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Arbitration of Tax Treaty Disputes: The OECD Proposal

by DR. MARCUS DESAX and DR. MARC VEIT*

ABSTRACT

In February 2007, the Organization for Economic Co-operation and Development (OECD) published the Report adopted by its Committee on Fiscal Affairs (CFA) on 30 January 2007, *Improving the Resolution of Tax Treaty Disputes*.[1] The main feature of the OECD Report is to supplement the current dispute resolution mechanism – the mutual agreement procedure – by mandatory arbitration. The OECD Report calls for the insertion of a new paragraph 5 in Article 25 of the OECD Model Tax Convention, provides amendments to the Commentary to the Model Tax Convention and a draft of a Mutual Agreement on Arbitration to be entered into by the Contracting States to set out the specifics of the arbitration procedure.

The authors, arbitration and tax practitioners, give an overview over the current dispute resolution mechanism in Article 25 of the OECD Model Tax Convention, summarize the proposed amendment of the Model Tax Convention together with the draft Mutual Agreement on Arbitration and set out the arbitration procedure proposed from a practical viewpoint.

I. INTERNATIONAL TAX CONTROVERSIES POSSIBLY RESULTING IN DOUBLE TAXATION

THE INCREASE in international trade and investment has multiplied the situations in which international tax controversies can arise, both between

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1 Available at www.oecd.org/dataoecd/17/59/38055311.pdf

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taxpayers and states but also between the states themselves. These disputes may include the following:

- Transfer pricing disputes (*e.g.* the parent in country A charged its subsidiary in country B a 5 per cent royalty as per existing licence agreement. The tax authorities in country A deem a royalty rate of 7 per cent to be appropriate and make an income adjustment of 2 per cent for the parent. The subsidiary expects the tax authorities in country B to make a correlative adjustment of 2 per cent and to allow a tax deduction of 7 per cent. However, the tax authorities in country B disagree).
- Determination of a permanent establishment or of residence (*e.g.* do the activities in country B of a company incorporated in country A cause such company to have a taxable permanent establishment in country B? Does the presence of an individual in country B amount to tax residence?).
- Attribution of income to a foreign permanent establishment (*e.g.* a company in country A has a branch office in country B. The tax authorities in country A want to allocate to the branch in country B a given amount of executive and general administrative expenses incurred at headquarters in country A. The authorities in country B disagree).
- Characterisation of income (*e.g.* income from music recordings derived by a resident of country A from sources in country B is characterised in country A as business profits, thus only taxable in country A, whereas country B characterises them as royalties, taxable only in country B).
- Thin capitalisation (*e.g.* the subsidiary in country B pays interest on a loan from its parent in country A. The tax authorities in country B deem the subsidiary to be inadequately capitalised and treat the interest as a non-deductible dividend. The authorities in country A treat it as fully taxable interest and refuse the tax relief otherwise granted with respect to dividends received).

Unless these controversies can be resolved by the states involved, double taxation arises.

II. MODELS OF RESOLUTION OF TAX TREATY DISPUTES

A bilateral tax treaty allocates the taxing power for different types of income between the state of source and the one of residence and provides for the mode of elimination of double taxation either by a credit or exemption system.

For resolution of disputes, the following models are available.

(a) One Extreme: Complete Control of the Tax Authorities

In this model, the tax authorities are not only charged with implementing the tax treaty but also with the resolution of all disputes arising thereunder. As such resolution requires the agreement of either tax authority, the tax treaty can only

require them to 'endeavour' to resolve the dispute by mutual agreement. As further explained below, this is the current situation under most treaties where such 'obligation' is imposed but no tie-breaker is provided for the event that the tax authorities cannot reach agreement.

Basically the same result is achieved by a clause submitting the disagreement to arbitration provided that both tax authorities agree. Such lip service paid to arbitration is found in several tax treaties; while it may be appealing to the eye, its practical effect has been non-existent so far.

(b) Other Extreme: Submission to Arbitrators for Resolution in a Process under their Control

The opposite model is for the tax authorities to yield the process to arbitrators if they cannot dispose of the dispute themselves within a given time period. The process is then conducted under the authority of the arbitrators and the status of the tax authorities is reduced to one of the parties in arbitral proceedings.

This kind of arbitration was proposed by the International Chamber of Commerce in 2002 with the draft of a new provision to be adopted in the bilateral tax treaties.[2]

The concept of tax treaty arbitration to fit within the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 10 June 1958 was further developed by William W. Park and David R. Tillinghast.[3] They proposed a new provision to be inserted in the bilateral tax treaties and a Memorandum of Understanding to determine the procedure. The arbitrators are granted wide powers to decide the entire case, even if the competent authorities have reached an agreement which the taxpayer deems not in compliance with the tax treaty.

(c) Intermediate Model: Notwithstanding Arbitration, the Tax Authorities Remain in Control and the Arbitrators are Entrusted with Decision of the Unresolved Issues

Under this model, a compromise between the two extremes, the arbitration is set up as a supplement to the already existing dispute resolution mechanism: the tax authorities remain in control and the arbitrators are charged with deciding the still disputed issues – but only those – on their behalf. The arbitration is not the end of the dispute resolution procedure, merely an intermediary step.

The role of the arbitrators in this model is similar to the one of an expert in an expert determination procedure, albeit with inverted roles: here the experts, the tax administrations, decide the case, while the arbitrators decide the disputed issues only.

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[2] International Chamber of Commerce Commission on Taxation, *Arbitration in International Tax Matters* (180/455 Rev. 2, 6 February 2002), available at www.iccwbo.org/policy/taxation/id501/index.html

[3] William W. Park and David R. Tillinghast, *Income Tax Treaty Arbitration* (prepared under the auspices of the International Fiscal Association, Amersfoort, 2004). *See also* William W. Park, 'Tax Treaty Arbitration: What is Needed and Why?' in *Arbitration of International Business Disputes* (Studies in Law and Practice, Oxford, 2006), p. 609.

Following a long political decision-making process, this model was found to be the only one acceptable to a large number of states and was finally chosen by OECD for the resolution of disputes arising under tax treaties.

III. OECD MODEL TAX CONVENTION AND ITS CURRENT DISPUTE RESOLUTION PROCEDURE: MUTUAL AGREEMENT PROCEDURE

The first efforts tending to avoidance of international double taxation were initiated under the auspices of the League of Nations. In 1953, the Organization for European Economic Co-operation (later expanded to become the Organization for Economic Co-operation and Development (OECD)) created the Committee on Fiscal Affairs and entrusted it with the study of international double taxation matters. The first Draft Double Taxation Convention on Income and Capital was published in 1963. In 1977, OECD published a Model Double Taxation Convention, together with a Commentary, based on the experience of the numerous bilateral double taxation treaties entered into since 1963. This Model Tax Convention has exerted a tremendous influence on the content of tax treaties[4] entered into, not only between OECD countries, but also those entered into with or between non-member countries.

