to observe, and to disregard the rest of the treaty<sup>875</sup>. That would indeed be contrary to good faith, which requires observance of the *whole* mutual agreement. As a consequence, state conduct that is in line with one objective of the treaty, but at odds with another, is still a failure to comply with the treaty as a whole. In tax matters, therefore, it may be noted in my opinion that if the domestic anti-avoidance measure of a state –which is supposedly in line with the treaty objective insofar it curbs international tax avoidance and evasion- results in a failure to comply with the treaty rules on allocation of income, elimination methods of double taxation, or non-discrimination, that state is not observing the treaty in good faith.

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54-56.; Wurm, F., “Treaty Shopping in the 1992 OECD Model Convention”, *Intertax*, 1992, p. 669.; Ijzerman, R., *The Doctrine of Abuse of Law in Taxation*, Kluwer, 1990, 141.

<sup>871</sup> See also above, footnote about Gustafson.

<sup>872</sup> See, in general, Servaas van Thiel, *EU Case Law on Income Tax, Part I, IBFD*, 2001.

<sup>873</sup> Namely (1) the avoidance of double taxation by means of allocation rules and rules on methods to eliminate double taxation, (2) the prevention of tax avoidance and evasion by exchanging information between the contracting states and (3) the curbing of discrimination in matters of taxation.

<sup>874</sup> Gouthierre, B., *Les Impôts dans les Affaires Internationales*, Ed. Francis Lefebvre, 1989, p. 619.; Davies, D.R., *Principles of International Taxation Relief*, London, Sweet & Maxwell, 1985, p. 54.; Krabbe, H., “Measures against Intragroup Financing and DTAs “(in German), *R.I.W.*, 1984, p. 127. See also the OECD Commentary, article 1, par. 7: “The purpose of DTAs is to promote, by elimination of international double taxation, exchanges of goods and services, and the movement of capital and persons: they should not, however, help tax avoidance or evasion.”

<sup>875</sup> Art. 44 VCLT.

On the other hand, the point has been raised that “the rule *pacta sunt servanda*, mentioned in art. 26 of the VCLT, does not require a literal interpretation of the treaty”, where the author was implying that domestic anti-avoidance measures may not always be rendered inoperative by a too literal interpretation of the text of a double taxation convention<sup>876</sup>. This argument in fact says that the contracting states did not really intend to oppose the application of their domestic anti-avoidance measures in treaty situations, and that it is the common intent of the contracting states not to have their respective anti-avoidance measures curtailed by the double taxation convention<sup>877</sup>. It is however a well-established rule of the international law of treaties that the common intent of the contracting states must first and foremost be shown on the basis of the text of the treaty<sup>878</sup>. The intent of the contracting states may, under the rules on treaty interpretation of customary international law and the VCLT, not be used as an independent, alternative means of interpretation besides the text of the treaty itself<sup>879</sup>. In other words, provided the treaty contains no specific rule on the subject<sup>880</sup>, the application of a domestic anti-abuse measure that leads to the negation of a clear tax treaty provision on the allocation of income, on the elimination of double taxation, or on non-discrimination, is not in accordance with the duty to observe the treaty in good faith, irrespective of the suggestion that the other contracting state may not be opposed to applying the treaty in this manner. However, clear evidence<sup>881</sup> that the contracting states did not intend to restrict their

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<sup>876</sup> Lowe, V., Proceedings of the 1994 IFA Seminar Vol. 19c “How domestic anti-avoidance rules affect double taxation conventions”, p. 7 and 23.

<sup>877</sup> Krabbe, H., “Measures against Intragroup Financing and DTAs “(in German), *R.I.W.*, 1984, p. 127.

<sup>878</sup> Art. 31 VCLT.

<sup>879</sup> Siclair, I., *ibid.*, ft. 701, p. 72-76.

