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**Economising International Tax  
Dispute Resolution: Transaction-Cost  
Perspective**

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Presented for the degree of Doctor of Philosophy

The University of Edinburgh

2019



## **Declaration**

I, Qiang Cai, hereby declare that this thesis was composed solely by myself and has not been submitted, in whole or in part, for any other degree or professional qualification. Except where explicitly stated otherwise in the text, the work presented is entirely my own.

Qiang Cai

Edinburgh

October 2019



## Abbreviations and Acronyms

ADR	Alternative Dispute Resolution
APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting
BOS	Battle of Sexes
CJEU	Court of Justice of the European Union
CRA	Canadian Revenue Agency
CTPA	Centre for Tax Policy and Administration
CUP	Comparable Uncontrolled Price
DSB	Dispute Settlement Body
DSU	Dispute settlement Understanding
FDI	Foreign Direct Investment
FTA	Forum on Tax Administration
G20	Group of 20
GATT	General Agreement on Tariffs and Trade
ICC	International Chamber of Commerce
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information and Communication Technology
IMF	International Monetary Fund
IR	International Relations
IRS	Internal Revenue Service
IT	Information Technology
ITC	International Tax Court
ITT	International Tax Tribunal
ITDR	International Tax Dispute Resolution
ITDRP	International Tax Dispute Resolution Process
ITO	International Tax Organization
JTPF	Joint Transfer Pricing Forum
LCIA	London Court of International Arbitration
MAP	Mutual Agreement Procedure

MEMAP	Manual on Effective Mutual Agreement Procedures
MLB	Major League Baseball
MLI	Multilateral Instrument
MNE	Multinational Enterprise
MoU	Memorandum of Understanding
NAFTA	North American Free Trade Agreement
NIE	New Institutional Economics
OECD	Organisation for Economic Co-operation and Development
OMC	Open Method Coordination
PCIJ	Permanent Court of International Justice
PD	Prisoner's Dilemma
PE	Permanent Establishment
SCC	Arbitration Institute of the Stockholm and Chamber of Commerce
TC	Transaction Cost
TCE	Transaction Cost Economics
UNCITRAL	United Nations Commission on International Trade Law
WTO	World Trade Organization

## **Abstract**

The unprecedented extent of globalisation, the growth of international business and global value chains, and businesses' greater use of tax optimisation schemes have all spurred the proliferation of international tax disputes. The situation may be further exacerbated, at least in the short run, by the newly launched Base Erosion and Profit Shifting (BEPS) Project, which was initiated by the Organisation for Economic Co-operation and Development (OECD) together with the Group of 20 (G20) as a response to aggressive tax planning by many multinational enterprises (MNEs). These are all placing significant pressure on the current system of international tax dispute resolution (ITDR).

Traditionally, most tax disputes have been finalised through the Mutual Agreement Procedure (MAP). However, this mechanism has been increasingly criticised for its lack of efficiency, finality and transparency. Many believe the procedure is fundamentally broken. Correspondingly, the orthodox literature of ITDR has placed an overwhelming focus on legalistic methods of dispute resolution, such as tax arbitration or adjudication. In particular, students of ITDR tend to draw on lessons from trade and investment regimes, both of which are characterised by a legalistic dispute-settlement system.

This research questions the validity of the comparative study based purely on legal terms, and seeks to build a self-sufficient, interdisciplinary framework for the topic of ITDR, drawing on the light of transaction cost (TC) theory. The framework facilitates a benefit-cost evaluation of the ITDR system. On the benefit side, the concern is to identify a dispute-settlement mode that can best economise the entire international tax regime. On the cost side, the question is which ITDR mode implies the lowest transaction costs. Based on this benefit-cost analysis, a MAP-based dispute-settlement system, which will be centred upon the MAP but supplemented by tax arbitration and mediation, is derived as the optimal mode of ITDR.

This research further explores ways to economise various ITDR mechanisms including the MAP, tax arbitration and mediation, still based on the TC framework. With respect to the MAP, the proposals on the structuring of the MAP process, the efficient model of tax participation, and the reassessment of “package deals” are intended as the most original contribution from this research to the existing literature of ITDR. As to tax arbitration, this research emphasises the synergy between the MAP and tax arbitration, highlighting the supplementary role of tax arbitration in the MAP-based system. In particular, the proposals on the documentary trial method and the wider use of final-offer arbitration are distinguished from the past studies. This author also explores solutions to address the underuse of tax mediation. In addition to the measures that are particular to each of these ITDR mechanisms, this thesis also proposes a holistic solutions to economise the entire ITDR system, i.e., to institutionalise the system.

## Lay Summary

Stories of “tax battles” or even a “global tax war” increasingly appeared on social media. A number of leading MNEs, such as Google, Apple, Amazon and Starbucks, have come under fire from several tax authorities. The OECD statistics of the MAP cases also indicate the proliferation of tax disputes. This trend could be further exacerbated by the newly initiated BEPS Project. This is because, among others, the BEPS Project was originated by the OECD /G20 as a response to the aggressive tax-avoidance schemes by MNEs. Against this background, this thesis aims to strengthen the current ITDR system.

This thesis was also inspired by an interesting observation: while trade and investment regimes have developed legalistic methods of dispute resolution, typically in the form of arbitration or panel procedures, most tax disputes are channelled through the MAP. Many believe that trade/investment dispute settlement system represents a promising direction for the evolution of the tax equivalent, since the MAP, which is essentially an inter-governmental negotiation procedure, falls short of finality and transparency and could be extremely time-consuming. As a result, the orthodox literature of ITDR is overwhelmingly focused on tax arbitration. However, as one commentator contends: even centuries ago, there were calls for an International Tax Court (ITC), but until now, most tax disputes have been resolved through the MAP. So the question is what makes tax disputes resolution so different. The orthodox reply is that taxation is the lifeblood of sovereignty. However, isn't it the case that investment law and trade law also involve vital national interests?

In seeking to identify the optimal mode of an ITDR system, this author chose not to rely on the sovereignty argument, but to conduct a benefit-cost analysis of the system, drawing on economic theory, especially TC theory. The analysis indicates that a MAP-based system is the optimal mode of ITDR.

From the benefit perspective, this system is congruent with the characteristics of the entire international tax regime. Specifically, this author argues that the international tax regime is remarkably benign as opposed to its trade and investment equivalents. Normally, legalistic dispute settlement is far more likely to occur when there is no ongoing relationship between the parties or where such a relationship has terminated.

From a cost perspective, this thesis argues that the MAP-based system is the most cost-efficient ITDR mode. Specifically, the MAP is more flexible than either tax arbitration or mediation. Tax authorities are specialists not only in general tax administration but also in the specific allocation of cross-border tax bases. Therefore, it is efficient to have tax disputes resolved by tax authorities through the MAP in the first place. It is true that “unscrupulous” tax authorities may strategically obstruct the process. However, the nature of the international tax regime determines that the risk of opportunism with the ITDR process is substantially lower than with the dispute settlement process in trade and investment regimes.

Despite the advantages of the MAP and the MAP-based ITDR system, this thesis does acknowledge the MAP’s deficiencies. Among others, tax authorities may care more about revenue collection than about the timely resolution of tax disputes and the elimination of double taxation. The negotiation between tax authorities may end up in deadlock. Therefore, the MAP mechanism needs to be strengthened from both within and without. From within the MAP mechanism, this thesis focuses on how to: (a) constrain the opportunism of the tax authorities in charge of MAP cases; and (b) break the bargaining impasse in MAP negotiations. From without, the MAP can be strengthened by third-party procedures including tax arbitration and mediation. This thesis also proposes a holistic solution to economise the entire ITDR system, i.e. to institutionalise the system. Various dispute-settlement institutions can engage in the resolution of tax disputes as well as the international coordination of ITDR policies.

