Novel Treaty-Based Approaches to Resolving International Investment and Tax Disputes in the Asia-Pacific Region

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Abstract

Trade and investment treaties have proliferated throughout the Asia-Pacific region. Their dispute resolution mechanisms are important in entrenching market access commitments, especially when providing for direct claims by firms against States. However, the 'Global Financial Crisis' has also heightened calls to balance liberalisation with harmonised regulatory safeguards. The way investment treaties sometimes deal with certain claims over taxes imposed by host States, limiting the scope for investors to proceed with direct arbitration claims, suggests one innovative mechanism for resolving claims about other types of investment disputes. A second possibility is to redesign investment treaties covering such claims — like some contemporary double tax treaties, which have also burgeoned through the Asia-Pacific region based on the Organisation for Economic Co-operation and Development ('OECD') *Model Tax Convention*. Just as a taxpayer can be given rights under tax treaties to force treaty partner tax authorities to initiate an inter-state arbitration, an investor could be entitled to trigger an inter-state arbitration of other sensitive issues under an investment treaty. Both dispute resolution mechanisms address state sovereignty and public interest access, yet preserve a role for private interests. They represent only some of various possibilities for improving the treaty-based investor–state arbitration system, instead of abandoning it for Australia's future treaties as proposed by the Gillard Government's April 2011 'Trade Policy Statement'.

Introduction

Particularly through the Asia-Pacific Economic Cooperation ('APEC') forum, much effort has been expended over the last two decades to build up regulatory harmonisation and cooperation in order to liberalise and facilitate cross-border trade and investment in the Asia-Pacific region. The creation of APEC in 1989 helped to galvanise an expansion and formalisation of related initiatives within the Association of Southeast Asian Nations ('ASEAN'). That process within ASEAN has accelerated since 2000, when negotiations stalled for a new round of multilateral liberalisation measures under the World Trade

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Organization ('WTO'), and as its member states, along with other Asian nations, became increasingly concerned about the economic rise of China.[1]

South-East Asian nations have begun actively concluding bilateral free trade agreements ('FTAs'), such as the Japan–Singapore FTA (signed in 2001) and the Australia–Singapore FTA (2003), as well as regional 'ASEAN+1' FTAs first with China (framework agreement signed in 2002) and now including FTAs between ASEAN and Korea, Japan, India and Australia–New Zealand.[2] Although no FTAs have been concluded yet among China, Korea and Japan, 'transgovernmentalism' among these closely-linked economic powerhouses has expanded dramatically — particularly since the Asian Financial Crisis of 1997 — and studies are now well underway for 'ASEAN+3' or 'ASEAN+6' FTAs.

A parallel development is the Trans-Pacific Partnership Agreement ('TPPA'). Initially agreed in 2005 among New Zealand, Singapore, Brunei and Chile, negotiations are now underway to add chapters on 'Investment' and 'Services', and to bring in Australia, the United States ('US'), Malaysia, Vietnam and possibly Japan — creating the first Asia-Pacific regional FTA to include the US.[3] These and other Asia-Pacific States have also greatly expanded the numbers and scope of application of intra-regional bilateral investment treaties ('BITs'), hitherto mainly concluded with capital exporting countries from the West.[4]

Various concerns have been raised about this expansion of bilateral and regional trade agreements ('BRTAs'). The TPPA, in particular, has been criticised as entrenching assumptions about free markets and 'light-handed regulation' that have proven risky and inequitable in the context of the 'Global Financial Crisis' ('GFC') of 2008 and its aftermath.[5] More moderate commentators point to the experience of the European Union ('EU') as providing some insights into how to balance market liberalisation with regulatory safeguards to prevent an unsustainable 'race to the bottom', while acknowledging that significant differences remain among economic, sociopolitical and legal systems across Asia.[6]

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1 Christopher Dent, 'Organizing the Wider East Asia Region' (Working Paper Series on Regional Economic Integration No 62, Asian Development Bank, 2010) <http://ideas.repec.org/s/ris/adbrei.html>.

2 See Association of Southeast Asian Nations (2010) <http://www.aseansec.org/4920.htm>; Saadia M Pekkanen, *Japan's Aggressive Legalism: Law and Foreign Trade Politics Beyond the WTO* (Stanford University Press, 2008); Kenneth Heydon and Stephen Woolcock, *The Rise of Bilateralism* (United Nations University Press, 2009).

3 Dent, above n 1; Kent Calder and Min Ye, *The Making of Northeast Asia* (Stanford University Press, 2010). On 'transgovernmentalism' generally, see Anne-Marie Slaughter, *A New World Order* (Princeton University Press, 2004). ASEAN+3 would bring in China, Korea and Japan; ASEAN+6 would add Australia, New Zealand and India.

4 Vivienne Bath and Luke Nottage, 'Foreign Investment and Dispute Resolution Law and Practice in Asia: An Overview' (Research Paper No 11/20, Sydney Law School, 2011) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1789306>.

5 Jane Kelsey, 'The TPPA and Financial Sector Deregulation' in Jane Kelsey (ed), *No Ordinary Deal: Unmasking the Trans-Pacific Partnership* (Bridget Williams Books, 2010) 214.

