Reimagining Tax Treaty Dispute Resolution; beyond MAP and Arbitration

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Introduction

Tax treaties may seem like strange instruments of law. Although they belong to the realm of public international law, they are interpreted by municipal courts. In contrast, many other treaties are interpreted by international tribunals. There has been a call for resolving tax treaty disputes through binding arbitration. However, this solution appears to be unacceptable to some countries.

The principal argument often made against tax treaty arbitration is that it infringes upon the sovereignty of the contracting states. The chief criticism of this argument is that the conclusion of a tax treaty is itself a sovereign act, but it is one that restricts a state's tax sovereignty. Why, one may ask, having ceded a part of its tax sovereignty by concluding a tax treaty, must a state withhold its sovereignty for interpreting it?

This article examines the tension between how bilateral tax treaties are applied and interpreted by each of the contracting states and what happens when disputes arise. Finally, we look into how disputes are now resolved and propose a new way to deal with treaty disputes.

Two tax treaties in one!

The reluctance on the part of some states to commit to arbitration, however, may not be entirely without reason. Contracting states may well sign one document, but, in essence, they conclude two tax treaties, yes two! Counterintuitive as it may sound, a different version applies to each of the contracting states to a tax treaty, as discussed next.

Contrary to some common beliefs, a tax treaty's primary function is not to "allocate taxing rights" to a contracting state. Rather they restrict a contracting state from exercising its taxing rights (which it enjoys in full as a sovereign state) within certain contours agreed to by the treaty partners. To achieve this, a tax treaty must interact with two sets of domestic tax laws at several points of intersection. Article 3(2) of the OECD Model provides an important rule that facilitates a smooth intersection of treaties and domestic law. It stipulates that undefined terms of a tax treaty adopt the meaning they have under the domestic law of a contracting state at the time of applying the tax treaty, unless the context requires otherwise.

It is usually for the state other than the state of which the taxpayer is a resident (colloquially referred to as the "source state") to determine whether the taxpayer's tax liability in that state is reduced by a

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tax treaty. If this involves the interpretation of undefined treaty terms, the source state may well interpret those terms through the prism of its domestic law. Domestic laws of two contracting states may, however, accord different meanings to the same term. Therefore, it is conceivable that the treaty restricts source taxing rights if interpreted from the perspective of one of the contracting states, but not the other way around.

Domestic law meanings of a term may also change over a period of time. To address this occurrence, Article 3(2) (explicitly since 1995) provides for a dynamic reference to domestic law. A contracting state may perceive that dynamic reference to domestic law in the interpretation of tax treaties as an acknowledgement of its sovereignty over how to interpret tax treaties. It is conceivable that it is this sovereignty of interpreting tax treaties through its municipal courts that some states are reluctant to give up.

When the context "requires otherwise"

While the dynamic reference to domestic law in the interpretation of tax treaties provides the rule, this rule is subject to an exception. The reference to the domestic law meaning of an undefined term is suspended should the "context require otherwise". When the context does require otherwise, an undefined treaty term should be interpreted autonomously. Sometimes this autonomous interpretation is said to belong to the "international tax language" developed by the OECD Model and Commentaries. The Commentaries introduced these terms to address concepts that are common across tax treaties, and not the technical meaning the term might have under the domestic laws of a state. "Beneficial owner" is perhaps the most obvious example of such a term. Some other expressions which come to mind are "liable to tax", "fixed place of business", and "secret formula or process".

This raises this question: When does the context "otherwise require" an autonomous meaning to be ascribed to a treaty term? This question is the subject of considerable controversy. Some believe that nearly all undefined terms ought to be interpreted autonomously, whereas others believe they should never be interpreted in this way. The correct answer may lie somewhere in the middle.

Relief from Double Taxation and Non-taxation

So far we have examined the issues facing the source state's application of a tax treaty. What happens in the state of which the taxpayer is a resident? If the residence state believes that the source state has applied its version of the treaty correctly, it must relieve double taxation. But what happens if the residence state disagrees with the source state's application of its domestic law, and believes that the context requires otherwise? Unfortunately, no relief from double taxation may be available in such a case, which may result in double taxation, unless resolved by way of the mutual agreement procedure (MAP).

