CHAPTER 26

APPLICATION AND INTERPRETATION OF TAX TREATIES



LEARNING OUTCOMES

After studying this chapter, you would be able to

- **identify** the connecting factors of double taxation;
- **appreciate** the meaning of, and need for, tax treaties;
- **appreciate** the basic principles of interpretation of tax treaties;
- **identify** the extrinsic aids to interpretation of a tax treaty;
- **appreciate** the importance of commentaries in interpretation of tax treaties;
- **appreciate** the role of Vienna Convention in application and interpretation of tax treaties.

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26.1 INTRODUCTION

Article 38(1) of the International Court of Justice (ICJ)[1] provides that the court shall apply the following in deciding on a particular matter –

International Convention(s) [general or particular]

- establishing rules expressly recognised by the contesting states

International Customs

- serving as evidence of general practice accepted as law

General principles

- recognised by civilised nations

Judicial decisions and teachings of highly qualified publicists of various nations

- serving as subsidiary means for determination of rules of law

Success of any law depends upon the manner in which it is interpreted and administered. In order to interpret any law or agreement, one needs to understand the philosophy of law which has been kept in mind at the time of passing such law in a country or at the time of forming an agreement between the two countries on a particular aspect. This gives rise to the principles of public international law (example – U.N principles on business and human rights).

The interpretation of DTAAs require a different approach than the interpretation of domestic tax laws as the latter is based on interpretative principles set out by the national courts, whereas, the DTAAs are an international agreement between the government of two countries. The treaties are interpreted in light of the customary principles set out under the Vienna Convention of the Law of treaties.

[1] https://www.icj-cij.org/en/statute#CHAPTER_II. *The International Court of Justice acts as a world court. The Court's jurisdiction is twofold: it decides, in accordance with international law, disputes of a legal nature that are submitted to it by States (jurisdiction in contentious cases); and it gives advisory opinions on legal questions at the request of the organs of the United Nations or specialized agencies.*

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Source(s) of International Tax Law

S. No.	Source	Particulars relating to the source/origin
(i)	Double Taxation Avoidance Agreement (DTAA)	DTAAs may be comprehensive or limited. It is to be noted that along with the DTAA, it is the protocols, memorandum of understanding, and exchange of information, etc. forming part of the DTAA which enables interpretation of a DTAA.
(ii)	Customary international law and general principles of law	Customary international law is the aspect of international law that derives from customs and conventions. Along with general principles of law and treaties, custom is also considered by the International Court of Justice, jurists, the United Nations, and its member states to be among the primary sources of international law. The vast majority of the world's governments accept, in principle, the existence of customary international law, although there are many differing opinions as to what rules are contained therein.
(iii)	Vienna Convention on Law of Treaties (VCLT)	VCLT is a multilateral treaty signed and ratified by several countries, which codifies the customary international law for interpretation of tax treaties.

26.2 DOUBLE TAXATION AND CONNECTING FACTORS

The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is "connecting factors". There are two types of connecting factors, namely, "Residence" and "Source". It means a company can be subject to tax either on its residence link or its source link with a country.

If a company is doing business **in a** host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in

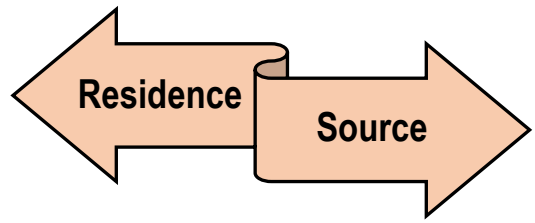
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the host country on the basis of its source link as the company would be heavily engaged in doing business in the territory of other country, for example, through its branch in that country.

However, if a company is doing business **with** another country (i.e., host/source country), then, it would generally be subject to tax in its home country alone, based on its residence link, since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods to another country). In this regard, it may, however, be noted that significant economic presence in another country may result in tax liability in the other country.

For example, as per section 9(9)(d) of the Income-tax Act, 2025, transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India if aggregate of payments arising from such transaction or transactions during the tax year exceeds ₹ 2 crores or systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India i.e., 3,00,000, would be deemed as significant economic presence of such non-resident in India.

Significant economic presence of a non-resident in India would constitute business connection in India and consequently, income would be deemed to accrue or arise in India and hence, be taxable in India (the Source country).



Juridical double taxation

Juridical double taxation arises where the same taxpayer is subjected to tax in two or more States in respect of the same income. It may arise from residence-source, residence-residence or source-source conflicts under the respective domestic laws.

In order to avoid such double taxation, a company can invoke provisions of Double Taxation Avoidance Agreements (DTAAs) (also known as **Tax Treaty** or

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Double Taxation Convention–DTC) with the host/source country, or in the absence of such an agreement, an Indian company can invoke provisions of section 160, providing unilateral relief in the event of double taxation.



Company ICO is a resident of India. It has set up a branch in UK. Here, India would be the country of residence for ICO, whereas UK would be the country of source. UK would tax the profits earned by the branch of ICO located in UK, whereas ICO would be taxed on worldwide basis in India, including profits of its UK branch. However, ICO can claim relief in respect of taxes paid in UK while filing its tax return in India under the Indo-UK Double Taxation Avoidance Agreement.

If, instead of UK, ICO has a branch in a state with which India does not have tax treaty, then it can claim unilateral relief under section 160 of the Income-tax Act, 2025 in respect of taxes paid by its branch in that state.

Economic double taxation

'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different persons (because of lack of subject identity)



When one State attributes an income/capital to its legal owner whereas the tax law of other State attributes it in the hands of the person in possession or having economic control over the income, it leads to economic double taxation.

For example, if one State (say, Country X) levies dividend distribution tax on the company resident in that State (say, ABC Ltd.) and the other State (say, Country Y) levies tax on dividend received by the shareholder who is resident of Country Y, receiving dividend income from shares held in ABC Ltd., the company resident in Country X, then, economic double taxation arises.

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26.3 TAX TREATIES: AN OVERVIEW

(1) Definition of "Treaty"

Treaty is a generic term embracing all instruments binding under international law, regardless of their formal designation, concluded between two or more international juridical persons.

The application of the term treaty signifies that the parties intend to create rights and obligations enforceable under international law.

Article 2 of Vienna Convention on Law of Treaties, 1969 defines a "treaty" as an international **agreement** concluded between States **in written form** and **governed by international law**, whether embodied in a **single instrument or in two or more related instruments** and whatever its particular designation.

