The court suggests that such a rule can be applied by a single state to give an undefined term the meaning under its domestic law, but that the rule cannot be used to arbitrate divergences of interpretation between two contracting states. A contrary view to that taken by the court would be to treat art 3(2) in such a situation as requiring priority to be given to the interpretation in one of the two states; for example, priority to be given to the interpretation in the state of source. That, however, is not the approach taken by the Court of Justice: instead, the court applies the methods of international law, and specifically art 31 of the Vienna Convention on the Law of Treaties, to the issue of interpretation. That approach leads the court to its conclusion.

In a series of cases pending before the Court of Justice at the current time, the issue of the interpretation of the term 'beneficial owner' is central, and that will require the court to look at issues such as the changes made to the OECD Commentaries. It is quite possible, therefore, to see the court as gradually developing a common European approach to tax treaty interpretation.

COMMENTARY

The Grand Chamber of the European Court in its capacity of chosen arbitrator under the Germany-Austria treaty (2000) has given its first decision interpreting a tax treaty. When this arbitration provision was first introduced some of us had reservations about asking the Court to do something outside its normal jurisdiction. There are aspects of the decision that prove that we were right to be concerned.

The issue is whether the certificates in question issued by a German bank fell within art 11(1) of the treaty (see para 4) (in which case only Austria could tax the interest), or within art 11(2) (see para 5[1]) (in which case Germany had a right to tax under its domestic law and Austria had to give credit for that tax). The certificates had a fixed rate of interest but were subject to the qualification that if payment of the interest would give rise to an accounting loss then payment was deferred and the arrears were payable with the subsequent period but subject to the same qualification. As the court put it clearly at para 53 *payment* might be affected by the sufficiency of profit but there was no *entitlement*, in addition to annual interest, to share in any profit. The issue is therefore whether certificates with these terms were 'debt-claims with participation in profits.' One would have thought that since they could never participate in any profit

1 The court's translation of the German original seems accurate, except that 'Contracting State' would be better than 'Contracting Party'. However, the IBFD database translation starts 'However, income derived by a silent partner …' omitting the opening general words 'Income from rights or debt-claims with participation in profits, including income received by a silent partner …' The IBFD has been informed of this.

a the answer was clearly that they were not. However, the case arose because the *Bundesfinanzhof* had previously decided to the contrary in interpreting this treaty.

Two methods of interpretation come into play with tax treaties: art 3(2) (see para 3) and the interpretation provisions of the Vienna Convention on
b the Law of Treaties (VCLT) (see para 39). The authors disagree about the order in which these should be applied: JAJ considers that the wording of art 3(2) requires one to decide not to use domestic law before considering an alternative interpretation; JL considers that one should first consider whether the expression can be interpreted in accordance with its wording,
c as the *Bundesfinanzhof* did in the judgment referred to at para 34. Without attempting to resolve this here because, as will appear, domestic law does not give a clear answer, the following questions potentially arise without agreeing about the order of their application:

d (a) does the expression 'debt-claims with participation in profits' (*Gewinnbeteiligung*) have a meaning in German tax law that includes these certificates?

(b) if so, does the context (as that term is used in art 3(2)) require that one should *not* interpret that expression in accordance with
e German tax law?

(c) if so, how should it be interpreted?

As to question (a) Germany seemingly relied on the interpretation of the concept under its national law (para 34).[2] This is strange because the *Bundesfinanzhof* judgment referred to at para 34 is in fact an
f interpretation of those words in this particular treaty, and the *Bundesfinanzhof* derived its interpretation by referring to the general linguistic usage (*allgemeiner Sprachgebrauch*) which needs to be in accordance with the meaning and context of the treaty (m.no. 19); hence, there was no need for the court to refer to domestic law (m.no. 25). The
g ECJ does not make any finding on German domestic law.

