

# Mexican Court Rules on Principle of Good Faith in Treaties

**Kluwer International Tax Blog**

November 30, 2017

Koen van 't Hek (EY Mexico)

*Please refer tot his post as: Koen van 't Hek, 'Mexican Court Rules on Principle of Good Faith in Treaties', Kluwer International Tax Blog, November 30 2017, <http://kluwertaxblog.com/2017/11/30/mexican-court-rules-principle-good-faith-treaties/>*

---

Recently, a special Mexican Circuit Court (“the Court”) issued a ruling regarding the interpretation of an international convention (the North American Free Trade Agreement or “NAFTA”) which may signal broader guidance for the interpretation of treaties in Mexico. The case was ruled in order to resolve conflicting decisions by two Circuit Courts, as a result of which jurisprudence is established according to the Mexican legal system.

The Court, in effect, used “good faith” as a guiding principle in a balancing act between a literal versus a more liberal, almost teleological interpretation of a treaty term.

Even though the case involved a specific procedural aspect of NAFTA related to the process for verifying the origin of products, the generic elements of the ruling should apply to any international convention, including treaties for the avoidance of double taxation (“tax treaties”).

The rule of interpretation of article 31-32 of the Vienna Convention on the Law of Treaties (“VCLT”) and, specifically, the principle of good faith established in these rules will likely play a greater role in the context of tax treaties in the future, considering the recent signing of the Multilateral Convention to Implement Tax Treaty related Measures to Prevent Base Erosion and Profit Shifting (“MLI”).

Specifically, the MLI, by establishing new objects and purposes and introducing highly subjective and ambiguous terminology to tax treaties, has effectively

transferred discretionary powers to the tax authorities. As a result, courts will be required to interpret tax treaties in good faith thereby tempering states in the exercise of these discretionary powers.

## **The Case**

The recent Court case is related to the procedure of verifying the origin of products under a free trade agreement. Specifically, the issue at stake was whether the term “questionnaire” should be given a literal meaning, or whether the term should be interpreted more in line with the context of the verification process within NAFTA and in light of the objects and purposes of NAFTA.

In this regard, NAFTA establishes that the “certificate of origin” issued by the producer/exporter is the basic document to support the origin of products. However, this certificate is also the starting point for exercising the right to review and verify the origin by the customs authorities of the states, either by means of either (i) a questionnaire or (ii) a domiciliary visit.

The procedure of (i) the questionnaire is simple, fast and economic as it involves responding to a list of questions and is generally appropriate for sectors that do not involve a complex process. The (ii) domiciliary visit, on the contrary, is much more costly for the authorities and intrusive for the producer/exporter, and involves giving insight to the bookkeeping and providing original documents to support the purchase of raw materials and components used in the production process (which may be appropriate in more complex sectors such as automotive or chemicals).

The answers provided by the exporter/producer in the questionnaire can obviously raise additional questions whereby customs authorities may require supporting documentation in the form of copies of documents and invoices.

In this regard, the tax payer argued that the term “questionnaire” should be given a literal meaning (just a set of questions to be answered) which would preclude customs authorities from requesting such additional information.

The authorities argued that the term “questionnaire” is part of an overall verification process which is an essential element of NAFTA. The abovementioned literal interpretation would frustrate the questionnaire process as it would practically oblige authorities to initiate domiciliary visits in order to further verify a

certificate of origin. In order for the questionnaire process to have any practical effect, it should therefore be possible for authorities to request additional information (documents, invoices) to support information included or questions arising from a questionnaire.

### **The Vienna Convention on the Law of treaties**

The Court builds its decision around the main elements of the rule of interpretation laid down in article 31, paragraph 1 of the VCLT:

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

As part of this analysis, the Court refers to several cases of international courts and tribunals, including the International Court of Justice (“ICJ”), as well as parts of the reports of the International Law Commission (“ILC”) of the UN that formed the basis of the VCLT in the 1960’s.

In this respect, the Court first states that the interpretation of treaties is “governed by” the principle of **good faith** in order to give treaty terms their ordinary meaning, in their context and in light of the object and purpose of the treaty. As such, the function of the interpretation of good faith of the terms used in a treaty is that it makes effective the object or purpose that the treaty parties intended.