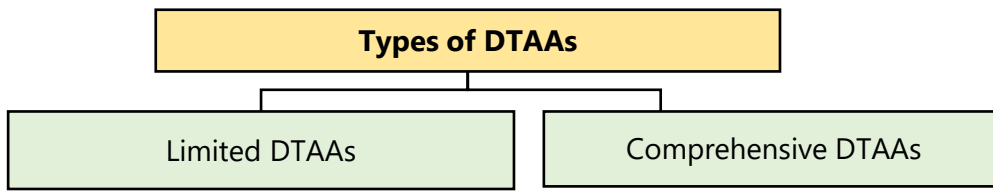
(2) Role of Tax Treaties

"Treaty" represents various compromises agreed upon by the respective Contracting States depending upon the economic expediency of a particular country.

Tax, in the country of source is considered as a cost, whereas the same is an obligation in the country of residence. Therefore, there is need to achieve tax efficiency. Double Tax Avoidance Agreements come into play to mitigate hardship caused by subjecting the same income to double taxation.

Tax Treaties attempt to eliminate double taxation and try to achieve balance and equity. They aim at sharing of tax revenues by the concerned States on a rational basis. Tax treaties do not always succeed in eliminating Double Taxation, but contain the incidence to a tolerable level.

(3) Types of DTAAs



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Limited DTAAs are those which are limited to certain types of incomes only. e.g., DTAA between India and Pakistan is limited to income from international air transport only.

Comprehensive DTAAs are those which cover almost all types of incomes covered by any model convention. Many a time, a treaty also covers wealth tax, gift tax, surtax, etc.

(4) Directive Principles set out in the Indian Constitution

In the Indian context, Article 51 of the Indian Constitution has, *inter alia*, set out some directive principles which must be followed by the State in the context of International agreements and relationships. It has been provided that-

"The State shall endeavor to -

(a) Promote international peace and security;

(b) Maintain just and honourable relations amongst nations;

(c) Foster respect for international law and treaty obligations in the dealings of organised people with one another; and

(d) Encourage settlement of international disputes by arbitration.

Article 253 of the Indian Constitution provides that Parliament has power to make any law for the whole or any part of the territory of India for implementing any treaty, agreement or convention with any other country or countries or any decision made at any international conference, association or other body.

It is pertinent to note that Entries 10 and 14 of List I of the Seventh Schedule confer legislative competence on Parliament in relation to foreign affairs and treaties, and Article 253 empowers Parliament to make laws for implementing treaties, agreements and conventions. Section 159 of the Income-tax Act, 2025 confers statutory authority on the Central Government to enter into and notify agreements for the purposes specified therein. Section 160 provides unilateral relief and does not constitute treaty-making authority.

(5) Need for tax treaties

The concept of source and residence prevailing in a majority of the countries is the root cause of double taxation. Hence, there is a need to have tax treaties in force.

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Generally, a Residence State taxes its residents on the basis of residence, while a Source State may tax income having the requisite source nexus. A DTAA allocates or limits these taxing rights on an article-by-article basis: in some cases, the Residence State has an exclusive right to tax; in others, the Source State has an exclusive or shared right to tax; and in still others, source taxation is permitted only if specified conditions, such as the existence of a permanent establishment, are satisfied. The allocation of taxing rights reflects the treaty bargain between the Contracting States.

Tax treaties only distribute or assign taxing jurisdiction. It does not impose tax. Having assigned the jurisdiction of tax between the State of Residence and State of Source, the domestic tax laws of the respective State determine taxing rules. Taxing experts in early 1920 appointed by the League of Nations describe the method of classification as Contracting States dividing tax sources and tax objects amongst themselves by mutually binding themselves not to levy taxes or to tax only to a limited extent.

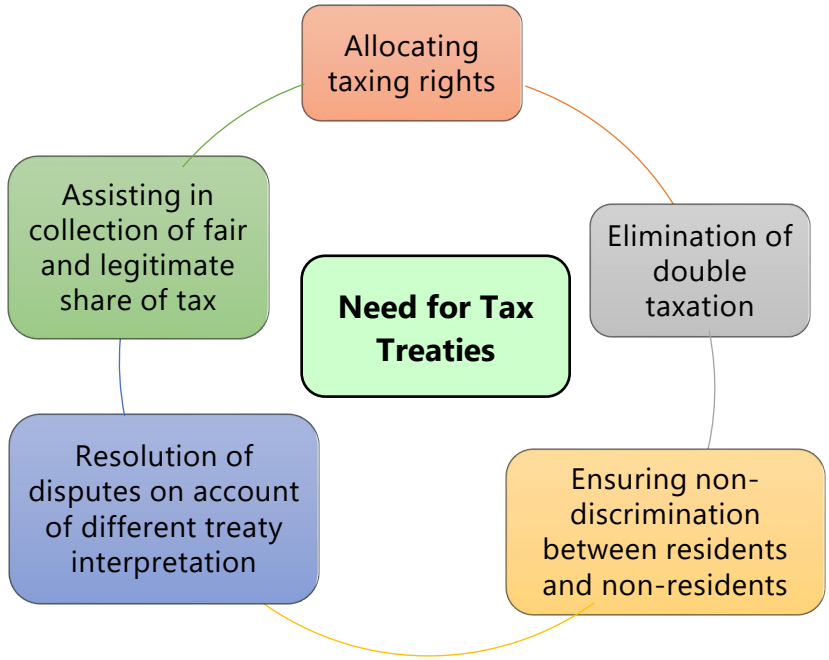
English lawyers called it "Classification and Assignment Rule", whereas German jurists called it the **"Distributive Rule".** According to this principle, "to the extent that an exemption is agreed to, its effect is, in principle, independent of whether the Contracting States imposes a tax, in the situation to which the exemption applies, and irrespective of whether the State actually levies the tax".

The point here is that having agreed to give the right of tax to the other state, that state may or may not levy tax and if the state in whose favour right to tax is devolved, chooses not to tax such income, then, it may result in double non-taxation. The argument in favour of double non-taxation is that income would be subject to tax in the exempt state as and when the exemption is withdrawn or tax is levied. Thus, this rule ensures that double taxation does not arise in future also, if the source state decides to levy tax.

In addition to allocating the taxing rights and eliminating double taxation, there are various other important considerations as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.