Globalisation of international trade, the development of the national tax systems and experience with the application of tax treaties led to numerous partial revisions of the Model Tax Convention.

Article 25 of the Model Tax Convention entitled 'Mutual Agreement Procedure' contains the dispute resolution mechanism. It reads as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

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[4] To differentiate between the OECD Model Tax Convention and the double taxation conventions actually entered into by the various countries, the latter are referred to as 'tax treaties'.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

The following two situations are to be distinguished:

Article 25(1) and (2) of the Model Tax Convention deal with the situation where a taxpayer considers that he has been or will be taxed in violation of a provision of the Convention. He may present his case to the competent authority of his country of residence. The competent authority is usually the division of the tax administration in charge of international tax matters.[5] The case must be so presented within three years from the first notification of the objectionable taxation. The taxpayer can bring his case irrespective of the existence of other remedies available under domestic law. If the objection by the taxpayer appears to be justified, the competent authorities will endeavour to resolve the case by mutual agreement. The authorities are under an obligation only to 'endeavour' to seek a solution – not to reach a solution.

Article 25(3) and (4) of the Model Convention provide for a procedure at the initiative of the competent authorities. They can communicate directly to resolve difficulties or doubts regarding the implementation of the Convention. The initiative rests entirely with the competent authorities; there is no involvement of the taxpayer.

IV. DRAWBACKS OF THE MUTUAL AGREEMENT PROCEDURE

(a) Avoidance of Double Taxation not Guaranteed

Albeit the purpose of a tax treaty is to avoid double taxation, in practice this result is not always achieved. Under Article 25(2) of the Model Tax Convention, the competent authorities are only required to 'endeavour' to resolve the case. There is no obligation for the two countries to reach agreement effectively removing double taxation. Although in practice, agreement is often reached, in some situations the mutual agreement procedure is closed by an agreement to disagree: possibly because two competent authorities are afraid of creating a

[5] Contact details of the competent authorities in the various countries and other information about domestic regulations dealing with the mutual agreement procedure are available at www.oecd.org/document/31/0,2340,en_2649_37427_29601439_1_1_1_37427,00.html

precedent detrimental to their respective economies or the amount in dispute is simply too large and the competent authorities are reluctant to forgo a substantial amount of revenue.

(b) Taxpayer not Actively Involved

The second drawback of the mutual agreement procedure is the lack of active involvement of the taxpayer: Although the Model Tax Convention grants the taxpayer the right to initiate the mutual agreement procedure if he considers that the actions by one or both of the Contracting States will result in taxation not in accordance with the provisions of the Convention, after the procedure has been set in motion, the taxpayer is no longer involved. It may well be that, as a matter of courtesy, the taxpayer is informed by his national tax authority about the status of the proceedings and even consulted with respect to the position that such authority should take in the negotiations and how such position should be documented; however, under the provisions of the Model Tax Convention, the taxpayer enjoys no procedural rights.

(c) Opaque Decision-making Process

Together with the lack of active involvement of the taxpayer goes the non-transparent decision-making process. It is not uncommon that, if several mutual agreement procedures are pending between two competent authorities, a 'package' deal is struck: one competent authority gives in in some of the cases, the other one in others, and for the third category an agreement to disagree is reached. At the end, the taxpayer may find his case solved or not solved without being made aware what the precise reasons have been.

(d) Length of Procedure

A last reproach made against the mutual agreement procedure pertains to its duration: the competent authorities are under no obligation to reach agreement, let alone to reach one within a given time period. This results sometimes in protracted procedures during which the taxpayer has to live with uncertainty.

V. NEW ARBITRATION AGREEMENT IN THE MODEL TAX CONVENTION

On 27 July 2004, the OECD Committee on Fiscal Affairs released a Progress Report on its work for improving the resolution of cross-border tax disputes. The report, entitled *Improving the Process for Resolving International Tax Disputes*, contained 31 proposals. Two of the most important proposals dealt with the use of supplementary dispute resolution mechanisms, in particular arbitration.

On 1 February 2006, OECD released its Public Discussion Draft entitled *Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes*. At the public

consultation of 13 March 2006, in Tokyo, recognising that there are a number of different approaches to tax treaty arbitration, OECD expressed its intention to supplement the mutual agreement procedure with an arbitration procedure providing as much flexibility as possible. At this consultation and in a number of written comments, several modifications were proposed by representatives of the private sector.

At its meeting on 30 January 2007, the OECD Committee on Fiscal Affairs adopted the Report *Improving the Resolution of Tax Treaty Disputes* ('OECD Report'). It provides for the insertion of an arbitration agreement in Article 25 of the Model Tax Convention.

The new paragraph 5 of Article 25 of the Model Tax Convention reads as follows:

> 5. Where,
>
> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
> b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,
>
> any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.[1]

Text of the footnote:

> 1 In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 47 of the Commentary on the paragraph. As mentioned in paragraph 54 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals.

Together with the new Article 25(5) of the Model Tax Convention, OECD published the following documents:

- revision of existing paragraphs 45 to 48 and new paragraphs 49 to 69 of the Commentary to Article 25 of the Model Tax Convention ('Commentary to the Model Tax Convention, Article 25') and
- sample Mutual Agreement on Arbitration ('MA on Arbitration') together with comments thereto ('Comment to MA on Arbitration').

VI. LEGAL NATURE OF OECD TAX TREATY ARBITRATION

(a) Supplement to Mutual Agreement Procedure, not an Independent Judicial Remedy

OECD has made it clear that tax treaty arbitration is not an independent judicial dispute resolution mechanism but rather a supplement to the mutual agreement procedure under Article 25 of the Model Tax Convention: 'Recourse to these [*i.e.* dispute resolution] techniques, however, must be an integral part of the mutual agreement procedure and should not constitute an alternative route to solving tax treaty disputes between States, which would risk undermining the effectiveness of the mutual agreement procedure'.[6]

As a consequence of this characterisation, the arbitral process does not result in the *case* to be decided by the arbitrators; rather the *issues* upon which the competent authorities have been unable to reach agreement are decided by the arbitrators for the competent authorities' benefit. Preliminary issues already decided by the competent authorities cannot be reopened by the arbitrators; the competent authorities' decision is binding on the arbitrators. Eventually, based on the arbitrators' determination of the disputed *issues*, the competent authorities will then decide the *case* and thereupon close the mutual agreement procedure.

