WHO IS AFRAID OF ARBITRATION TO SOLVE TAX DISPUTES? A LOOK INTO THE CARIBBEAN REGION FOR SPOTTING PROBLEMS AND PROPOSING SOLUTIONS

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The recourse to arbitration as the last stage of the mutual agreement procedure ('MAP') to solve tax disputes is not universally accepted.[1] Arbitration is not listed as a minimum standard in Part VI of the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting ("MLI"). Looking into the Caribbean Region, this trend is confirmed. Jamaica and Belize have opted out of arbitration in Part VI of MLI. The double tax treaties ("DTCs") signed by Countries like the Dominican Republic and Cuba, which are not MLI signatories but concentrate important foreign direct investment in the Caribbean Region (i.e. tourism is a huge economic driver), do not contain the arbitration clause laid down in Article 25 (5) OECD and 25 (5) (B) UN Model Tax Convention. In regional organizations like the Caricom, Article 23 of the Caricom Double Taxation Treaty (1994) carved out arbitration. Barbados[2] and Curaçao[3] are perhaps the few exceptions in the Caribbean Region that opted in for Part VI of the MLI.

In the author's view, arbitration is crucial to be endorsed as a dispute resolution mechanism in double tax treaties ("DTCs"), provided the MAP ends without an agreement. Every tax dispute must be concluded with a final and binding decision as the only way to comply with the legal certainty principle. There are two reasons to support arbitration as an effective dispute resolution mechanism. First, investors aim to secure an effective solution to their disputes regarding tax treaties. The lack of arbitration clauses in DTCs may discourage the choice of a particular jurisdiction to structure a cross-border investment. Second, the fact that arbitration is not universally accepted in international taxation is a clear anomaly within international economic law. In the framework of international investment agreements ("IIAs"), all the agreements contain a referral to mandatory arbitration to solve disputes between the investor and the host state. Yet, there is an important caveat to add. The author's faith in arbitration as an effective dispute-resolution mechanism cannot be assimilated to support arbitrary or discretionary awards by the arbitrators. Arbitration must be always reconciled with the rule of law, and the award must contain proper legal reasoning.

This contribution aims first to examine the causes of why arbitration is traditionally discarded as a dispute resolution mechanism in international taxation, and second, propose several solutions that can be applied to the Caribbean Region to increase the acceptance of arbitration as an effective dispute resolution mechanism. The last section summarizes the principal findings.

THE RELUCTANCE TO ARBITRATION TO SOLVE TAX DISPUTES

The literature has underlined the most frequent concerns against arbitration conveyed by countries: risks of national sovereignty, constitutional limits, high costs, and the need for expertise.[4] Such concerns are decisive when developing countries are involved. Arbitration is perceived as a threat to national sovereignty since enables appointed arbitrators to potentially overcome national judicial decisions and give away tax collection. Arbitration challenges the power of the state to autonomously decide its tax matters. The arbitration costs (i.e. fees of arbitrators, lawyers, and independent experts) are indeed quite high, bearing in mind the lack of expertise associated with the tax administration of developing countries.

Aside from the previous concerns frequently handled by states, the OECD has not contributed much to supporting arbitration in Article 25 (5) OECD Model Tax Convention and Part VI of the MLI. First, Article 25 (5) OECD Model Tax Convention (2017) presents important limitations: (i) arbitration is only permitted in respect of actions of one or both states that "have resulted" in taxation not in accordance with the treaty (i.e. actions that "will result" are excluded); (ii) only unresolved issues in the MAP can be subject to arbitration (i.e. the arbitrators cannot solve the dispute as a whole if there was agreement on certain elements).[5] Second, Article 25 (5) OECD MC (2017) allows the states to exclude certain matters from arbitration (i.e. issues that are primarily factual in nature as Paragraph 66 of the Commentaries to OECD Model Convention (2017) point out).[6]