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Section 159 also provides that the Central Government may enter into an agreement with the Government of any country outside India for

(a) granting of relief in respect of

- income on which income-tax under this Act or income-tax in that country or specified territory Income-tax have been paid or
- income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment:

(b) avoidance of double taxation of income under this Act or under the corresponding law in force in that country or specified territory outside India without creating any opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including treaty shopping arrangements aimed at obtaining reliefs provided in the said agreement for the indirect benefit to residents of any other country or territory); or

(c) exchange of information for

- the prevention of evasion or avoidance of income-tax under this Act or under the corresponding law in force in that country or specified territory or

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- investigation of cases of such evasion or avoidance; or

(d) recovery of income-tax under this Act or under the corresponding law in force in that country or specified territory.

Further, in addition to above, there are some other principles which must be considered by countries in tax treaties –

(i) Equity and fairness: Tax systems seek to ensure fair treatment to all the taxpayers who are similarly situated, i.e., taxpayers who are alike in relevant respects should generally receive similar tax treatment. This does not necessarily require identical tax rates for all taxpayers or for all categories or sources of income.

(ii) Neutrality and efficiency: Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) Promotion of mutual economic relation, trade and investment: In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country's overall economic growth and development.'

26.4 INTERPRETATION OF TAX TREATIES

(1) Introduction

Tax treaties are signed between two sovereign nations by competent authorities under delegated powers from the respective Governments. Thus, an international agreement has to be respected and interpreted in accordance with the rules of international law as laid down in the Vienna Convention on Law of Treaties (VCLT). These rules of interpretation are not restricted to tax treaties but also

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apply to any treaty between two countries. Therefore, any dispute between two nations in respect of Article 25 relating to Mutual Agreement Procedure of the OECD/UN Model Conventions has to be solved in the light of the VCLT.

However, when it comes to application of a tax treaty in the domestic forum, the appellate authorities and the courts are primarily governed by the laws of the respective countries for interpretation.

In India, even before insertion of Section 159 (corresponding to section 90(2) of the Income-tax Act, 1961), the CBDT had clarified *vide Circular No. 333 dated 2-4-1982* that where a specific provision is made in the DTAA, the provisions of the DTAA will prevail over the general provisions contained in the Act and where there is no specific provision in the DTAA, it is the basic law i.e. the provisions of the Act, that will govern the taxation of such income.

Section 159(4) of the Income-tax Act, 2025 provides that where the Central Government has entered into an agreement which applies to an assessee, the provisions of the Act shall apply to the extent they are more beneficial to that assessee.

Interpretation of any statute, more so international tax treaties, requires that we follow some rules of interpretation. In subsequent paragraphs, we shall deal with rules of interpretation of tax treaties.

(2) Role of Vienna Convention in Application and Interpretation of Tax Treaties

The International Law Commission initiated the work on the Vienna Convention on Law of Treaties in the year 1949 which was completed in the year 1969. It came into force in the year 1980. As of 24.7.2026, it was ratified by 119 Countries. It is an open treaty whereby any country can become signatory of the Convention at any time.

Since tax treaty is a part of international law, its interpretation should be based on certain set of principles and rules of interpretation. The Vienna Convention on Law of Treaties provides the basic rules of interpretation of any international agreement (including a tax treaty). It represents the customary international law.

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The VCLT codifies the principles of interpretation laid down by usage, custom and courts over centuries.

The principles engraved in Vienna Convention on Law of Treaties have been acknowledged and embraced by the Indian courts of law while pronouncing their ruling. Para 60 of the Supreme Court ruling in *Ram Jethmalani & Ors. v. Union of India & Ors* Writ Petition (Civil) No. 176/2009 reads as follows –

"Article 31, "General Rule of Interpretation", of the Vienna Convention of the Law of Treaties, 1969 provides that a "treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." While India is not a party to the Vienna Convention, it contains many principles of customary international law, and the principle of interpretation, of Article 31 of the Vienna Convention, provides a broad guideline as to what could be an appropriate manner of interpreting a treaty in the Indian context also".

The Delhi High Court ruling in *AWAS Ireland v. Directorate General of Civil Aviation (W.P.(C) 671/2005 delivered on 19th March 2015*, applied the principles enshrined in the Vienna Convention of Law of Treaties, 1969. The said ruling invited reference to Article 51(c) of the Constitution of India which enjoins that the State shall endeavour to "foster respect for international law". The Court observed that the provisions of Article 51(c) of the Constitution of India when read with Articles 26, 27 and 31 of the Vienna Convention of Law of Treaties clearly cast an obligation on the Contracting States to not only remain bound by the terms of a treaty entered into by it but also obliges the State not to cite internal law as a justification for failure to perform its obligations under a treaty. An international convention, i.e., a treaty, is required to be interpreted in good faith, in accordance with the ordinary meaning given to the terms of the treaty, in their context and in light of its stated object and purpose.

Therefore, it would be worthy to understand some of the Articles of the Vienna Convention of Law of Treaties which would help appreciate the manner of application and interpretation of tax treaties.

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Principles enunciated in the Vienna Convention on Law of Treaties[2]

Article No.	Article Heading	Principle enunciated
26	***Pacta Sunt Servanda (in good faith)***	Every treaty in force is binding upon the parties and must be followed by them in good faith.
27	**Internal law and observance of treaties**	A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. For instance, the parties to the treaty should not dishonour their international commitments with each other by retrospectively amending their domestic tax laws or by not abiding by the treaty terms.
28	**Non-retroactivity of treaties**	Unless a different intention appears from the treaty or is otherwise established, treaty provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to that party. In other words, unless otherwise provided, treaties cannot have retrospective application
29	**Territorial Scope of Treaties**	Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.
31	**General Rule of Interpretation**	• A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of the treaty's object and purpose. These elements form an integrated general rule of treaty interpretation under Article 31(1) of the Vienna Convention on the Law

[2] *https://treaties.un.org/doc/Publication/UNTS/Volume%201155/volume-1155-I-18232-English.pdf*

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		of Treaties; the object and purpose of the treaty are not merely a secondary aid to be considered only where the ordinary meaning is ambiguous. • The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto. • The following shall be taken into account, together with the context in that: (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) Any relevant rules of international law applicable to relation between the parties. • A special meaning shall be given to a term if it is established that the parties so intended.
32	**Supplementary means of interpretation**	Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning

