

1. Introduction

Amid the common concerns about the growing uncertainty exacerbated by the already existing backlog of unresolved tax treaty related disputes, there is an interest in arbitration in tax matters. The idea is not new and, in order to understand the current discussions, it is important to trace back its roots. This thesis undertakes this challenge. It aims to show the milestones in the development of arbitration in international tax law.

The point of departure is understanding the basic need for arbitration in tax treaty law. Arbitration, as a practice, has already proven its merit in several other fields like investment, trade, and commercial arbitration. However, it formally entered the field of international taxation, becoming a heavily debated issue after the Mutual Agreement Procedure (MAP) failed to effectively resolve cross-border taxation disputes. The shortcomings of the MAP coupled with the potential for arbitration in tax treaty law necessitated the need for a formal approach towards arbitration. This is followed by tracing the evolution of the arbitration procedure from the very beginning when it was included in treaties between nations of their own accord. This is the lesser-known part of the history of arbitration and proves to be very interesting as it provides an insight into the attitude of several nations towards arbitration in tax matters at the time. This is succeeded by the development of arbitration through various organizational efforts, like the OECD and the UN, and its growth in the EU. The scope of analysis is limited only to its history as several other nuances of arbitration in tax treaty law are discussed in great detail throughout the course of this book.

This thesis aims at tracing the history of arbitration in tax treaty law beginning with the different arbitration clauses included in the earliest bilateral tax treaties (Section 3.), progressing to its evolution as a result of various organizational efforts (Section 4.), and concluding with a brief status of arbitration in today's international tax arena (Section 5.). In order to predict the success of mandatory and binding arbitration in tax treaty law in the future, it is essential to understand its origin and associated background.

2. Arbitration and its Need in Tax Treaty Law

2.1. Shortcomings of the MAP

For a long time, the only mechanism for resolving tax treaty related disputes was the MAP. It is conducted by the Competent Authorities (CAs) of either contracting State who act as the representatives of their respective State and are usually identified in the double taxation convention (DTC) itself. This procedural provision enables the contracting States to implement the substantive provisions of the convention with respect to the allocation of taxing rights among them. It is usu-

ally initiated by a taxpayer who believes that there has been taxation that is not in accordance with the provisions of the DTC.

The MAP has been found to suffer from several shortcomings. Among others, it does not oblige CAs to solve a dispute but merely “endeavors” to arrive at a resolution. There also is no deadline prescribed for a solution to be reached under the MAP, making it a time-consuming and cumbersome process.¹ As a result, the taxpayer is not ensured of a satisfactory outcome even after a long, arduous, and time-consuming process.² Moreover, there are many issues resulting from the complicated relationship between the MAP and domestic legal remedies. In addition, since the MAP is considered as a dialogue between the contracting States to settle issues brought to its attention, the taxpayer legally has no status in the proceedings and is often denied the opportunity to make any representation leading to a lack of transparency.³ In light of these limitations, arbitration was explored as a means of alternative dispute resolution; and to truly comprehend its benefits, it is necessary to understand exactly what arbitration entails.

2.2. The definition of arbitration

Arbitration can be defined as a quasi-judicial, binding, and private instrument of dispute settlement based on a contract between the involved parties. It is characterized as a “quasi-judicial” concept as it is distinct from both judicial and non-judicial methods; it is not judicial as arbitrators are selected on an ad-hoc basis, and the process does not revolve around permanent institutions like courts. On the other hand, it is not non-judicial like mediation or conciliation as arbitration embodies a mandatory dispute resolution settlement whereas non-judicial methods do not create such an obligation. Arbitration relies on the application of substantive law in international relations thereby substituting domestic judicial jurisdiction with agreed-upon binding settlements leading to solutions that rely on logic and merit.⁴

1 Based upon statistics recorded at the 1981 IFA Congress, there has been an increase in the average MAP duration from 15 months in 1971 to two years in 1980 with some cases even taking five years to be resolved. *Read more* in Michelle S Bertolini, ‘Mandatory Arbitration Provisions within the Modern Tax Treaty Structure – Policy Implications of Confidentiality and the Rights of the Public to Arbitration Outcomes’, *Bepress* (2010), p. 19.

2 Jasmin Kollmann/Laura Turcan, ‘Overview of the Existing Mechanisms to Resolve Disputes and Their Challenges’ in: Michael Lang/Jeffrey Owens (eds.) *International Arbitration in Tax Matters*, Volume 2 (the Netherlands: IBFD, 2015) p. 25–26.

3 A detailed discussion regarding the shortcomings of the MAP is dealt with in Chapter 4., Ana Elena Dominguez Gonzalez, “The Need for arbitration in tax treaties – deficiencies of the MAP under the OECD and UN tax treaties”.

4 Carlo Garbarino/Marina Lombardo, ‘Arbitration of Unresolved Issues in Mutual Agreement Cases: The New Para. 5, Art. 25 of the OECD Model Convention, a Multi-Tiered Dispute Resolution Clause’ in: Michael Lang/Pasquale Pistone/Josef Schuch/Claud Staringer/Alfred Storck/Martin Zagler, *Tax Treaties: Building Bridges between Law and Economics*, (The Netherlands: IBFD, 2010), p. 459–462.