This limitation of the arbitrators' power distinguishes tax treaty arbitration under the OECD Report from other forms of commercial or government-private party arbitration where the jurisdiction of the arbitrators extends to resolving the whole case.[7]

Tax treaty arbitration is mandatory; no prior authorisation by the competent authorities is necessary. Once the requisite procedural requirements have been met, the unresolved issues must be submitted to the arbitrators for decision.[8] In that respect, OECD tax treaty arbitration differs from arbitration already provided for by several existing tax treaties[9] where arbitration requires prior agreement of the competent authorities. However, as of 2005, no cases had ever been brought to arbitration under these provisions;[10] doubts about their usefulness appear to be justified.

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6 OECD Report, p. 4.

7 Commentary to Model Tax Convention, Article 25, para. 46.

8 *Ibid.* para. 45.

9 For a listing of arbitration clauses existing in tax treaties, *see* Mario Züger, 'Arbitration under Tax Treaties: Improving Legal Protection in International Tax Law' in (2001) 5 *Doctoral Series International Bureau of Fiscal Documentation*, p. 239. As of 2005, 57 tax treaties contained an arbitration provision: Zvi D. Altman, 'Dispute Resolution under Tax Treaties' in (2005) 11 *Doctoral Series International Bureau of Fiscal Documentation*, p. 313.

10 Altman, *supra* n. 9 at p. 346.

A person familiar with international commercial or investment arbitration may regret that OECD has shied away from setting up an independent system of arbitration. However, it must be recognised that the process leading to the proposal to supplement the mutual agreement procedure by arbitration had been a tedious one whereby lots of obstacles had to be removed. Several national tax authorities were afraid that by setting up an independent system of arbitration, they would give up a substantial part of their legal prerogatives to tax, which could raise delicate constitutional issues.[11] In addition, by introducing arbitration as a supplement to the already regulated mutual agreement procedure, arbitration can be provided for simply by adding paragraph 5 to the existing Article 25 of the Model Tax Convention, which avoids the need for fundamental renegotiations of the tax treaty.

Given that there is still reluctance in some countries with respect to tax treaty arbitration, the OECD Report allows such countries to introduce arbitration only for a narrowly defined range of issues, such as transfer pricing, but not for others. Such limitation can be easily included in their tax treaties.

(b) Scope of the Arbitration

The earlier Discussion Draft of the OECD Report has given rise to extensive discussions at the public consultation. While the private sector and arbitration practitioners argued in favour of a system that, akin to commercial arbitration, empowers the arbitrators themselves to determine the scope of the arbitration within Article 25(5) of the Model Tax Convention as the arbitration convention, government representatives insisted on their prerogative to deal with the disputed case within the mutual agreement procedure, the dispute resolution procedure of the tax treaty being set up for that purpose only. While arbitration was accepted as a means to break the deadlock, it was felt by some government representatives that the arbitration decision should only be a means for the competent authorities to resolve the dispute within the framework of the mutual agreement procedure. It should therefore also be up to the competent authorities to determine the kind and the extent of the issues that they are unable to agree upon and which are therefore submitted to the arbitrators for their decision.

Against this background, the OECD Report now distinguishes between *issues* and the *case*.[12] Only if and to the extent that the competent authorities in the mutual agreement procedure have not reached agreement on disputed issues and have left them unresolved can arbitration proceedings be brought. If agreement has been reached on some but not all the issues, the taxpayer is prevented from submitting the issues on which agreement had been reached to the arbitrators even if the taxpayer is dissatisfied with the result. Only the remaining unresolved issues may be submitted to the arbitrators for decision.

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[11] Even tax treaty arbitration in the present form may raise constitutional problems in some countries, which are addressed in Commentary to Model Tax Convention, Article 25, para. 47.

[12] *See ibid.* para. 46, also with respect to the following.

The ensuing arbitration procedure is limited to resolving such *issues* as they are determined by the competent authorities. The decision of the *case*, however, remains the responsibility of the competent authorities. After the arbitration decision has been rendered, they will reconvene and decide the case on the basis of the arbitrators' determination of the disputed issue(s).

As a consequence of this system, the competent authorities, notwithstanding the institution of the arbitration, are always free to reconsider the issue(s) pending before the arbitrators and reach agreement. As long as the arbitrators have not rendered their decision, the competent authorities can reach agreement on such issue(s), thereby bringing the arbitration procedure to an end:[13] 'Since the arbitration process is an exceptional mechanism to deal with issues that cannot be solved under the mutual agreement procedure, it is appropriate to put an end to that exceptional mechanism if the competent authorities are able to resolve these issues by themselves'.[14]

The competent authorities may therefore by agreement on the disputed issue(s) prevent the arbitrators from taking a decision. However, the agreement must effectively dispose of all pending issues. The competent authorities may agree that taxation in both Contracting States has been in accordance with the tax treaty, in which case there are no unresolved issues and the case may be considered to have been resolved even in the event that there might be double taxation that is not addressed by the provisions of the tax treaty.[15] However, the competent authorities could not thwart the arbitration process by simply 'agreeing not to agree'.

This effectively limits the scope of the power of the arbitrators to decide the issues submitted to the scope of the tax treaty itself. The existence of tax treaty arbitration is no guarantee against double taxation; if instances of double taxation are not addressed by the treaty, relief against such double taxation may not be obtained from the arbitrators.

(c) Only Actual Cases of Double Taxation to be Examined

Only actual cases where it is argued that the actions of one or both of the Contracting States has resulted in taxation not in accordance with the tax treaty can be brought in arbitration. If it is only argued that such double taxation will eventually result from such actions this is not sufficient to allow the arbitrators to take a decision. It is therefore necessary that a tax has been paid, assessed or otherwise determined or that the taxpayer has been informed by the tax authorities that they intend to tax him on certain elements of income.[16]

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[13] MA on Arbitration, para. 20.
[14] Comments to MA on Arbitration, para. 43.
[15] Commentary to Model Tax Convention, Article 25, para. 53.
[16] *Ibid.* para. 54.