Part VI of the MLI neither benefits the widespread of arbitration since (i) it allows the states to introduce important reservations to arbitration and, (ii) makes a regrettable choice for baseball arbitration. The first block of reservations allowed under article 19(12) of the MLI ensures that domestic proceedings prevail over an arbitration procedure. Those reservations are the following: (i) an unresolved issue from a MAP cannot be referred to arbitration if a court or administrative body of any of the contracting states has previously ruled on the same matter; and (ii) if, at any time after the request for arbitration but before the arbitral commission has rendered its arbitration award, a decision is rendered by a court or administrative body of one of the contracting states, the arbitration procedure must be terminated. The latter reservation does not oblige the taxpayer to waive its domestic appeals in order to reach the arbitration stage. However, there is a risk that, if he does not do it, there could be a judicial solution prior to the arbitration award that would put an immediate end to the arbitration procedure.[7]

The second block of reservations is related to the scope of arbitration allowed under Article 28(2)(a) of the MLI. The Spanish position to the MLI offers an exhaustive catalogue of limitations to enter into arbitration: (i) cases involving the application of anti-abuse norms; (ii) cases in which a person directly affected by the case has been subject, by a final ruling resulting from legal or administrative proceedings of either contracting state, to a penalty for tax fraud, wilful default, and gross negligence; (iii) cases of transfer pricing involving items of income or wealth which are not subject to tax in a jurisdiction, either because they are excluded in the taxable base of that contracting jurisdiction, or because they are exempt or taxed at a reduced rate in that contracting jurisdiction; (iv) cases eligible for arbitration under the Arbitration Convention (90/436/ EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises); and (v) cases in which both contracting states agree that they are not suitable for arbitration (discretionary provision). These in-scope limitations jeopardize the effectiveness of arbitration. According to article 23(1) of the MLI, the so-called baseball arbitration (last best offer) is the default option instead of the reasoned opinion arbitration. Commentators have been critical of applying baseball arbitration to tax matters, particularly regarding (i) the limited role of the taxpayers; (ii) a decision being made without any reasoning, by a simple majority; and (iii) the lack of publication of the decision.[8] Despite the speed, low cost, and simplicity of baseball arbitration, this author agrees with the previous criticisms that pose serious breaches of legal certainty and fairness. If arbitration needs to align with the rule of law to be generally accepted by states as an effective dispute resolution mechanism, baseball arbitration is not the way forward.

In conclusion, the reluctance to accept arbitration as an effective dispute resolution mechanism for international tax disputes clashes with the states, which are concerned with the high costs and severe limitations to tax sovereignty. In addition, such unwillingness for arbitration pervades the OECD's work both in Article 25 (5) of the OECD Model Convention and Part VI of the MLI. On one hand, the OECD seems to encourage

MAP (i.e. BEPS Action 14 and Part V of the MLI are minimum standards) but blocks arbitration, on the other hand. Such a contradictory strategy will result in "fake MAPs": the administration opens the MAP without any endeavor to solve it since access to arbitration will be precluded in a later stage (i.e. the state has introduced an in-scope reservation for arbitration for cases of applying anti-avoidance provisions).[9]

FOSTERING ARBITRATION IN THE CARIBBEAN REGION

The disappointing picture of arbitration as a dispute resolution mechanism needs to be reverted. Strikingly in the Caricom, the rejection of arbitration in the Caricom Double Taxation Treaty (1994) contrasts with the inclusion of arbitration as a dispute resolution mechanism to solve the disputes between the Member States of the CARICOM (Articles 204-206 of the Revised Treaty of Chaguaramas establishing the Caribbean Community, 2001 – ´Caricom Treaty´). In Addition, Article 223 of the Caricom encourages the Member States to facilitate arbitration to solve private commercial disputes among Community nationals as well as Community nationals and nationals of third states. Why tax disputes cannot be aligned with other international commercial disputes?

To increase the acceptance of arbitration, especially in the Caribbean Region, there are four potential areas of improvement: (i) elimination of restrictions to arbitration in tax matters; (ii) selection of arbitrators; (ii) the enforcement of uniform procedural rules for tax disputes in the Region with a substantial increase in taxpayers' rights ; (iii) reduction of the arbitration costs. Concerning the first block of measures, there are important improvements to make. First, the OECD should amend Article 25 (5) OECD Model Convention (2017) to allow the arbitrators to review the whole of tax disputes, and not only the issues not solved in the MAP. Resolving the whole case is crucial since all issues of a case are interconnected. Limiting the scope of review to "unresolved issues" constraints arbitrators to issues already agreed by the states. Second, limiting arbitration to actions that "have resulted" and not "will result" in Article 25 (5) OECD Model Convention (2017) is not aligned with 25 (1) OECD Model Convention (2017) that relates to the opening of a MAP. While for requesting a MAP, action that "will result" in taxation not in accordance with the treaty is allowed, there is no justification to exclude it from the opening of arbitration in 25 (5). Third, the OECD should limit the scope of reservations that