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		resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable.
33	**Interpretation of Treaties Authenticated in two or more languages**	• When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail. • A version of the treaty in a language other than the one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree. • The terms of the treaty are presumed to have the same meaning in each authentic text. • Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference in meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.
34	**General Rule regarding third states**	A treaty does not create either obligations or rights for a third State without its consent.
42	**Validity and Continuance in force of treaties**	• The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the Convention. • The termination of a treaty, its denunciation or the withdrawal of a party, may take place

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		only as a result of the application of the provisions of the treaty or of the Convention. The same rule applies to suspension of the operation of a treaty
60	**Termination or Suspension of the operation of a treaty as a consequence of its breach**	• A material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part. • A material breach of a multilateral treaty by one of the parties entitles: (a) the other parties by unanimous agreement to suspend the operation of the treaty in whole or in part or to terminate it either: (i) in the relations amongst themselves and the defaulting State, or (ii) as between all the parties; (b) a party specially affected by the breach to invoke it as a ground for suspending the operation of the treaty in whole or in part in the relations between itself and the defaulting State; (c) any party other than the defaulting State to invoke the breach as a ground for suspending the operation of the treaty in whole or in part with respect to itself if the treaty is of such a character that a material breach of its provisions by one party radically changes the position of every other party with respect to further performance of its obligations under the treaty. • A material breach of a treaty, for the purposes of this Article, consists in:

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		(a) a repudiation of the treaty not sanctioned by the Convention; or (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty. • The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
61	**Supervening impossibility of performance**	• A party may invoke the impossibility of performing provision of a treaty as a ground for terminating or withdrawing from it, if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending its operation. • Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party thereto.
62	**Fundamental change of circumstances**	• A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless – (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and

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		(b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. • A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty – (a) if the treaty establishes a boundary; or (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty. • If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending its operation.
64	**Emergence of new peremptory norm of general international law**	If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and stands terminated.

(3) Basic Principles of Interpretation of law for interpreting a Treaty

Treaty interpretation is governed by the general rule in Article 31 of the VCLT regardless of whether the treaty language ultimately appears clear or ambiguous. However, recourse to supplementary means under Article 32; would be relevant where terms or words used in treaties are ambiguous, vague or are such that different meanings are possible.

Prior to the Vienna Convention, treaties were interpreted according to the customary international law. Just as each country's legal system has its own canons of statutory construction and interpretation, likewise, several principles exist for the interpretation of treaties in customary international law.

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Some of the important principles of Customary International law in interpretation of tax treaties are as follows:

(i) **Golden Rule – Objective Interpretation:** Ideally, any term or word should be interpreted keeping its objective or ordinary or literal meaning in mind. The term has to be interpreted contextually.

Words and phrases are in the first instance to be construed according to their plain and natural meaning. However, if the grammatical interpretation would result in an absurdity, or in marked inconsistency with other portions of the treaty, or would clearly go beyond the intention of the parties, it should not be adopted[3].

(ii) **Subjective Interpretation:** Under this approach, the terms of a treaty are to be interpreted according to the common intention of the contracting parties at the time the treaty was concluded. The intention must be ascertained from the words used in the treaty and the context thereof.

In *Abdul Razak A. Meman's case [2005] 276 ITR 306,* the Authority for Advance Rulings [the AAR] relied on the speeches delivered by the Finance Ministers of India as well as UAE to arrive at the intention of parties in signing the India-UAE Tax Treaty.

(iii) **Purposive Interpretation:** In this approach the treaty is to be interpreted so as to facilitate the attainment of the aims and objectives of the treaty. This approach is also known as the 'objects and purpose' method. For identifying the intention of the parties entering into treaty, reference can be made to the preamble of the treaty, its protocol and the technical memorandum.

In case of *Union of India v. Azadi Bachao Andolan 263 ITR 706,* the Supreme Court of India observed that "the principles adopted for interpretation of treaties are not the same as those in interpretation of statutory legislation. The interpretation of provisions of an international treaty, including one for double taxation relief, is that the treaties are entered into at a political level and have several considerations as their bases."

The Supreme Court also made the reference to the preamble of the treaty to ascertain the purpose of India-Mauritius Treaty. The Apex Court agreed with the contention of the Appellant that "the preamble to the Indo-

[3] *Prof. J. G. Starke in Introduction to International Law 10th Edition*

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Mauritius DTAA recites that it is for 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty".

(iv) **The Principle of Effectiveness:** According to this principle, a treaty should be interpreted in a manner as to have effect rather than make it void.

This principle, particularly stressed by the Permanent Court of International Justice, requires that the treaty should be given an interpretation which 'on the whole' will render the treaty 'most effective and useful', in other words, which will enable the provisions of the treaty to work and to have their appropriate effects[4].

(v) **Principle of *Contemporanea Expositio:*** A treaty's terms are generally interpreted having regard to their meaning and understanding at the time the treaty was concluded. However, this is not an absolute or universal principle and must be applied consistently with the general rule of treaty interpretation under Article 31 of the Vienna Convention on the Law of Treaties (VCLT).

In *Abdul Razak A. Meman's case [2005] 276 ITR 306 (AAR),* the AAR observed that regard may be had to material *contemporanea expositio* and, in that context, referred to Article 32 of the Vienna Convention and *K. P. Varghese v. ITO [1981] 131 ITR 597 (SC)*. Article 32, however, deals with supplementary means of treaty interpretation, including the preparatory work of the treaty and the circumstances of its conclusion; it does not expressly codify the domestic-law doctrine of *contemporanea expositio*.

(vi) **Liberal Construction:** It is a general principle of construction with respect to treaties that they shall be liberally construed so as to carry out the apparent intention of the parties.

In *John N. Gladden v. Her Majesty the Queen*[5], the principle of liberal interpretation of tax treaties was reiterated by the Federal Court, which observed that "contrary to an ordinary taxing statute a tax treaty or convention must be given a liberal interpretation with a view to implementing the true intentions of the parties. A literal or legalistic interpretation must be avoided when the basic object of the treaty might be

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[4] *Prof. J. G. Starke in Introduction to International Law 10th Edition*

[5] *85 D.T.C. 5188 at 5190, Source: UOI v. Azadi Bachao Andolan 263 ITR 706 (SC)*

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defeated or frustrated in so far as the particular item under consideration is concerned."

The Court further recognised that "we cannot expect to find the same nicety or strict definition as in modern documents, such as deeds, or Acts of Parliament, it has never been the habit of those engaged in diplomacy to use legal accuracy but rather to adopt more liberal terms."