6 Luke Nottage, 'Asia-Pacific Regional Architecture and Consumer Product Safety Regulation for a Post-FTA Era' (Research Paper No 09/125, Sydney Law School, 2009) <http://ssrn.com/abstract=1509810>; Simon Hix, 'Institutional Design of Regional Integration: Balancing Delegation and Representation' (Working Paper Series on Regional Economic Integration No 64, Asian Development Bank, 2010) <http://ideas.repec.org/s/ris/adbrei.html>; Richard Baldwin, 'Sequencing Regionalism: Theory, European Practice, and Lessons for Asia' (Working Paper Series on Regional Economic Integration, No 80, Asian Development Bank, 2011) <http://ideas.repec.org/s/ris/adbrei.html>; Philomena Murray, 'Regionalism and Community: Australia's Options in the Asia-Pacific' (Report, Australian Strategic Policy Institute, 23 November 2010) <http://www.aspi.org.au/publications/publication_details.aspx?ContentID=273&pubtype=>.

A third perspective, epitomised by the 'Gillard Government Trade Policy Statement' released in April 2011 ('TPS'),[7] instead sees BRTAs as potentially inward-looking and protectionist, dangerously distracting policy-makers' attention from initiatives such as the WTO's Doha Development Round. Australia's TPS urges instead a re-emphasis on multilateralist approaches, and even unilateral liberalisation, to promote economic prosperity.[8] Under this approach, unilateral liberalisation can be supported by capacity-building measures to support voluntary commitments made by regional neighbours, rather like the model of 'open regionalism' promoted by APEC.[9]

These debates have mainly been driven by senior politicians, officials and economists, and, more recently, by political scientists and specialists in regional integration studies. However, legal experts have an important role to play.[10] Adopting unilateral market access measures — including 'behind-the-border' measures such as enhanced transparency in regulatory decision-making and enforcement — calls especially for comparative law research into both the 'law in books' (formal rules) and the 'law in action' (implementation and impact of rules in practice), to determine optimal means of implementing reforms. Comparative law studies are also important when market liberalisation commitments entrenched through BRTAs are combined with novel features such as 'mutual recognition' principles and, consequently, perhaps joint standard-setting between national regulators.[11] International law is crucial to interpret and enforce commitments undertaken through treaties. More broadly, legal discourse — both in designing cross-border frameworks for liberalisation and/or regulatory safeguards, and implementing procedures for resolving disputes that arise when those frameworks are not adhered to — can help entrench positive 'habits of cooperation' that draw also on economic and political factors.[12]

In the multilateral WTO system covering mainly trade in goods and services (including investments in services sectors where the host State has bound itself to allow foreign

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7 Department of Foreign Affairs and Trade (Cth), 'Gillard Government Trade Policy Statement: Trading Our Way to More Jobs and Prosperity' (Department of Foreign Affairs and Trade, Australian Government, 2011) <http://www.dfat.gov.au/publications/trade/trading-our-way-to-more-jobs-and-prosperity.html>. See also Jurgen Kurtz, 'The Australian Trade Policy Statement on Investor-State Dispute Settlement' (2011) 15(22) *ASIL Insights* <http://www.asil.org/insights110802.cfm>; Leon Trakman, 'Investor State Arbitration or Local Courts: Will Australia Set a New Trend? ' (2012) *Journal of World Trade* (forthcoming) .

8 The emphasis on multilateralism also accords with a political critique of the former Howard government, emphasised during the Rudd Government (June 2007–November 2010), as favouring bilateral relationships in economic and especially security matters. See Nicholas Stuart, *Rudd's Way: November 2007–June 2010* (Scribe Publications, 2010) 143; Ben Saul, 'Throwing Stones at Streetlights or Cuckolding Dictators? Australian Foreign Policy and Human Rights in the Developing World' (2011) 100(415) *The Round Table* 423, 434–5.

9 Under this model, States were encouraged — but not required — to liberalise market access (such as bringing down tariff rates) on a non-preferential basis, to achieve 'global standards' for those States' economic benefit even if others did not follow suit. See Hal Hill and Jayant Menon, 'ASEAN Economic Integration: Features, Fulfillments, Failures and the Future' (Working Paper Series on Regional Economic Integration No 69, Asian Development Bank, 2010) <http://ideas.repec.org/s/ris/adbrei.html> and generally Peter Drysdale, 'Introduction' in Philippa Dee (ed), *Institutions for Economic Reform in Asia* (Routledge, 2010) XXX.

10 See also generally Tamio Nakamura, *East Asian Regionalism From a Legal Perspective* (Routledge, 2010).

11 Nottage, 'Asia-Pacific Regional Architecture and Consumer Product Safety Regulation for a Post-FTA Era', above n 6.

12 The phrase comes from Ralf Dahrendorf, *Law and Order* (The Hamlyn Trust, 1985), referring primarily to the EU; but was used by former Australian Prime Minister (and now Foreign Minister) Kevin Rudd when proposing in 2008 the idea of a new 'Asia Pacific community'. See Murray, above n 6; Richard Woolcott, 'Asia Pacific Community Could Be Rudd's Golden Legacy', *The Sydney Morning Herald* (online), 19 January 2011 <http://www.smh.com.au/opinion/politics/asiapacific-community-could-be-rudds-golden-legacy-20110119-19wj1.html>; Daniel Flitton, 'My Dream of Asia is Here Now, Says Rudd', *The Sun-Herald* (online), 24 July 2011, <http://www.smh.com.au/world/my-dream-of-asia-is-here-now-says-rudd-20110723-1hu3i.html>.

investment via a 'commercial presence'), disputes that commitments have not been honoured are resolved through an inter-state process under the Dispute Settlement Understanding.[13] This approach is also generally found in BRTAs, as well as BITs, although with no permanent appellate body checking for substantive error of law by the tribunal initially appointed under the relevant treaty. By contrast, the EU has developed a system allowing affected firms and citizens (and indeed the European Commission, the main executive body) to bring claims directly before the European Court of Justice, alleging violation of rights to free movement of goods, services, capital and people. This mechanism has been viewed as an important mechanism to entrench commitments and promote deeper economic integration. The lack of a close equivalent within the Asia-Pacific region is paralleled by arguably ambiguous evidence as to whether BRTAs have contributed much to 'behind-the-borders' improvements in market access.[14]

Investment treaty arbitration: Asia versus Australia?