Arbitration can be of different types, optional or obligatory and ad-hoc or institutional. In the former, optional arbitration implies that both parties need to consent for the case to be submitted to arbitration whereas obligatory arbitration can take place if a case is unilaterally referred to arbitration, and the other party cannot oppose the same. In the latter, ad-hoc arbitration is aimed at a settlement of any kind of dispute and is not administered by an arbitration center. On the other hand, institutional arbitration is focused on a class of disputes and is supervised under the guidance and regulations of an arbitral center.⁵

This broad understanding of the basis and features of an arbitration process along with its proven success in other fields of international law reinforced the adoption of arbitration in tax treaty law as well.

2.3. Potential of Arbitration in Tax Matters

Many arguments have already been raised in favor of arbitration. Arbitration as a practice has been proven to be successful in other fields where it has been employed as it has several benefits.

Firstly, the use of arbitration requires fewer resources than the formal court system. In fact, it ensures an optimum utilization of the resources involved as arbitrators are appointed for a particular dispute and usually have expertise in the area concerned in the case thereby leading to savings for the parties in court and attorney fees. Secondly, arbitration proceedings are usually confidential, requiring even the arbitrators to adhere to the standards of privacy defined in the contract between the parties. This is essential as many individuals and companies would not like news about their disputes to be made public due to a fear of loss of reputation and status. The parties involved in an arbitration are able to prevent the publication of the outcome and, since these judgments do not have any precedential value, it is reasonable for the outcome and the entire arbitration process to remain private and privy to only the parties involved, including the arbitrators. Finally, there is a lot of freedom associated with arbitration as it provides the choice of law and jurisdiction. International arbitration has a supranational nature, implying that the parties are not restricted to one type of law or jurisdiction unless they contractually agree to do so or are bound by a treaty.⁶ This last advantage would not hold true for arbitration in tax treaty law, as any arbitration decision would be based on the treaty between the two contracting States that are involved. Nevertheless, it is important to mention that the merit of such decisions lies in the fact that the arbitrators have the freedom to apply substantive law to arrive at an appropriate conclusion.

5 Carlo Garbarino/Marina Lombardo, in: Michael Lang/Pasquale Pistone/Josef Schuch/Claud Staringer/Alfred Storck/Martin Zagler, *Tax Treaties: Building Bridges between Law and Economics*, p. 459–462.

6 Jake Heyka, 'A World Tax Court: The Solution to Tax Treaty Arbitration', *Tax Analysts* (2016).

These advantages have paved the way for arbitration into international tax dispute resolution. This is apparent in the following section as we discover the various arbitration clauses that were included in the earliest bilateral tax treaties.

3. Development of the Arbitration Clause through double tax treaties

3.1. Early Inclusion in Bilateral Tax Treaties

3.1.1. The 1922 Multilateral Treaty of Rome⁷

In between the two world wars, the 1922 Treaty of Rome—a multilateral treaty—was signed on 6 April 1922 between Italy, Hungary, Poland, Romania, and Yugoslavia. It was one of the first treaties that acknowledged the role of the taxpayer in requesting a consultation process between governments in case of double taxation of income. The clause included in this treaty (reproduced in the Annexure) described a two-stage MAP, much like the format of the MAP we have in practice today. The clause gave the aggrieved taxpayer the right to petition the fiscal authorities of the residence State to bring the double taxation of income to their attention. If the fiscal authorities of the residence State believed that, in order to resolve this case, the counterpart fiscal authority needed to be approached, they were allowed to do so “on some equitable arrangement”. Accordingly, it can be inferred that the 1922 Treaty of Rome was the first convention to formalize the practice of contracting States indulging in a domestic “appeal” procedure, allowing the taxpayers to have a limited status in the process that forms the basis for any kind of international arbitration.⁸

3.1.2. The 1926 United Kingdom-Irish Free State income tax treaty⁹

Soon after the aforementioned multilateral treaty, a treaty was executed on 14 April 1926 between the United Kingdom and Ireland that included another version of the arbitration clause. The clause pertaining to arbitration (reproduced in the Annexure) provided for delivery of binding judgements by a tribunal.¹⁰ This treaty

7 Convention for the Purpose of Avoiding Double Taxation between Austria, Hungary, Italy, Poland, Romania and the Kingdom of the Serbs, Croats and Slovenes (signed on 6 April 1922) *Read more* in Footnote 45, Zvi D. Altman, ‘Defining the research questions’ in: Zvi D. Altman, *Dispute Resolution under Tax Treaties*, (The Netherlands: IBFD, 2005) p. 15.

8 Zvi D. Altman, ‘Defining the research questions’ in: Zvi D. Altman, *Dispute Resolution under Tax Treaties*, (The Netherlands: IBFD, 2005) p. 14–16.