(vii) **Treaty as a Whole – Integrated Approach:** A treaty should be construed as a whole, and effect should be given to each word which would be construed in the same manner wherever it occurs. Any provision should not be interpreted in isolation; rather the entire treaty should be read as a whole to arrive at its object and purpose.

(viii) **Reasonableness and consistency[6]:** Treaties should be given an interpretation in which the reasonable meaning of words and phrases is preferred, and in which a consistent meaning is given to different portions of the instrument. In accordance with the principles of consistency, treaties should be interpreted in the light of existing international law.

An important aspect to be noted regarding the rules of interpretation is that they are not rules of law and are not to be applied like the rules enacted by the legislature in an Interpretation Act.

(4) Extrinsic Aids to Interpretation of a Tax Treaty

A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

It is important to distinguish Article 31(3) from Article 32. A subsequent agreement between the parties regarding the interpretation of the treaty, subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation, and relevant rules of international law applicable in the relations between the parties are matters to be taken into account under the general rule in Article 31(3). They are therefore not merely supplementary means of interpretation under Article 32.

[6] *Prof. J. G. Starke in Introduction to International Law 10th Edition*

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According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

(ii) A subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions [Art. 31(3) of the VCLT];

(iii) Subsequent conduct of the state parties, as evidence of the intention of the parties and their conception of the treaty;

(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y? Though the interpretation or explanations in treaty X would not be binding while interpreting the treaty Y, however, if the language is similar between the two treaties, one can make a reference to treaty X for understanding the intention of the Contracting parties.

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

International Articles/Essays/Reports

Like in the direct tax cases, Courts many a times refer to the Commentaries of Kanga Palkhiwala and Sampath Iyengar for interpretation as they are considered authoritative source. Also under the International taxation, various authors like Phillip Baker and Klaus Vogel's commentary are considered as classic sources of interpretation for understanding the tax treaties. International Article/ Essays/ Reports are referred as extrinsic aid for interpretation of tax treaties. Like, in case of *CIT v. Vishakhapatnam Port Trust (1983) 144 ITR 146 (AP)*, the High Court obtained "useful material" through international articles.

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Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation (MFN) Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.



MFN clause is usually found in Protocols and Exchange of Notes to DTCs. Under this clause a country agrees to extend the benefits to the residents of the other country, which it had (first country) promised to the residents of third country. It tries to avoid discrimination between residents of different countries.

Normally, the benefit under this clause is restricted to a specific group like OECD countries or developing countries. The nature of benefits under MFN clause could either be application of lower rate of tax or narrowing the scope of the income liable to tax or allowing higher deduction in respect of executive and general administrative expenses of head office.



CLARIFICATION REGARDING THE MOST-FAVOURED-NATION (MFN) CLAUSE IN THE PROTOCOL TO INDIA'S DTAAS WITH CERTAIN COUNTRIES [CIRCULAR NO.3/2022 DATED 3.2.2022]

The Protocol to India's DTAAs with some of the countries, especially European States and OECD members (The Netherlands, France, the Swiss Confederation, Sweden, Spain and Hungary) contains a provision, referred to as the Most-Favoured-Nation (MFN) clause. Though each MFN clause in these DTAAs has a different formulation, the general underlying provision is that if after the signature/ entry into force (depending upon the language of the MFN clause)

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of the DTAA with the first State, India enters into a DTAA with another OECD Member State, wherein India limits its source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, Fees for Technical Services, etc.) to a rate lower or a scope more restricted than the scope provided for those items of income in the DTAA with the first State, such beneficial treatment should also be extended to the first State.

Through this circular, the CBDT clarifies that the applicability of the MFN clause and benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income (such as dividends, interest income, royalties, Fees for Technical Services, etc.) provided in India's DTAAs with the third States will be available to the first (OECD) State only when all the following conditions are met:

(i) The second treaty (with the third State) is entered into after the signature/ Entry into Force (depending upon the language of the MFN clause) of the treaty between India and the first State;

(ii) The second treaty is entered into between India and a State which is a member of the OECD at the time of signing the treaty with it;

(iii) India limits its taxing rights in the second treaty in relation to rate or scope of taxation in respect of the relevant items of income; and

(iv) A separate notification has been issued by India, importing the benefits of the second treaty into the treaty with the first State, as required by the provisions of section 159(1) of the Income-tax Act, 2025.

If all the conditions enumerated in (i) to (iv) are satisfied, then, the lower rate or restricted scope in the treaty with the third State is imported into the treaty with an OECD State having MFN clause from the date as per the provisions of the MFN clause in the DTAA, after following the due procedure under the Indian tax law.

The Apex Court, in the case of *AO v Nestle SA [2023] 458 ITR 756*, held that the above (iv) condition of issuance of notification under section 159 of the Income-tax Act, 2025 is necessary and a mandatory condition to give effect to a tax treaty or any protocol which has the effect of altering the existing provisions of the law.

