BELGIAN FOREIGN TAX CREDIT RULES IN CASE OF DIFFERING INCOME CHARACTERIZATION: DECISION OF THE BELGIAN SUPREME COURT OF 22 JANUARY 2010

I. Introduction

Problems of double taxation relief often arise from different characterization of income. Many of those interpretation issues are caused by the interaction of the treaty with internal law. When two parties to a tax treaty qualify transactions differently, like the Belgian and Czech tax authorities did in the case we discuss hereafter, this leads in some situations to double taxation. Needless to say, it is important to resolve those issues and avoid where possible.

If a treaty is concluded according to the OECD Model Convention (hereinafter: the Model), different items of income, like dividends, interest and royalties are identified by reference to the treaty articles containing the definitions of those expressions. As a general principle, the residence State is obliged to give credit, when the source State taxes in accordance with these definitions.[1] Despite this, states often grant a treaty foreign tax credit (hereinafter: FTC) by reference to internal law rules. Generally, under domestic law rules, credit is given irrespective of the characterization of the income in the source State. Belgian tax authorities for example[2], have always applied the domestic law definitions of dividends, interest and royalties when giving credit, regardless of the treaty definition. Belgian tax authorities are of the opinion that Belgium should not grant the credit determined by the qualification of the income under the treaty, and as a consequence for the underlying tax that is charged by the source State in accordance with the treaty, but on a basis of the characterization of income that does accord with the Belgian definition. In this respect the Belgian Supreme Court confirmed on 22 January 2010[3] that the Belgian FTC has to be granted in function of the qualification of the income under Belgian *domestic* law. The different qualification of this income for treaty purposes has to be ignored. As a consequence, as the Court enunciated, the amount of FTC granted by the Belgian tax authorities has only to be calculated on the interest part incorporated in the allowance for the lease, since under Belgian internal law the lease qualified as a finance lease. Hereby, the Court has overturned the decisions taken by the Brussels Court of First Instance[4], as well as the Brussels Court of Appeals[5], which both decided that the treaty classification should be followed.

[1] Art. 23 A.2 OECD Model Convention; see also John F. Avery Jones et al., ‘Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization’, European Taxation 1996, pp.118-134, at p.119.

[2] Belgium is an exemption state that nevertheless uses credit for relieving double taxation on “income from movable property and funds and some [negligible] miscellaneous income”.

[3] Supreme Court, 22 January 2010, F.08.0100.F.

[4] Court of First Instance Brussels, 7 October 2004, *FJF* 2006, No. 91, 292.

[5] Court of Appeal Brussels, 12 September 2008, *FJF* 2009, No. 186, 752.

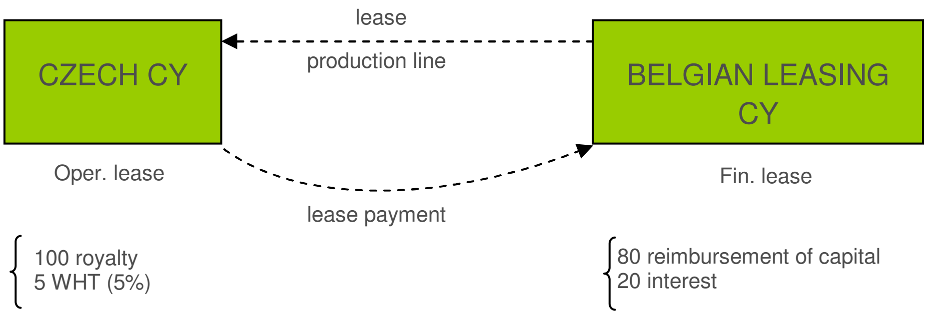
II. Summary of facts

The facts were the following: the taxpayer, a Belgian leasing company, leased a rubber production line to a Czech company in exchange for lease payments. Under Czech law, the arrangement was characterized as an operating lease. In accordance with Art. 12 (royalties) of the Belgium - Czech Republic Income and Capital Tax Treaty of 19 June 1975 (hereinafter: the treaty) the Czech tax authorities withheld a 5% source tax on the total amount of the lease payments.

Art. 12.3.(b) of the treaty defines "the term 'royalties', as used in this Article" as: *"payments of any kind received as a consideration for the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment not being immovable property mentioned in Article 6, and for information concerning industrial, commercial or scientific experience."*

Art. 12.2 of the treaty allows the Czech Republic to tax the lease payments under the following conditions: *"Notwithstanding the provisions of paragraph 1, the royalties mentioned in paragraph 3 at (b) may also be taxed in the Contracting State from which they are derived and according to the law of that State, but if the recipient of the royalties is the beneficial owner thereof, then the tax so charged shall not exceed 5 percent of the gross amount of the royalties."*

The Belgian tax authorities, however, classified the arrangement as a *finance* lease referring to Belgian accounting law. Contrary to an operating lease, which is a genuine rental, a finance lease or capital lease is primarily a method of raising finance to pay for assets. In return for the initial purchase of the asset by the lessor the lessee pays a series of instalments for the use of the asset. Under Belgian accounting law (and therefore also for Belgian corporate income tax purposes), these lease payments do qualify partially as interest and, unlike the amount of instalments which covers the cost of the asset, only the earned interest from the rentals paid by the lessee is regarded as taxable income. As a result, only the interest part of the lease payments was included in the taxable income of the lease company for purposes of Belgian corporate income tax.