(d) Taxpayer's Procedural Status

The taxpayer will usually be more motivated than the involved Contracting States to have the dispute between the competent authorities resolved. Sometimes the taxpayer's aim is simply to avoid double taxation, looking to offset income in one jurisdiction with a correlative deduction in another. In other situations, however, the taxpayer is striving for a specific result, *e.g.* a determination of residence in Germany instead of the United States, rather than mere fiscal symmetry.[17]

Acknowledging these circumstances, it is the taxpayer who initiates the arbitration by filing a request for arbitration with one of the competent authorities. The request for arbitration can be filed no earlier than two years since the mutual agreement procedure has been started.[18] In addition to initiating the arbitration, the taxpayer also has the right to file submissions and present evidence.[19]

The status of the taxpayer in tax treaty arbitration differs from the status of the claimant in commercial arbitration in several ways. Under most commercial and investment arbitration rules the two parties involved each nominate an arbitrator and these arbitrators designate the presiding arbitrator. In multiparty arbitration, it is usually an appointing authority (such as the International Chamber of Commerce (ICC) or the London Court of International Arbitration (LCIA)) that nominates all arbitrators. The sample Mutual Agreement on Arbitration provides for a different solution: while the taxpayer can initiate the arbitration process, he will not be involved in the appointment of the arbitral tribunal. Each competent authority appoints one arbitrator and the Chair will be appointed either by common consent or by an appointing authority. Although this system gives some concerns to commercial arbitration practitioners in respect of the equal treatment of the parties, it can well be argued that the taxpayer's interest will be aligned with the interest of one of the governments, and that an independent Chair could protect any separate interest that the taxpayer might have.[20]

Similar to the EU Arbitration Convention, the Commentary to the new Article 25(5) of the Model Convention provides for the possibility for the Contracting States to exclude recourse to arbitration in the event of a 'serious violation involving significant penalties'. This is consistent with the provisions governing the mutual agreement procedure and which state that this remedy may not be available under these circumstances.[21] Since, in such instances, the road to arbitration is blocked, it is not possible for the arbitrators to decide whether the conditions of a 'serious violation involving significant penalty' are met (hence no '*Kompetenz-Kompetenz*' with the arbitrators).

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[17] Park and Tillinghast, *supra* n. 3 at p. 43.
[18] Model Convention, Art. 25(5)(2); MA on Arbitration, para. 2.
[19] MA on Arbitration, para. 11.
[20] Park and Tillinghast, *supra* n. 3 at p. 32.
[21] Commentary to Model Tax Convention, Article 25, para. 50.

(e) Relationship between Arbitration Process and Domestic Remedies

As in the case of investment treaty arbitration, the taxpayer, when filing a request for arbitration, must supply a declaration signed by it and any affiliated party affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the Contracting State.[22]

This is consistent with the situation with respect to the mutual agreement procedure in most countries: a person cannot pursue simultaneously such procedure and domestic legal remedies. If such remedies are still available, the competent authority either requires that the taxpayer agree to the suspension of these remedies or, if the taxpayer does not agree, will delay the mutual agreement procedure until these remedies are exhausted. If the mutual agreement procedure is conducted and agreement is reached, the taxpayer may reject such agreement and pursue domestic remedies that had been suspended. Should the taxpayer favour the agreement reached in the mutual agreement procedure to apply, then he must renounce the exercise of domestic legal remedies as regards the issue covered by the agreement. If domestic legal remedies are pursued and are exhausted in one Contracting State, only the mutual agreement procedure in the other Contracting State is available, as most countries consider it impossible to override such a final decision in such procedure. The same basic rules apply to arbitration.[23]

The earlier OECD Discussion Draft of 2006 had required, in addition, that the taxpayer renounce irrevocably any recourse to courts or tribunals and that it also waive irrevocably any right to have the arbitration decision challenged by any courts or tribunals. This provision was heavily criticised at the public consultation; in particular, it was pointed out that the taxpayer was not given any assurance that double taxation will effectively be avoided and he may therefore find himself with no arbitration decision and with no right of recourse under domestic law.

The OECD Report now provides only for suspension of domestic legal remedies that have not been exhausted. Such remedies are suspended pending the arbitration and the procedure following the arbitration decision. The agreement of the competent authorities following the arbitration decision is presented to the taxpayers who would then have to choose between such agreement, which would require abandoning any remaining domestic remedies, or reject the agreement to pursue such remedies.[24]

Experience with the mutual agreement procedure has shown that in most cases where agreement has been reached by the competent authorities, the taxpayer accepts such agreement. It is therefore fair to say that it will be unlikely that the agreement reached by the competent authorities following the arbitration decision will be rejected and domestic legal remedies will be pursued instead.[25]

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[22] MA on Arbitration, para. 1.
[23] Commentary to Model Tax Convention, Article 25, para. 58.
[24] *Ibid.* para. 59.
[25] *Ibid.* para. 61.

VII. ARBITRATION PROCEDURE

(a) Initiation of the Arbitration

The taxpayer can initiate the arbitration proceedings by filing a request for arbitration with one of the competent authorities no earlier than two years after the date on which the case was presented by the competent authority seized pursuant to Article 25(1) of the Model Tax Convention to the other competent authority. The request must be in writing and be accompanied by a statement in writing of each of the persons who either made the request or is directly affected by the case (in the case of a transfer pricing dispute: the affiliated company that has entered into the challenged transaction with the taxpayer) that no decision on the same issue has already been rendered by a court or administrative tribunal of the Contracting States.[26] There is no advance of costs to be made by the taxpayer.

Within ten days, the competent authority which received the request for arbitration must send a copy of the request and accompanying statements to the other competent authority.[27]

(b) Terms of Reference

Within three months after the request for arbitration has been received by both competent authorities, the competent authorities must agree on the questions to be resolved by the arbitration panel and communicate them as 'Terms of Reference' in writing to the taxpayer. The competent authorities may also provide procedural rules that are additional to, or different from, their Mutual Agreement on Arbitration and deal with other matters as are deemed appropriate.[28]

The Terms of Reference constitute the jurisdictional basis for the questions to be decided by the arbitration panel.[29] The competent authorities are at liberty to draft the Terms of Reference in such a way that the *whole case* and not just certain specific issues are submitted to arbitration.[30]

If within the period of three months after the request for arbitration has been communicated to both competent authorities, the Terms of Reference have not been communicated by the competent authorities to the taxpayer, the competent authorities and the taxpayer may, within one month after that period, communicate in writing to each other the list of issues to be resolved through arbitration, which list will then constitute the tentative Terms of Reference.[31]

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[26] MA on Arbitration, paras 1 and 2.
[27] *Ibid.* para. 1.
[28] *Ibid.* para. 3.
[29] Comments to MA on Arbitration, para. 9.
[30] *Ibid.* para. 10.
[31] MA on Arbitration, para. 4, also with respect to the following.

Within one month after the appointment of all arbitrators, the arbitrators will communicate to the competent authorities and to the taxpayer a revised version of the tentative Terms of Reference.

Within one month after the revised version of the tentative Terms of Reference has been received by both of them, the competent authorities may agree on different Terms of Reference and communicate them in writing to the arbitrators and to the taxpayer. If they do so, these different Terms of Reference constitute the Terms of Reference for the case. If no such different Terms of Reference have been agreed to by the competent authorities and communicated within the period set, the revised version of the tentative Terms of Reference prepared by the arbitrators will constitute the Terms of Reference for the case.