states can make to arbitration in Part VI, as well as eliminate baseball arbitration as a default system for arbitration. These suggested modifications aim to reduce the dependency of tax arbitration in international taxation from the MAP procedure. Granting major autonomy to tax arbitration aims to get closer to arbitration in other areas of international law, like investment law.

About the second block of improvements, the appointment of arbitrators has been always controversial. Developing countries cast doubts on the impartiality of panel members coming from developed countries. To prevent this outcome, Article 20 of the MLI imposes an arbitration panel of 3 individuals with expertise in international tax matters. Each competent authority appoints one panel member and the two panel members appoint the third panel member, who will be the chair of the arbitration panel and cannot be a national/resident of either contracting state. In the author's view, regional organizations like Caricom, Andean Community, and Mercosur should play a major role in the appointment of the chair (the third member of the panel) for arbitration cases in the Caribbean and South America. Arbitrators listed by these regional organizations should have expertise in international taxation, as well as knowledge of the economic, legal, and political circumstances in the regions. Another improvement that can be made to assist the arbitrators without any previous background in international taxation is the creation of a permanent committee of tax experts that render non-binding opinions to arbitrators.[10] An impartial permanent tax committee, under the auspices of the UN, could increase the trust in arbitration by developing countries. If the final decision of the arbitrators deviates from the opinion of the permanent committee of tax experts, one should expect explicit and well-argued reasons to do so.

Regarding the third block, there is a need to uniformly regulate the binding procedural aspects of arbitration, the so-called Lex Arbitrii, for the whole Caribbean Region. Part VI of the MLI as well as the Commentaries to Article 25 UN/OECD Models contains detailed procedural rules on arbitration that states may agree upon (i.e. OECD/UN Sample Mutual Agreement on Arbitration). Some countries like Spain have entered into ad hoc Memorandum of Understanding with treaty partners (i.e. DTC between Spain and the UK, 2013) that provide detailed arbitration rules. The procedural rules cover issues related to the selection and requirement of the arbitrators, confidentiality, deadlines, interaction with domestic procedures, suspension, costs, implementation of the award, and participation of the taxpayer in the arbitration proceedings. In the author's view, countries in the Caribbean Region, via Caricom for example, should approve a Lex Arbitrii for tax disputes in the Region. In doing so, one of the crucial aspects will be to increase the participation of the taxpayer in comparison to the MAP. This has been already the trend in other jurisdictions like the EU. The EU Dispute Resolution Directive (Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union) provides for more extensive rights for the taxpayer.

Finally, the fourth block, third-country funding could be used to alleviate the costs of arbitration. Third-party funding has been used in commercial arbitration since the 1990s to allow a third-party funder to provide financial resources to the party to the dispute without, or insufficient financial resources for a proceeding in exchange for shares of the case.[11] Some authors have already concluded that third-party funding does not present major legal barriers to be transplanted to international tax disputes.[12] The recourse to third-party funders can eliminate the high costs that developing countries may face. For third-party funders, financing tax arbitration could be attractive due to the economic magnitude of tax cases.

CONCLUSIONS

Arbitration in international tax matters has not yet been emancipated from the MAP narrative, an inter-state procedure that does not oblige the states to reach a solution. As such, arbitration in international tax matters cannot be leveraged to arbitration in commercial and investment disputes. The reluctance to arbitration in taxation is twofold. On one hand, the states are afraid of losing tax sovereignty and incurring substantial costs. And, on the other hand, it seems that the OECD/UN introduces serious obstacles to enable arbitration to be generally accepted (reservations, limited scope, baseball arbitration, etc.). Arbitration in tax matters is unfortunately a mere extension of an unsuccessful MAP.[13]

Contrary to this narrative, this author has emphasized that tax arbitration should be aligned with commercial and investment arbitration. Taxpayers have the right to obtain a binding resolution that puts an end to litigation on treaty disputes. In the Caribbean region, where foreign direct investment is crucial in sectors like tourism, investors request legal certainty.