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# Introduction

## 1. Background problem and research question

Where cross-border flows of trade and investment take place, there are risks that two or more countries claim tax jurisdictions over the same taxpayer with respect to the same income.<sup>1</sup> The resulting tax disputes and double taxation may overburden cross-border economic activities. In a 2014 Ernst & Young survey covering over 830 tax and finance executives in 25 jurisdictions, 81% of the respondents voiced their uneasiness about tax risks and tax controversies over the next two years.<sup>2</sup> The MAP statistics also speak for themselves. For instance, 2,509 new MAP cases were initiated in the OECD economies during 2015, an increase of 142.2% over the 1,036 cases in 2006.<sup>3</sup> The inventory of unresolved MAP cases at the end of 2015 amounted to 6,176, an increase of 162.59% over the number of cases at the end of 2006.<sup>4</sup> Furthermore, stories of “tax battles” or even a “global tax war” have increasingly appeared in headlines on social media. A number of leading MNEs, such as Google, Apple, Amazon, and Starbucks, have been challenged by the relevant states’ tax authorities about their tax planning arrangements.<sup>5</sup>

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<sup>1</sup> OECD, ‘Manual on Effective Mutual Agreement Procedures (MEMAP)’ 8 (Section 1.1.2).  
<<http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementprocedures-index.htm>>  
accessed 18 March 2018.

<sup>2</sup> ‘EY 2014 Tax Risk and Controversy Survey Highlights’  
<<http://www.ey.com/GL/en/Services/Tax/Tax-policy-and-controversy/EY-2014-tax-risk-controversy-survey-01-summary>> accessed 1 February 2018.

<sup>3</sup> ‘Mutual Agreement Procedure Statistics (2006-2015)’ (OECD)  
<<http://www.oecd.org/tax/dispute/map-statistics-2006-2015.htm>> accessed 31 January 2018.

<sup>4</sup> *ibid.*

<sup>5</sup> John Gapper, ‘Alphabet and Apple Spell Global Tax War’ (*Financial Times*, 27 January 2016)  
<<https://www.ft.com/content/7414a126-c41d-11e5-b3b1-7b2481276e45>> accessed 31 January 2018;  
Juliette Garside, ‘War of Words Hots up between US and EU over Tax Avoidance’ (*the Guardian*, 25 August 2016)  
<<http://www.theguardian.com/business/2016/aug/25/war-of-words-eu-us-tax-avoidance-starbucks-apple-amazon>> accessed 31 January 2018.

The proliferation of tax disputes overlaps with an era when the international tax regime has undergone some sea changes from both within and without, including the financial and economic crisis, global attempts to prevent international tax avoidance and evasion, and particularly, the BEPS Project launched by the OECD/G20 in response to aggressive tax-optimisation schemes by MNEs.<sup>6</sup> These events, separately and in combination, have unavoidably led to escalated tensions between national tax authorities and taxpayers. Meanwhile, the BEPS Project, which consists of 15 action plans, set forth the most fundamental rewrite of international tax rules in the last century.<sup>7</sup> In particular, Action 14 provides a comprehensive reform of the ITDR system.<sup>8</sup> Against this background, it is now the high time to evaluate the effectiveness of the current ITDR system and to explore the optimal ways to move the system forward. This is the core research question of this thesis.

## **2. Interdisciplinary approach and the antilegalistic position**

Almost in coincidence with the proliferation of tax disputes over the past few decades, there has also been a steep increase in the number of articles, books, and institutional reports devoted to the study of ITDR.<sup>9</sup> Some even believe that a new discipline called the International Tax Dispute Resolution Process (ITDRP) is emerging.<sup>10</sup> What difference can this research make within this context? To address this question, it is beneficial to take stock of the three common features of the existing literature on ITDR, which will be further elaborated in Section 2.6 of Chapter 2. The first feature is a

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<sup>6</sup> Luca Cerioni, 'Book Review: Advanced Issues in International and European Tax Law' (2016) 44 *Intertax* 284, 284.

<sup>7</sup> 'OECD Presents Outputs of OECD/G20 BEPS Project for Discussion at G20 Finance Ministers Meeting - OECD' <<http://www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-financ-e-ministers-meeting.htm>> accessed 8 April 2018.

<sup>8</sup> See below, Chapter 1, Section 1.7.1.

<sup>9</sup> Daniele de Carolis, 'A New Approach to International Taxation Dispute Resolution Process (ITDRP)' (2017) 45 *Intertax* 391, 391.

<sup>10</sup> *ibid.*

comparative approach based on purely legal terms. Students of ITDR tend to take trade and investment dispute-settlement systems as role models for the rule design of the ITDR system. Since both trade and investment regimes have developed a legalistic system of dispute resolution, which is characterised by the use of binding arbitration or a panel procedure, this comparative approach has led to the second feature of the ITDR literature: an overwhelming interest in legalistic methods of dispute resolution. A vast majority of the studies in the domain begin with dissatisfaction or even disappointment with the traditional MAP mechanism, and end with a proposal on the method of arbitration or adjudication in resolving tax disputes. Many even go further to recommend the establishment of an ITC. Brown voices her doubts about this “legalistic fancy”:

*Almost before there were tax treaties to provide substantive rules for allocating tax revenues between sovereign nations, there were calls from business to establish an international organization to which taxpayers could appeal tax disputes with governments. Yet nearly a century later, there is no permanent international tribunal for resolving tax disputes and only a handful of international tax disputes have been considered by arbitration panels. Meanwhile, thousands of tax cases have been resolved through the mutual agreement procedure (MAP) established by tax treaties.<sup>11</sup>*

The third feature of the literature is the paucity of theoretical reflection. Most studies in this field focus on the rule design of various ITDR mechanisms while largely overlooking the theoretical foundation of the system. To some extent, this feature accounts for the other two: due to the lack of a self-sufficient theoretical ground, it becomes natural for students in this area to resort to the comparative studies, which in turn, reinforce the “legalistic

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<sup>11</sup> Patricia A Brown, ‘Enhancing the Mutual Agreement Procedure by Adopting Appropriate Arbitration Provisions’ in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015) 85.

fancy” in the literature on ITDR.

If scholars are justified in promoting a new discipline of the ITDRP, it is beneficial to keep in mind that a solid theoretical foundation is indispensable for any discipline worthy of academic pursuit.<sup>12</sup> For that reason, this author elects to build an interdisciplinary approach to the research of ITDR, drawing on TC theory. Based on this law-and-economic framework, an antilegalistic, rather than legalistic, approach to the ITDR system will be proposed. In particular, this thesis will demonstrate that a MAP-based system is the optimal approach to coping with the proliferation of tax disputes. It is this theoretical and interdisciplinary methodology, together with an antilegalistic position, that primarily distinguishes this research from the bulk of the existing ITDR literature.<sup>13</sup>

### **3. Methodology**

There are five methodological strands in this thesis: theoretical analysis, doctrinal analysis, document analysis, comparative study, and quantitative analysis.

(1) Theoretical analysis. As discussed above, a distinctive feature of this thesis is the adoption of an interdisciplinary approach that draws on TC theory. Based on this interdisciplinary framework, the research derives the optimal mode of the ITDR system and develops numerous measures to strengthen the system.

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<sup>12</sup> Qiang Cai and Pengfei Zhang, 'A Theoretical Reflection on the OECD's New Statistics Reporting Framework for the Mutual Agreement Procedure: Isolating, Measuring, and Monitoring' (2018) 21 *Journal of International Economic Law* 867, 884.

<sup>13</sup> By "legalistic mode", this author refers to the third-party adjudication procedures that can apply predetermined rules objectively in disputed cases and deliver binding judgments thereafter. On the contrary, the "antilegalistic" mode mainly relies on the diplomatic resolution of disputes through intergovernmental consultation or negotiation. See Robert A Green, 'Antilegalistic Approaches to Resolving Disputes between Governments: A Comparison of the International Tax and Trade Regimes' (1998) 23 *Yale J. Int'l L.* 79, 82.

(2) Doctrinal analysis. The ITDR system is mostly manifested in dispute-settlement clauses and other relevant provisions under income-tax treaties (henceforth referred to as tax treaties). Therefore, a doctrinal analysis of these legal instruments will be necessary for the understanding of the system. In particular, the recent reform of the system embodied in BEPS Action 14 and Parts V and VI of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, often termed the Multilateral Instrument (MLI), will be assessed separately against the theoretical principles and propositions developed in this thesis.<sup>14</sup> The doctrinal analysis of countries' treaty practice on ITDR will focus on the relevant provisions of the OECD Model Tax Convention on Income and on Capital (OECD Model Convention), as most tax treaties are based on the OECD Model Convention.