<sup>880</sup> See for example the Protocol to the double taxation agreement between Canada and Chili of 21 January 1998 (point 3): “Considering that the main aim of the Convention is to avoid international double taxation, the Contracting States agree that, in the event the provisions of the Convention are used in such a manner as to provide benefits not contemplated or not intended, the competent authorities of the Contracting States shall, under the mutual agreement procedure of Article 25, recommend specific amendments to be made to the Convention. The Contracting States further agree that any such recommendation will be considered and discussed in an expeditious manner with a view to amending the Convention, where necessary”.

<sup>881</sup> From the perspective of international law, few sources would be worthy of being taken into account in this respect, namely preparatory work, interpretative protocols that are not a part of the treaty itself, and subsequent agreements (for example in the course of an interpretative mutual agreement procedure). The value of ‘subsequent practice of the parties’ is in my view problematic for this debate, but will not further be discussed.

domestic anti-avoidance measures by the text of the treaty in these particular circumstances may not in good faith be disregarded, as long as such would not be contrary to the text of the treaty itself.

Of crucial importance is therefore whether the text of the agreement would contradict the application of domestic anti-avoidance measures. In practice, however, not all the rules of double taxation conventions are completely autonomous, but often refer to domestic law and are thus not in a position to contradict it. As was discussed above with respect to tax treaty interpretation, there are many instances where the text of the treaty will not explicitly contradict a domestic re-characterization because the treaty text itself refers to the domestic law of the state that applies the convention (art. 3(2), dividends, etc.) or simply because the treaty is silent on the matter (for example concerning the deductibility of expenses). Even so, the all-overriding principle of good faith will temper the states' discretion to interpret at will, and to invoke its domestic anti-avoidance rules<sup>882</sup>. The principle of good faith requires the state to be reasonable, fair and honest considering the circumstances<sup>883</sup>. In my view, this *inter alia* entails that it may not go without saying to apply domestic anti-abuse provisions to treaty situations that deviate considerably from the normal practice in the international community of nations on this subject. At the very least, the other contracting state should be notified and consulted in that case particularly when conventional procedures of the treaty make such consultation possible. Also, when domestic anti-avoidance measures are indeed directed against international tax avoidance, it may be contrary to good faith for a state to use measures with an unreasonable wide scope, targeting both abusive and legitimate taxpayer behavior while offering the taxpayer little remedy. There must indeed be a reasonable relationship between the measure applied and the abuse targeted. Finally, it can be said that a contracting state, when applying domestic anti-avoidance measures to a tax treaty relationship, would be acting in accordance with good faith if it first makes every effort to verify if by doing so, it does not risk creating a situation of double taxation. If double taxation would arise as a consequence, it may in my opinion not be in accordance with the principle of good faith for a state to apply its domestic anti-avoidance measures regardless, and to simply ignore the consequences for the other state and its taxpayers.

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<sup>882</sup> See above, part 2.

<sup>883</sup> Ibid.

## 10. Practical Aspects Concerning the Application of Tax Treaties

Double taxation conventions contain little or no rules regarding the practical implementation of tax treaty provisions. Yet, it can be said that to a certain extent, the context and the manner in which a treaty is intended to be implemented and likely to be implemented, also belongs to the agreement of the contracting states<sup>884</sup>. Ensuring that taxpayers can in practice receive the benefits of the treaty usually requires additional domestic administrative procedures, such as the issuance of certificates of residence or of tax paid<sup>885</sup>.

In international law, it has been held that contracting states must ensure that treaty obligations can be carried out effectively<sup>886</sup>. The World Court has had little patience with states that rendered rights, in theory existing under a treaty, in fact inoperative because of its practical application or execution by that state<sup>887</sup>. There is a general duty to bring domestic law into conformity with obligations under international law<sup>888</sup>. In view of that requirement, which is associated with good faith, it is noted that the tax treaty obligation not to subject a certain income to taxation, for example, is an obligation of result, not of conduct. Administrative requirements of a contracting state facilitating or restricting that result may, from the perspective of good faith, not be unreasonable. What is “reasonable” in this respect must in my view be determined in accordance with the prevailing practice of the international community of nations in these matters<sup>889</sup>. Administrative requirements that are far beyond what most contracting states are satisfied with in similar conditions, may thus be subject to scrutiny on the basis of good faith.