There is no reason to keep the "tax exceptionalism" in the area of disputes, as this author has elsewhere written.[14] The convergence of tax arbitration with commercial and investment arbitration requires facing important challenges. First, tax arbitration should respond to the rule of law. Therein lies the need to replace baseball arbitration with reasoned opinion arbitration, and increase taxpayer's rights. Second, regional integration organizations like Caricom, Andean Community, and Mercosur should play a major role in increasing trust in arbitration (i.e. appointment of the chair and enforcement of procedural rules). Third, the OECD, UN, and G20/ OECD Inclusive Framework should work towards the elimination of restrictions that jeopardize the effectiveness of tax arbitration (i.e. reservations and procedural limitations). Fourth, third-party funding needs to be explored as an effective way to alleviate the costs derived from arbitration procedures.

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[1]J. de Goede & Sam Maruca, Practical Approaches to International Tax Dispute Prevention and Resolution, IFA Cahiers, Vol. 108 (2024), p. 79
[2]Barbados chose to apply Part VI to its network of treaties subject to MLI (31 treaties). Available at https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/beps-mli/beps-mli-position-barbados-instrument-deposit.pdf (Access 15.12.2024)
[3]There was an arbitration provision in Article 24 (5) of the Netherlands in respect of Curaçao – Malta Income and Capital Tax Treaty (2015), IBFD treaty database; The arbitration provision in the MLI applies to the Netherlands in respect of Netherlands Antilles – Norway Income and Capital Tax Treaty (1989), IBFD treaty database
[4]J. de Goede & Sam Maruca, supra n. 1, p. 79
[5]See a detailed analysis in J. Schwarz, Scope of Arbitration under the OECD and UN Model Provision, in G. Maisto (ed), Dispute Resolution under Tax Treaties and Beyond, (IBFD, 2023)
[6]The matters excluded from arbitration are usually profit allocation, existence of permanent establishment, residence, and application of anti-abuse provisions. See J. Schwarz, supra n. 5, p. 232
[7]See A. Maldonado and R. García Antón, Spain, in G. Maisto (ed), Dispute Resolution under Tax Treaties and Beyond, (IBFD, 2023)
[8]Baker, P. and Pistone, P. BEPS Action 16: The Taxpayer's Right to an Effective Legal Remedy Under European Law in Cross-Border Situations, 25 EC Tax Review 5/6 (2016) pp. 335-345; and Flavio Neto, L. Baseball Arbitration: The Trendiest Alternative Dispute Resolution Mechanism in International Taxation, in Pistone P. (ed), Flexible Multi-Tier Dispute Resolution in International Tax Disputes, (IBFD 2021).
[9]On this idea of "fake MAPs", see A. Martín Jiménez, Acceptance and Denial of MAP Requests and Related Remedies, in G. Maisto (ed), Dispute Resolution under Tax Treaties and Beyond, (IBFD, 2023)
[10]Such initiative has been advocated by S. Van Weeghel and B. Kuzniacki, Raising Tax Certainty in Cross-Border Tax Disputes Through a Body of Experts, 3 Belt and Road Initiative Tax Journal 2, (2022) pp. 64-73
[11]E. De Brabandere & J. Lepeltak, Third Party Funding in International Investment Arbitration, Grotius Ctr. Working Paper No. 2012/1, (2012).
[12]K. Chol Kim, Justice, Third-Party Funding, and Tax Treaty Arbitration. 33 Indiana International and Comparative Law Review, (2023) pp. 39- 91.
[13]B. Malek, Procedural Aspects of Arbitration, in G. Maisto (ed), Dispute Resolution under Tax Treaties and Beyond, (IBFD, 2023)
[14]R. García Antón, Tax Exceptionalism – Should Tax law converge/diverge with other legal disciplines?, Kluwer International Tax Blog, July 8 2024. Available at https://kluwertaxblog.com/2024/07/08/tax-exceptionalism-should-tax-law-converge-diverge-with-other-legal-disciplines/ (Accessed 19 December 2024)