(3) Document analysis. Documents released by the OECD, EU, or other relevant institutions constitute important sources of data that can be fed into this research.<sup>15</sup> In particular, the thesis provides an extensive analysis of 45 peer-review reports published by the OECD in relation to the peer-review process in BEPS Action 14.<sup>16</sup> The reports contain a large volume of peer comments on the MAP practices of the assessed jurisdictions. Due to the general requirement of confidentiality in the tax domain, previous assessments of ITDR practices in the literature were largely based on unpublished sources such as anecdotes or personal experiences.

(4) Comparative study. Chapter 4 compares the ITDR system with the

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<sup>14</sup> See below, Chapter 5, Section 4; Chapter 6, Section 7.

<sup>15</sup> For the method of document analysis, see Alan Bryman, *Social Research Methods* (2nd edn, Oxford University Press 2004) 380.

<sup>16</sup> See below, Chapter 3, Section 5.3.

dispute-settlement systems in trade and investment regimes. In line with the law-and-economic approach, this comparative study focuses on institutional aspects, rather than purely legal aspects, of those systems.

(5) Quantitative analysis. While the above four methods are all qualitative in nature, both Section 5.2 in Chapter 3 and Section 4.5 in Chapter 5 contain a quantitative analysis of the MAP statistics.

## **4. Structure of the thesis**

Chapters 1 to 4 constitute the theoretical part of the thesis, while the remaining chapters focus on policy suggestions. Chapter 1 contains two parts. The first provides an overview of the ITDR system, mainly along historical lines. The second contains a review of the relevant literature. Chapter 2 provides an introduction to TC theory, which forms the theoretical foundation of the entire thesis. Chapter 3 conducts a benefit-cost analysis of various ITDR mechanisms based on TC theory. Chapter 4 compares the ITDR system with the trade and investment dispute-settlement systems, with a view to testing the viability of the arguments and conclusions put forth in the preceding chapter. Chapters 5 and 6 respectively explore specific measures to improve the MAP and the third-party procedures of ITDR (tax arbitration and mediation). Chapter 7 inquires into a holistic solution to strengthen the entire ITDR system: institutionalisation of the system. Chapter 8 concludes.

## **5. Delimitation**

### **5.1. EU practice in ITDR**

The way to deal with EU practice in ITDR presents a tricky question in this thesis. On the one hand, the EU has played an overarching role in shaping the ITDR system as well as the international tax regime. Above all, the

conclusion of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (EU Arbitration Convention or Arbitration Convention)<sup>17</sup> marked a historic milestone in the development of ITDR. Some believe that the OECD's inclusion of an arbitration clause into its Model Convention through its 2008 update was substantially inspired by the Arbitration Convention.<sup>18</sup> Recently, the EU approved the Council Directive on Tax Dispute Resolution Mechanisms in the European Union (EU Arbitration Directive),<sup>19</sup> which stands to further strengthen the dispute-settlement system under the EU tax regime. Furthermore, several important ITDR cases all concern the EU Arbitration Convention.<sup>20</sup>

On the other hand, considering the special governance structure of the EU, it is doubtful whether the resolution of cross-border tax disputes within the EU context can be classified as an international or even regional affair in the usual sense. Brexit notwithstanding, the integration of the EU is so deep that many describe this process as “creeping federalism”.<sup>21</sup> The term “federalism” denotes a form of political integration whereby member states would be controlled by a supranational power centre.<sup>22</sup> Typical examples of federalism include the US, Germany and Canada.<sup>23</sup> In contrast, a significant part of this thesis concerns the topic of *international* cooperation on ITDR, following the law-and-economic approach. Economic theory is premised on individuals' capability to make free choices.<sup>24</sup> Accordingly, for the purpose of studying ITDR through an economic lens, the assumption of international anarchy where individual countries are free – at least in de jure sense – to choose

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<sup>17</sup> 90/463/EEC.

<sup>18</sup> Michelle Markham, 'Seeking New Directions in Dispute Resolution Mechanisms: Do We Need a Revised Mutual Agreement Procedure?' (2016) 70 Bulletin for International Taxation 82, 83.

<sup>19</sup> Council Directive (EU) 2017/1852.

<sup>20</sup> For instance, see below, Chapter 3, Section 5.4; Chapter 5, Section 2.1.4.

<sup>21</sup> Nigel G Foster, *Foster on EU Law* (Sixth edition., Oxford University Press 2017) 14.

<sup>22</sup> *ibid* 14–15.

<sup>23</sup> *ibid* 15.

<sup>24</sup> See below, Chapter 1, Section 2.7.1.

their fiscal policies, is necessary. Obviously, this anarchical assumption does not fit into the EU context. For this reason, the EU's practice in cross-border tax-dispute resolution, particularly with respect to the EU Arbitration Convention and Arbitration Directive, will only be mentioned in passing in Chapter 1, with a view to laying out a general background for the thesis. The ITDR cases in the EU context will, however, be evaluated at some length, as those cases contain some general information about ITDR mechanisms regardless of the contexts in which those mechanisms operate.

## **5.2 Bilateral or multilateral tax disputes**

As corporations increasingly expand their business into a multitude of countries, it is not unusual for tax disputes to become multilateral. In such cases, the high level of similarity in fact patterns and legal issues from country to country strongly suggests the feasibility of a multilateral solution to dispute resolution.<sup>25</sup> Several countries have already reported experiences of dealing with trilateral MAP cases.<sup>26</sup> Nevertheless, the vast majority of tax disputes is handled in a bilateral manner, and experiences of multilateral ITDR processes are still relatively rare.<sup>27</sup> Accordingly, unless otherwise specified, the analysis in this thesis will be mostly premised on the predominance and resolute of bilateral tax disputes.

## **5.3 Meaning of “institution”**

Throughout this thesis, the words “institution”, “institutional”, “institutionalised” and “institutionalisation” will be frequently used. In the Oxford Dictionary, the word “institution” has two meanings. The first is “an important organisation”,

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<sup>25</sup> Leonard B Terr and others, ‘Resolving International Tax Disputes: APAs, Mutual Agreement Procedures, and Arbitration’ (2012) 41 *Tax Management International Journal* 435, 439.

<sup>26</sup> Peer Review Reports on Japan, 65 (para.170); Germany, 61 (para.143).

<sup>27</sup> Terr and others (n 25) 438–439.

such as a university or bank. The second is “an established law or custom”.<sup>28</sup> Both meanings are important to this thesis, depending on the particular context. In the particular discussion of institutional ITDR, or the institutionalisation of the ITDR process (Chapter 7), the first meaning governs. However, the thesis as a whole examines the institutional aspect of the ITDR system, and in this general sense, the second meaning is also relevant.

## **Chapter 1. Outline of the ITDR System and Literature Review**

### **1. Outline of the ITDR system**

#### **1.1 ITDR in early times**

Ever since before World War I, when the modern international tax regime was emerging, international tax treaties have been characterised by a nonbinding, negotiation-based, intergovernmental dispute-settlement mechanism.<sup>29</sup> For instance, the 1899 tax treaty between Austria-Hungary and Prussian, which was the earliest tax treaty recorded by the League of Nations, provided that in the event of double taxation imposed upon Austria and Prussian nationals, the Contracting States “will enter into an understanding and will take appropriate measures in accordance with this understanding”.<sup>30</sup>

In 1926, the United Kingdom and Ireland signed a tax treaty containing the

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<sup>28</sup> Catherine Soanes and Sara Hawker (eds), *Compact Oxford English Dictionary for Students* (Oxford University Press 2013) 526.

<sup>29</sup> Zvi Daniel Altman, *Dispute Resolution under Tax Treaties* (IBFD 2005) 13.