In fact the expression *Gewinnbeteiligung* is not used in German domestic tax law although the virtually identical expression *Beteiligung am Gewinn* (which is also used in art 11(3) of this treaty) is used; it is
h unclear whether the certificates in question fall within it.[3] What the court

2 *Heinz Jirousek*, who represented the Austrian tax ministry in the hearing at the ECJ on 6 December 2016, reports that Germany claimed that *Gewinnbeteiligung* should be interpreted referring to national law (art 3(2)), see SWK-Heft 28, 2017, p 1186.

i 3 It is used in two instances. First, it excludes the application of the Interest Royalty Directive on interest, as foreseen there in art 4(1)b. The legislative Material (of 2004) is not very clear, but mentions *partiarische Darlehen, Gewinnobligationen, stille Gesellschaft* and *Genussrechte* as being covered. Also covered (free translation) are payments, which instead of a fixed interest rate promise a higher or lower interest payment that is dependent on the profit of the debtor ('*vom Gewinn des Schuldners*

says about art 3(2) is extremely confusing. Having quoted it in full at para 3 the court wrongly paraphrases it at para 35 by saying that the term 'must be given the meaning it has under the tax law of the state applying it.' This omits[4] the phrase 'unless the context otherwise requires'. Worse is to come. At para 36 they try to write art 3(2) out of the treaty, saying that it is not a rule intended to arbitrate between divergencies of interpretation. The opposite is the case. Suppose both states had different domestic law definitions of a term, and suppose that the facts are that the income is exempt in the source state. The effect of domestic law applying by virtue of art 3(2) is that each state uses its own domestic law definition, with the result that each would exempt whatever it charged to tax. This is obviously the desirable result; it would not matter that each exempted something different because each taxed something different in the first place. Therefore the purpose of art 3(2) is to deal with such divergencies; whether it applies could be the precise issue in the case.[5] Next, and even more extraordinarily, at para 37 the court justifies writing art 3(2) out of the treaty by saying that its application would deprive the arbitration provision of all practical effect.[6] Surely whether domestic law applied would have been the issue to be decided in the arbitration. Let us suppose that the treaty had actually contained a definition of 'debt-claims with participation in profits' (*Gewinnbeteiligung*) the court would still have had to consider whether the context otherwise required that the definition should not be used. One presumes that the court would not have used either of these two arguments in deciding that the context did not otherwise require, although the result would have been that there was no reason for any arbitration. It should be no different where the definition is by reference to domestic law, again subject to the context otherwise requiring.

As domestic law is unclear about whether the certificates in question are included there is nothing to consider in relation to question (b). But if it had arisen the court would have needed to consider whether the context (in its widest sense, not the restrictive sense of the definition in the VCLT where its purpose is to distinguish between primary (art 31) and secondary

abhängig'). Second, it draws the line between deductible and non-deductible payments on *Genussrechte* if the instrument provides for a '*Beteiligung am Gewinn*' and a participation in the liquidation proceeds. There is no case law available which deals with a fixed interest which is subject to sufficient profits.

4 This is also criticized by *Heinz Jirousek* (see SWK-Heft 28, 2017, p 1187 in fn. 9).

5 The Advocate General at para 81 also makes the point that the definition of interest is independent of domestic law but that would not necessarily prevent domestic law being used to interpret a term within the interest article, which is the issue in question here.

6 The Advocate General at para 107 said the same but in relation to the *Bundesfinanzhof* judgment in the interpretation of the treaty, which is a different point.

(art 32) interpretative material) required that domestic law should not be used.[7] Question (b) is purely negative, that of deciding whether domestic law should *not* be used. It is not part of the step to establish a different meaning because if one did there would be a danger of mixing up the two meanings of 'context', the art 3(2) context to decide that domestic law should not be used, and the VCLT context to find another meaning, when trying to do both at the same time.

Having established that the domestic law meaning is unclear one can then move to question (c) and consider what is the meaning of 'debt-claims with participation in profits' (*Gewinnbeteiligung*).[8] No criticism can be made of the court's (and the Advocate General's) approach which regards the 'including' phrase as describing a genus of instruments which are *entitled* to share in the profits (see paras 44 to 47), that is to say that there is in all these cases the possibility of an 'upside' rather than a fixed return[9].