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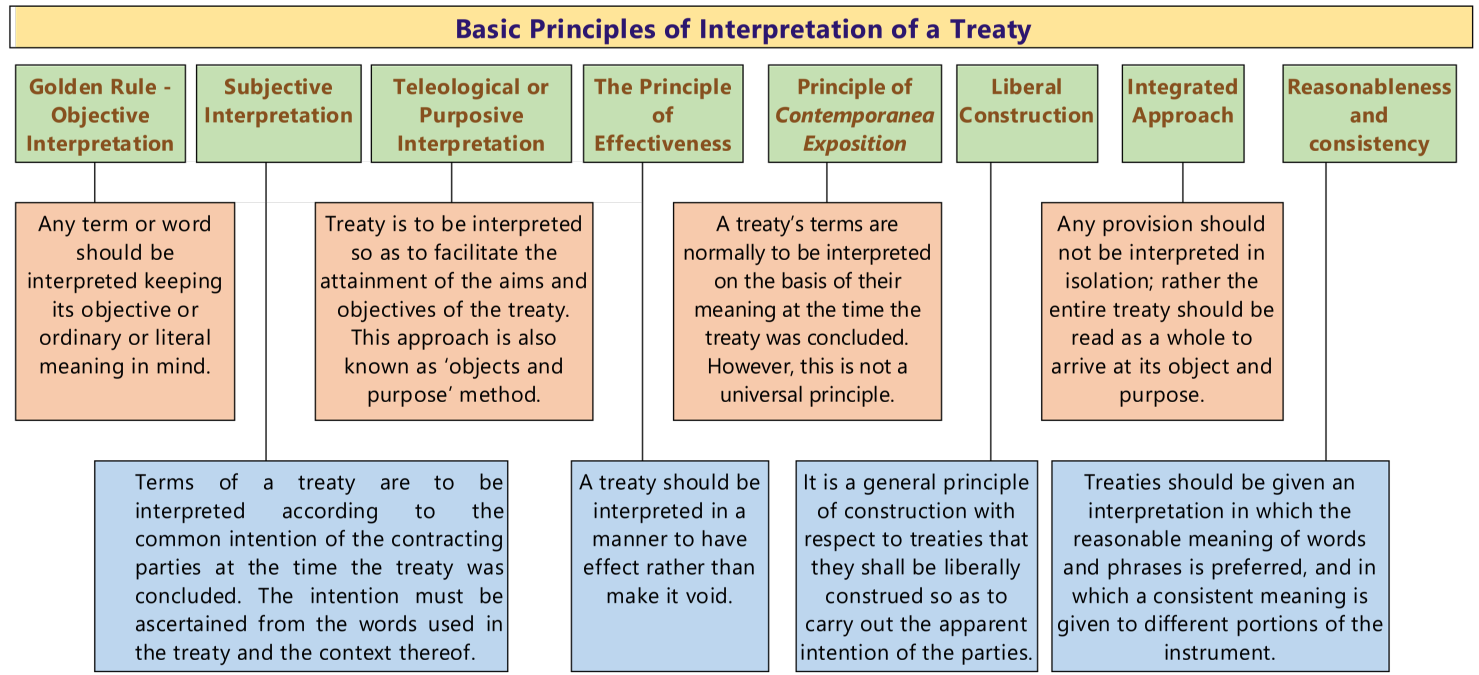
Preamble

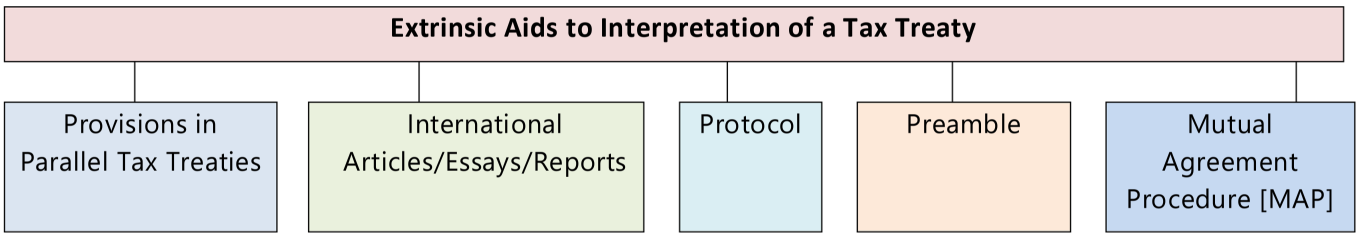
Preamble to a tax treaty could guide in interpretation of a tax treaty. As mentioned above, in case of *Azadi Bachao Andolan*, the Apex Court observed that 'the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty'. These observations are very significant whereby the Apex Court has upheld 'economic considerations' as one of the objectives of a Tax Treaty. Further, now after the BEPS Action Plan 6 recommendation and Multi-lateral Instrument (MLI), the new text has been added to the Preamble to reflect that the treaties are not intended for creating opportunities for double-non taxation and treaty shopping arrangements. This will play a key-role in interpreting the treaties post MLI.

Mutual Agreement Procedure [MAP]

MAP enables the competent authorities of the Contracting States to resolve difficulties or doubts arising as to the interpretation or application of a tax treaty through mutual agreement. A mutual agreement may provide important interpretative guidance to the Contracting States and may, where the requirements of Article 31(3) of the VCLT are satisfied, be relevant as a subsequent agreement or subsequent practice for purposes of treaty interpretation. However, a MAP resolution is not a judicial precedent and does not automatically bind the competent authorities in subsequent cases.

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(5) Commentaries on OECD/UN Model Conventions and their importance

There are two model conventions – OECD Model Convention and the UN Model Convention. The OECD Model was framed by the members from the developed countries. It gives importance to residence based taxation. UN Model Convention represents a compromise between the developing and developed countries. UN Model focusses on source based taxation. The OECD or UN Model Convention provides template to the tax administrations for negotiating the tax treaties. There are commentaries annexed to the Model Convention which helps in interpreting the model conventions. The OECD Model Commentaries represent the views of the Members of OECD from different countries. The UN Model Commentaries represent the views of the Group of Experts from different countries who represent in their individual capacity. Therefore, commentaries are one of the important rules of interpretation of tax treaties.

Views expressed in the commentaries carry great authority. However, the same are not binding on the countries even where the countries are signatories to the Model Convention. This is due to the fact that the actual treaties may be different from the model convention. Where Contracting States adopt the text of the Article as per OECD Model convention or UN Model Convention without any change, reliance can be placed on the Model Commentaries for interpreting the tax treaties. In the *Azadi Bachao Andolan* case, the Supreme Court has made reference to the OECD convention while interpreting terms used in DTAA.

The OECD Council approved the 2025 Update to the OECD Model Tax Convention and its Commentaries on 18 November 2025. Accordingly, where this chapter refers to the OECD Commentary, the applicable current Commentary, including the 2025 Update, should be considered. However, the Commentary remains interpretative material and an update to the Commentary does not, by itself, amend or rewrite an existing bilateral treaty. Its relevance to an earlier treaty depends, among other things, on whether the updated Commentary clarifies the interpretation of an existing treaty provision or reflects a substantive change to the OECD Model.

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(6) Foreign Courts' Decisions

Tax treaties may be interpreted differently by the different countries. A treaty signed between country A and B, may be interpreted by courts of Country A and B differently. Therefore, there may be no harmonization in the interpretation of tax treaties. A same income may be classified as royalty by one country and business income by another country. Therefore, reliance on foreign court rulings may result in harmonious interpretation.

In many of the rulings Indian courts have referred to the foreign court cases for interpretation of treaty provisions. In *CIT v. Vishakhapatnam Port Trust's* case *[1983] 144 ITR 146*, the Andhra Pradesh High Court observed that, "in view of the standard OECD Models which are being used in various countries, a new area of genuine 'international tax law' is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adoption is just as important as the initial removal of divergences. Therefore, the judgments rendered by courts in other countries or rulings given by other tax authorities would be relevant."