As far as the Belgium-Czech Republic treaty is concerned, Belgium had to grant relief from double taxation according to Art. 23.A.(b) of the treaty reading as follows: *"As regards […] any royalties subject to tax in accordance with paragraph 2 or 6 of Article 12, **a lump sum foreign tax credit**, **provided for by Belgian law**, shall be granted with respect to Belgian tax relating to such income**, under the conditions and at the rates provided for in that law.**"*

All depends therefore on the interpretation of the phrase: '*a lump sum foreign tax credit, provided for by Belgian law, shall be granted*' with a particular emphasis on the interpretation of the wording '*under the conditions and at the rates provided for in that law*'.

But before we reproduce the decision of the Court of First Instance, the Court of Appeal and finally the Supreme Court, we should briefly outline the underlying tax credit system under Belgian domestic law.

II.1 Belgian underlying tax credit system

II.1.1 Art. 285 BITC

Article 285 of the Belgian Income Tax Code 92 (hereinafter: BITC) provides that "a foreign tax credit is allocated on the Belgian tax due when such income has been subject to a foreign tax similar to personal, corporate or non-residents income tax, provided such capital and property are used in Belgium for professional purposes."

II.1.2 Art. 286 BITC

The text of Art. 286 BITC sets the foreign tax credit "at fifteen eighty-fifths of the net income (15/85), before Belgian withholding tax –if applicable- on dividends, interest and royalties". The income received is grossed up by the fixed credit.

II.1.3 Art. 287 BITC

For income "from movable property other than dividends and from income from renting, leasing, use or franchise of such movable property" (i.e. basically the FTC applicable on interest payments), however the foreign tax credit is determined according to a complicated equation as provided for in Art. 287 BITC. Basically is this credit equal to a fraction of which the numerator is equal to the foreign tax and the denominator is equal to 100 minus the rate of the foreign tax. In no case may the credit exceed 15/85 of the net amount received[6]. Furthermore is the foreign tax credit limited by a fraction of which the denominator is equal to the total ordinary gross income (excluding capital gains) and the numerator is equal to the same income minus

[6] Art. 287 BITC reads "The product of a fraction of which the numerator is equal to the foreign tax actually withheld expressed as a percent of the income to which it relates, without exceeding 15% of the income, and of which the denominator is equal to 100 minus the number of the numerator."

related financial expenses[7]. The income received is grossed up by the fixed credit.

The question therefore rises how the amount of FTC for Czech withholding taxes to be granted in Belgium, has to be determined and calculated?

[7] Art. 287 BITC further reads "The product of a fraction of which the numerator is equal to the positive difference between the total amount of the denominator and the total amount of income from funds and personal assets, excluding dividends, that the company bore during the taxable period, and of which the denominator is equal to the sum of the total amount of income from real property, funds and personal assets and of the gross amount of occupational income, excluding realized or unrealized capital gains."

The answer to this question made quite a difference for the taxpayer[8]. If the treaty classification of the payment (i.e. as a payment of *royalties*) is upheld for the application of the FTC, then a credit for the full amount of the payment is granted, at a fixed rate of 15/85 of the net amount. If we take the same numbers as utilized in the diagram above, this means that a lump sum credit at the fixed rate of 15/85 of the net amount has to be granted.

8 It should be noted, that the qualification under Belgian law as finance lease, does not necessarily results in an advantage for the Belgian lease company. If the Belgian accounting law would follow the treaty qualification, the lease would qualify as an operating lease. Unlike under a finance lease, as explained above, the whole lease payments would then be included in the taxable base. However the leased out asset would appear on the balance sheet of the lease company and, due to depreciation, the taxable profit would be reduced. This only leads to temporary differences. Throughout the times, the taxable income would not differ if the income qualifies as finance or operating lease. By contrast, for the FTC granted, the qualification is of major importance. The qualification as finance lease results in a much smaller amount of FTC. Under Arts. 286 and 287 of the Belgian Income Tax Act, the general rule for foreign source royalties and interest (and other income from movable property), not derived through a permanent esrablishment abroad, is that they are taxed in Belgium for their net amount whereby a fixed foreign tax credit (FTC) is granted if the income has been subject to a foreign income tax. The FTC is:

– in respect of royalties, equal to 15/85 of the net amount received. The income received is grossed up by the FTC (Art. 286 BITC).
– in respect of interest, equal to a fraction of which the numerator is equal to the foreign tax and the denominator is equal to 100 minus the rate of the foreign tax. In no case may the credit exceed 15/85 of the net amount received (Art. 287 BITC).

The Belgian lease company has to settle for a considerably lower FTC as would be the case for an operating lease, while the levying of taxes in Belgium on a finance lease is not substantially lower.

If, on the other hand, the domestic classification (i.e. payment of *interest*) applies, then the taxpayer is only entitled to a credit calculated on the interest part, and even more, is not determined by the fixed rate of 15/85, but is limited only to 5% (i.e. the foreign tax withheld at source) of the interest part. This can be illustrated by taking the same numbers as are utilized in the previous diagram. Since under Belgian domestic law only 20 of the total payment of 100 qualifies as interest, the taxpayer would only be entitled to a FTC calculated on this part. Moreover, the FTC would not be determined at the fixed rate of 15/85 but according to the complicated equation as provided for in Art. 287 BITC.

II.1.4 The official Belgian commentary on tax treaties

The official Belgian commentary on tax treaties[9] makes the point that credit for the underlying foreign tax under this type of income (dividend, interest, royalty) is given under domestic law, but only if the income is considered to be a dividend, interest or royalty under Belgian tax law. In *Com.Ov.* 23/124, the Belgian tax authorities put forward that granting FTC "*with respect to Belgian tax relating to such income, under the conditions and at the rates provided for in that law*" means that the method for granting the FTC is the one used to determine the amount of FTC purely under internal law, and besides these situations, no FTC is granted even though when the income does qualify under the treaty definition of dividends, interest or royalties in the source State.