<sup>30</sup> *ibid*; League of Nations, ‘Collection of International Agreements and International Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion - League of Nations Documents (C.345.M.102.1928. II)’ 249.

first binding and mandatory dispute-settlement mechanism.<sup>31</sup> Article 7 of the treaty provided that any disputes between the parties would be determined by a tribunal, and the determination of such tribunal would be final.<sup>32</sup> However, this legalistic method of dispute settlement was an absolute exception to the then treaty practice, which was characterised by an antilegalistic approach.<sup>33</sup> The 1926 United Kingdom-Ireland tax treaty itself was terminated in 1976 by a new tax treaty, which returns to the MAP as the only means of dispute resolution.<sup>34</sup>

## 1.2 Attempts by the League of Nations

From 1923 to the outbreak of World War II, the League of Nations had established several expert committees to study the question of double taxation as well as tax evasion.<sup>35</sup> Numerous draft conventions on the prevention of double taxation – which became the origin of the modern double-taxation regime – had been disseminated for discussion.<sup>36</sup> The dispute-settlement methods under these draft treaties largely followed Article 14 of the first draft released in 1927, which contained a non-binding expert procedure.<sup>37</sup> A main departure from this non-binding approach was in Articles 17-21 of the 1931 draft treaty, under which either party could bring the dispute to the Permanent Court of International Justice (PCIJ) for binding adjudication should the consultation and expert procedures fail to resolve the case.<sup>38</sup>

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<sup>31</sup> Altman (n 29) 16–17; Agreement between the British Government and the Government of the Irish Free State in respect of Double Income Tax (electronic Irish Statute) 1926 Art.7.

<sup>32</sup> Agreement between the British Government and the Government of the Irish Free State in respect of Double Income Tax (electronic Irish Statute) Art.7; see also Altman (n 29) 16–17.

<sup>33</sup> Altman (n 29) 18.

<sup>34</sup> UK/Ireland Income and Capital Gains Tax Convention (1976) 1976 Arts 24, 28.

<sup>35</sup> Altman (n 29) 40–50; Diane Ring, 'International Tax Relations: Theory and Implications' (2007) 101 *Tax Law Review* 83, 121.

<sup>36</sup> Altman (n 29) 43–50; Ring (n 35) 117.

<sup>37</sup> League of Nations, 'Report Presented to the Financial Committee of the League of Nations by The Committee Of Technical Experts on Double Taxation and Tax Evasion - League of Nations Documents (C.216.M. 85.1927. II)' 12; see also Altman (n 29) 44.

<sup>38</sup> League of Nations, 'Draft Plurilateral Convention for the Prevention of the Double Taxation of Certain Categories of Income - League of Nations Documents (C.415. M. 171. 1931. II. A)' 12–13; Altman (n 29) 48–49.

While this Article had received no objection in the discussion, the following drafts went back to the non-binding mode reflected in the 1927 draft.<sup>39</sup> The committee did not specify the rationale for this antilegalistic return.<sup>40</sup> Altman hints that this shift may be associated with a general movement away from relying on specific rules to a greater reliance on general principles in drafting the text of the convention.<sup>41</sup> As the committee stated in the introduction to the 1933 draft:

*In view of the diversity of national laws and the extreme complexity and variety of the individual cases that arise, the Committee thought it advisable to prescribe only general principles...it was of the opinion that the general principle...will enable all special problems to be solved with the necessary flexibility.*<sup>42</sup>

However, Altman does not give much weight to this speculation. Instead, he connects the shift of the 1933 draft convention with a League of Nations Resolution on international economic dispute settlement (28 January 1932).<sup>43</sup> The Resolution expressed a negative attitude toward the use of legalistic methods in resolving international economic disputes. Specifically, as the resolution noted, the creation of a permanent organisation and the appointment of arbitrators can be quite slow and laborious and may cause much anxiety.<sup>44</sup> As a result, the resolution recommended more flexible dispute-resolution mechanisms such as advisory opinions, conciliation, or

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<sup>39</sup> See 1933 draft convention League of Nations, 'Draft Convention Adopted for the Allocation of Business Income Between States for the Purpose of Taxation - League of Nations Documents (C.399.M.204.1933 II A)' 5; see also Altman (n 29) 50.

<sup>40</sup> See 1933 draft convention League of Nations, 'Draft Convention Adopted for the Allocation of Business Income Between States for the Purpose of Taxation - League of Nations Documents (C.399.M.204.1933 II A)' (n 39) 5; see also Altman (n 29) 50.

<sup>41</sup> Altman (n 29) 50.

<sup>42</sup> League of Nations, 'Draft Convention Adopted for the Allocation of Business Income Between States for the Purpose of Taxation - League of Nations Documents (C.399.M.204.1933 II A)' (n 39) 2; Altman (n 29) 50.

<sup>43</sup> League of Nations, 'Procedure for the Friendly Settlement of Economic Disputes Between States - League of Nations Documents (C.57.M.32.1932. II. B)' 4–5; see also Altman (n 29) 50–52.

<sup>44</sup> League of Nations, 'Procedure for the Friendly Settlement of Economic Disputes Between States - League of Nations Documents (C.57.M.32.1932. II. B)' (n 43) 4–5; see also Altman (n 29) 50–52.

arbitration.<sup>45</sup>

It could be seen that the move from a legalistic method of dispute settlement to a more flexible mode seemed not so much a result of concerns over sovereignty, but more an outcome of considerations of efficiency. In particular, the procedural costs and the special character of international tax rules played an overarching role in determining the characteristics of the ITDR system.

The League of Nations' effort to develop a model convention on the prevention of double taxation for all countries was ultimately disrupted by the outbreak of World War II.<sup>46</sup> Nor had those released draft conventions been fully accepted by national governments. Most tax treaties in force between the two World Wars featured the MAP or some other negotiation-based methods of dispute settlement.<sup>47</sup> Nonetheless, the League of Nations' work laid out a substantial ground for the current ITDR system.<sup>48</sup>

### **1.3 Dispute-resolution provisions of the OECD Model Convention and related documents**

#### **1.3.1 Overview**

From 1956 to 1963, the OECD undertook the task of developing a model convention that could effectively resolve double-taxation problems between OECD member countries, and would provide uniform principles, definitions, rules, and interpretation methods to all member countries.<sup>49</sup> These efforts culminated in the 1963 Draft Model and the Commentaries, both of which

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<sup>45</sup> League of Nations, 'Procedure for the Friendly Settlement of Economic Disputes Between States - League of Nations Documents (C.57.M.32.1932. II. B)' (n 43) 4–5; see also Altman (n 29) 50–52.

<sup>46</sup> Altman (n 29) 54–55.

<sup>47</sup> *ibid* 54.

<sup>48</sup> OECD Model Convention (2014) Introduction, 7 (para.4).

<sup>49</sup> *ibid* Introduction, 8 (paras 5, 6).

have since been revised and updated numerous times.<sup>50</sup> While originally the Model Convention was mainly intended for the OECD members, it has now become a basic document of reference in treaty negotiations for both OECD and non-OECD countries.<sup>51</sup> It has also been followed by the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model Convention), although the latter places a greater emphasis on developing countries' interests in allocating tax rights.<sup>52</sup>

### 1.3.2 Article 25 of the OECD Model

Article 25 of the OECD Model Convention provides the MAP as the exclusive means of resolving trans-border tax disputes. It sets forth three types of MAP: the specific case, the interpretative, and the legislative.<sup>53</sup> The specific-case MAP concerns the settlement of specific disputes in which taxpayers assert that they are not being taxed in accordance with the treaty.<sup>54</sup> The interpretative MAP aims to address difficulties concerning the interpretation and application of tax treaties.<sup>55</sup> The legislative MAP authorises the competent authorities to "consult together for the elimination of double taxation in cases not provided for in the Convention".<sup>56</sup>

The topic of ITDR mainly concerns the specific-case MAP,<sup>57</sup> which can generally be divided into two stages.<sup>58</sup> In the first stage, a taxpayer may submit a request for MAP assistance to the competent authority of the Contracting State of which it is a resident, if it considers that the action of one

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<sup>50</sup> *ibid* Introduction, 8 (para.6).

<sup>51</sup> *ibid* Introduction, 9-10 (paras 10, 14).