In the under-noted cases, foreign court cases have extensively been quoted for interpretation of treaty provisions:

Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

CIT v. Vishakhapatnam Port Trust [1983] 144 ITR 146

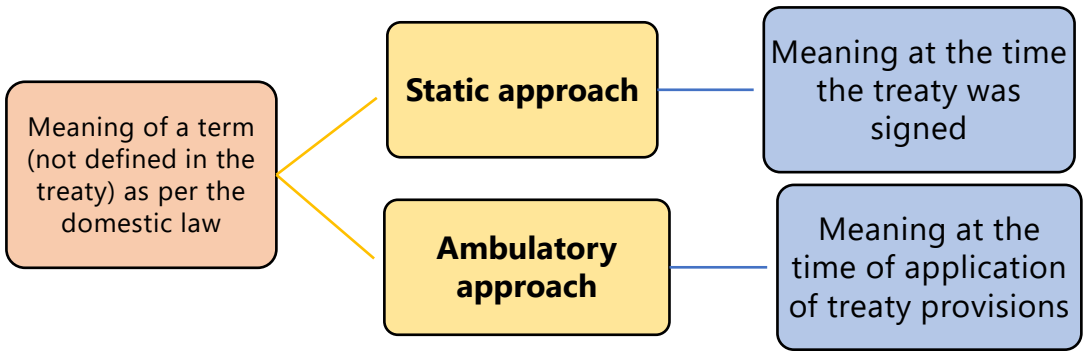
Abdul Razak A. Meman's case [2005] 276 ITR 306(AAR)

(7) Ambulatory v. Static Approach

International tax law gets updated from time to time to keep up with the developments in the society and the technology. Over the years, the OECD and UN have come up with different version of commentaries. Similarly, even the domestic tax laws also amended from time to time. The tax treaties make a reference to the domestic tax laws for the terms not defined under the treaty. Therefore, whenever a reference is made in a treaty to the provisions of domestic

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tax laws or to the Model Commentary for assigning meaning to a particular term, a question often arises what meaning to be assigned to the said term – the one which prevailed on the date of signing a tax treaty or the one prevailing on the date of application of a tax treaty. There are two views on the subject, namely, Static and Ambulatory.



Where a treaty refers to domestic law for the meaning of an undefined term, the domestic-law meaning in force at the time the treaty is applied may be relevant, subject to the wording and context of the particular treaty. This ambulatory operation of domestic-law references should be distinguished from the interpretative relevance of a later OECD or UN Model Tax Convention Commentary. A later Commentary may be persuasive, particularly where it clarifies unchanged treaty wording, but it cannot automatically alter the bargain embodied in an earlier treaty. Where a later Commentary reflects a substantive change in the meaning of a term, particular caution is required, and its relevance must be assessed against the treaty text, context, object and purpose, and the applicable principles of treaty interpretation under the VCLT.

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TEST YOUR KNOWLEDGE

Questions

1. *What do you mean by double taxation? Discuss the connecting factors which lead to double taxation.*

2. *"In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into tax treaty". Elucidate.*

3. *What is the General Rule of Interpretation under Vienna Convention of Law of Treaties?*

4. *What are the Extrinsic Aids to interpretation of a tax treaty?*

5. *Matrix Inc. incorporated in Country X, holds 26% controlling interest in Pilu Ltd., an Indian Company. Pilu Ltd. declared dividend of ₹ 50,00,000 during the T.Y. 2026-27. The DTAA between India and Country X, which came into force on 1.1.2018, provides for taxation of dividend @15%. Thereafter, India entered into a DTAA with Country Y, which came into force from 15.5.2018. The India-Country Y DTAA, inter alia, provides for concessional tax rate of 10% in respect of dividend. Country X is an OECD member since 2015 and Country Y is also an OECD member since 2017.*

   Mr. Jack, CFO of Matrix Inc. seeks your opinion on whether the concessional tax rate provided in the DTAA between India and Country Y can be availed by a resident of Country X and if so, are there any further conditions to be satisfied in this regard. You may assume that the protocol annexed to India's DTAAs with all OECD member countries contain the relevant tax parity clause.

   Would your answer change, if Country Y had become an OECD member only in the year 2020?

Answers

1. The taxability of a foreign entity in any country depends upon two distinct factors, namely, whether it is doing business **with that country** or **in that country**. Internationally, the term used to determine the jurisdiction for taxation is "connecting factors". There are two types of connecting factors, namely, "Residence" and "Source". It means a company can be subject to tax

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either on its residence link or its source link with a country. If a company is doing business in a host/source country, then, besides being taxed in the home country on the basis of its residence link, it will also be taxed in the host country on the basis of its source link as the company would be heavily engaged in doing business in the territory of other country, for example, through its branch in that country.

However, if a company is doing business with another country (i.e., host/source country), then, it would generally be subject to tax in its home country alone, based on its residence link, since the company is not engaged in carrying on the business in the territory of source country (for example, export of goods to another country).

In this regard, it may, however, be noted that significant economic presence in another country may result in tax liability in the other country.

For example, as per section 9(9)(d) of the Income-tax Act, 2025, transaction in respect of any goods, services or property carried out by a non-resident with any person in India including provision of download of data or software in India if aggregate of payments arising from such transaction or transactions during the tax year exceeds ₹ 2 crores or systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India i.e., 3,00,000, would be deemed as significant economic presence of such non-resident in India.

Significant economic presence of a non-resident in India would constitute business connection in India and consequently, income would be deemed to accrue or arise in India and hence, be taxable in India (the Source country).

- **Juridical double taxation:** Juridical double taxation arises where the same taxpayer is subjected to tax by two or more States in respect of the same income for the same period. It may arise from conflicts between residence and source jurisdictions, or between two residence or two source jurisdictions, under their respective domestic laws.

  In order to avoid such double taxation, a person may invoke the applicable Double Taxation Avoidance Agreement (DTAA) (also known as a Tax Treaty or Double Taxation Convention-DTC). In the absence of an agreement under section 159, a person resident in India may claim unilateral relief under section 160, subject to the conditions specified therein.

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- **Economic double taxation:** 'Economic double taxation' happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different persons (because of lack of subject identity)

2. In addition to allocating the taxing rights and elimination of double taxation, there are various other important considerations while entering into a tax treaty, as mentioned below:

- Ensuring non-discrimination between residents and non-residents
- Resolution of disputes arising on account of different interpretation of tax treaty by the treaty partner.
- Providing assistance in the collection of the fair and legitimate share of tax.