Consequently the Belgian tax authorities have decided that under Art. 23.A.(b) of the treaty only an FTC for the interest part of the lease payment can be allowed and the FTC has to be determined according the provision laid down in Art. 287 BITC.

9 *Com.Ov.* chapter 23, para. 23/124.

II.1.5 Court of First Instance and Court of Appeal

Both the Court of First Instance[10] and the Court of Appeal[11] decided in favour of the Belgian tax payer (i.e. the lease company). According to the Court of Appeal, the lease payments qualified as royalty payments within the meaning of Art. 12.3.(b) of the treaty. As a result, the Belgian tax authorities could not ignore this treaty classification when applying the FTC, even though that the creditable amount was determined by Belgian domestic law, it had to be done in function of the definition of the income under the treaty. In the Court's opinion, the integral lease payment has to be taken into consideration to calculate the FTC. The article of the treaty that deals with the elimination of double taxation (Art. 23.A.(b)) has to be understood in the sense that Belgium has to eliminate double taxation by granting the FTC, as is foreseen in the internal law for the type of income as it qualifies under the treaty. The qualification in the treaty is decisive for the grant of the credit under Belgian internal law. The fact that under Belgian domestic law a part of the leasing income was not taken into account when determining the taxable profits in the corporate income tax, because it corresponded for accounting purposes and from an economic perspective to a repayment of capital, and not to profits, did not affect this conclusion.

II.1.6 Decision Supreme Court

The Supreme Court[12], however, overturned that decision[13] and decided in favour of the tax authorities. According to the Supreme Court, the definition of 'royalties' incorporated in Art. 12.3.(b) only determines the field of application of this article. When it comes to Art. 23.A.(b) of the treaty, it held that the domestic classification should be decisive. The Court bases its decision – i.e. that the definition of royalties in Art. 12.3.(b) only determines the scope of *that* provision - on the wording of Art. 23.A.(b) which refers to "*a*

[10] Court of First Instance Brussels, 7 October 2004, *FJF* 2006, No. 91, 292.
[11] Court of Appeal Brussels, 12 September 2008, *FJF* 2009, No. 186, 752.
[12] Supreme Court, 22 January 2010, F.08.0100.F
[13] Since the decision of the Brussels Court of Appeal was overruled, it has now been redirected to the Court of Appeal of Mons.

fixed foreign tax credit, provided for by Belgian law, under the ***conditions and at the rates*** *provided for in that law*". According to the Supreme Court, this reference to domestic law includes the characterization of the income, the determination of the **taxable base and the calculation** of the amount of the FTC. Consequently, the Supreme Court decided that the domestic classification should be followed for the calculation of the FTC. As a result, the FTC was granted only for the interest part of the lease payments, and not for the total amount of the lease payments.

As indicated above art. 287 BITC contains the following exact wording: "*The product of a fraction of which the numerator is equal to* ***the foreign tax actually withheld*** *expressed as a percent of the income to which it relates, without exceeding 15% of the income, and of which the denominator is equal to 100 minus the number of the numerator*." But what exactly constitutes "the foreign tax actually withheld"? Is this the nominal amount as withheld by the debtor or is it 5 % of only that part of the payments which are taxable under Belgian domestic law (i.e. the interest part).

Let's exemplify this: The Czech Republic has withheld a tax 5% of a total lease payment which amounts up to e.g. 100. If Belgium only considers e.g. 20 (i.e. the interest part) as taxable income of the total lease payments of 100, a different reading of "*the foreign tax actually withheld*" has important consequences for the amount of relieved double taxation:

Unfortunately, this issue was not addressed by the Supreme Court, since it was neither contested by the Belgian tax authorities nor the Belgian tax payer. The Supreme Court simply states in its judgment that the "*treaty thus refers to the calculation as is regulated by the Belgian law, including the settlement of the taxable basis and the calculation*" to fix a lump sum of the foreign taxes. The Court simply refers to the determination of the taxable base and calculation of the FTC as is foreseen under Belgian law and it is regrettable that the Court didn't discuss this subject matter more into detail.

III. Comments

The questions that have to be answered, in the following order, are:

1. Does the distributive rule of Art. 11 or 12 of the treaty apply?
2. Does the qualification of the income under Art. 12 also govern Art. 23?
3. If the definition provided in Art. 12 does affect Art. 23, does the express reference to internal law as mentioned in the Belgian-Czech treaty influence this?

III.1 Is the distributive rule of Article 11 (interest) or Article 12 (royalties) of the treaty applicable?

As residence State, Belgium has the right to analyze if the qualification of the lease payments under the treaty made by the Czech authorities is correct, since the residence State is not bound by the qualification of the income made by the source State if it is incorrect[14]. The treaty contains an autonomous definition of interest and royalties which with certainty applies for treaty purposes, regardless of how the internal tax of accounting law in the residence state qualifies the income[15].

The Belgian tax authorities raised before the Court of Appeal the objection that their Czech colleagues had misinterpreted the treaty. The Belgian authorities upheld that also under the treaty, a part of the lease payments had to be qualified as interest (and consequently fell within the scope of Art. 11 of the treaty) and the other part was to be considered as a reinstatement of the invested capital. However, the qualification of the lease payments by the Czech authorities as 'royalties', as is defined in Art. 12.3.(b) of the treaty, was in the authors' opinion undoubtedly correct. The decision by the Court of

[14] Model Tax Convention on Income and on Capital, Commentary on Art. 23, § 32.5 (Paris, July 2010)
[15] Klaus Vogel et al., *Klaus Vogel on Double Tax Conventions*, Third edition (London, Kluwer Law International,1997), p. 785.