<sup>52</sup> UN Model Convention(2017) Introduction, iii (para. 3). For the introduction of source jurisdiction and residence jurisdiction, see below, Chapter 3, Section 3.1.1.

<sup>53</sup> Green (n 13) 96; OECD, 'MEMAP' (n 1) 9-10 (Sections 1.2.1, 1.2.2).

<sup>54</sup> OECD Model Convention (2014) Art. 25 (1),(2).

<sup>55</sup> *ibid* Art. 25 (3).

<sup>56</sup> *ibid* Art.25(3).

<sup>57</sup> OECD, 'MEMAP' (n 1) 9 (Section 1.2.1).

<sup>58</sup> OECD Model Convention (2014) Art. 25 (1)(2); see also Jasmin Kollmann and Laura Turcan, 'Overview of the Existing Mechanisms to Resolve Disputes and Their Challenges' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015) 21-22.

or both Contracting States has resulted in taxation not in accordance with the tax treaty provisions.<sup>59</sup> If the competent authority that receives the request (henceforth referred to as the first competent authority) decides that the taxpayer's objection is justified and that it could by itself resolve the dispute, this authority should then unilaterally grant double-taxation relief to the taxpayer.<sup>60</sup> Until this stage, the proceedings take place exclusively between the taxpayer and the first competent authority. However, if the first competent authority is unable to arrive at a satisfactory solution on its own, usually because the resolution of the issue involves the other Contracting State, then it should initiate the second stage of the proceedings: to approach the competent authority of its treaty partner (the second competent authority) for a mutual negotiation.<sup>61</sup> The two competent authorities shall then "endeavour" to resolve the case by mutual agreement.<sup>62</sup> To this end, the competent authorities may refer the issue to a joint commission consisting of themselves or their representatives.<sup>63</sup>

### **1.3.3 Manual on Effective Mutual Agreement Procedures (MEMAP)**

Besides the dispute settlement provision in the Model Convention, the OECD, mainly through its Committee on Fiscal Affairs and the Centre for Tax Policy and Administrative (CTPA), has also engaged in continuous research on the improvement of ITDR, leading to numerous reports and guidelines on the subject.<sup>64</sup> In particular, the OECD published the MEMAP in 2007, a guide intended to increase the awareness of the MAP process and how it should function.<sup>65</sup> Specifically, it provides tax administrations and taxpayers with

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<sup>59</sup> OECD Model Convention (2014) Art. 25(1).

<sup>60</sup> *ibid* Art. 25(2).

<sup>61</sup> *ibid* Art. 25 (2).

<sup>62</sup> *ibid*.

<sup>63</sup> *ibid* Art. 25 (4).

<sup>64</sup> For example, see the OECD's 2004 Report on 'Improving the Process for Resolving International Tax Disputes', 2007 Report on 'Improving the Resolution of Tax Treaty Disputes'; see also Altman (n 29) 61–66.

<sup>65</sup> OECD, 'MEMAP' (n 1) Preface.

basic information on the operation of the MAP and identifies best MAP practices, albeit with no binding effects.<sup>66</sup> Some ten years later, numerous measures recommended in the MEMAP as best practices were incorporated in BEPS Action 14 as the minimum standard of MAP practice.<sup>67</sup>

#### 1.4 EU Arbitration Convention

Recognising that double taxation constitutes an impediment to the internal market of Europe, the Council of the European Communities signed the Arbitration Convention in 1990.<sup>68</sup> The Convention came into effect on 1 January 1995 after all the then-Member States ratified the instrument.<sup>69</sup> The dispute-resolution procedure under the Arbitration Convention begins with a typical specific-case MAP, which presents no significant difference from Article 25 of the OECD Model Convention. The two instruments diverge at the point where the MAP goes awry.<sup>70</sup> Article 7(1) of the Arbitration Convention provides that if the competent authorities fail to reach an agreement within two years from the presentation of the case, they are then required to set up an Advisory Commission charged with delivering an opinion on the case.<sup>71</sup> The Advisory Commission typically consists of two representatives of each competent authority concerned and an even number of independent persons of standing to be appointed by mutual agreement.<sup>72</sup> The opinion of the Advisory Commission is decided by a simple majority vote and should be delivered within no more than six months from the date on which the matter

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<sup>66</sup> *ibid.*

<sup>67</sup> See below, Chapter 5, Sections 4.2, 4.6.

<sup>68</sup> 90/463/EEC; see also Andreas Bernath, 'The Implications of the Arbitration Convention: A Step Back for the European Community or a Step Forward for Elimination of Transfer Pricing Related Double Taxation (Thesis)?' [2006] Jönköping University 20–21.

<sup>69</sup> EU Commission, 'Transfer Pricing and the Arbitration Convention' (*Taxation and Customs Union - European Commission*, 13 September 2016)

<[https://ec.europa.eu/taxation\\_customs/business/company-tax/transfer-pricing-eu-context/transfer-pricing-arbitration-convention\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/transfer-pricing-arbitration-convention_en)> accessed 1 May 2019; Bernath (n 68) 22.

<sup>70</sup> Bernath (n 68) 47–48.

<sup>71</sup> 90/463/EEC, Art. 7(1).

<sup>72</sup> 90/463/EEC, Art. 9(1), (4).

was referred to it.<sup>73</sup> After the opinion has been delivered, the competent authorities have additional six months to take a decision to eliminate the double taxation.<sup>74</sup> The competent authorities may by consent take a decision that deviates from the Advisory Commission's opinion.<sup>75</sup> However if they fail to agree on such a decision, they are obliged to comply with the Advisory Commission's opinion.<sup>76</sup>

## **1.5 2008 update to the OECD Model Convention**

In Article 25 of its 2008 update, the OECD Model Convention included an arbitration clause.<sup>77</sup> Specifically, where the competent authorities are unable to resolve the dispute within the two-year time frame of the MAP, any unresolved issues will be submitted to arbitration upon the request of the taxpayer concerned.<sup>78</sup> The arbitration decision shall be binding on both Contracting States unless the taxpayer does not accept it.<sup>79</sup> The Commentary on the Article notes that the arbitration procedure is instituted as an extension of the MAP rather than an alternative means of dispute resolution.<sup>80</sup>

Article 25(5) does not set out any detailed rules for the operation of tax arbitration. Only the Commentary on the Article contains in its Annex a sample arbitration procedure (OECD Sample Procedure), which can be used by the competent authorities as a basis to agree on the mode of implementing the arbitration procedures.<sup>81</sup> The Sample Procedure takes conventional arbitration as the starting point, but allows the competent authorities to

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<sup>73</sup> 90/463/EEC, Art. 11(1), (2).

<sup>74</sup> 90/463/EEC, Art. 12(1).

<sup>75</sup> *ibid.*

<sup>76</sup> *ibid.*

<sup>77</sup> Chloe Burnett, 'International Tax Arbitration' (2007) 36 Australian Tax Review 173, 173.

<sup>78</sup> OECD Model Convention (2014) Art. 25(5).

<sup>79</sup> *ibid.*

<sup>80</sup> *ibid* Commentary on Art. 25, 388-389 (para. 64).

<sup>81</sup> *ibid* Sample Procedure, 398-413; See also Kollmann and Turcan (n 58) 35-36.

choose the “streamline arbitration process”, typically the final-offer arbitration, as an alternative mode of arbitration.<sup>82</sup> The comparison between the conventional and final-offer modes of arbitration will be discussed later in this thesis.<sup>83</sup> The Sample Procedure also provides rules for the key stages of tax arbitration including the submission of an arbitration request, the settlement of the Terms of Reference, the appointment of arbitrators, procedural and evidentiary rules, costs, and so on.<sup>84</sup>

Following the 2008 update to the OECD Model Convention, the UN Model also added in its 2011 update an optional version of Article 25 (Alternative B), which provides arbitration for unresolved MAP issues.<sup>85</sup> The UN Commentary on Article 25 also contains in its Annex a sample arbitration procedure (UN Sample Procedure).<sup>86</sup> The arbitral procedure under the UN Model differs from that of the OECD Model in five major aspects:<sup>87</sup>

(1) The time period required for the trigger of arbitration is three years from the presentation of the case, rather than two years, as is in the OECD Model.<sup>88</sup>

(2) The arbitration must be requested by the competent authority of one of the Contracting States rather than the taxpayer. This means that access to arbitration would be denied for cases where the competent authorities of both Contracting States consider such cases not suitable for arbitration.<sup>89</sup>

(3) The competent authorities may depart from the arbitration decision if they agree to do so within six months after the decision is issued.<sup>90</sup> This is akin to Article 12(1) of the EU Arbitration Convention.