Further, in addition to above, there are some other principles which must be considered by countries in their tax system –

(i) **Equity and fairness:** Tax systems seek to ensure fair treatment to all the taxpayers who are similarly situated, i.e., taxpayers who are alike in relevant respects should generally receive similar tax treatment. This does not necessarily require identical tax rates for all taxpayers or for all categories or sources of income.

(ii) **Neutrality and efficiency:** Neutrality factor provides that economic processes should not be affected by external factors such as taxation. Neutrality is two-fold.

(a) Capital export neutrality and

(b) Capital import neutrality (CIN).

Capital export neutrality (CEN) provides that business decision must not be affected by tax factors between the country of residence and the target country; whereas CIN provides that the level of tax imposed on non-residents as well as the residents must be similar.

(iii) **Promotion of mutual economic relation, trade and investment:** In some cases, it is observed that avoidance of double taxation is not the only objective. The other objective may be to give impetus to a country's overall economic growth and development.

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3. Article 31 of Vienna Convention of Law of Treaties contains the General Rule of Interpretation. It lays down that following general rule of interpretation:

- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms thereof in the context and in the light of its object and purpose.
- The context for the purpose of interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexure
  - (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
  - (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related thereto.
- The following shall be taken into account, together with the context in that:
  - (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - (c) Any relevant rules of international law applicable to relation between the parties.
- A special meaning shall be given to a term if it is established that the parties so intended.

4. A wide range of extrinsic material is permitted to be used in interpretation of tax treaties. According to Article 32 of the Vienna Convention, the supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion.

According to Prof. Starke, one may resort to following extrinsic aids to interpret a tax treaty provided that clear words are not thereby contradicted:

(i) Interpretative Protocols, Resolutions and Committee Reports, setting out agreed interpretations;

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(iv) Other treaties, in *pari materia* (i.e., relating to the same subject matter), in case of doubt.

Provisions in Parallel Tax Treaties

If the language used in two tax treaties (say treaties: X and Y) are same and one treaty is more elaborative or clear in its meaning (say treaty X) can one rely on the interpretation/explanations provided in a treaty X while applying provisions of a treaty Y? Though the interpretation or explanations in treaty X would not be binding while interpreting the treaty Y, however, if the language is similar between the two treaties, one can make a reference to treaty X for understanding the intention of the Contracting parties.

The views of the Indian Judiciary are, however, not consistent in this respect. There are contradictory judgments by Indian courts/Tribunal in this regard.

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Protocol

Protocol is like a supplement to the treaty. In many treaties, in order to put certain matters beyond doubt, there is a protocol annexed at the end of the treaty, which clarifies borderline issues.

A protocol is an integral part of a tax treaty and has the same binding force as the main clauses therein.

Protocol to India France treaty contains the Most Favoured Nation (MFN) Clause. Thus, one must refer to protocol before arriving at any final conclusion in respect of any tax treaty provision.

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Preamble

Preamble to a tax treaty could guide in interpretation of a tax treaty. As mentioned above, in case of *Azadi Bachao Andolan*, the Apex Court observed that 'the preamble to the Indo-Mauritius Double Tax Avoidance Treaty recites that it is for the 'encouragement of mutual trade and investment' and this aspect of the matter cannot be lost sight of while interpreting the treaty'. These observations are very significant whereby the Apex Court has upheld 'economic considerations' as one of the objectives of a Tax Treaty. Further, now after the BEPS Action Plan 6 recommendation and Multi-lateral Instrument (MLI), the new text has been added to the Preamble to reflect that the treaties are not intended for creating opportunities for double-non taxation and treaty shopping arrangements. This will play a key-role in interpreting the treaties post MLI.

Mutual Agreement Procedure [MAP]

MAP enables the competent authorities of the Contracting States to resolve difficulties or doubts arising as to the interpretation or application of a tax treaty through mutual agreement. A mutual agreement may provide important interpretative guidance to the Contracting States and may, where the requirements of Article 31(3) of the VCLT are satisfied, be relevant as a subsequent agreement or subsequent practice for purposes of treaty interpretation. However, a MAP resolution is not a judicial precedent and does not automatically bind the competent authorities in subsequent cases.

5. The CBDT has, vide *Circular No. 3/2022 dated 3.2.2022*, clarified that the applicability of the Most Favoured Nation (MFN) clause and benefit of the lower rate or restricted scope of source taxation rights in relation to certain items of income including dividends provided in India's DTAAs with the third State (Country Y, in this case) will be available to the first (OECD) State (Country X, in this case) **only when all the following conditions are met:**

Condition		Satisfaction of condition in the case on hand
(i)	The second treaty (with the third State) is entered into after the signature/ Entry into Force of the treaty between India and the first state	This condition is satisfied as India has entered into a DTAA with Country Y on 15.5.2018, after it has entered into a DTAA with Country X on 1.1.2018.

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(ii)	The second treaty is entered into between India and a State which is a member of the OECD at the time of signing the treaty with it;	This condition is satisfied as India has entered into a DTAA on 15.5.2018 with Country Y, which is a member of OECD since 2017. Hence, on 15.5.2018, Country Y was an OECD member.
(iii)	India limits its taxing rights in the second treaty in relation to rate or scope of taxation in respect of relevant items of income	This condition is satisfied since in DTAA between India and Country Y, dividend is taxable@10%.
(iv)	A separate notification has been issued by India, importing the benefits of the second treaty into the treaty with the first State as required by the provisions of section 159(1) of the Income-tax Act, 2025.	In this case, conditions (i), (ii) and (iii) mentioned above have been satisfied. The concessional rate of 10% can be applied for taxing the dividend received by Matrix Inc. from Pilu Ltd., an Indian company, only if India has issued a separate notification importing the benefits of India-Country Y tax treaty into India-Country X tax treaty, as required by the provisions of sections 159(1). If such notification has been issued, then, the concessional rate of 10% can be applied for taxing the dividend received by Matrix Inc. from Pilu Ltd., an Indian company; otherwise it cannot be applied, even if other conditions are satisfied.

In case if Country Y became an OECD member only in the year 2020, then, the concessional rate of 10% cannot be applied for taxing dividend received by Matrix Inc. from Pilu Ltd., since Country Y was not an OECD member on 15.5.2018, at the time when India signed the DTAA with it. Consequently, condition (ii) mentioned above would not be satisfied in such a case. Hence, dividend received by Matrix Inc. from Pilu Ltd. would be subject to tax@15%.

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