Appeal[16] confirmed this, as the Court judged that the finance lease didn't imply a transfer of ownership, but had the use of the production line as object. The Supreme Court didn't overturn the decision of the Court of Appeal on that point, and consequently the right to tax the payments by the source State (i.e. Czech Republic) is limited up to 5%. Moreover, in front of the Supreme Court the Belgian tax authorities didn't claim anymore that the lease payments disqualified under Art. 12 of the treaty.

III.1.1 Does the definition of royalties in Article 12.3.(b) also apply for the application of Art. 23 of the treaty, and more precisely for determining the method of eliminating double taxation?

III.1.1.1 Cross-reference in the relief article to the royalties article by number

The term royalties was defined in Article 12 of the Treaty and stated to be "*as used in this article*". The issue is whether the definition of the term royalties "*as used in this article*" limits the definition to that article or has to apply more generally. The provision for the avoidance of double taxation namely also refers to royalties.

For all royalties, credit is given in Art. 23.A.(b) for the withholding tax on royalties payable in accordance with the convention. Most authoritative commentators consider the definition of royalties in the Art. 12 (royalties) to be necessarily incorporated into the credit provision as this deals with the same subject matter: i.e. (a credit for) withholding tax and as art.23.A.(b) of the Treaty refers explicitly to *"any royalties <u>subject to tax in accordance with paragraph 2 or 6 of the Article 12</u>"*. The definition laid down in the distributive rule is related to a treaty article dealing with withholding taxes and so the definition of royalties, on which withholding tax was charged and for which a credit should be granted in Art. 23 of the Treaty, was obviously impliedly imported. Generally speaking it is accepted that a State should be more specific if it wants the '*royalties*' elsewhere in the treaty (in another article than the distributive rule (Art. 12)) to preserve its internal law meaning. It is not sufficient to rely on the limitation in the royalty article "*as used in this*

16 Court of Appeal Brussels, 12 September 2008, *FJF* 2009, No. 186, 752.

article" to restrict its effect to that article, particularly when the term is used elsewhere in the treaty in a context which imports the definition[17].

III.1.1.2 Article 3.2. of the Treaty : A term not defined in the treaty, has to be interpreted under the law of the state applying the treaty, unless the context otherwise requires.

If the answer however would be that the definition contained in Art. 12.3.(b) of the Belgian-Czech Treaty should despite the explicit reference to art. 12.3.(b) *not* be automatically used for the application of the double taxation relief article – quod non in the authors' opinion - it follows that the term royalties is undefined under Art. 23.A.(b) and so Article 3.2 of the treaty should apply *unless the context otherwise requires.*[18]

Klaus Vogel states in this respect the following: "*Art. 3.(2) MC however, refers to domestic law only in cases of terms not defined* ***by the treaty****. The Article does not read: "not defined in the relevant Article".*[19] *(…). If, however, an Article of a DTC employs a term defined - earlier - in another Article of the same DTC, the very context will militate for also using that definition in connection with an interpretation of the later Article, unless the Article giving the definition expressly rules this out (…).*"[20]

We therefore conclude that in the case at hand the definition of art. 12.3.(b) of the Belgian-Czech treaty should equally apply for art. 23,A,b of the same treaty.

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17 John F. Avery Jones et al., 'Whether the definition of dividend limited to the Dividend Article applies to the Double Taxation Article granting underlying credit', *Bulletin for international fiscal documentation* 3(1999), pp. 103-108, at p. 105; Debatin/Wassermeyer, *Doppelbesteuerung*, Band 1 OECD-MA, March 1998, Art. 10 MA annot.91; Klaus Vogel et al., *Klaus Vogel on Double Tax Conventions,* Third edition (London, Kluwer Law International,1997), p. 1226; John F. Avery Jones e.a., "Credit and Exemption…." , o.c., 126.

18 John F. Avery Jones e.a., "Whether the definition…", o.c., at p. 105;

19 This point of view is supported by case law cited by Klaus Vogel : a.o. German Bundesfinanzhof, 22 HFR 301 (1982);

20 Klaus Vogel et al., *Klaus Vogel on Double Tax Conventions*, Third edition (London, Kluwer Law International,1997), p. 1246.

III.1.2 Are the findings under 2. altered by an express reference to domestic law as mentioned in art. 23 of the Belgian-Czech Treaty?

III.1.2.1 Reasons for a reference to internal law

It is important to keep in mind that Art. 23.A.(b) Belgian-Czech Treaty only sets out the main rules of the credit method without going into any detail on the computation and operation of the credit[21]. Unlike the Model, Belgium makes treaty relief subject to internal law rules in its treaty double taxation relief articles. It goes without saying that the credit method has to rely more heavily of being complemented by domestic law than the exemption method. Reasons why treaties refer in their provisions for the avoidance of double taxation to internal rules are manifold. As Klaus Vogel describes it: "*Many reference figures and criteria depend so much on the tax law of the State allowing the credit that they are at all events incapable of being dealt with by a model convention, but are also in many cases unable to be defined more closely by individual bilateral treaties*"[22]. Most obviously, the reason lies in the fact that credit provisions often already existed in internal law before the treaties were concluded and, in addition, that they in general are complicated and contain more detailed rules than can conveniently be laid down in a treaty[23].