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<sup>82</sup> OECD Model Convention (2014) Sample Procedure, 405 (para.4).

<sup>83</sup> See below, Chapter 6, Section 4.

<sup>84</sup> OECD Model Convention (2014) Sample Procedure, 398-413.

<sup>85</sup> UN Model Convention(2011) Introduction, xi (para.18).

<sup>86</sup> *ibid* Sample Procedure, 414-435.

<sup>87</sup> Kollmann and Turcan (n 58) 38–39.

<sup>88</sup> UN Model Convention(2011) Art. 25(5) (Alternative B).

<sup>89</sup> *ibid*.

<sup>90</sup> *ibid*.

(4) The Commentary on Article 25(5) (Alternative B) provides voluntary arbitration as an alternative, the initiation of which is subject to *ex post* consent between the competent authorities.<sup>91</sup>

(5) The UN Sample Procedure shows a preference for final-offer arbitration.<sup>92</sup>

## 1.6 National practices in ITDR since World War II

The EU Arbitration Convention and the arbitration clause in the OECD and UN Model Conventions have substantially affected countries' ITDR practice. In particular, since the 2008 update to the OECD Model Convention, a growing number of countries have included arbitration clauses in their treaties.<sup>93</sup> However, this legalistic move should not be overestimated. According to Pit's study, as of March 2014, among nearly 3,000 tax treaties around the world, only 158 explicitly include some form of arbitration mechanism; and the majority of these 158 treaties have been concluded by the US, the Netherlands, Canada and Switzerland.<sup>94</sup> Furthermore, there have been few reported arbitration cases under bilateral tax treaties or the EU Arbitration Convention.<sup>95</sup> It appears that tax arbitration is significantly underused, and most tax disputes to date have been finalised through the MAP.<sup>96</sup>

For the purpose of this research, the US's treaty practice in ITDR is worthy of special attention. In 1976, the US officially published its own Model Income

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<sup>91</sup> *ibid* Commentary on Art. 25(5) (Alternative B), 393-394 (para.14).

<sup>92</sup> *ibid* Sample Procedure, para 12.

<sup>93</sup> Hugh J Ault, 'Dispute Resolution: The Mutual Agreement Procedure' [2013] United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries 20.

<sup>94</sup> HM Pit, 'Arbitration under the OECD Model Convention: Follow-up under Double Tax Conventions: An Evaluation' (2014) 42 *Intertax* 445, 448; 'Tax Treaties: Update to OECD Model Tax Convention Released - OECD'

<<https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm>> accessed 9 October 2019.

<sup>95</sup> Terr and others (n 25) 485-486.

<sup>96</sup> Burnett (n 77) 174.

Tax Convention (US Model Convention).<sup>97</sup> Article 25 of the US Model Convention provides the MAP as an exclusive means of dispute resolution.<sup>98</sup> In 1989, the US and Germany signed the world's first tax treaty that contained an arbitration provision since World War II.<sup>99</sup> Subsequently, the US concluded several more tax treaties with arbitration clauses.<sup>100</sup> In its 2016 revision, the US Model Convention included a mandatory and binding arbitration clause in Article 25.<sup>101</sup> The US Model Convention and most US tax treaties with arbitration clauses adopt the final-offer approach as the default mode of arbitration.<sup>102</sup>

## 1.7 Recent development of ITDR

### 1.7.1 BEPS Project

The international tax environment has changed considerably in recently years. Above all, the financial crisis and the aggressive tax planning by many MNEs have put BEPS high on the political agenda.<sup>103</sup> In this context, since 2013, the OECD/G20 has launched the BEPS Project, which is hailed by many as the most significant rewrite of the international tax rules in a century.<sup>104</sup> The project identifies 15 action plans including a variety of measures, such as new minimum standards, the revision of existing standards, and guidance drawing on best practices.<sup>105</sup> The goal is to align international tax rules to the developments in the world economy, and to ensure that profits are taxed

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<sup>97</sup> Doron Narotzki, 'Tax Treaty Models-Past, Present, and a Suggested Future' (2017) 50 *Akron Law Review* 383, 387.

<sup>98</sup> US Model Convention (1976) Art.25.

<sup>99</sup> US-Germany tax treaty 1989 Art. 25(5); see also Altman (n 29) 19.

<sup>100</sup> For instance, US treaties with Canada (amending protocol signed on 17 May 1995), the Netherlands (1993), France (1994), etc.; see also Altman (n 29) 21.

<sup>101</sup> US Model Convention (2016) Art. 25 (6); Narotzki (n 97) 393; William Byrnes, 'Analysis of the New US Model Tax Treaty' (*Kluwer International Tax Blog*, 24 February 2016) <<http://kluwertaxblog.com/2016/02/25/analysis-of-the-new-us-model-tax-treaty/>> accessed 3 May 2019.

<sup>102</sup> Brown (n 11) 108; Byrnes (n 101).

<sup>103</sup> OECD, 'Background Brief: Inclusive Framework on BEPS' (2017) 9.

<sup>104</sup> OECD, 'OECD/G20 Base Erosion and Profit Shifting Project: Information Brief' (OECD 2015) 3.

<sup>105</sup> OECD, 'BEPS Background Brief' (n 103) 9.

where economic activities are carried out and value is created.<sup>106</sup> Many of the measures developed through these action plans were later incorporated into the 2017 updates to the OECD and UN Model Conventions.<sup>107</sup>

The major implications of the BEPS Project for the ITDR system are twofold. First, the project may have an impact on the trend of tax disputes. Second, several actions are directly relevant to ITDR.

(1) Impact of the BEPS Project on tax disputes. Concerns have already been raised that the BEPS Project will lead to a staggering increase in tax disputes.<sup>108</sup> As its name suggests, the BEPS Project was initiated as a countermeasure against aggressive tax-optimisation schemes by MNEs. National governments may even see the project as a means to get an increased slice of the “tax cake”.<sup>109</sup> Moreover, since the Project has overhauled international tax rules, taxpayers and tax administrations will need time to adjust to the changes.<sup>110</sup> During this transitional period, enormous uncertainties may arise for stakeholders. For instance, the taxpayers and the relevant tax administrations, or the tax authorities of different countries, may have divergent interpretations of the new rules proposed in the project. Potential inconsistencies within the project may also give rise to controversies.<sup>111</sup> For instance, some have noted that the proposals to address the tax challenges regarding the digital economy may contradict those addressing transfer-pricing issues regarding

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<sup>106</sup> OECD, ‘BEPS Information Brief’ (n 104) 3.

<sup>107</sup> OECD Model Convention(2017) Introduction, 11 (para.11.2); UN Model Convention(2017) Introduction, ix (para.17.1).

<sup>108</sup> Kollmann and Turcan (n 58) 16–18; Michael Lang and others, *International Arbitration in Tax Matters* (IBFD Publications 2015) preface, xxiii.

<sup>109</sup> ‘ICC warns enhanced tax dispute resolution mechanism needed to prevent exacerbating double taxation’ (*ICC - International Chamber of Commerce*, 4 November 2014) <<https://iccwbo.org/media-wall/news-speeches/icc-warns-enhanced-tax-dispute-resolution-mechanism-needed-to-prevent-exacerbating-double-taxation/>> accessed 31 January 2018.

<sup>110</sup> Kollmann and Turcan (n 58) 17.