9 Agreement between the British Government and the Government of the Irish Free State in Respect of Double Income Tax (signed on 14 April 1926) *Read more* in Footnote 54, Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties* p. 16.

10 Jean-Philippe Chetcuti, ‘Tax Dispute Resolution: Arbitration in International Tax Dispute Resolution’, *Inter-Lawyer, Law Firms Directories* (2001).

greatly contributed in the advancement of the evolution of international tax arbitration by making use of the word “final” as it rendered a positive declaration that the decision adjudicated by the tribunal during the dispute resolution process will be binding and mandatory.¹¹

3.1.3. The 1934 Czechoslovakia-Romania succession duties convention¹²

In contrast to the above-mentioned conventions that dealt with direct taxes, a succession duties convention between Czechoslovakia and Romania contemplated a similar mode of dispute resolution. This clause (reproduced in the Annexure) prescribed that a board was to be formed by the Fiscal Committee within the League of Nations to give both parties an opportunity to be heard and to bind the parties with its decision.¹³ This succession duties convention was very advanced and unique for its time as among roughly 27 different bilateral succession duty treaties executed before 1939 contained either no provisions for dispute resolution or a basic version of the MAP. This was the only treaty that called for the constitution of a separate board to render a binding opinion on the contracting States.¹⁴

3.1.4. The 1985 Draft Germany-Sweden Treaty¹⁵

In 1985, amidst widespread opposition from the other States, Germany and Sweden drafted a DTC between themselves that contained an arbitration clause. At the same time, the dispute resolution mechanism contemplated by the European Convention for the Peaceful Settlement of Disputes of 1957 was also in force, but the contracting States decided to have the option of referring a dispute to the Court of Arbitration whose decision would be binding on both of the contracting States.¹⁶

The importance of the arbitration provision in this treaty was that it was a first sign of a new development. It included various details about the Court of Arbitration, e.g., its composition, the court was prescribed to have judges from the contracting States, third countries, or international organizations. Additionally, its procedures were stipulated to conform to the internationally recognized principles of arbitration procedures. The interested parties were expected to have a higher

11 Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties* p. 16–17.

12 Convention between the Kingdom of Romania and the Czechoslovak Republic Concerning Double Taxation in Connection With Succession Duties (20 June 1934) *Read More* in Footnote 57, Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties* p. 17.

13 Jean-Philippe Chetcuti, *Inter-Lawyer, Law Firms Directories* (2001).

14 Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties* p. 17–18.

15 Convention Between the Kingdom of Sweden and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital as well as on Estate and Gift and Concerning the Offering of Mutual Fiscal Cooperation with respect to Such Taxes (signed 14 July 1992) *Read More* in Footnote 63, Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties*, p. 19.

16 Jean-Philippe Chetcuti, *Inter-Lawyer, Law Firms Directories* (2001).

level of participation in the proceedings and the decision was to be strictly based upon the treaties of the contracting States and general international law. It is of less relevance that the arbitration clause suffered from minor shortcomings; its use was completely voluntary, and the absence of a time limit rendered the entire process ineffective.¹⁷ The fact that a large State like Germany had the foresight to include the arbitration provision in even one of its DTCs reinforced the importance of this dispute resolution mechanism.

3.2. Mandatory arbitration contained in the United States tax treaties

3.2.1. US policy towards arbitration in DTCs

This section is exclusively concentrated on the United States' (US) positions regarding arbitration. The US played a meaningful role in developing the international tax arbitration as we experience it today by including an extremely detailed arbitration process in its treaty with Germany in 1989¹⁸ even before the same was conceptualized by the OECD or the UN. This treaty is considered to be a breakthrough, almost a turning point, in the evolution of international tax arbitration. Its merits lie in the substantive details of the arbitration article of the treaty and the fact that two of the most significant and developed countries agreed to enter into such an agreement. The diplomatic notes that were exchanged were extensive and established an intricate set of rules to be followed during impending arbitration proceedings.

The US has changed its position regarding arbitration over the passage of time. A voluntary arbitration provision was included in its treaty with Germany, which was unusual at the time as it was the first DTC for the US that included an arbitration provision. Nevertheless, it was broadly worded in order to give the CAs of both contracting States the discretion to decide which cases were to be submitted to arbitration. Over time, it was observed that the US, like all other States, was in favor of voluntary arbitration and against mandatory or binding arbitration. This approach of the US was confirmed when it adopted voluntary arbitration provisions with several other treaty partners, namely, Canada, Ireland, Italy, Mexico, the Netherlands, Switzerland, Kazakhstan, and France.¹⁹ However, the recent ratifications of US treaties wherein mandatory and binding arbitration has been accepted seems to suggest a change in US tax policy. However, on a closer examina-

17 Gustaf Lindencrona/Nils Mattson, 'How to resolve international tax disputes? New approaches to an old problem', *International Tax Review* 266 (1990).

18 Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (signed 29 August 1989) *Read More* in Footnote 64, Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties* p. 19.

19 *Read More* in Footnote 72, Zvi D. Altman, in: Zvi D. Altman, *Dispute Resolution under Tax Treaties*, p. 21.