[21] Para. 60 OECD Comm. on Art. 23.

[22] Klaus Vogel et al., *Klaus Vogel on Double Tax Conventions*, Third edition (London,Kluwer Law International,1997), p. 1225.

[23] John F. Avery Jones et al., 'Whether the definition of dividend limited to the Dividend Article applies to the Double Taxation Article granting underlying credit', *Bulletin for international fiscal documentation* 3(1999), pp. 103-108, at p. 105.

III.1.2.2 Danger of referring to internal law rules in the double taxation relief article

As rightly indicated by John F. Avery Jones, the danger in the reference to internal law rules lies in the fact that it makes the question whether credit is given in cases of differing characterization of income primarily an internal law issue, rather than one of treaty interpretation, although it could become a treaty issue if internal law denied relief or was silent on the question of relief in cases of differing characterization[24].

Such an **express reference** to the conditions upon which a credit is given under domestic tax law[25] leads therefore more easily to the denial of relief for double taxation.

Another danger is caused by the fact that if the reference made to internal tax law is ambulatory, this may have as an affect that treaty relief can be influenced easily through a change in internal law. The Belgian Supreme Court ruled in such a sense on 19 June 2000[26], when confirming that the reference in the treaty concluded on 10 October 1970 between Belgium and the Netherlands which refers in the relief provision to the FTC as determined under Belgian internal law, gives the legislator the power to modify and adapt the credit system which was in existence on the date of conclusion of the treaty. This issue will be discussed more into detail under III.1.4.3.

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24 John F. Avery Jones et al., 'Credit an Exemption under Tax Treaties in Cases of Differing Income Characterization' 36 *European Taxation* 4(1996), pp. 118-134, at p. 119-121.

25 See Official Belgian Commentary on tax Treaties (*Com.Ov*.), para 23/124.

26 Supreme Court, 16 June 2000, F980029N, *Pas.* 2000, No. 377, 1120.

III.1.3 Belgian case law

III.1.3.1 Appeal and First Instance: FTC granted in function of the qualification of income under Art. 12.3.(b)

According to the Court of First Instance and the Court of Appeal, for the determination of the applicable method to eliminate double taxation, we have to take account of the *qualification under the treaty*. The Court of Appeal judged that the lease company was entitled to a FTC as is foreseen in the Belgian internal law for 'royalties' (on the total amount of lease payments). In the Courts opinion the **calculation** may be determined by the Belgian law, but has to be done in the light of the **qualification** under the treaty. The Court of Appeal is of the opinion that the reference made in the treaty to domestic law only has a limited range and implies only that the conditions and rules under internal law are referred to in *abstracto,* i.e. that they have to be applied in function of the treaty qualification. The point of view of the Court is supported by the explicit reference made in Art. 23 to the income of Art. 12.3.(b). As a consequence, the definition contained in this article is also applicable for the application of Art. 23, irrespective of the qualification under internal or accounting law. If the conditions laid down in internal law would lead to a requalification of the income in case of applying the article on elimination of double taxation, this would according to the Court harm this treaty provision. In addition did the Court of First Instance explicitly refer to the Vienna Convention of 23 May 1969 concerning treaty interpretation and propounded that a treaty has to be applied in 'good faith'.

The decision by the Brussels Court of Appeal is in line with the earlier decision of the Ghent Court of Appeal taken on 6 March 2001. In that case, concerning default interests paid by a French company to a Belgian Company, the Belgian tax authorities denied the grant of a FTC since they don't qualify under "income from funds and personal assets" as is required in Art. 287 BITC, although they did qualify under the interest article of the double tax treaty concluded between Belgium and France. The Court decided that treaty law transcends internal law and decides that the FTC has to be granted. It has to be noted that in the Ghent Court of Appeal case the total FTC was denied by the Belgian tax authorities due to the reference to domestic law, whereas in the case discussed above FTC would be granted, but only for a lower amount than would be the case if the treaty qualification would govern the application of the FTC. In the Ghent Court of Appeal case , under the qualification of the Belgian internal law, the double taxation on the default payments remained totally maintained.

III.1.3.2 Supreme Court and Belgian tax authorities: definition in domestic law applies

The tax authorities nevertheless explains the reference to conditions and rate differently which consequently leads to a new qualification issue. The administration departs from the position that the income qualifies as 'royalties' and totally ignores the treaty qualification. The administration upholds that the meaning on the term '**conditions'** is that the income has, as is provided in Art. 285 BITC, to qualify as "*income from funds and personal assets*" according to Belgian domestic law. Besides this they do refer to Art. 123 of the Royal Decree to the BITC, which requires that the income has to be included in the taxable basis under the corporation tax in order to grant a FTC. Well then, only the 'interest' part is included in this taxable base.

What concerns the **rate**, the administration is of the opinion that the rate as is provided in Art. 287 BITC (which is the lower rate for interest) (equal to a fraction of which the numerator is equal to the foreign tax and the denominator is equal to 100 minus the rate of the foreign tax, as this is the FTC-system under Belgian tax law in respect of 'interest') has to be applied.

As is explained above, the Supreme Court decided in favour of the administration. The Supreme Court's interpretation of Art. 23.A.(b) of the treaty is remarkable and (in the authors' opinion) regrettable since the Supreme Court simply states that Art. 23.A.(b) of the Treaty refers to the entire FTC-system, provided for by Belgian law which is granted "*under the conditions and at the rates provided for in that law*" and is in the Court's opinion applicable without any limitation (including the underlying Belgian accounting law).