It may be contrary to good faith, for example, that the amount and nature of documentation required to substantiate a tax claim on the basis of a DTC is set so that the invoking the benefits normally available under the

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<sup>884</sup> Higgins, R., *Problems and Process – International Law and How We Use It*, 1994, p. 18-22.; Qureshi, A., *The World Trade Organization*, Manchester University Press, 1996, p. 49.

<sup>885</sup> Williams, D.W., “General Report – Practical Issues in the application of double taxation conventions”, *Cahiers Dr. Fisc. Int.*, 1998, p. 40-57.

<sup>886</sup> *Exchange of Greek and Turkish Populations*, PCIJ, 1925 Serie B, no. 10, p. 20.; Zemanek, in Neuhold/Hummer/Schreuer/, p. 65.

<sup>887</sup> *Minority Schools in Albania case*, PCIJ, 1935, Ser. A/B, no. 64, p. 18; *Polish Nationals in Danzig case*, PCIJ, 1932, Ser. A/B, no. 44 p. 28.

<sup>888</sup> Fitzmaurice, *Hague Recueil*, 1957, II, 89; Brownlie, I., *ibid.*, ft. 641, p. 35.

<sup>889</sup> See above, part 2.

treaty is no longer worth it to taxpayers<sup>890</sup>. In addition, the policy of a contracting state with respect to issuing treaty-related certificates needed to obtain tax treaty benefits in the other state, must be in accordance with good faith. Refusing to do so on grounds that are not related to the treaty itself (for example to pressure the taxpayer to pay a disputed tax debt)<sup>891</sup>, is in my view unreasonable and therefore contrary to the requirement of good faith.

### **11. Can a Taxpayer Invoke the Principle of Good Faith of International Public Law?**

We now turn to the question whether besides being operative on the international plane –between states- the principle of good faith can also be called upon to determine the normative content of a taxpayer’s rights under double taxation conventions. For this discussion, it is assumed that a right has indeed been created for the taxpayer by the treaty. The question is how if the taxpayer has access to that part of the normative content of a double taxation agreement which is derived from good faith?

The starting point of the answer to that question is the assertion that good faith plays a crucial part in determining the depth of the state’s obligations towards each other on the international plane, such as with respect to exchange of information, the mutual agreement procedure and state conduct while negotiating tax treaties. Some of those provisions, obviously also affect the taxpayer’s position, be it indirectly.

Of direct importance to the taxpayer, however, is the impact the principle of good faith has on the interpretation and application of the treaty in his domestic legal order, before his domestic courts. In order to become operative in the municipal legal order, tax treaties usually must be incorporated in that legal order in some way or another, which is a matter left to the contracting states. As was seen above, the provisions of those incorporated tax treaties are to be interpreted and performed in good faith, indicating the depth of the international obligation upon the state. It is that ‘interpretation in good faith’ which determines to which extent domestic law must be limited, not just the strict treaty text. Trying to isolate the agreement between the contracting states from ‘good faith’ is,

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<sup>890</sup>Williams, D.W., “General Report – Practical Issues in the application of double taxation conventions”, *Cahiers Dr. Fisc. Int.*, 1998, p. 56.

<sup>891</sup> Williams, D.W, *ibid*, ft. 890, p. 48-49.