Potentially significant, therefore, is the emerging importance of investor–state arbitration ('ISA') provisions in investment treaties concluded by Asia-Pacific States as well as ASEAN as a whole.[15] Growing numbers and proportions of BITs entrench substantive protections for foreign investments, such as protections against 'expropriation' or violations of due process or other 'fair and equitable treatment' ('FET') standards, by allowing foreign investors to claim directly against host States in international arbitral proceedings. Investment chapters in BRTAs, restating similar protections, but also recording market liberalisation commitments, also generally add this dispute resolution ('DR') mechanism. Both types of treaties also still include an inter-state DR mechanism, similar to that found in the WTO and for trade disputes under FTAs, but a foreign investor will typically not invoke that because it further 'politicises' the dispute. The affected firm must persuade its home State to espouse the claim and commence inter-state proceedings, which the State may be reluctant to do, because it has other diplomatic objectives or interests in its current dealings with the host State.

ISA claims and arbitral awards have increased dramatically over the last decade, in particular, leading some to proclaim the emergence of a 'global administrative law'.[16] Others contend that this overstates the derivation, coherence and impact of the principles developed and applied by arbitrators deciding investment treaty claims.[17] There is also

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13 *Marrakesh Agreement Establishing the World Trade Organization*, opened for signature 15 April 1994, 1867 UNTS 3, (entered into force 1 January 1995), annex 2 ('*Understanding on rules and procedures governing the settlement of disputes*'). See in this Issue: Brett G Williams, 'Innovative Mechanisms for Resolving or Avoiding Inter-State Trade Disputes in an Asia-Pacific Regional Free Trade Agreement', (2011) 18 *Australian International Law Journal* 141.

14 Philippa Dee and Anne McNaughton, 'Promoting Domestic Reforms through Regionalism' (Research Paper No 7, Crawford School, April 2011) <http://ssrn.com/abstract=1925934>.

15 Bath and Nottage, above n 4; Erik Voeten, 'Regional Judicial Institutions and Economic Cooperation: Lessons for Asia?' (Working Paper Series on Regional Economic Integration No 65, Asian Development Bank, 2010) <http://ideas.repec.org/s/ris/adbrei.html>; Mark Mangan, 'Australia's Investment Treaty Program and Investor-State Arbitration' in Luke Nottage and Richard Garnett (eds), *International Arbitration in Australia* (Federation Press, 2010) 191.

16 See, eg, Gus Van Harten and Martin Loughlin, 'Investment Treaty Arbitration as a Species of Global Administrative Law' (2006) 17 *European Journal of International Law* 121 .

17 See, eg, Moshe Hirsch, 'Investment Tribunals and Human Rights: Divergent Paths' in Pierre-Marie Dupuy, Francesco Francioni and Ernst-Ulrich Petersmann (eds), *Human Rights in International Investment Law and Arbitration* (Oxford University Press, 2009) 97.

some statistical evidence that ISA protections do not significantly affect 'good governance' generally within the States that offer such commitments,[18] but data is limited and determining causation is difficult. Another potential problem in determining the effect of ISA provisions is that the proportion of Asian host States in actual proceedings appears quite low compared to the extent of treaty protections nowadays, as well as inbound foreign direct investment ('FDI').[19] Nonetheless, the numbers and visibility of claims involving Asian parties are growing, thus contributing to the likelihood of investment treaty commitments generating lasting 'behind-the-border' improvements in the regulatory environment for investors.

This regional development, however, has recently been threatened by Australia's TPS, which blew cold on ISA provisions in future treaties — such as the TPPA. A literal interpretation is that Australia will no longer agree to ISA in any future treaty, even with developing countries. That effectively means no more ISA in treaties with anyone. This follows because Australian investors are less concerned anyway about ISA protections where the host State has a more developed legal system — offering a reliable court system applying domestic substantive law supportive of the rights of all investors.

Alternatively, the TPS can be read in the context of Productivity Commission ('PC') recommendations from its inquiry into BRTA policy for Australia, finalised in December 2010 and largely adopted by the Gillard Government.[20] This interpretation of the TPS would still allow scope for Australia to include ISA in future treaties, such as the TPPA, under certain conditions. In particular, the PC was amenable to ISA provisions provided foreign investors are not accorded better substantive or procedural rights than local investors. Thus, if the partner country's domestic law protections are lower than Australia's, future treaties can at least include substantive protections (benefitting mainly Australian investors abroad) capped at the Australian domestic law standard of protection. In addition, future Australian treaties would have to eschew provisions allowing foreign investors the option of arbitration under the 1965 *International Centre for Settlement of Investment Disputes (ICSID) Convention*,[21] as this procedure provides an advantageous enforcement system compared to the usual regime for arbitration (or litigation). Yet, even this policy stance generates complex implications, and the theory and evidence contained in the PC's analysis reveal significant weaknesses.[22]

Unfortunately, as of September 2011 it appears that the Gillard Government has decided to go beyond even the PC's recommendation regarding ISA, and to eschew such provisions altogether in future treaties. This stance was probably entrenched when, on

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18 Tom Ginsburg, 'International Substitutes for Domestic Institutions' (2005) 25 *International Review of Law and Economics* 107 .