Speaking of non-taxation, judges are often influenced by the fact that a particular interpretation may result in double non-taxation. The title "double taxation avoidance agreement" tends to influence them to disregard the customary rules of international law on the interpretation of treaties, often ignoring the fact that such non-taxation may be intended and caused by a domestic law exemption in the other contracting state. For example, in the famous case *Fowler v Commissioners* [2020] UKSC 22, the UK Supreme Court was faced with the question of whether a diver's income could be characterised as employment income or business profits. The court was concerned about whether a conflict of how the income was characterised in the two countries might result in the non-taxation of income in both countries. This concern may even have influenced its decision to adopt a somewhat autonomous interpretation of the treaty.

A New Way Forward?

Clearly, a tax treaty relies heavily on the domestic law of a contracting state for the meaning of undefined terms. This peculiarity suggests that tax treaties preserve more of a state's sovereignty than do some other types of treaties. On the other hand, a state must respect the permanency of commitments it has made upon the conclusion of a tax treaty. This occurs when the context requires an autonomous or static interpretation of undefined terms. Thus, the interpretation of tax treaties seems to be a delicate balancing act. After all, treaties are bilateral in nature, and a disagreement on how to interpret a term can result in the harmful result of unrelieved double taxation. This scenario also merits an international approach to interpretation of tax treaties that transcends the inefficient system of the MAP. To this end, I propose the following alternative to arbitration, which balances sovereignty with bilateralism, beginning with an understanding of how treaty disputes are resolved in a litigation setting.

Tax treaty litigation goes through a chain of appellate forums. For example, in India, the assessing officer scrutinises tax returns, and the first appeals lie before the Commissioner of Income Tax (Appeals). These authorities are purely administrative, although they are, theoretically, required to adopt a judicial temper whilst reaching their decisions. The Income Tax Appellate Tribunal is the final fact-finding authority at the appellate level. This is a truly quasi-judicial authority, which comprises a two-member bench. Appeals from the Tribunal lie before High Courts, but they are not a matter of right, insofar as they ought to be entertained only if the decision of the Income Tax Appellate Tribunal raises a "substantial question of law". Appeals to the Supreme Court of India are also discretionary and may be entertained only in rare cases.

I propose that *all* questions of tax treaty interpretation be decided by special benches of appellate tribunals, comprised of judges from each of the contracting states. In India, this could be at the stage where appeals are made before the Income Tax Appellate Tribunal, and the bench would comprise an Indian judge, and one from the other Contracting State. This would allow for a bilateral examination of questions of tax treaty interpretation at a judicial level, once the questions of law and facts have been ascertained adequately.

Such a tribunal need not be set up every time a tax treaty dispute emerges in a country. There may well be an international tax tribunal with a permanent staff of judges from a number of countries, with the possibility of adding *ad hoc* judges. However, unlike the International Court of Justice (where the full court adjudicates disputes), only judges from the contracting states may adjudicate a case involving the interpretation of a tax treaty.

The proposed tribunal, I posit, would be better suited to determinine whether the “context requires otherwise” than the meaning accorded by domestic law to undefined terms. It should also prevent unintended instances of double taxation or double non-taxation. Given the specialised nature of such tribunals, it may be expected that the rules of customary law on the interpretation of treaties are followed more rigorously, and that judgments are expressed more tightly. Also unlike the ICJ, this tribunal would not be the final arbiter of a disputes. Appeals from such a tribunal may continue to lie before a country’s courts, which too would benefit from the examination of the facts and the law by the bilateral appellate tribunal.

One may question if the is any legal basis for such a bilateral tribunal to be constituted. Article 25(3) of the OECD Model provides for the “competent authorities” of the Contracting States to a tax treaty to “endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application” of the tax treaty. It also empowers the competent authorities to consult together to eliminate double taxation in cases not provided for in the treaty. I posit that questions of interpretation of undefined terms carry within themselves the difficult question of whether they should be interpreted by reference to domestic law, or if the context requires otherwise. Therefore, I posit that there may be a number of cases in which the judges of such a tribunal might be empowered as competent authorities within the legal basis found in Article 25(3). It is possible that these judges of the proposed tribunal are appointed as “authorised representatives” of revenue authorities of each state, as provided in a large number of treaties. I also acknowledge that Article 25(3) might not in all cases provide such a legal basis. It may be concluded that such cases may not merit examination by the proposed bilateral tribunal. However, such a conclusion adds the complexity of determining which cases are referred to the proposed tribunal and which not. Therefore, it may be useful for international bodies like the United Nations to consider evolving a clause to provide the creation of such bilateral tribunals for questions of tax treaty interpretation. This approach should, in my view, combine efficiency with international accountability, and balance sovereignty with bilateral cooperation.