both impossible and useless<sup>892</sup>. For almost every treaty, including a tax treaty, can be rendered ineffective or even inoperative by a contracting state determined to escape its treaty obligations without infringing the literal text of the agreement. The dual character of a tax treaty (between states and between state and taxpayers) and its incorporation into the domestic legal order, does not mean that between state and taxpayer, the good faith-interpretation of treaty rules is no longer taken into account. When a treaty is incorporated into domestic law, the international nature of the provisions of the treaty is not lost, as the PCIJ explicitly decided in its Advisory Opinion on the *Exchange of Greek and Turkish Populations*<sup>893</sup>. If according to municipal law, the national court indeed has the authority to limit the application of national tax laws insofar they conflict with the provisions of a tax treaty, which is usually but not always the case<sup>894</sup>, the true depth and scope of those treaty provisions will only become apparent if they are applied and interpreted in accordance with the principle of good faith. A domestic court, therefore, may not ignore the implications of the principle of good faith in international public law while applying the provisions of a double taxation convention, and this has immediate consequences for the taxpayer who invokes the convention. Ignoring that would come down to ignoring an important part of the treaty, namely the part that says something on the depth or the scope of the treaty obligations. A strictly literal approach to the

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<sup>892</sup> International Law Commission, (5) of the Commentary on art. 31 of the VCLT; McNair, A.D., *The Law of Treaties*, Oxford, 1961, p. 465.

<sup>893</sup> Series A/B 49, 1925, p. 300 (“Lithuania drew attention to the fact that in form it was a Lithuanian enactment, and that it had in fact been enacted as a Lithuanian law. She therefore submitted that it should be regarded and interpreted as such. [...] For the purpose of the present proceedings, the Court feels no doubt that, according to the very terms of Art. 16 of the Convention, the Statute of Memel must be regarded as a conventional arrangement binding upon Lithuania and that it must be interpreted as such”); See also: Jacobs, F. and Roberts, S., (eds) *The Effect of Treaties in Domestic Law*, 1987, p. 37.; Plender, R., and Wilderspin, M., *The European Contracts Convention*, 2<sup>nd</sup> ed., Sweet & Maxwell, London, 2001, 2-01.; Schwarzenberger, G., *International Law*, Vol. 1, 3<sup>rd</sup> ed., 1957, p. 71.; It may further be mentioned that the “general principles of law recognized by civilised nations” (art. 38 par. 1c Statute of the ICJ) have also been applied by municipal courts (even before the Statute) without alleging that these principles should previously have been transferred into their municipal law, as observed by Erades, L., *Interactions between international and municipal law*, T.M.C. Asser Instituut, 1993, p. 949 (with references to that case law).

<sup>894</sup> On this issue Becker and Wurm, “Double taxation agreements and the conflict between international agreements and subsequent domestic laws”, *Intertax*, 1988, 259; Baker, PH., *Double Taxation Conventions*, *ibid.*, ft.631, p. 46-54 (reference to good faith on page 51).; Mann, F. A., “Treaties before Municipal Courts”, in *Notes and Comments on Cases in International Law, Commercial Law and Arbitration*, 1992, 131.

observance of treaties in the domestic legal order may lead to undesirable results<sup>895</sup>, and may even render the treaty without any real meaning, purpose or effect. From the standpoint of international law, such a “literal” application of the treaty (for example by a domestic court), stripped of the implications of the principle of good faith, constitutes a breach of the treaty that entails international responsibility. Such would clearly be the case if the domestic court would allow a contracting state to apply domestic tax law definitions that were introduced after the conclusion of the treaty in view of shifting the balance of taxing power in its own favor<sup>896</sup>. Such would also be the case, in my view, when a domestic court allows a contracting state to interpret tax treaty provisions along the lines of its own legislation with blatant disregard for the common intent, or if you will, the object and purpose of the double taxation convention, even where the treaty itself refers to domestic law.

From the standpoint of municipal law, however, the matter may be more complicated than a rigorous priority of the international norms. On this level, the implications of the principle of good faith cited above evoke a question of the relationship between international treaties and domestic law in the municipal legal order<sup>897</sup>. For several states, including the US<sup>898</sup> and the UK<sup>899</sup>, the fact that international law is part of the “law of the land” does not mean that international law will have priority over domestic statutes, although usually only domestic law that is clearly contrary to treaty rules will be upheld. Lacking that authority, the courts of those countries will have in the case of a clear conflict no choice but to

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<sup>895</sup> Jacobs, F. and Roberts, S., (eds) *The Effect of Treaties in Domestic Law*, Sweet & Maxwell, 1987, p. 106.