19 Luke Nottage and J Romesh Weeramantry, 'Investment Arbitration in Asia: Five Perspectives on Law and Practice' in Vivienne Bath and Luke Nottage (eds), *Investment Law and Dispute Resolution Law and Practice in Asia* (Routledge, 2011) ch 2.

20 Productivity Commission, 'Bilateral and Regional Trade Agreements' (Research Report, Productivity Commission, Australian Government, 2010) <http://www.pc.gov.au/projects/study/trade-agreements>.

21 *Washington Convention on the Settlement of Investment Disputes between States and Nationals of other States*, opened for signature 18 March 1965, (entered into force 14 October 1966) <http://icsid.worldbank.org/ICSID/ICSID/RulesMain.jsp>.

22 Luke Nottage, 'The Rise and Possible Fall of Investor-State Arbitration in Asia: A Skeptic's View of Australia's 'Gillard Government Trade Policy Statement" (2011) *Transnational Dispute Management* (forthcoming) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1860505>.

27 June 2011, Philip Morris Asia ('PMA') initiated an investor–state claim based on the *Agreement between the Government of Australia and the Government of Hong Kong for the Promotion and Protection of Investments* (Hong Kong BIT, signed in 2003). PMA alleged that Australia's Tobacco Plain Packaging Bill violated expropriation and FET provisions. The Bill still passed the House of Representatives on 25 August 2011, making it difficult for the case to settle and, thus, further highlighting its visibility in the public eye. Many will see it as a 'big bad company' impugning a 'good law', whereas ISA proceedings can often involve smaller companies complaining about bad laws adopted by host States. The case is also unfortunate in that allegations of 'regulatory expropriations' and related breaches of FET are certainly some of the hardest to resolve — especially under older, broadly worded treaties.[23]

In future treaties — or, indeed, old treaties like the Hong Kong BIT that are now open for unilateral termination — it would have been possible to tailor provisions to address more effectively such difficult issues. For example, treaties could include express exceptions to substantive obligations for non-discriminatory regulation bona fide in the public interest, such as for public health purposes. These are already found in WTO agreements, and indeed in some of Australia's more recent investment treaties. It is also feasible to limit the scope of covered 'investment' or to exclude certain sensitive sectors altogether from the scope of ISA protections, at least.[24] Future treaties might also simply include an exception for investments involving 'dangerous goods'.[25] However, a difficulty arises if States try to be too specific — by listing certain types of goods as outside the scope of ISA provisions — because treaties last often for decades, yet they are infrequently renegotiated.

Instead or in addition, however, some other innovations seem worthwhile exploring in this field. One inspiration comes from the way many countries now deal with frequently sensitive and complex issues arising from international taxation disputes. For example, US and Canadian BITs commonly exclude from coverage taxation measures adopted by the host State, unless they are arguably 'expropriatory'. The 2003 Canadian *Model BIT* goes on to exclude ISA unless the investor has asked the tax authorities of both States to determine whether the measure constitutes an expropriation, and the authorities fail to agree within

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23 Luke Nottage, 'Consumer Product Safety Regulation and Investor-State Arbitration Policy and Practice after Philip Morris Asia v Australia' (Working Paper No 29, Sydney Centre for Intenational Law, 2011) <http://sydney.edu.au/law/scil/documents/2011/WP29_Nottage_Investor_APLR2011.pdf>, updated and expanded in Leon Trakman et al, *International Investment Law* (Oxford University Press, 2012 forthcoming). See also 'World First Plain Packaging for Tobacco Products a Step Closer to Becoming Law', *The Conversation* (Online) 25 August 2011 <http://theconversation.edu.au/world-first-plain-packaging-for-tobacco-products-a-step-closer-to-becoming-law-3053> .

24 See, eg, *Free Trade Agreement, Australia-Chile*, signed 30 July 2008, [2009] ATS 06 (entered into force 6 March 2009) art 3(b) of annex 10-B on expropriation; art 13(5) of the *Model Foreign Investment Protection and Promotion Agreement (Canada)* of 2003 (expropriation of intellectual property rights held by investors can be enforced via ISA, but such a claim is expressly limited to the standard of protection provided under WTO law); *Agreement Between the Government of the Republic of Korea and the Government of Japan for the Liberalisation, Promotion and Protection of Investment*, signed 22 March 2002 (entered into force 1 January 2003) art 7(7) (no ISA for certain prudential measures relating to financial transactions).

25 In a quite similar vein, in relation to FET obligations for example, Mitchell and Wurzberger suggest that '[i]nvestors dealing with dangerous products must, in our view, meet a higher threshold than investors in other areas to prove that they had "legitimate" expectations concerning future regulation by the host state': Andrew Mitchell and Sebastian Wurzberger, 'Boxed In? Australia's Plain Tobacco Packaging Initiative and International Investment Law' (2011) 27 *Arbitration International* <http://ssrn.com/abstract=1896125> 21 .

180 days that it does not.[26] In other words, the States perform a screening function by deciding whether or not the host State's taxation measure constitutes expropriation.