III.1.4 Potential influence of general principles of interpretation of tax treaties under International law

III.1.4.1 Preliminary

Tax treaties are international agreements entered into between States. The interpretation of international treaties is governed by public international law, and especially by the Vienna Convention on the laws of Treaties (hereinafter: VCLT) of 23 May 1969. Belgium has ratified this treaty on 1 January 1992 and it came into force on 1 October 1992. The interpretation of the Belgium - Czech Republic Income and Capital Tax Treaty of 19 June 1975 can also be governed by the rules of interpretation in the Vienna Convention, since it is generally accepted that the Vienna Convention is also used in interpreting treaties concluded before this date due to the fact that it codifies international customary law[27].

The principle *pacta sunt servanda* is enshrined in Article 26 VCLT which provides that "*Every treaty in force is binding upon the parties to it and must be performed by them in good faith*". Given the facts described above it should also be emphasized that according to Article 27 VCLT "*A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty*".

The general rule of interpretation is laid down in Art. 31.1 VCLT.

"*A treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.*"

[27] See Para. 5 of the Official Explanation on Arts. 31-33 of the Vienna Convention on the laws of Treaties.

This provision contains three principles:

a) a treaty shall be interpreted in good faith;
b) terms are presumed to have their ordinary meaning;
c) taking into account the context of the treaty and in the light of its object and purpose.

The text of a tax treaty is the primary object of interpretation. The starting point of any interpretation is the elucidation of the meaning of the text, not an investigation into the intention of the parties. An interpretation going beyond what the treaty actually says in its terms (even if it is the presumed intention of the parties) is contradictory to Article 31 of the VCLT. [28]

III.1.4.2 Strict reading of the text

One possible point of view is that a *textual reading* of the treaty seems to require the treaty classification of the income to be upheld - since no reference in the text is made to the characterization of the income provided for in internal Belgian law - after which the FTC is applied under the **conditions and at the rates** provided for in Belgian domestic tax law. In such a strict reading only the conditions and rates, as foreseen in the Belgian FTC-system, will be applicable on the income which qualifies under the treaty as royalties. This results in a similar outcome as the overruled decision made by the Court of Appeal[29]. However, the Supreme Court reaches a different conclusion, holding that the reference to domestic law in the treaty includes the characterization of the income.. In the authors' opinion, however, such a conclusion can not be deduced from the strict terms used. Conversely, neither the opposite view contrary to the Supreme Courts opinion can be inferred.

It is therefore in the authors' opinion self-evident that the text of Art. 23.A.(b) which refers to "*under the conditions and at the rates provided for in that law*" is not 'plain vanilla' and leaves some interpretative issues unresolved.

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28 Frank Engelen, *Interpretation of Tax Treaties under International Law,* (Amsterdam;IBFD Publications, 2004), p. 427.

29 Mathieu Isenbaert, ' Royalty: Verdragskwalificatie niet relevant voor toepassing FBB', *Fiscoloog Internationaal* 316, pp.1-3, at p. 3.

This is externalized a.o. by the different positions taken by the Court of First Instance and the Court of Appeal on the one side and the tax administration and the Supreme Court on the other hand. In the authors' opinion this leads to the conclusion that the wording of the **reference** to Belgian internal law is unclear and a textual approach leads to an unsatisfactory result.

If the wording of Art. 23.A.(b) of the Treaty is unclear we have to interpret this provision taking into account the context of the Treaty and in the light of the '*object and purpose'* of this provision.

III.1.4.3 Good faith and object and purpose

The Supreme Court limits its judgement almost merely to a simple reference to domestic law. From the reading of the decision of the Supreme Court and the opinion of the Advocate General can be inferred that its main argument for its line of reasoning is that the determination of the basis of assessment is not a matter regulated by tax treaties. In the authors' opinion however, this is not the right question to address. Conversely, the Supreme Court had to ask itself, if by concluding the treaty Belgium has committed itself to take further steps towards the avoidance of double taxation than the provisions in its domestic tax law. In the authors' opinion, this question has to be answered with a straightforward 'yes', based on the following reasoning:

1. If the text is unclear, the VCLT provides that we have to determine the 'object and purpose' of the treaty. If the provision contained in Art. 23.A.(b) of the treaty cannot be considered as a clear text, the opinion of the Supreme Court is difficult to reconcile with the *object and purpose* of the treaty and Art. 23.A.(b) in particular. Consequently we have to determine what constitutes this '*good faith*' and '*object and purpose*' of the provision. Belgium, as the taxpayer's state of residence, has agreed to alleviate double taxation by granting a credit for tax withheld in the Czech Republic if the treaty allows the income to be taxed at source. The interpretation given to Art. 23.A.(b) by the Supreme Court has the effect of limiting the credit granted in Belgium to the interest part of the payments, even though the total amount of

the payment was taxable in the Czech Republic in accordance with the treaty. As a result, double taxation has not been entirely removed.

It is the purpose of double taxation treaties to fairly distribute revenues amongst Contracting States, to avoid double taxation, eliminate tax barriers to trade, encourage foreign investment, etc…[30] The primary purpose of a tax treaty is to avoid international juridical double taxation. Para. 3 of the Introduction to the OECD Model 2010 provides that the main purpose of the OECD Model tax convention is "*settling on a uniform basis the most common problems that arise in the field of international double taxation*". The treaty between Belgium and the Czechoslovak Socialist Republic refers in its title to the "Convention […] for the avoidance of double taxation". Besides this does the Recommendation of the OECD Council of 23 October 1997 recite as the reason for treaties that: "*Considering the need to remove the obstacles that international juridical double taxation presents to the free movement of goods, services, capital and persons between the Member countries and where appropriate to non-Member countries"*

Frank Engelen proclaims therefore that "*In cases where a tax treaty is open to two interpretations one of which does and the other does not eliminate double taxation, good faith and the object and purpose of the treaty demand that the former interpretation be adopted*"[31].