Comment

Experience from commercial and investment arbitration shows that it is not practical to leave the issues or questions to be resolved to the agreement of the parties without the involvement of the arbitration panel. Similarly to commercial or investment arbitration, one would expect the description of the claims that emanate from the request for arbitration to form the contours of the issues to be decided by the arbitration panel. In addition, preliminary submissions of both competent authorities would also clarify or amend the issues to be resolved by the arbitration panel.

Since the arbitration process will be initiated only if the competent authorities have failed to find a solution under the mutual agreement procedure, it would not come as a surprise if the competent authorities could not agree on the specific issues and questions to be resolved either. Leaving the drafting of the Terms of Reference to the competent authorities and not to the arbitrators could jeopardise the arbitration process right from the beginning. The Terms of Reference should therefore be set up by the arbitrators, taking into account the claims presented by the taxpayer as well as the positions taken by the competent authorities.

The Terms of Reference should also clarify administrative matters such as the place of arbitration, the language of the arbitration and the briefing schedule. These issues will have to be discussed by the arbitrators with the competent authorities and the person who made the request for arbitration.

It is anticipated that the Terms of Reference will be drawn up by the arbitrators and signed by them, the competent authorities and the person who made the request for arbitration. If, contrary to expectations, one of these parties should refuse to sign the Terms of Reference, the arbitration should continue on the basis of the Terms of Reference signed by the arbitrators.

The authors had therefore suggested in the public consultation to modify the provision of the sample Mutual Agreement on Arbitration dealing with the Terms of Reference as follows:

> *Terms of Reference*. Within three months after arbitrators have been appointed, the arbitration panel shall draw up, based on the documents or in the presence of the competent authorities and the person who made the request for arbitration, a document containing the questions to be resolved by the arbitration panel, the place and language of the arbitration. This will constitute the 'Terms of Reference' for the case. Notwithstanding the following paragraphs of this agreement, the arbitration panel, after consultation with the competent authorities and the person who made the request for arbitration may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as are deemed appropriate. The Terms of Reference shall be signed by the arbitrators, the competent authorities and the person who made the request for arbitration. If the Terms of Reference are not signed by all parties, the arbitration shall proceed on the basis of the Terms of Reference signed by the arbitrators.

(c) Selection of Arbitrators

Within three months after the Terms of Reference have been received by the taxpayer or, if the competent authorities cannot agree upon the Terms of Reference, four months after the request for arbitration has been received by both competent authorities, each competent authority must appoint an arbitrator.[32]

If both competent authorities agree that the failure to resolve an issue within the two-year period is mainly attributable to the taxpayer's failure to provide information in a timely manner, the competent authorities may postpone the appointment of the arbitrators for a period of time corresponding to the delay in providing the information.[33]

Within two months of the latter appointment, the arbitrators so appointed must appoint the third arbitrator who will function as the Chair.

If any appointment is not made within the required time period, the arbitrator(s) not yet appointed will be appointed by the Director of the OECD Center for Tax Policy and Administration within ten days of receiving a request to that effect from the taxpayer. The same procedure applies if the replacement of an arbitrator becomes necessary.

Any person, including a government official of a Contracting State, may be appointed as arbitrator unless that person has been involved in prior stages of the case. A justification for the waiver of the requirement of neutrality is given in Comment to the sample Mutual Agreement on Arbitration, paragraph 15:

> There may be advantages in having representatives of each Contracting State appointed as arbitrators as they would be familiar with this type of issue. Thus it should be possible to appoint to the panel governmental officials who have not been directly involved in the case. Once an arbitrator has been appointed, it should be clear that his role is to decide the case on a neutral and objective basis; he is no longer functioning as an advocate for the country that appointed him.

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[32] *Ibid.* para. 5, also with respect to the following.
[33] *Ibid.* para. 9.

Comment

Given the nature of tax treaty arbitration as a procedure between the Contracting States for the benefit of the taxpayer, it is certainly not objectionable that the arbitrators are appointed by the competent authorities only and that the taxpayer does not enjoy the same right. In any event, given the known difficulties with multiparty arbitrations, another solution of appointment of the arbitration panel would be cumbersome and would not be likely to appeal to the tax administrations.

At the public consultation, the possibility for a competent authority to appoint a government official was heavily criticised as constituting a violation of the universally accepted principle of international arbitration that the arbitrators should be neutral and independent from the parties who have appointed them. The fear was expressed that, with arbitrators coming from the tax administrations involved in the case, the role of the Chair will be reduced to one of a sole arbitrator. It was also pointed out the difficulty that a neutral arbitrator may have if he realises that his co-arbitrator lacks the same quality.

It is regrettable that these valid concerns have not resulted in a change of the OECD Report. All modern international arbitration rules, both in commercial arbitration and investment arbitration, require the arbitrators – and not only the Chair – to be independent from the parties. The reason given by OECD to allow government officials of the Contracting States to sit as arbitrators – namely that such arbitrators would be familiar with the issues – cannot outweigh the most serious disadvantage of having arbitrators that are not independent from the parties.

In commercial and investment arbitration, the issues to be decided are quite often far more complex and technically or economically more challenging than the questions to be resolved in tax arbitration. The experience shows that independent arbitrators are very capable of understanding these issues if the party representatives explain them in an adequate form.

Independence connotes an absence of inappropriate personal or financial links with a party. However, independence does not mean that the arbitrators must be devoid of doctrinal predispositions. The competent authorities could thus very well select arbitrators in (foreign) government positions or the publications of whom seem to be in line with the arguments that the authority will bring in the arbitration proceedings. The concept of independence, as understood in modern arbitration, would, however, not allow current officials, employees or consultants of a party to the proceedings to act as arbitrators.

It would have been useful to impose neutrality and independence on the arbitrators by specifically stating that they should be impartial and independent from the governments of the Contracting State and from the taxpayer at the time of accepting the appointment and should remain so during the entire arbitration proceedings until the arbitration decision shall have been rendered or the procedure shall otherwise have been terminated.

As to the requirements for the Chair, the Comments to the sample Mutual Agreement on Arbitration state the following in paragraph 15:

> It is important that the Chair of the panel have experience with this type of procedural, evidentiary and logistical issues which are likely to arise in the course of the arbitral proceedings as well as having familiarity with tax issues.

While this statement is certainly accurate, one may wonder whether the Director of the OECD Center of Tax Policy and Administration, who acts as appointing authority, is familiar with persons experienced in the conduct of international arbitration proceedings. For this reason, it was suggested in the public consultation that the appointing authority should rather be the Permanent Court of Arbitration or the President of the International Court of Arbitration of the International Chamber of Commerce.