Similarly, future investment treaties could allow ISA claims by investors against a host State introducing measures aimed at promoting public health based on its assessment that the investors' goods are 'dangerous', but the treaties could add that ISA protections become unavailable if both States party agree that the host State's measure did genuinely promote non-discriminatory public health objectives by regulating dangerous products (of course, such agreement would also preclude an inter-state claim). This approach has the advantage of encouraging States to work together to try to reach consensus on emerging consumer product safety issues, thus promoting deeper cross-border economic integration.[27] One could well imagine that if there had been such a provision in the Australia–Hong Kong BIT, the respective governments would have worked very hard to try to reach agreement on whether the Australian Bill was justified.[28] A possible further consequence could well have been a decision by Hong Kong to introduce similar legislation there.

Another approach is also worthy of consideration. It derives also from recent developments in resolving cross-border tax disputes, but is inspired by tax treaty practice. As outlined further below, the *Model Tax Convention on Income and on Capital* promoted by the Organisation for Economic Co-operation and Development ('OECD'),[29] to provide a template for thousands of bilateral tax treaties, had provided only for a 'Mutual Agreement Procedure' ('MAP').[30] This allowed a taxpayer, finding itself subject to tax both in its home State and the other State (contrary to the intention of the treaty aimed at *avoiding* such double taxation), to initiate a process of mutual negotiations between the states party to the treaty in the hope that they would reach agreement on who had the sole right to impose tax. However, the *OECD Model Tax Convention* was recently amended to provide that if the MAP did not lead to a negotiated settlement between the respective tax authorities, the taxpayer could force them to commence arbitration generating a decision binding on the States. Australia and New Zealand introduced such 'Nego-Arb' provisions in their revised tax treaty of 2009;[31] Japan did so with Hong Kong in 2010.[32]

Similarly, the Australia–Hong Kong BIT could have provided that any claim by an investor that a host State's measure was not a justified public health measure, regulating a dangerous product, could not be pursued through ISA. Instead, the investor could have been entitled to trigger inter-state negotiations to see if they could agree on whether the

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26 Andrew Newcombe and Lluis Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Kluwer Law International, 2009) 336. A precursor can be found in *North American Free Trade Agreement,* signed 17 December 1992, [1994] CTS 2 (entered into force 1 January 1994) Art 2103(6).

27 Nottage, 'Asia-Pacific Regional Architecture and Consumer Product Safety Regulation for a Post-FTA Era', above n 6.

28 In the PMA case, Australia and Hong Kong could also agree to amend their treaty to prevent the claim proceeding. See Tania Voon and Andrew Mitchell, 'Time to Quit? Assessing International Investment Claims against Plain Tobacco Packaging in Australia' (2011) 14(3) *Journal of International Economic Law* <http://ssrn.com/abstract=1906560> 12–14. However, absent provisions set out in advance like those suggested here, this is difficult from both international law and practical perspectives.

29 *OECD Model Tax Convention on Income and on Capital* (updated 22 July 2010) ('*OECD Model Tax Convention*').

30 *OECD Model Tax Convention* art 25.

31 See Australian Taxation Office, *Australia and New Zealand Treaty: Key Points* (9 August 2011) Australian Taxation Office <http://www.ato.gov.au/businesses/content.aspx?doc=/content/61011.htm>.

32 See Inland Revenue Department (UK), *Comprehensive Double Taxation Relief* (1 December 2011) <http://www.ird.gov.hk/eng/tax/dta_inc.htm>.

host State's measure was justified. If no agreement was reached within a set period (say, 6 or 12 months), the investor could have been permitted to trigger inter-state arbitration to resolve the issue. Various further permutations are possible on this model. For example, consideration would need to be given to whether and how the investor could be involved — although not as a party, per se — in the negotiation phase and especially in any consequent inter-state arbitration phase.[33]

Adding exceptions or exclusions to ISA coverage, as well as more carefully drafted definitions for 'investment' or 'investor', were options that were generally acknowledged in the PC's final report in December 2010 as possible ways forward to minimise excessive 'regulatory chill' on government policy-making.[34] However, the PC did not fully appreciate the various options available to re-balance private and public interests in the investment treaty regime. Both for that purpose, but also as an innovative mechanism purely for resolving international tax disputes, it is worth next taking a closer look at the new *OECD Model Tax Convention* dispute resolution system.

Tax treaty arbitration: Global and regional developments

International tax law, as embodied in a network of thousands of bilateral tax treaties, has as its main goal the elimination of double taxation of international trade and investment results. Most bilateral tax treaties, and the vast majority of those between developed nations, are based on the *OECD Model Tax Convention*. In addition to substantive provisions aimed at eliminating double taxation, the *OECD Model Tax Convention* has an article that sets forth procedures for resolving taxpayer-initiated disputes under the treaty while at the same time preserving the integrity of each signatory's fiscal sovereignty.

Under the standard *OECD Model Tax Convention* MAP provision found in most current tax treaties, appropriately made taxpayer claims that they are being taxed not in accordance with the treaty (for example, that they are being double-taxed) require only that the two competent authorities 'endeavour' to resolve the dispute through bilateral negotiation.[35]

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[33] A particular issue could arise regarding inter-state settlement, which the investor may feel is disadvantageous. Similar concerns arise in the tax treaty arbitration arena: see Marcus Desax and Mark Veit, 'Arbitration of Tax Treaty Disputes: The OECD Proposal' (2007) 23 *Arbitration International* 405. In the context of investment treaty dispute resolution, we might also want to include a clear discretion for the states party or the arbitrators to receive evidence or submissions from NGOs. See generally Luke Nottage and Kate Miles, ' "Back to the Future" for Investor-State Arbitrations: Revising Rules in Australia and Japan for Public Interests' (2009) 26(1) *Journal of International Arbitration* 25, 41–2.