The same principle can be found in the Commentary on Articles 27 and 28 made by the International Law Commission to its final draft articles on the law of treaties. In cases where a treaty is open to two interpretations one of which does and the other does not enable the treaty to have appropriate effect, the dogma *ut res magis valeat quam pereat,* often referred to as 'the principle of effectiveness' which is implicit in the general rule of interpretation, through

30 "Interpretation of double taxation conventions", Cahiers de droit fiscal international, LXXVIIIa, Kluwer, 1993, 72;

31 Frank Engelen, *Interpretation of Tax Treaties under International Law,*(Amsterdam, IBFD Publications, 2004), p. 429.

the reference to good faith and the treaty object and purpose, demands the adoption of the former interpretation[32].

The authors are therefore of the opinion that in case of an unclear wording, a general principle of interpretation of double tax treaties based on Art. 31 of the VCTL should be withheld according to which an interpretation avoiding as much as possible double (non-)taxation should prevail (without brushing off the text itself of course).

2. Furthermore in the authors' view the principle of interpreting a text in the sense that it resorts effect has been set aside by the line of reasoning of the Supreme Court. Indeed, which added value has the engagement made by Belgium in Art. 23, A (b) if it exclusively refers to domestic law? If this is the interpretation we have to adhere, than this provision of the treaty does not add anything, and this section may just as well have been omitted. Again, this seems contrary to the 'object and purpose' of the treaty.

3. In addition can the interpretation by the Supreme Court lead to undesirable and sometimes absurd results. In the authors' view this can a.o. be supported by having a look at the reverse situation. Let's assume for a moment that the Czech authorities would have considered the agreement as a finance lease and had consequently limited the withholding tax to the interest part of the payment, e.g. 20 % of the total lease payment of 100. In such a case the Czech authorities would have limited their withholding tax claim to 10 %[33] of 20, being 2.

Let's further assume that Belgian law would consider the agreement as a 'simple' operational lease. In the view of the tax authorities, the characterization of the income should for double taxation relief purposes be done by reference to Belgian domestic tax law. In such a case Belgium will consequently consider the whole lease payment as a royalty which has been subject to tax in the source State. Still in the view of the tax authorities,

[32] YBILC, 1966-II, P.219, par. 6
[33] Art. 11.2. of the Treaty

Belgium will therefore by reference to its domestic tax law have to grant a lump sum tax credit equal to 15 % of the gross lease payment, being 15! Which is more than 7 times the withholding tax paid in the source State!

And this analysis can be supported by another example: let's assume that the above mentioned Belgian company is leasing a Czech real property to the Czech company. Let's further assume that the Czech Republic considers this lease as a financial lease and Belgium as a operating lease. Since the Czech Republic considers the lease to be a financial lease, a withholding tax of 10 % will be withheld by the Czech company on the interest part of the lease payment. The question then arises what kind of credit Belgium should grant for this Czech withholding tax? If the analysis of the Belgian Supreme Court were to be followed, Belgium will characterize this income as income from real property and grant a foreign tax credit as foreseen in Belgian domestic law for foreign real property income. The problem however is that Belgian domestic law doesn't have such a credit anymore in its domestic tax law which means that no avoidance of double taxation *at all* would be granted in this case. If on the contrary the characterization of the income for treaty purposes would have to be withheld when applying Belgian domestic FTC provisions – as advocated by the authors - Belgium will have to consider this income for foreign tax credit purposes as interest – which is the characterization of the income in the source country – and grant the relating foreign tax credit.

A textual argument for such an obligation can according to John F. Avery Jones[34] be found in the wording of the relief article of the Treaty (art. 23), which, unlike the Model, states that: "*Double taxation shall be avoided in the following manner*". Since there is a requirement to avoid double taxation, it seems clear that the residence state must follow the interpretation which avoids double taxation rather that the interpretation as applied by the Supreme Court which leads to no alleviation of double taxation at all.

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34 John F. Avery Jones et al., 'Credit an Exemption under Tax Treaties in Cases of Differing Income Characterization' 36 *European Taxation* 4(1996), pp. 118-134, at p.119.

The latter interpretation frustrates indeed the object and purpose of double tax treaties. It is therefore in the authors' view very questionable whether the interpretation of the unclear text of Art. 23.A.(b) of the Belgium-Czech Republic treaty, as made by the Belgian tax authorities and the Belgian Supreme Court, meets the principle of good faith, as well as the object and purpose of the treaty as referred to in the Vienna Convention.

4. On top of the above mentioned arguments does the argument of the 'ambulatory interpretation' favour the authors' opinion. One of the main difficulties in interpreting double tax treaties is whether one must apply the internal law meaning of terms at the time the treaty was signed (static interpretation) or the meaning it has at the time the treaty is applied (ambulatory interpretation). The latter view has been endorsed in the OECD Commentary[35]: i.e. the legislation in force when the treaty is applied must be referred to. Such an ambulatory interpretation has also implicitly been applied in prior case law by the Belgian Supreme Court[36].

On the moment when the treaty was concluded Belgium domestic tax law provided for a lump sum foreign tax credit of 15 % for royalties, interest etc…. Is was only many years later that Belgium changed its provision on foreign tax credit for foreign interest payments[37].