<sup>111</sup> *ibid*; David Ernick, ‘BEPS, Broken Promises, and What the OECD Can Learn from the WTO About Dispute Settlement Procedures’ [2014] *Tax Management International Journal* 624, 624.

intangibles.<sup>112</sup> In numerous BEPS actions, multiple options that are equally acceptable have been presented for each issue in order to minimise political obstacles from member states.<sup>113</sup>

(2) Action 14. The action aims to strengthen the ITDR system, in the awareness that measures to tackle BEPS might lead to unnecessary uncertainties for compliant taxpayers.<sup>114</sup> The Action develops a minimum standard for MAP practice, plus a peer-review process to monitor countries' compliance with the standard.<sup>115</sup> The OECD also intended to promote a universal adoption of an arbitration mechanism in tax treaties.<sup>116</sup> However, the Action 14 Final Report notes that only 20 OECD countries expressed an interest in doing so, and there is no consensus among all OECD and G20 countries on the initiative.<sup>117</sup> As a result, the Final Report confirms that the Action is focused on the MAP, while tax arbitration will be developed later as part of the negotiation of the MLI undertaken in Action 15.<sup>118</sup>

(3) Action 15 and Parts V and VI of the MLI. Action 15 aims to develop an MLI to modify existing bilateral tax treaties in order to swiftly implement the measures developed in the course of the BEPS Project.<sup>119</sup> The MLI was concluded and adopted by the OECD/G20 in November 2016.<sup>120</sup> Parts V and VI of the MLI concern the MAP and tax arbitration,

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<sup>112</sup> Kollmann and Turcan (n 58) 17.

<sup>113</sup> For instance, a majority of Articles in the MLI have reservation options, see MLI; see also *ibid*.

<sup>114</sup> OECD, 'Making Dispute Resolution Mechanisms More Effective, Action 14 Final Report' (OECD 2015) 9.

<sup>115</sup> *ibid* Executive Summary, 9.

<sup>116</sup> OECD, 'BEPS Action 14: Public Discussion Draft' (OECD) 1.

<sup>117</sup> OECD, 'Action 14 Final Report' (n 114) 41 (para.62).

<sup>118</sup> *ibid* 41 (para.63).

<sup>119</sup> OECD, 'Developing a Multilateral Instrument to Modify Bilateral Tax Treaties , Action 15 Final Report' (OECD 2015) 11.

<sup>120</sup> 'Countries Adopt Multilateral Convention to Close Tax Treaty Loopholes and Improve Functioning of International Tax System - OECD'

<<https://www.oecd.org/tax/beps/countries-adopt-multilateral-convention-to-close-tax-treaty-loopholes-and-improve-functioning-of-international-tax-system.htm>> accessed 4 May 2019.

respectively.<sup>121</sup>

(4) Tie-breaker rule for companies in Action 6. Action 6 aims to identify and tackle treaty abuse, particularly treaty shopping, which is one of the major sources of BEPS problems.<sup>122</sup> A particular measure proposed in the Action involves the revision to the tie-breaker rule for companies in tax treaties.<sup>123</sup> Tax treaties are normally set up in such a manner that for any particular taxpayer, one Contracting State is deemed as the country of residence and the other the country where the foreign income arises.<sup>124</sup> Tax treaties do not define tax residence directly, leaving the issue to domestic laws.<sup>125</sup> Since domestic laws usually define residence in a rather broad manner, it is highly possible that a taxpayer may be simultaneously identified as a resident in both Contracting States.<sup>126</sup> In this connection, the tie-breaker rule is to decide which of the two states will be treated as the residence country for the purpose of applying the tax treaty at issue.<sup>127</sup> Previously, the tie-breaker rule for companies stated that a company shall be deemed to be a resident only in the state in which its place of effective management is situated.<sup>128</sup> This rule was radically changed by Action 6, which provides that the issue of dual residency will be determined through the MAP mechanism between the two competent authorities on a case-by-case basis.<sup>129</sup> This is somewhat surprising, as dispute-settlement rules normally only come into play when the substantive rules are disputed.

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<sup>121</sup> MLI, Parts V and VI.

<sup>122</sup> OECD, 'Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 Final Report' (OECD 2015) 9.

<sup>123</sup> *ibid* 72 (paras 45–48).

<sup>124</sup> Lynne Oats, Angharad Miller and Emer Mulligan, *Principles of International Taxation* (Sixth edition., Bloomsbury Professional 2017) 89.

<sup>125</sup> *ibid*.

<sup>126</sup> *ibid*.

<sup>127</sup> *ibid*.

<sup>128</sup> OECD Model Convention (2014) Art. 4(3).

<sup>129</sup> OECD, 'Action 6 Final Report' (n 122) 72 (para.47).

### 1.7.2 EU Arbitration Directive

In October 2017, as a critical step to implement the BEPS Project, the EU Council adopted the Arbitration Directive.<sup>130</sup> This new legislation builds on existing systems in the EU, including tax treaties between EU Member States and the Arbitration Convention.<sup>131</sup> In particular, the Directive supplements the Arbitration Convention in several key ways.<sup>132</sup> First, the Directive forms a part of the Community law, and therefore has superior legal status to the Arbitration Convention.<sup>133</sup> Second, the Directive applies to all taxpayers subject to taxes on income and capital, whereas the Arbitration Convention is limited to disputes over transfer pricing cases (including disputes involving the attribution of profits to permanent establishments (PEs)).<sup>134</sup> Third, the procedures under the Directive are more refined than those of the Arbitration Convention. On the one hand, more clearly defined and enforceable timelines makes the procedures more robust; on the other hand, the inclusion of final-offer arbitration and the alternative dispute resolution (ADR) method increases the procedures' flexibility.<sup>135</sup>

### 1.7.3 A note on how to handle the new development in the thesis

The need to deal with these new developments in ITDR presents a tricky question. Should BEPS Action 14 and Parts V and VI of the MLI be treated as new laws, and hence singled out for separate evaluation, or regarded as having already been incorporated into the current ITDR system, and thus

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<sup>130</sup> Council Directive (EU) 2017/1852, Preamble.

<sup>131</sup> Council Directive (EU) 2017/1852, Preamble.

<sup>132</sup> For detailed analysis of the EU Arbitration Directive, see Sriram Govind, 'The New Face of International Tax Dispute Resolution: Comparing the OECD Multilateral Instrument with the EU Dispute Resolution Directive' (2018) 27 EC Tax Review 309.

<sup>133</sup> Council Directive (EU) 2017/1852, Preamble; see also EU Commission, 'Resolution of Double Taxation Disputes in the European Union' (*Taxation and Customs Union - European Commission*, 19 October 2016)

<[https://ec.europa.eu/taxation\\_customs/business/company-tax/resolution-double-taxation-disputes\\_en\\_en](https://ec.europa.eu/taxation_customs/business/company-tax/resolution-double-taxation-disputes_en_en)> accessed 5 May 2019.

<sup>134</sup> Council Directive (EU) 2017/1852, Preamble. *ibid.*

<sup>135</sup> *ibid.*

woven into the general analysis of this thesis? This author prefers to approach them separately for two reasons. First, most tax treaties around the world have been based on the traditional rules and the process of implementing Action 14 and the MLI is still ongoing.<sup>136</sup> Second, those new developments manifest the logic of TC theory, and thereby deserve special attention. Therefore, Action 14 (as well as Part V of the MLI) will be assessed in Chapter 5, while Part VI of the MLI will be evaluated in Chapter 6. Detailed analysis of the EU Arbitration Directive is outside the scope of this thesis.

## 1.8 Summary

In general, the historic evolution of the ITDR system to date features the predominance and stagnancy of the MAP. While treaty practice since the 1980s has shown an increased acceptance of tax arbitration, the mechanism has not been widely embraced by national governments, and where it is adopted, it is remarkably underused. The upshot is that by far, most tax disputes have been finalised through the MAP.<sup>137</sup> Furthermore, the structure of tax arbitration itself features an “antilegalistic style”. Specifically, the initiation of the procedure is preconditioned upon the failure of the MAP. The procedure inherits the inter-governmental character of the MAP, allowing for a very limited taxpayer involvement.<sup>138</sup> Under the UN Model Convention and the EU Arbitration Convention, the competent authorities are permitted, after the release of an arbitral decision, to agree on a solution that deviates from that arbitral decision. In addition, the UN Model Convention, the MLI, and the US treaty practice all take the final-offer approach as the default mode of tax arbitration. In short, tax arbitration is instituted as an integrated part of the

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<sup>136</sup> ‘Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS - OECD’ <<https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>> accessed 1 September 2019.