[34] Productivity Commission, above n 20, 276–7.

[35] Article 25 of the *OECD Model Tax Convention*, which reads:

> Where:
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> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the action of one or both of the Contracting States have resulted for the person in taxation not in accordance with the provision 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,
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> any unresolved issue arising from the case shall be submitted to arbitration if the person so requests. These unresolved issue 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

There is a genuine commitment to the elimination to double taxation amongst OECD nations, and the MAP indisputably works in many cases, facilitated by cooperative institutional and personal links globally and regionally between tax officials and other international tax law experts.[36] However, the international business community in particular (for example, multinational enterprises for which transfer pricing is an important issue) has long complained that the treaty-based dispute resolution procedures are inadequate with respect to any given case.

The assertion is that the MAP is inherently limited by the willingness and ability of the participating competent authorities to resolve the dispute via essentially voluntary bilateral negotiations.[37] There is no requirement that they resolve the dispute and there are no repercussions for their failure to do so. This fact underlies the other major perceived weaknesses of the MAP, including that:

- it does not permit taxpayer participation in the dispute resolution process (aside from initiating it);
- it can be cumbersome and wasteful;
- it is an invitation for the competent authorities to conduct a 'joint audit' of the taxpayer; and
- an individual taxpayer's case might become the object of horse-trading with respect to the resolution of other cases in the two competent authorities' portfolio of disputes to resolve.

In order to at least partially address these concerns, the OECD initiated a potentially major development in international tax dispute resolution when, in 2008, culminating decades of discussion and deliberation, it included a mandatory arbitration provision in its *Model Tax Convention*.[38] The controversial new article 25(5) requires States to arbitrate tax disputes arising under the Convention if they remain unresolved after two years of negotiation between the competent tax authorities of the two States.

The provision is a delicate balance between the preservation of jealously protected fiscal sovereignty, on the one hand, and effective dispute resolution in the name of taxpayer rights, on the other. While arbitration is a generally accepted facet of international

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notwithstanding any time limits in the domestic law of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph[.]

36 For example, an official from Japan's National Tax Agency is regularly seconded to the Australian Tax Office to maintain and develop cooperative relationships between the tax authorities particularly in cross-border tax matters. More broadly on such transgovernmentalism, see also, eg, Internal Revenue Service, Pacific Association of Tax Administrators (PATA) Transfer Pricing Documentation Package, 24 June 2009, <http://www.irs.gov/businesses/international/article/0,,id=156266,00.html>, a set of principles agreed by the member nations of the PATA (Australia, Canada, Japan and the US) under which taxpayers can create uniformly accepted transfer pricing documentation; Slaughter, above n 3. These types of relationships help build up an 'epistemic community' of international tax law experts that facilitates the negotiation and implementation of tax treaties: cf generally John Braithwaite and Peter Drahos, *Global Business Regulation* (Cambridge University Press, 2000). Like other communities, however, it may not be well known to others or engage fully with them, such as the international trade law or investment law communities.

37 See, eg, William Park, 'Income Tax Treaty Arbitration' (2002) 10 *George Mason Law Review* 803, 808–9.

38 Organisation for Economic Cooperation and Development, 'The 2008 Update to the OECD Model Tax Convention' (2008) <http://www.oecd.org/dataoecd/20/34/41032078.pdf>.

commercial dispute resolution worldwide, and now throughout Asia,[39] dispute resolution under bilateral tax treaties has only slowly and begrudgingly started to gain acceptance, at least amongst important and trusted trading partners. Its inclusion in the *OECD Model Tax Convention* and its nascent acceptance would seem to run counter to the long-held and deeply engrained resistance to ceding fiscal sovereignty, especially over tax policy matters. In fact, the OECD's own view — less than 30 years ago — on mandatory arbitration in the international tax area was that it 'would represent an unacceptable surrender of fiscal sovereignty'.[40]

Yet, while arbitration under the provision is 'mandatory', it is at the same time quite limited. Article 25 differs from commercial or investor–state arbitration provisions in that there is greater control given to the competent authorities (generally to the perceived disadvantage of the affected taxpayer). The competent authorities appoint the arbitrators, determine the questions to be resolved (the Australia–New Zealand treaty, for example, limits arbitrable disputes to those involving 'issues of fact'), and otherwise retain significant control over the arbitral procedure. In short, to the extent possible, even the arbitration provision itself addresses sensitive concerns regarding fiscal sovereignty.

Despite — or perhaps rather because of — its newness, this compromise arbitration procedure has yielded few tangible results so far (no known tax treaty disputes have progressed through the MAP to arbitration under new article 25), but a variety of opinions as to its merit. The international business community[41] and some commentators have hailed the new provision as a needed step forward in clearing the backlog of MAP cases (and, ultimately, encouraging free trade). However, some have dismissed it as ineffective,[42] and others have seen it as a giveaway to the international business community.[43]

However, almost all concede that the provision's likely practical effect will be upon the competent authorities' negotiations pursuant to the MAP in which the arbitration is embedded. The theory is that States are so averse to submitting to arbitration (especially in the admittedly rare case involving tax policy rather than transfer pricing) that they will earnestly endeavour to resolve international tax disputes through negotiation in the two years allowed pursuant to the relevant treaty's MAP.