It is true that the Supreme Court[38] has already decided previously that an altered domestic provision with respect to the foreign tax credit can find application in treaties concluded before the modification of the FTC provisions. But this was in a situation which is in the authors' view not comparable to the situation at hand. One should know that Belgium changed in the eighties of the previous century its taxation of dividends, interest,

35 Paras. 11-12 OECD Comm. On Art. 3.

36 Supreme Court, 21 September 1990, RG F1851N, *Pas.* 1991, No. 219, 403.

37 The Belgium - Czech Republic tax treaty was concluded in 1975, whereas the 'fixed' FTC for interest was replaced by the product of two fractions only in 1993.

38 Supreme Court, 16 June 2000, F980029N, *Pas.* 2000, No. 377, 1120; See also under III.1.2.2.

royalties, etc… from a taxation at progressive rates to a taxation at a lump sum rate of 15 or 25 % depending of the nature of the income. Since the taxation in Belgium was therefore in most cases lowered, there is something to say for a denial of the foreign tax credit as mentioned in Belgians treaties (at least those which are referring to Belgian domestic tax law as the Belgian-Czech treaty did). One could say that the balance which was reached at the level of the treaty was disrupted in favour of the tax payer by modifying the taxation of income of movable property. In other words: if Belgium lowers its taxation on such items of income, Belgium could still lower its FTC without increasing the overall tax burden of the tax payer.

This is however not true for the case hand. Since the ratification of the Belgian-Czech treaty, no modification of the taxation at source in the Czech Republic neither of Belgian domestic corporate tax (except for the lowering of the standard rate) was introduced. At the time of the ratification of the treaty double taxation was fully avoided in Belgium. By changing its domestic provisions on foreign tax credit however and following the reasoning of the Supreme Court, the balance of the treaty was upset by Belgium: contrary to the commitment of Belgium at the moment of the ratification of the treaty, Belgium no longer fully avoids double taxation.

Due to the fact that through relevant changes in the domestic tax law, a State could rewrite the treaty and alter the scope of its international obligation, reference to internal law is in the authors' view subject in any case to the context not otherwise requiring. Accordingly, the ambulatory approach is subject to a limitation, i.e. it is valid as long as to the basis of the Convention was not significantly altered due to changes in domestic tax law. This is the so called 'limited ambulatory interpretation method'.

According to such an interpretation method changes in domestic law do affect earlier concluded treaties *except in two circumstances*. First, changes in domestic law can't work through on the treaty level if this would harm the balance or substance of the treaty. Second, changes in domestic law only work through if the context doesn't otherwise require.

5. Finally, on the first sight it might seem rather surprising that Belgium has to administer two different principles during processing the tax assessment: that is to say that on the one hand the income still qualifies as interest under domestic law, but on the other hand Belgium is obliged to grant a FTC for royalties based on the far-reaching commitments entered into through the conclusion of the treaty. This is however a logical application of treaty principles and is since many years applicable in Belgian tax law also in other circumstances. For example, if a Belgian resident individual rents out immovable property situated in Germany under a long term lease, such income may qualify under certain conditions in Belgian domestic tax law (Art. 10,§2 BITC) as interest income[39] Well then, while under domestic law such income will be treated as interest , Belgium will nonetheless have to exempt this income based on Art. 6 *juncto* 23 of the respective tax treaty. This means that due to a more far reaching commitment in the Treaty, Belgium will have to avoid double taxation (exemption with progression) as if it were income from real property even if the income fully keeps it characterization of interest for Belgian domestic tax law purposes.

IV. Conclusion

Opposed to the judgment given by the Belgian Supreme Court on 22 January 2010, which they consider very questionable, the authors conversely do adhere the decision taken by the Ghent Court of Appeal on 6 March 2001, the Brussels Court of Appeal on 12 September 2008 and the Brussels Court of First Instance on 7 October 2004, which all are in line. Given that the reference to a "*tax credit, provided for by Belgian law, shall be granted with respect to Belgian tax relating to such income, under the conditions and at the rates provided for in that law*" is unclear, we have to turn to the object and purpose of treaty. The authors refer for that to general treaty law, and more

39 "*income defined in Section 1* [*i.e. income from real estate*] *shall not include the sums obtained for the concession of a right of usage on improved real estate by virtue of a non-cancelable long term lease, surface rights or of similar real property rights*".

specifically, to the Vienna Convention on the laws of Treaties of 23 May 1969. As demonstrated under III.1.4. the application of Art. 31 of the Vienna Convention would support the position taken by the Court of First Instance and Court of Appeal, since it may be difficult to reconcile the Supreme Court's conclusion with the object and purpose of Art. 23.A.(b) of the treaty. Under that provision, Belgium as the taxpayer's state of residence has agreed to alleviate double taxation by granting a credit for the tax withheld in the Czech Republic if the treaty allows the income to be taxed at source. It seems that the Supreme Court's line of reasoning can be explained by its traditional position that tax treaties "do not regulate the basis of assessment" (see Supreme Court, decision of 29 June 1984, *Velasquez*, *FJF* 1984, No. 164, 279). That matter is governed by domestic law. From this traditional position, the Court infers here that the determination of the taxable base for purposes of the FTC is governed by domestic law. As a result, the classification of the income to be used for the purpose of applying the FTC is not the treaty classification but the domestic classification. This Velasquez doctrine of the Supreme Court has been heavily criticized before by Belgian and international tax practitioners and was finally condemned by the ECJ. It looks like this Velasquez alike analysis used by the Court in its ruling of January 22, 2010 is once more very questionable.