Another criticism can be made of para 49. The idea of strict interpretation of a derogation is a European concept which has no place in the VCLT. Article 11(1) and 11(2) live together and are to be interpreted in the same way in accordance with the rules of the VCLT without, we suggest, one being interpreted more strictly than the other.[10]

The arbitration provision in that treaty was ahead of its time when it was introduced and one can understand the parties wishing to have an arbitrator with the standing of the European Court. The world has,

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7 The Advocate General at para 82 does make such a finding (but without saying whether there was any domestic law meaning).

8 Interestingly, neither the *Bundesfinanzhof* nor the ECJ look at the purpose and historical development of the clause, which was developed by German treaty practice. An early example can be found in Germany-New Zealand (1978) '… is derived from rights or debt-claims carrying the right to participate in profits (including income derived by a sleeping partner …' (art 4 lit. b)aa) protocol). The purpose was, in particular since the introduction of the CPT imputation system in 1977, to prevent foreigners from replacing profit distributions (without a CPT credit being available) by tax deductible profit depending payments (see legislative materials, BT-Drucks. 8/3918, p 26). A similar provision is included in art 7 protocol to Germany-Canada (1981). The legislative materials mention for the inclusion of a '*stille Gesellschaft*' the fact that the participation on the profit of the company leads to deductible payments and for the inclusion of '*partiarische Darlehen*' the avoidance of abusive legal structuring options (see BT-Drucks. 9/1620, p 40/41). Appropriate fixed interest rates, yet subject to sufficient balance sheet profits, were not in the focus.

9 The Austrian tax administration mainly relied on the missing 'upside' in contrast to the 'downside' of a 'participation' in losses, if any (see EAS 2641, 20 July 2005). They admitted, however, that there might be a 'participation in profits', if the fixed interest rate is that high that under normal circumstances the actual payments would always be lower (see EAS 3104, 25 November 2009). Critically to the ECJ reasoning *Michael Lang*, SWI 2017, p 513.

10 Similarly *Michael Lang*, SWI 2017, p 513.

of course, moved on since then, particularly with the optional arbitration provision in the MLI which has found favour with 27 states (to which should be added the US as a leader in the tax treaty arbitration field even though it did not sign the MLI). This allows each party to choose an arbitrator and for the chosen arbitrators to appoint a chairman from a third state. Our conclusion is that this is the way forward as it enables expert arbitrators to be chosen. In the light of its decision we do not expect the court to be included in an arbitration clause again.

The judgment was as usual preceded by an Advocate General's opinion, which is not reproduced here. We would describe it as unnecessarily lengthy running to 111 paragraphs, and coming to the same conclusion as the court. It is an additional step in what should be a speedy procedure. Arbitrators chosen by the parties for their expertise on treaties would produce a decision without the delay of any such intermediate step.

John Avery Jones
Juergen Luedicke

Cases cited

Brita GmbH v Hauptzollamt Hamburg-Hafen Case C-386/08 [2010] ECR I-1289, ECJ.

Pringle v Government of Ireland (Case C-370/12) EU:C:2012:756, [2013] All ER (EC) 1, ECJ.

12 September 2017. The **Court of Justice** (**Grand Chamber**) gave the following judgment.

Judgment.

1. By its application, the Republic of Austria asks the court to rule on the dispute which has arisen between it and the Federal Republic of Germany concerning the interpretation of art 11(2) of the Abkommen zwischen der Republik Österreich und der Bundesrepublik Deutschland zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen (Convention between the Republic of Austria and the Federal Republic of Germany for the avoidance of double taxation with respect to taxes on income and capital) of 24 August 2000 (BGBl. III, 182/2002, 'the Austro-German Convention') concerning the taxation of the interest from financial instruments (*Genussscheine*) issued by a company with its seat in the Federal Republic of Germany and held by a company with its seat in the Republic of Austria.

LEGAL CONTEXT

The Vienna Convention

2. Article 31(1) of the Vienna Convention on the Law of Treaties (Vienna, 23 May 1969; TS 58 (1980); Cmnd 7964) (United Nations