The principle of good faith should, according to the Court, also avoid that the ordinary meaning of terms frustrates the object (and purpose) of a norm. That is, the literal meaning of a term should be congruent with what the treaty parties tried to achieve in the context of the norm and considering the (technical) matter that regulates the norm, such that the meaning results in a useful and functional effect to achieve the object and purpose that treaty partners intended. This so-called principle of effectiveness is further explained by means of references and citations to other cases and advisory opinions of the ICJ.

Regarding the prevalence of the **ordinary and natural meaning** of terms, the Court cites an advisory opinion issued by the ICJ establishing that

*“the first obligation of a tribunal regarding the interpretation and application of treaty terms is to give effect to the terms in accordance with their ordinary and*

*natural meaning in their context. In case the words make sense upon giving them their ordinary meaning in their context, there is no need to investigate any further. On the contrary, where the ordinary meaning of the terms is erroneous or leads to irrational results, the tribunal needs to look further – through another method – to determine what parties really had in mind when they used the terminology in the treaty”.*

The Mexican Supreme Court had previously ruled in the same sense when it established that in case of international treaties, *“their interpretation has to be in accordance with the text in case the meaning of the words is clear and are aligned with their object and purpose”.*

The **context** of a treaty term includes the set of provisions to which the analyzed text should have a logical dependence. Treaty terms should therefore not be interpreted in isolation, but rather in harmony with other parts or sections in the treaty (or even other treaties).

According to paragraph 2 of article 31, the context specifically includes the preamble to the treaty, which is considered by the Court as a fundamental element, as it generally describes the object and purpose of the treaty that parties intend to achieve.

The last element of the rule of interpretation of article 31, paragraph 1 VCLT – the **object and purpose** of the treaty – according to the Court, in a way reflects the intention of the parties upon signing the treaty (NAFTA). As mentioned, the object and purpose of a treaty can generally be found in its preamble.

## **Court Decision**

The starting point of the Court analysis is the general positioning (context) of the questionnaire procedure, that is, its position and function as part of an overall country of origin review process. On the one hand, the questionnaire functions as a first step in the review process of a certificate of origin, and on the other hand it represents a (simple, practical and efficient) tool for customs authorities to perform a review without the (immediate) need for a domiciliary visit (which is much more costly and intrusive).

In this regard, the term “questionnaire” should not be given a literal meaning in isolation, but rather should be seen in harmony with other parts or sections of the

treaty.

This analysis, according to the Court, is closely connected to the object and purpose of the treaty. Article 102 of NAFTA lists several objectives of the treaty, including facilitating the cross border flow of goods and services, promote conditions of fair competition in the region, create effective procedures for the application of the convention, to mention a few.

According to the Court, the above described review procedure (of certificates of origin) helps to accomplish the supervision of the cross border flow of goods, which is one of the objectives of NAFTA, as a result of which the review procedure – considering its object and purpose – cannot be limited to its literal meaning (just a set of questions to be answered), but rather should entail a procedure that allows authorities to request additional information such as copies of documents or invoices. As such, considering that the questionnaire procedure is part of the overall origin review process required to obtain preferential duty treatment, the term “questionnaire” should have a broader, more useful or functional scope (as to include the right for authorities to obtain additional information).

Any other interpretation would frustrate the review process, and would position the reviewing authorities in the same situation as with only having the certificate of origin. Specifically, without documentation that allows for a higher degree of certainty as to the origin of the goods needed to avoid the abuse of the customs law (by obtaining preferential duty rates without being entitled to them), the customs authorities would be practically limited to the application of the domiciliary visit process as a means to verify a certificate of origin.

The principle of good faith, concludes the Court, therefore allows for a conclusion that the ordinary meaning of the term “questionnaire” has to be complemented with the object and purpose of the overall review procedure, and of the treaty (NAFTA) in general. In this regard, good faith cannot permit that giving an ordinary meaning to a term would result in disavowing the context of the term. Rather, the term should be given a meaning in harmony with its object and purpose, in order to establish its useful and functional effect, which means taking into account the technical and legal context of the matter, as well as the intention of the parties upon signing the treaty.