It would also have been wise to include in the sample Mutual Agreement on Arbitration a specific requirement that the Chair be independent from the governments of the Contracting States and the taxpayer and should neither be a national nor a resident of the Contracting States and that he or she must be fluent in the language appropriate for both competent authorities.

(d) Place (Seat) of the Arbitration

The OECD Report and the sample Mutual Agreement on Arbitration do not provide for the place, rather the seat, of arbitration. They merely mention that the logistical arrangements will be the responsibility of the competent authority to which the case giving rise to the arbitration was initially presented by the taxpayer.

Comment

The failure to specifically fix the seat of the arbitration beyond setting the place where the actual meetings take place has the effect that it remains uncertain which national arbitration law is applied to the tax treaty arbitration procedure. The consequence of this failure to state a seat will be that matters such as removal of arbitrators no longer meeting the requirements or unwilling to perform their functions is not possible and that there are no remedies to set aside the arbitration decision in the event of fundamental violation of the right to be heard or of decisions *infra* or *ultra petita*.

The failure to set a seat of the arbitration may lead to the conclusion that the international arbitration laws of both Contracting States apply, which would have the undesirable consequence that the arbitration decision could be set aside in either of the Contracting States.

In the public consultation the authors had suggested that the seat of arbitration should be determined by the competent authorities to be located in one of the Contracting States or in a third state. Failing agreement of the competent

authorities, the seat of arbitration should be deemed to be at the place of residence of the Chair.

(e) Challenge of an Arbitrator

As indicated, the Report does not provide for the challenge of an arbitrator. In the public consultation, the authors had proposed the following provision:

> *Challenge of Arbitrators*: Either competent authority or the person who made the request for arbitration may challenge an arbitrator's qualification or independence by submitting a written statement to the [appointing authority] specifying the facts on which the challenge is based. Such challenge shall be made within thirty (30) days from receipt of the notification of the appointment or from the date on which the challenging party became aware of the circumstances on which the challenge is based. The [appointing authority] shall determine whether the individuals shall serve or continue to serve. Its decision shall be final.

It would be desirable for the parties to a tax treaty to include such a provision in the Mutual Agreement on Arbitration.

(f) Streamlined Arbitration

The competent authorities may agree in the Terms of Reference on a streamlined arbitration process with the following particularities.[34]

The issues are decided by a sole arbitrator to be appointed by the competent authorities within one month after receipt of the Terms of Reference by the taxpayer and, failing them, by the Director of the OECD Center for Tax Policy and Administration within ten days after receipt of a corresponding request by the taxpayer.

Within two months from the appointment of the sole arbitrator, each competent authority will present in writing its own reply to the questions contained in the Terms of Reference.

Within one month after having received the last of the replies from the competent authorities, the sole arbitrator will decide and briefly give reasons for each question included in the Terms of Reference in accordance with one of the two replies received from the competent authorities.

Paragraph 13 of the Comments to the sample Mutual Agreement on Arbitration, further explains the streamlined procedure:

> That process, which will then override other procedural rules of the sample agreement, takes the form of the so-called 'last best offer' or 'final offer' arbitration, under which each competent authority is required to give to an arbitrator appointed by common consent that competent authority's own reply to the questions included in the Terms of Reference and the arbitrator simply chooses one of the submitted replies.

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[34] *Ibid.* para. 6.

Such procedure is said to be suitable, on the one hand, if primarily factual issues are at stake, often arising in transfer pricing disputes, where the unresolved issue may be simply the determination of an arm's length transfer price or range of prices or, on the other hand, if the issue involves determining the existence of a permanent establishment.

Comment

This kind of fast-track arbitration with the arbitrators selecting one of the parties' position (also called 'baseball arbitration') is suitable for transfer pricing disputes but seems to be less appropriate for other matters, such as characterisation of income or determination of a permanent establishment.

It is noteworthy that the taxpayer does not play any role after the competent authorities have agreed on streamlined arbitration. There is no reason to exclude the taxpayer from taking a position himself which would then allow the arbitrators to choose one of the three figures presented. In addition, the taxpayer may present evidence for one of the competent authorities' position.

(g) Establishment of Procedural and Evidentiary Rules

The procedural and evidentiary rules are those established in the Contracting States' Mutual Agreement on Arbitration, those agreed upon by the competent authorities in the Terms of Reference or as adopted by the arbitrators.[35] The arbitrators will have access to all information necessary to decide the issues submitted to them, including confidential information.[36] Unless the competent authorities agree otherwise, any information that was not available to both competent authorities in the mutual agreement procedure will not be taken into account for the purposes of the decision.[37]

Comment

As tax treaty arbitration is a supplement to the mutual agreement procedure, it makes some sense to entrust the competent authorities with setting the procedural rules in the Terms of Reference (in addition to those already contained in the Mutual Agreement on Arbitration). However, experience in commercial international arbitration shows that the rules of procedure are best set by the arbitrators, more specifically by the Chair. Under the OECD Report, it may well be possible that the competent authorities, probably lacking experience with the problems encountered in international arbitrations, may establish rules not suitable for the conduct of an arbitration or not addressing possible procedural incidents. For this reason, it has been suggested at the public consultation that the

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[35] *Ibid.* para. 10, also with respect to the following.
[36] *Ibid.* para. 8.
[37] *Ibid.* para 10.

Terms of Reference be drafted by the arbitrators conjointly with the competent authorities and the taxpayer.

Doubts appear to be justified with respect to the exclusion, in principle, of new evidence that was not available to the competent authorities in the mutual agreement procedure: one of the characteristics of tax treaty arbitration is the active involvement of the taxpayer in the dispute resolution process. Why should the taxpayer's evidence be limited to the one that was available in the mutual agreement procedure? It is possible that the competent authority that was in possession of such evidence chose not to introduce it in the mutual agreement procedure for egoistic reasons unrelated to the taxpayer or because it simply deemed it not to be conclusive. In both cases, the taxpayer's right to proffer evidence should not be so limited.

Furthermore, each competent authority should not be given a veto power whether such new matters are admissible. If the taxpayer had failed to provide the necessary evidence when initiating the mutual agreement procedure although it could have done so, the decision as to the admissibility of such new matter should lie with the arbitrators, not with either of the competent authorities.

(h) Taxpayer Participation

The taxpayer may present his position to the arbitrators in writing and, with the permission of the arbitrators, may also present his position orally during the arbitration proceedings.[38] The earlier OECD Discussion Draft specifically empowered the competent authorities to provide otherwise in the Terms of Reference. This possibility for the competent authorities to curtail the taxpayer's right to intervene has been dropped.

(i) Logistical Arrangements

Unless agreed otherwise by the competent authorities, the competent authority to which the case giving rise to the arbitration was initially presented will be responsible for all the logistical arrangements for the meetings of the arbitration panel and will provide the administrative personnel necessary for the conduct of the arbitration process. The administrative personnel will report only to the Chair concerning any matter related to the process.