<sup>896</sup> A practical illustration may be the situation where a developing country uses a broad definition of royalties to maximize (withholding) tax revenue on payments for technology that would ordinarily be characterized as business profits for the purpose of the double taxation conventions: Sprague, G.D., Whatley, *E.T.*, Weisman, R.L., “An Analysis of the Proper Tax Treatment of International Payments for Computer Software Products”, *Asia-Pacific Tax Bulletin*, 1995, p. 158 (“tax authorities of some nations in the Asia-Pacific region view (every) such payments as royalties subject to withholding tax”); Other examples are quoted in the OECD Report on tax Treaty Override, Paris, 1989, included in the OECD Model Tax Convention 2000 as R(8), the examples being cited on par. 27-33.

<sup>897</sup> Edwardes-Kerr, M., Chapter 44.; Conforti, B., *International Law and the Role of Domestic Legal Systems*, Martinus Nijhoff, 1993, p. 81-89.; Jacobs, F. and Roberts, S., (eds) *The Effect of Treaties in Domestic Law*, Sweet & Maxwell, 1987, p. 37.

<sup>898</sup> Federal Income Tax Project, *International Aspects of US Income Taxation II, Proposals on US Income Tax Treaties*, *A.L.I.*, 1992, p. 63-73.

<sup>899</sup> *Inland Revenue Commissioners vs. Collco Dealings Ltd*, 1962, AC 1

break international law and thus possibly engage its nation's international responsibility, needless to say a highly unsatisfactory status of affairs<sup>900</sup>.

In a way, therefore, the issue of taxpayers invoking good faith in the law of treaties before a domestic court is not different from the legal value of those treaties themselves before the national judge, the two being intertwined. Consequently, in my view, the taxpayer will indeed be able to appeal to the principle of good faith in the municipal courts, but international obligations on the state derived from the principle of good faith will have much the same legal status in a particular municipal law as the provisions of the treaty itself. There may therefore be practical differences in this respect, depending on the country concerned and the international obligation invoked.

Of course, the principle of good faith can only be invoked by the taxpayer (at least under international law) insofar this principle must be applied to determine the normative content of the provisions of the treaty that create rights for that taxpayer. Put another way, when the principle of good faith is operative in determining the normative content of an obligation on the state *alone*, it goes without saying that the taxpayer is not concerned by the article nor the implications the principle of good faith might have for that provision.

## **12. Conclusions: The Significance of the Principle of 'Good Faith' for Double Taxation Conventions**

Good faith is a fundamental but not easily defined principle<sup>901</sup>, and it is often difficult to delineate it from notions such as *pacta sunt servanda*, reciprocity and treaty interpretation rules (most of which are, it must be said, actually based upon the principle of good faith). The principle is associated with moral values of reasonableness, fairness and honesty, which by their very nature escape a clear definition. It is therefore tempting to dismiss the practical importance that good faith might have in matters so worldly as double taxation conventions. Some might think that reasonableness, fairness and honesty are too "vague" to be used in tax matters. It is indeed true that, given the function of good faith, namely

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<sup>900</sup> Van Der Bruggen, E., "State responsibility under customary international law in matters of taxation and tax competition", *Intertax*, 2001, p. 134.

<sup>901</sup> Critchfield, R., Honson N., and Mendelowitz, M., "Passthrough Entities, Income Tax Treaties, and Treaty Overrides", *Tax Notes International*, February 8 1999, p. 587 (on good faith and treaty overrides, stating among other things that the definition of good faith is not clear).

being a yardstick applicable to existing international obligations rather than a source of those obligations itself, this principle is by its very nature to be applied on a case-by-case basis, taking into account all relevant circumstances. There are therefore, by definition, few clearly established rules on this subject<sup>902</sup>, and those who expected them in this article may have been disappointed.