## **Analysis**

As can be appreciated, the arguments that form the basis of the decision are very much intertwined with the technical and legal aspects of the specific subject matter (origin review procedure). Nevertheless, the manner in which the Court builds its case around the elements of article 31, paragraph 1 of the VCLT, is quite generic and should therefore provide guidance for future cases on different subject matters.

In the case at hand, the ordinary meaning of a term (“questionnaire”) was determined to be not clear, based on its context, as well as the object and purpose of the particular (origin review) provisions and the treaty as a whole. As a result, the Court established that good faith allowed for an interpretation that is more in line with the context of the provisions and the object and purpose of the treaty, and therefore did not attribute an ordinary meaning to the term. A literal interpretation of the term would leave the questionnaire procedure practically without effect, thereby violating the principle of effectiveness.

The abovementioned makes it clear that the Court applied the various elements of interpretation of article 31 VCLT as part of one single operation, thereby confirming that this provision represents one general rule of interpretation. The principle of good faith functioned as a guiding- or binding principle within the area of discretion that the interpreter has by giving more or less weight to either the ordinary meaning, the context or the object and purpose respectively.

This seems to be consistent with the general presumption (expressed by the ICJ, the ILC comments when developing the VCLT and most scholars) that on the one hand, the “ordinary meaning” to be given to a term does not justify a literal interpretation, whilst on the other hand, the reference to the “object and purpose” should not imply a teleological interpretation.

In this respect, the outcome of the ruling may seem logical and straightforward. However, in a Mexican context, there are not many precedents (specifically in treaty interpretation) of such a balancing act between not falling into a literal interpretation, but at the same time avoiding a (fully) teleological interpretation.

It is important to note that under the integrated interpretation of article 31 CVLT, even in case the object and purpose is taken into account, it would generally not be allowed for the interpreter to fill in gaps in the law or treaty, or revise and repair an unclear (deficient) treaty provision. The question may be asked whether the

Court exceeded its function of interpreter in the case at hand.

Finally, the question can be asked whether the driver of the Court's decision was the fact that it was related to a review procedure the purpose of which is to *avoid the potential abuse* of NAFTA. In this regard, in the case at hand, good faith allowed for a broad (liberal) interpretation of a treaty term, thereby avoiding abuse or evasion of NAFTA by taxpayer attempting to claim origin, incorrectly.

It remains to be seen whether the Court would also apply the good faith principle in a case to protect the interests of taxpayers (residents) where a state (Mexico) exercises its discretionary powers in an unreasonable manner.

## **Income Tax Treaties**

The above described analysis used to interpret NAFTA should equally apply to tax treaties. Tax treaties may have some special features, such as the many references to domestic law of the contracting states (not common in most other types of treaties) and the fact that tax treaties are highly standardized, and designed after model conventions developed by international organizations such as the OECD and the UN.

Nevertheless, irrespective of these special features of tax treaties, the application of the general interpretation principles (under articles 31-33 VCLT) should equally apply to them. This has been confirmed by many courts and tribunals in different countries, including Mexico.

The principle of good faith has generally been addressed by courts and scholars in the context of tax treaty override. For example, the abovementioned references to domestic law of contracting states in tax treaties (specifically under article 3, paragraph 2 of the OECD Model Convention) may open the door to treaty override as a result of states changing their domestic laws, thereby (intentionally or unintentionally) affecting the interpretation of undefined treaty terms.

The OECD has recognized this element of good faith in paragraph 13 of the OECD Commentaries to article 3, paragraph 2 of the OECD Model Convention where it establishes that "*.. a state should not be allowed to make a convention inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention..*". Good faith has also been addressed in different ways in the context of tax treaty abuse by tax payers. For instance, paragraph 9.3 of the 2014 OECD

Commentaries to article 1 (see also page 81 BEPS Action 6 Report) addresses an interpretation of tax conventions that allows states to disregard abusive transactions, when entered into with the view of obtaining unintended benefits:

*“This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties)”.*

This clause has been highly criticized as it fails to mention that article 31 VCLT also establishes that terms should be given an “ordinary meaning” in their “context”. That is, the denial of treaty benefits in case of an abusive transaction must be supported by the terms of the treaty read in their context, as article 31 VCLT does not permit a mere teleological interpretation (prevalence of object and purpose over and above what is expressed in the text of the treaty).