Comment

Experience from commercial and investment arbitration suggests that this provision charging one competent authority to provide for the logistics may indeed jeopardise the arbitration process. Recently, the temptations of a disgruntled party in commercial arbitration to sabotage the proceedings have become more and more common. These tactics include failure to file the submissions on time, obtaining anti-arbitration injunctions from state courts,

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[38] *Ibid.* para. 11.

surveillance and intimidation of the arbitrators and even the kidnapping of arbitrators.

It cannot be excluded that the competent authority to which the case was initially presented may have an interest in there being no quick and smooth resolution of the arbitration. There could be an obvious temptation to stall the arbitration process for the competent authority that is responsible for the practical arrangements. To avoid negative interference of the parties in the arbitration process, it would be more advisable that the Chair, rather than one of the competent authorities, be responsible for the logistical arrangements.

It has already been mentioned that the OECD Proposal fails to state the seat of the arbitration. If the Contracting States merely adopt the sample Mutual Agreement on Arbitration as proposed by OECD and, in a given case, the issue of the seat arises (removal of an arbitrator, review of the arbitration decision), the conclusion could well be reached that by attributing the responsibility for the logistics to the competent authority to which the case was initially presented, the seat of the arbitration was determined to be in the capital of that country. As the taxpayer must file a request for the mutual agreement procedure with the competent authority of his country of residence, the practical consequence would be that the seat of the arbitration will always be in the taxpayer's country. Whether this is desirable remains open.

(j) Costs

The OECD Report provides that the fees of the arbitrators should be dealt with specifically in the Contracting States' Mutual Agreement on Arbitration[39] and refers to the EC Arbitration Convention[40] as a possibility: 'The fees should be large enough to ensure that appropriately qualified experts could be recruited. One possibility would be to use a fee structure similar to that established under the EU Arbitration Convention Code of Conduct'.[41]

The EU Code of Conduct of 31 March 2005 for the effective implementation of the Arbitration Convention[42] provides in its paragraph 4.3(f) as follows:

> Unless the competent authorities of the Contracting States concerned agree otherwise:
>
> (i) the reimbursement of the expenses of the independent persons of standing will be limited to the reimbursement usual for high ranking civil servants of the Contracting State which has taken the initiative to establish the advisory commission;
> (ii) the fees of the independent persons of standing will be fixed at Euro 1,000 per person per meeting day of the advisory commission, and the Chairman will receive a 10% higher fee than the other independent persons of standing.

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39 *Ibid.* para. 6(a).

40 Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [1990] OJ L225/10 (20 August 1990). Also available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:41990A0436:en:NOT

41 Comments to MA on Arbitration, para. 29.

42 [2006] OJ C176/8 (28 July 2006). Also available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_176/c_17620060728en00080012.pdf

The OECD Report provides the following as to the costs:[43]

- each competent authority and the taxpayer bear their own expenses;
- each competent authority bears the costs of the arbitrator appointed by it or for it by the Director of the OECD Center of Tax Policy and Administration;
- the costs of the Chair are borne equally by the two Contracting States;
- the costs of the meetings and of the administrative personnel necessary are borne by the competent authority to which the case was initially presented;
- all other costs, including costs of translation and recording, 'related to expenses that both competent authorities have agreed to incur'[44] are borne equally by the two Contracting States.

Comment

It remains to be seen whether the fee of 1,100 euros per day of meeting will allow the recruitment of qualified experts, in particular persons experienced in both international arbitration and taxation, to assume the function of the Chair. For many practitioners, a fee commensurate with the days of actual meetings only and disregarding the time for study of the file, travelling and drafting the arbitration decision, will not even cover the costs of such practitioner.

By way of comparison, the schedule of arbitration fees of the LCIA provides for a range of hourly fees for arbitrators between £150 and £350. If only those costs that they have agreed to are borne equally by the competent authorities, what about costs of experts, witnesses, translators, in the event that there is no such agreement? Such costs may be incurred for additional evidence submitted by the taxpayer. Regularly, experts will ask for an advance on their costs and fees. It would be hard to reconcile with the basic philosophy of arbitration that, by refusing to bear the costs, the competent authorities have effectively a veto power with respect to administration of evidence proffered by the taxpayer and that the arbitration panel deems to be admissible.

The arbitration practitioner is also struck by the fact that the sample Mutual Agreement on Arbitration does not provide for advance payments of fees and costs of the arbitrators. The following proposal to deal with the issue of costs was made by the authors in the public consultation:

> *Costs*. Unless agreed otherwise by the competent authorities:
>
> (a) each competent authority and the person who requested the arbitration will bear the costs related to his own participation in the arbitration proceedings (including travel costs and costs related to the preparation and presentation of his views);

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[43] MA on Arbitration, para. 13.
[44] *Ibid.* para. 13(e).

(b) the amount of the remuneration of the arbitrators shall be determined as follows … (the mode of remuneration should be described here; one possibility would be to refer to the method used in the Code of Conduct on the EC Arbitration Convention);
(c) the remuneration of the arbitrators and their travel, telecommunication and secretariat costs as well as costs related to the meetings of the arbitration panel and to the administrative personnel necessary for the conduct of the arbitration procedure (including costs of translation and of recording the proceedings and value added tax and the like, if any, levied on the remuneration and/or costs) will be borne equally by the two Contracting States;
(d) the arbitration panel may request an advance on its remuneration and the other costs of the arbitration, subject to later adjustment as appropriate. Should either Contracting State refuse to pay its portion of the advance on costs, the other Contracting State or the person who made the request for arbitration may make substitute payment on behalf of the defaulting Contracting State and will be entitled to reimbursement thereof as the arbitration panel deems appropriate

(k) Time for the Arbitration Decision

The arbitration decision must be communicated to the competent authorities and to the taxpayer within six months after the Chair's declaration that he or she has received all the information necessary to begin consideration of the case.[45] If the decision is not communicated within the time period set, the competent authorities may agree to extend that period by a period not exceeding six months or, if they fail to do so, within one month from the end of the period they must appoint new arbitrators.[46]

Comment

Practitioners familiar with the Rules of Arbitration of the International Chamber of Commerce recall article 24, also providing for a time limit of six months. But they also know how often, in the real world, this time limit can be met! Merely the scheduling of a meeting for three persons coming from three different countries, even disregarding the wishes of the competent authorities and the taxpayer, may make it impossible to meet that requirement of time.

It is most unfortunate that this time period can only be extended once by a period of six months and that each competent authority can bring the arbitration procedure with this panel to an end just by failing to agree to an extension.