The US Department of Treasury International Tax Counsel testified before US Congress, shortly before the adoption of the OECD report that led to the inclusion of article 25(5), that 'the prospect of impending mandatory arbitration creates a significant incentive to compromise' and that 'mandatory binding arbitration as the final step in the … process can be an effective and appropriate tool to facilitate mutual agreement'.[44] A Dutch

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39 Simon Greenberg, Christopher Kee and J Romesh Weeramantry, *International Commercial Arbitration: An Asia-Pacific Perspective* (Cambridge University Press, 2010); Nottage and Weeramantry, above n 19.

40 *Organisation for Economic Cooperation and Development, Transfer Pricing and Multinational Enterprises, Three Taxation Issues* (OECD Publications, 1984) [115].

41 Indeed, it was pressure from the international business community (particularly in the form of the International Chamber of Commerce) that was in large part the impetus for the OECD's work in this regard. See, eg, Diane Ring, 'Who is Making International Tax Policy?: International Organizations as Power Players in a High Stakes World' (2009) 33 *Fordham International Law Journal* 649 .

42 See, eg, Ehab Farah, 'Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem' (2009) 9 *Florida Tax Review* 703 .

43 See, eg, Michael J McIntyre, 'Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes' (2006) 7 *Florida Tax Review* 622 .

44 Testimony to Senate Committee on Foreign Relations on Pending Income Tax Agreements, United States Senate, 17 July 2007, HP-494 (John Harrington, Department of Treasury International Tax Counsel).

official, in typically less formal European fashion, echoed the sentiment: 'We love arbitration but we will never use it'.[45] The pressure point is, thus, the relationship between the two competent authorities. This can explain the fact that early adopters of the arbitration provision seem to be trading partners with a close existing relationship (such as Australia–New Zealand, US–Canada, Japan–Netherlands and Japan–Hong Kong).

The context in which most MAP cases arise is also important in understanding this new hybrid form of dispute resolution. The overwhelming majority of cases submitted for resolution under MAPs involve transfer pricing disputes[46] — the result of increased international trade and growing numbers of regionally active multinational enterprises. Transfer pricing disputes more easily lend themselves to arbitration as they are fact-intensive and do not generally implicate matters of national tax policy (and, as such, are not particularly threatening to anyone's fiscal sovereignty).

Nonetheless, the need for more effective dispute resolution mechanisms is real: the number of such cases is rising steadily. Among OECD countries, the number of new MAP cases per year increased 60 per cent (to almost 1,600 cases) in the four years from 2006 to 2009; the total number of outstanding cases at year-end increased 50 per cent during the same period (to an inventory of over 3,400 cases).[47] One important regional economy, Japan, has seen its number of MAP cases (90 per cent of which involve transfer pricing) nearly quadruple in the past decade.[48] Furthermore, Japan, like other major trading partners, has also seen a dramatic increase in advance pricing arrangements ('APAs'), whereby tax authorities approve, in advance, the method for calculating arm's length transfer prices, and a large number of MAP cases arise out of the APA program.[49] In 2009, Japan's National Tax Agency received 127 requests for an APA, up from 76 such requests in 2005.[50]

If the provision's primary effect is to improve MAP outcomes without actual resort to arbitration, as appears likely to be the case, it could indeed facilitate the resolution of a specialised, but important, class of international tax disputes. Perhaps more importantly, however, the mechanism might also suggest an alternative way forward in the seemingly stalled discussions about a 'top-down' Asia-Pacific community.[51] The emerging dispute resolution paradigm for tax treaty arbitrations points to an interesting hybrid model for the many sovereign States that make up this particular regional community. Via a process of dispute resolution dependent on the flows of international trade and investment (in other words, 'bottom-up'), tax treaty arbitration can play an important part in helping to define the Asia-Pacific region's 'culture' of dispute resolution. As taxpayers initiate more and more claims, and the competent tax authorities are forced to develop relationships that allow for the efficient and fair resolution of such claims, even if limited to transfer pricing

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45 Marlies de Ruiter, 'Supplementary Dispute Resolution' (2008) 9 *European Taxation* 499 .

46 See generally, Zvi Altman, *Dispute Resolution under Tax Treaties* (Amsterdam, IBFD Doctoral Series Vol 11, 2005).

47 Organisation for Economic Cooperation and Development, *Dispute Resolution: Country Mutual Agreement Procedure Statistics of 2008 and 2009,* Centre for Tax Policy and Administration <http://www.oecd.org/document/25/0,3746,en_2649_37989739_46501785_1_1_1_1,00.html>.

48 National Tax Agency, 'Japan National Tax Agency Report 2011' (2011) 42–3 <http://www.nta.go.jp/foreign_language/Report_pdf/2011e.pdf>. A significant proportion involve the US and Australia, as well as with China.

49 Ibid 41.

50 Ibid.

51 Murray, above n 6.

disputes, further 'habits of cooperation'[52] will probably develop between the region's main trading partners. This interactive process can lead to 'top-down' efforts in response to the 'bottom-up' generation of disputes, including initiatives such as the PATA Documentation Package,[53] with the cycle reinforcing and highlighting regional relationships.

Important regional powers appear to be embracing the arbitration provision and what it represents. Australia, Japan, New Zealand, the US and Hong Kong have already been mentioned. Canada, Singapore, and South Korea have also recently included a version of the new article 25(5) in recent tax treaties. Japan, which has gradually become familiar with using arbitration to resolve commercial disputes, has appeared particularly keen to embrace international tax arbitration in its recent, and important, treaties. With little fanfare, in August 2010 it signed its first double tax treaty to include a mandatory arbitration clause (with the Netherlands).[54] The Hong Kong–Japan tax treaty, signed in November 2010, also includes the provision. Currently Japan is negotiating amendments to its tax treaty with the US, and it is believed that mandatory arbitration under the MAP is being discussed. The National Tax Agency has published a sample timeline for MAP arbitrations[55] and has begun to train a specialist arbitration team. Such actions can be interpreted as Japan signalling to its trading partners (and their tax-resident multinational enterprises) that it is committed to resolving international tax disputes, even at the cost of potentially putting jealously guarded tax sovereignty on the line. Such a willingness to potentially cede even a very limited aspect of fiscal sovereignty would seem to be necessary for the creation of a robust regional arrangement.