The principle of good faith has also arisen with respect to the application of domestic antiabuse rules in tax treaties. In this respect, the OECD Commentaries (clauses 9.2 and 22.1) have stated that there is no conflict between domestic antiabuse rules and tax treaties, therefore, treaty benefits can be denied under the application of domestic rules (this statement is slightly nuanced in BEPS Action 6 Report pages 82-85, reflected in paragraphs 66-80 of the draft 2017 OECD Commentaries to article 1 of the draft 2017 OECD Model Convention). Also this position has been severely questioned by scholars, including taking into account the principle of good faith. In this regard, similar to good faith limits on states to change their domestic laws in order to affect the interpretation of treaty terms, a state should also not be able to avoid its treaty obligations by arguing that all transactions are abusive.

### **Multilateral Instrument to implement BEPS measures**

The rule of interpretation of treaties laid down in articles 31-32 VCLT, and the function of good faith specifically, will become even more important as a result of the transfer of discretionary powers to tax authorities of states and the introduction of highly subjective, abstract and vague terminology and concepts in tax treaties under the MLI. These new treaty terms have to be given an “ordinary meaning” in their “context” and “in light of the object and purpose”.

For instance, article 4 of the MLI grants discretionary powers to competent authorities in order to determine residency under a tax treaty and deny treaty

benefits in the absence of agreement by the competent authorities. In addition, the Principal Purpose Test (article 7 of the MLI) provides a high level of discretion to tax authorities to deny tax payers access to a treaty, in case it is “reasonable to conclude”, that “one of the principle purposes” is to obtain treaty benefits. Other subjective and abstract terms can be found in the permanent establishment provisions of articles 12 and 13 of the MLI (the “principal role ... that results in the conclusion of agreements” and “preparatory and auxiliary” activities), among others.

As mentioned above, these ambiguous terms have to be given an ordinary meaning in their *context*, which now entails an unprecedented amount of instruments, agreements and documents that have to be taken into account. This interpretative material includes not only the MLI itself, the MLI’s Explanatory Notes, the original bilateral agreements with which the MLI will coexist, but it in essence also includes the whole “OECD/G20 BEPS Package” as a result of which the MLI was created.

There will also be greater importance attributed to supplementary means of interpretation, considering that the new treaty terms are, in many instances (or per definition) “ambiguous” and/or “obscure” (article 32 VCLT). As mentioned above, recourse can be had to a broad range of documents, such as the original BEPS reports from 2013, the several drafts of the final BEPS Reports, pre-BEPS work of the OECD (and follow up work to finalize the BEPS Reports), but also foreign doctrine and jurisprudence that may shed light on some of the new treaty concepts, in case they originate from other jurisdictions, such as the Principal Purpose Test.

These new subjective treaty terms have to be given an ordinary meaning in the aforementioned context and in light of the *object(s) and purpose(s)* of tax treaties, which can generally be found in the preamble of treaties.

In this respect, the preamble of the MLI refers to the loss of tax revenues for governments due to

*“aggressive international tax planning that has the effect of artificially shifting profits to locations where they are subject to non-taxation or reduced taxation”*

and

*“the importance of ensuring that profits are taxed where substantive economic activities generating the profits are carried out and where value is created”.*

Article 6 of the MLI (and the preamble of the MLI itself) establishes that tax treaties intend to eliminate double taxation

*“without creating opportunities for non-taxation or reduced taxation....”.*

It is not entirely clear which of these considerations in the MLI represent a real stated purpose of the MLI and their application to bilateral tax treaties, nor how they relate to the “principal purpose” of tax treaties (clause 7 of the OECD Commentaries), which is

*“to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons”.*

In one way or another, however, all of these new considerations will have to be taken into account to shed light on the ordinary (or special) meaning of the treaty terms, in the (BEPS) context as outlined above.

In summary, the BEPS project in general, and the MLI specifically, have given a new dimension to tax treaty interpretation under the principles of article 31-33 VCLT. Good faith will have to play a key role in attributing the appropriate weight to the ordinary meaning of treaty terms, in their new context and in light of the new objects and purposes of tax treaties, specifically taking into account its function of tempering states in the exercise of the (now broader than ever) discretion to deny treaty application to tax payers.

Let’s hope that Mexican Courts are prepared for this.