Nevertheless, dismissing the significance of good faith in matters of double taxation conventions would be a mistake. Its operation goes far beyond the mere sanctioning of the classic notion of direct tax treaty-override. The principle of good faith is essential to every treaty if that treaty is to have any real meaning at all<sup>903</sup>, but applying the yardstick of good faith to tax treaties is in my opinion particularly important for the interpretation and application of double taxation conventions<sup>904</sup> and for the development of international tax law as a whole. For this opinion, I have the following reasons.

Double taxation conventions primarily aim to facilitate international trade and investment by establishing international obligations on the states with respect to income allocation and the elimination or tempering of double taxation. According to the text of the conventions, however, each contracting state has much discretion as to the depth and scope of its own international obligations, so much so that it is not unconceivable that the object and purpose of the treaty could in fact be frustrated to a large extent while still respecting the literal text of the agreement.

These circumstances clearly hinder the realization of the object and purpose of double taxation conventions, as has repeatedly been pointed

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<sup>902</sup> As Virally noted, while still acknowledging the fundamental importance of the principle: Virally, M., “Review essay: good faith in international public law”, *AJIL*, 1983, p. 132.

<sup>903</sup> International Law Commission, point (5) of the Commentary on art. 31 of the VCLT; The analogy used by Virally is particularly descriptive: “...good faith plays a role that is *mutatis mutandis* comparable to that of a catalyst in a chemical reaction. Alone, the catalyst is completely passive. It must be added to other elements for a reaction to occur; without it, nothing will happen, even if all the necessary components are present in sufficient quantities.” (Virally, M., “Review essay: good faith in international public law, *AJIL*, 1983, p. 133).

<sup>904</sup> Becker, H. and Wurm, F., “Double taxation conventions and the conflict between international agreements and subsequent domestic laws”, *Intertax*, 1988, p. 261 (“If these principles [*pacta sunt servanda* and good faith] were ignored, international law would lose its effectiveness, and the only means to resolve conflicts and disputes would be the exercise of power”).

out by scholarly writings<sup>905</sup>. Furthermore, the impact of these circumstances is worsened because there exists no international process to safeguard the common interpretation and application of the treaty, or the equivalent of the WTO's policy review<sup>906</sup>, no uniform interpretations by international courts or tribunals<sup>907</sup>, and a mutual agreement procedure that has been described as "flawed"<sup>908</sup>. Given the fact that tax treaties primarily establish direct benefits for taxpayers (as opposed to benefits for states), it is mainly the taxpayer that will be hurt by state behavior that is not in accordance with the principle of good faith, which is in sharp contrast with his lack of standing on the international plane.

Hence, the fundamental importance of the principle of good faith for double taxation agreements. Good faith is an all-overriding principle that emphasizes common intent and uniformity with respect to treaty interpretation and application<sup>909</sup>. As such, good faith tempers any (even the conventionally granted) discretion the contracting states may have for interpreting and applying the treaty, and favors the international character

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<sup>905</sup> On divergence in tax treaty interpretation: Lindencrona, G. and Mattson, N., "How to resolve international tax disputes?", *Intertax*, 1990, p. 273.; Vicchi, *Interpretation of Double Taxation Conventions*, 1993, *Cahiers de Droit Fiscal International*, vol. 78a, p. 175.; Van Raad, K., "Interpretation of Tax Treaties by Tax Courts", *E.T.*, 1996, 6; Van Raad, K., "International coordination of tax treaty interpretation and application", *Intertax*, 2001, p. 212-218.; On the importance of practical application by contracting states see above 7.4.

<sup>906</sup> Annex 3 of the Marrakesh Agreement establishing the Trade Policy Review Mechanism; Quereshi, A., *The World Trade Organization*, Manchester U.P., p. 108; See also (on notifying tariff policy) GATT L/3464, 18S/97.

<sup>907</sup> Van Der Bruggen, E., "Compulsory jurisdiction of the International Court of Justice in tax cases", *Intertax*, 2001, p. 264-267.