Australia, for its part, also recognises the importance of a modern treaty network to its aspirations of becoming a regional hub for multinational companies and does not want to discourage growing Asian economies from competing for its resources. To date, Australia's only tax treaty to include an arbitration provision is the Australia–New Zealand treaty signed in 2009, and it is too early to tell how Australia will approach tax treaty dispute resolution going forward with its Asian and other trading partners.[56] In the grander scheme of things, Australia's ambivalence towards tying its own hands when resolving trade and investment disputes may suggest a broader more sceptical attitude nowadays towards arbitration of international disputes involving State interests.[57]

Nonetheless, as the web of bilateral tax treaties between Asia-Pacific States grows — with treaties being renegotiated and updated as trade and investment generates increased disputes — the inclusion of the 'hammer' of mandatory arbitration would refocus the emphasis on bilateral negotiation between the two competent taxing authorities in resolving international tax disputes pursuant to the MAP.

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52 Dahrendorf, above n 12.

53 PATA, now superseded by the Leeds Castle group, includes the four members of the former PATA as well as China, France, Germany, India, South Korea, and the United Kingdom.

54 H Vollebregt, R Thomas and W Pieschel, 'Arbitration under the New Japan-Netherlands Tax Treaty' (2011) 65(4/5) *Bulletin for International Taxation* 223.

55 National Tax Agency (Japan) 'Implementing Arrangement regarding Paragraph 5 of Article 24 of the Convention between Japan and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income' <http://www.nta.go.jp/sonota/kokusai/kokusai-sonota/1009/01.pdf>.

56 See generally, Chloe Burnett, 'International Tax Arbitration' (2007) 36(3) *Australian Tax Review* 173 . Australia and Japan revised their bilateral tax treaty in 2008, but the arbitration provision was not added — perhaps because Australia only agreed to such a provision for the first time in 2009 (with New Zealand), and because Japan only did so in 2010 (with Hong Kong).

57 Nottage, 'The Rise and Possible Fall of Investor-State Arbitration in Asia', above n 22.

The growing number of transfer pricing (and other) disputes arising under MAPs (particularly in light of the increasing prevalence of APAs) and the growing acceptance of the model arbitration provision in tax treaties (particularly between States with close relationships) mean that there will be more and more occasions for arbitration cases to arise. They will increasingly highlight the importance of the sovereignty concerns underlying international tax arbitration. Dispute resolution in this area can be an indicator and determinant of the cohesion of any meaningful Asia-Pacific community. Such a community will be forced to take account of the glorious variety of (sometimes still quite neurotic) attitudes toward sovereignty exhibited by the regional powers. Tax treaty arbitration provides one interesting avenue for doing so.

Conclusion

Bilateral double tax treaties have a long and quite uncontroversial history. A more recent phenomenon is the proliferation of investment treaties, and now trade agreements, throughout the Asia-Pacific region. Some now call for abandoning such BRTAs or drastically winding them back. Yet their dispute resolution mechanisms are potentially very important in entrenching market access commitments, especially when providing for direct claims by firms against States. However, the GFC has heightened calls to balance liberalisation with enhanced and better-harmonised regulatory safeguards.

The way investment treaties sometimes deal with certain claims over taxes imposed by host States, limiting the scope for investors to proceed with direct arbitration claims, suggests one innovative solution for resolving claims about other types of investment disputes — such as those involving consumer product safety regulation. Another possibility is to redesign investment treaties covering such claims, like some contemporary double tax treaties. Just as a taxpayer can be given rights under tax treaties to force treaty partner tax authorities to initiate an inter-state arbitration, an investor could be entitled to trigger an inter-state arbitration under an investment treaty.

Both dispute resolution mechanisms address State sovereignty and public interest concerns, while preserving a role for private interests. They may also trigger earlier and more cost-effective resolution of disputes, even before proceeding to arbitration.[58] The mechanisms also represent only some of various possibilities for improving the treaty-based investor–state arbitration system, instead of abandoning it for future treaties as proposed by Australia's TPS. That policy may generate disastrous effects on investment law policy and FDI flows, particularly in the Asia-Pacific region.

In any case, cross-border FDI and trade depend on an effective treaty-based regime for avoiding double taxation. A phenomenon in the Asia-Pacific region that has been little noticed, outside a small community of international tax law experts, is the emergence of an additional arbitration mechanism to resolve tax treaty disputes more quickly and effectively. Preliminary evidence suggests that both States and business interests increasingly see the benefits of providing for a harder-edged procedure, particularly to facilitate settlements without having formally to invoke that extra procedure. Hopefully Australia will not extend its new-found aversion to ISA to backtrack as well from this

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[58] Susan D Franck, 'Integrating Investment Treaty Conflict and Dispute Systems Design' (2007) 92 *Minnesota Law Review* 161 .

useful new development in building up an Asia-Pacific community. Otherwise Australia risks missing opportunities to further expand trade and investment relations, particularly in the Asia-Pacific region.