(l) Taking of Arbitration Decision

Where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators.[47] Unless provided otherwise in the Terms of Reference, the decision will be with reasons in writing and, with the permission of the taxpayer, may be made public in a redacted form.

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[45] *Ibid.* para. 16.
[46] *Ibid.* para. 17.
[47] *Ibid.* para. 15.

Comment

While it is uncontested that the issues presented in arbitration can – and indeed should – be decided in most cases with a majority decision, it is not inconceivable that no result is accepted by a majority of the arbitrators. In this situation, the Chair should be empowered to take the decision alone (akin to article 25 of the ICC Rules of Arbitration).

The necessity of this rule may be shown by the following example: if the first arbitrator deems the appropriate rate of a royalty to be 0.5 per cent and according to the second arbitrator it should be 5 per cent, whereas the Chair would award 2.5 per cent, the Chair should be able to cast the decisive vote at 2.5 per cent rather than having to accept one or the other of the rates that he or she deems inappropriate.

(m) Setting Aside the Arbitration Decision

Paragraph 18 of the sample Mutual Agreement on Arbitration provides the following:

> 18. *Final decision*. The arbitration decision shall be final, unless that decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or of any procedural rule included in the Terms of Reference or in this agreement that may reasonably have affected the decision. If a decision is found to be unenforceable for one of these reasons, the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place (except for the purposes of paragraphs 8 'Communication of information and confidentiality' and 13 'Costs').

Comment

This provision provides for the possibility for the courts of one of the Contracting States to set aside the decision of the arbitrators in the event of a violation of paragraph 5 of Article 25 or of any procedural rules included in the Terms of Reference or in the Mutual Agreement. It is hard to reconcile this provision with the nature of arbitration. The very concept of arbitration following the mutual agreement procedure is that the decision rendered by the arbitrators is assimilated with an agreement reached by the competent authorities in such procedure. An agreement reached in mutual agreement procedure is not reviewable by any court.

In addition, the provision that any violation of any procedural rule in the Terms of Reference or in the Mutual Agreement on Arbitration would be sufficient to allow the courts of the Contracting States to nullify the decision, would give such courts wide jurisdiction to thwart arbitration. The legal situation in the various countries regarding judicial review of arbitral awards rendered in commercial arbitration differs widely. While in some countries, there is no such possibility at all, in other countries the scope of judicial review is narrowly limited. Generally, grounds for setting aside an arbitral award are lack of jurisdiction of the arbitral tribunal, gross violation of procedural rights, decision

beyond the claims submitted (*ultra petita*) or failure to decide one of the items of the claim (*infra petita*).

In tax treaty arbitration, given the active involvement of the two competent authorities, the ground for annulment for lack of jurisdiction of the arbitrators does not appear as an issue that should be reviewable. Likewise, the decision of the arbitrators to decline jurisdiction should stay as it is.

On the other hand, however, there should be some judicial control that the arbitral tribunal not go beyond the issues submitted to it or that it decide all the issues submitted. In addition, serious violations of the parties' rights to be heard or of the competent authorities' rights to be treated equally should be able to be enforced by the courts of the place of arbitration, if necessary.

In the public consultation the authors had submitted to modify this paragraph of the sample Mutual Agreement on Arbitration as follows:

> *Final nature of the decision*: The arbitration decision shall be final. The decision may be set aside by the competent court of the place of arbitration, if provided for by applicable law, in the following situations only: (a) the arbitrators went beyond the issues submitted to them or failed to decide one item of the issues submitted; or (b) the principle of equal treatment of the competent authorities or the right to be heard in adversary proceedings of the competent authorities and/or the person who made the request for arbitration was violated. Any other grounds for annulment of the arbitration decision provided for by the law of the seat of arbitration, if any, are expressly excluded.

VIII. IMPLEMENTATION OF THE ARBITRATION DECISION

The competent authorities must implement the arbitration decision within six months after communication by reaching a mutual agreement on the case that led to arbitration.[48] Failure of the competent authorities to assess the taxpayer in accordance with the arbitration decision would result in taxation not in accordance with the tax treaty and as such, allows the taxpayer to seek relief through domestic legal remedies or by making a new request for arbitration.[49]

IX. APPRAISAL OF THE OECD REPORT

The OECD Report is timely and to be welcomed! It does away with the now generally recognised drawback that the only means of dispute resolution under the tax treaties is the mutual agreement procedure with no guarantee that taxation not in conformity with the tax treaty is effectively avoided. Possibly, the mere existence of the supplemental arbitration procedure will cause the competent authorities to reach agreement, and to reach agreement before the two-year waiting period to institute arbitration proceedings expires.

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[48] *Ibid.* para. 19.

[49] Comments to MA on Arbitration, para. 42.

As indicated above, from the viewpoint of an international arbitration practitioner, the OECD Report has some substantive and procedural weaknesses. It may be regretted that OECD has not listened more to commercial and investment arbitration practitioners to learn about the practical difficulties that were encountered in the past and how they have since been remedied by enactments of specific rules by the arbitration institutions or through guidelines by international organisations such as the International Bar Association (IBA). Some of the weaknesses pointed out, most importantly the waiver of neutrality and independence of the arbitrators, may become apparent when the first arbitration proceedings are conducted.

It must be recognised that, until a few years ago, several countries, most importantly the United States, were opposed to tax treaty arbitration, at least to 'mandatory arbitration', which was not based upon prior express agreement of the competent authorities to submit their dispute to arbitration. Often, sovereignty and other constitutional obstacles were invoked as to why the matter could not be taken out of the hands of the competent authorities when they were unable to agree to be entrusted to arbitrators. Now, a change of mind has occurred. Had the OECD Proposal gone in the direction of a judicial type of arbitration comparable with international commercial and investment arbitration, it is uncertain whether it would have met with approval by all countries represented in OECD's Committee on Fiscal Affairs. It is certainly better to have any kind of arbitration, even if a less-than-perfect one, rather than having such a 'perfect' arbitration system which is found unacceptable by major countries.

If future tax treaty arbitration procedures reveal that the current wording of the sample Mutual Agreement on Arbitration does not provide the optimal result, it is open to the competent authorities of the Contracting States to amend their Mutual Agreement on Arbitration to take into consideration the relevant experience. In addition, the Model Tax Convention and its Commentary are both subject to constant revision by the OECD Committee on Fiscal Affairs. One can be assured that OECD will be closely watching the experience which unfolds under the new paragraph 5 of Article 25 of the Model Convention and its Mutual Agreement on Arbitration. If such experience warrants it, OECD will undoubtedly proceed with the necessary amendments.

The OECD Proposal, in spite of its many weaknesses, is therefore a substantial step to ensure that tax treaties intended to avoid double taxation are effectively enforced.