<sup>908</sup> Bricker, M.P., "Arbitration Procedures in Tax Treaties", *Intertax*, 1998, p. 97.; OECD Commentary on art. 24, par. 45.; Avery Jones, J.F. et al, *The Legal Nature of the Mutual Agreement Procedure under the OECD-Model Convention*, *B.T.R.*, 1979, 333 and 1980, 13.

<sup>909</sup> The relationship between good faith and uniformity (although admittedly with respect to private international law) is explicitly made by art. 7 (1) of the UN Convention on Contracts for the International Sale of Goods and art. 6 (1) of the Unidroit Convention on Agency in the International Sale of Goods which provide that: "In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade"; See Honnold, J.O., *Uniform Law for International Sales*, 3<sup>rd</sup> ed, Kluwer, 1999, p. 17-18.; Despite this provision, however, significant divergence remains: General Report to the 12<sup>th</sup> Congress of the International Academy of Comparative Law by John Honnold, *Methodology to Achieve Uniformity in Applying International Agreements*, Sydney, 1986.; Stanford, M.J., "Unidroit", in *Effects of Treaties in Domestic Law*, Sweet & Maxwell, 1987, p. 265.

of the agreement. A contracting state (or its court), therefore, that makes every effort to establish a common, uniform tax treaty meaning when interpreting a tax treaty term, is acting in accordance good faith. On the contrary, a contracting state that uses its domestic law to define tax treaty terms without bothering to verify if a common, tax treaty meaning can be found, is not acting in accordance with the principle of good faith, even when the treaty text bestowed that discretion. Above, I have also repeatedly defended the view that, in certain circumstances, the principle of good faith dictates that the contracting states may not assume a behavior or adopt interpretations that unreasonably deviate from the prevailing practice of the community of (tax treaty concluding) nations on that particular subject as such would not be in accordance with the legitimate expectations of the parties<sup>910</sup>.

With respect to the *application* of double taxation conventions, the yardstick of good faith must be applied to all measures that the contracting states take to ensure or restrict treaty benefits for taxpayers. As was discussed above, those measures must be reasonable, fair and honest. This means, among other things, that states may be expected to essentially observe the prevailing international practice on the subject, must extend certificates of residence or proof of tax paid in a timely manner, and may not refuse extending treaty benefits to a taxpayer for reasons that have nothing to do with the treaty itself. The principle of good faith also has implications for the debate on applying domestic anti-avoidance measures in a tax treaty situation, and for instances of double non-taxation.

With respect to the *international exchange of information and the mutual agreement procedure*, it is fair to say that without the principle of good faith, both provisions could easily be reduced to “dead letter law” by a contracting state which is determined to escape its treaty obligations while still respecting the literal text of the agreement. The principle tempers the possibilities for refusal included in the text of the provision on the international exchange of information, *inter alia* by comparing the conduct of a state in that regard with the international practice and standard on the subject. States are also to conduct the mutual agreement procedure with a sincere effort to reach an agreement, which sanctions for example unnecessary delays and an uncompromising state attitude.

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<sup>910</sup> Such as with respect to tax incentives qualifying for tax sparing credits, domestic anti-abuse provisions and applications measures of double taxation conventions.

Even if good faith may have few fixed rules to offer, therefore, the principle is nevertheless of fundamental importance to double taxation conventions, not only because it emphasizes the importance of the common intent of the contracting states, but also because it is associated with the prevailing standards of reasonableness, fairness and honesty in the international community of nations. As such, the principle of good faith can be seen as the opposite of “fiscal unilateralism”<sup>911</sup>, and is crucial to the effectiveness of double taxation conventions, as well as to the development of international tax law as a whole. Good faith always promotes uniformity, never divergence. And that is a function of which tax treaties, with their ample references to domestic law and dependence on internal means of application, are in great need.

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<sup>911</sup> Compare with “legal unilateralism” as used by Conforti B., *International Law and the Role of Domestic Legal Systems*, Martinus Nijhoff, 1993, p. 107.