<sup>137</sup> Burnett (n 77) 174.

<sup>138</sup> Terr and others (n 25) 493–494.

MAP. Its major purpose is to facilitate dialogues between competent authorities rather than to vindicate taxpayers' claims or to ensure a consistent interpretation and application of tax treaties.<sup>139</sup> Lastly, the antilegalistic character of the ITDR system has been further reinforced by the recent reform of the tie-breaker rule, whereby dual-residency situations for corporate taxpayers are to be determined by the MAP on a case-by-case basis.

Another outstanding feature of the ITDR history is that mediation, which is a typical method of international dispute settlement, has been entirely overlooked.<sup>140</sup> When the parties to an international dispute are unable to achieve an agreement by negotiation, the intervention or facilitation by a mediator is a promising means to break the impasse.<sup>141</sup> The form of mediation spans a broad spectrum. At one end, a third party may simply provide the disputing parties with an additional channel of communication, and encourage them to resume negotiations. In this situation, the third party is said to be providing a "good office".<sup>142</sup> At the other end, the intermediary may undertake independent investigation, and present the parties with a set of formal proposals for dispute resolution. This form of intervention is called "conciliation" or expert procedure.<sup>143</sup> Between the two lies the most common type of mediation, whereby the mediator actively participates in the negotiation between the parties and help them find a solution.<sup>144</sup> Regardless of the above types, the hallmark of mediation is its non-binding character.<sup>145</sup>

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<sup>139</sup> Brown (n 11) 107.

<sup>140</sup> Joe Dalton, 'Unlocking MAP Disputes: Is Mediation the Key?' [2013] *International Tax Review* 14.

<sup>141</sup> John Graham Merrills, *International Dispute Settlement* (Cambridge university press 2017) 26.

<sup>142</sup> *ibid.*

<sup>143</sup> *ibid.*

<sup>144</sup> *ibid.*

<sup>145</sup> Alan G Saler, 'Binding Mediation Is No Mediation at All' Advocate.

## 2. Literature review

### 2.1 Historic sketch of the literature

According to Altman, the literature of ITDR can be traced back to a 1895 study by a German scholar Ludwig von Bar, who proposed the establishment of an ITC.<sup>146</sup> This preference for legalistic methods of dispute resolution also characterised other studies on ITDR before World War II.<sup>147</sup>

The post-war period saw a few articles and reports supporting the use of the MAP in resolving tax disputes.<sup>148</sup> Presumably, this antilegalistic shift was associated with the publication of the first OECD Model Convention (1963), which confirmed the MAP as an exclusive means of resolving tax disputes. Nonetheless, scholarly efforts to explore more legalistic methods of ITDR, including tax arbitration and ITC, have never ceased.<sup>149</sup>

In 1981, Lindencrona and Deventer examined the imperfections of the MAP, and suggested arbitration as a preferable approach to ITDR.<sup>150</sup> Since then, interests in legalistic methods of ITDR have grown among tax professionals, researchers and policymakers.<sup>151</sup> This growth was further reinforced by the conclusion of the EU Arbitration Convention and the 2008 update to the OECD Model Convention, both of which soon became topics of great interests for tax academics.<sup>152</sup>

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<sup>146</sup> Altman (n 29) 75.

<sup>147</sup> *ibid.*

<sup>148</sup> *ibid* 76–78; Glenn L Madere, 'International Pricing: Allocation Guidelines and Relief from Double Taxation' (1975) 10 *Tex. Int'l LJ* 108.

<sup>149</sup> Altman (n 29) 82–86.

<sup>150</sup> Gustaf Lindencrona and Nils Mattsson, *Arbitration in Taxation* (Kluwer 1981); Gustaf Lindencrona and Nils Mattsson, 'Arbitration in Taxation' (1982) 10 *Intertax* 76.

<sup>151</sup> Roland Ismer and Sophia Piotrowski, 'A BIT Too Much: Or How Best to Resolve Tax Treaty Disputes?' (2016) 44 *Intertax* 348, 353–354; Altman (n 29) 85, 94.

<sup>152</sup> For representative articles on EU Arbitration Convention, see Luc Hinnekens, 'The Tax Arbitration Convention. Its Significance for the EC Based Enterprise, the EC Itself, and for Belgian and International Tax Law' (1992) 1 *EC Tax Review* 70; J David B Oliver, 'Transfer Pricing and the EC Arbitration Convention' (2002) 30 *Intertax* 340; Bernath (n 68); Burnett (n 77). For representative articles on arbitration under the OECD Model Convention, see Pit (n 94).

During the past few decades, there has been a steep increase in the number of studies concerning ITDR. Some believe that this research growth has laid some foundation for the transformation of the topic into a new academic discipline: the ITDRP.<sup>153</sup> As will be discussed below, this body of literature is highly concentrated on the topic of arbitration as opposed to the MAP or other non-binding dispute settlement mechanisms.

From the above historic account, it could be seen that while ITDR practice is predominantly concerned with the MAP, academic consideration of the topic shows a persistent preference for a more legalistic mode of dispute settlement. This disparity constitutes a prominent feature of ITDR.

## **2.2 Literature on the MAP**

### **2.2.1 Criticisms of the MAP**

The MAP has long been criticised.<sup>154</sup> Indeed, given the legalistic tendency of the ITDR literature, studies in this field typically start with dissatisfaction with the MAP. Above all, the mechanism is often perceived to be time-consuming, with no guarantee of finality.<sup>155</sup> It is possible that the competent authorities do not reach agreement on all points of the case or that they achieve no agreement at all.<sup>156</sup> Many particularly attribute the MAP's protraction or failure to the soft wording of tax treaties, which only call upon the competent authorities to "endeavour" to resolve MAP cases.<sup>157</sup>

The MAP is also criticised for its lack of transparency. The procedure is carried out only by the two competent authorities, with the taxpayer

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<sup>153</sup> Carolis (n 9) 391.

<sup>154</sup> Kollmann and Turcan (n 58) 25–32; see also Terr and others (n 25) 471–482; Burnett (n 77) 178–180; Hugh J Ault, 'Improving the Resolution of International Tax Disputes' (2005) 7 Fla. Tax Rev. 137, 139–142; William W Park, 'Income Tax Treaty Arbitration' (2001) 10 Geo. Mason L. Rev. 803, 808–810; Lindencrona and Mattsson (n 150) 61–62.

<sup>155</sup> Kollmann and Turcan (n 58) 25–26.

<sup>156</sup> *ibid* 26.

<sup>157</sup> *ibid*; Terr and others (n 25) 471–472; Burnett (n 77) 178; Park (n 154) 809.

concerned excluded from the process. The competent authorities are perceived to be a gatekeeper, prosecutor and judge simultaneously.<sup>158</sup> Related to the transparency issue is the concern about “package deals”, a situation where two competent authorities have several cases to be resolved at the same time and engage in horse-trading over these cases.<sup>159</sup> For taxpayers facing the prospect of a package deal, “there is always a fear of being a sacrificial lamb”.<sup>160</sup> Another related concern is that the use of the MAP in resolving the growing number of tax disputes may lead to inconsistent decisions, and thus compromise the value of legal certainty.<sup>161</sup>

Many also voice their concerns about the procedure’s accessibility. Pursuant to Article 25 (2) of the OECD Model Convention, the first competent authority can unilaterally determine the eligibility of MAP requests. It is concerned that competent authorities may exercise such discretion in an arbitrary manner.<sup>162</sup>

Those critics of the MAP do not necessarily deny the strength of the mechanism in its entirety. They acknowledge that the process may imply flexibility and goodwill.<sup>163</sup> It could be an economical option for taxpayers, as the direct costs of the procedure are largely shouldered by the competent authorities involved in the case.<sup>164</sup> Moreover, the competent authorities of many countries have long-established MAP experience.<sup>165</sup> Nevertheless, these strengths of the MAP are generally downplayed in the orthodox literature. It is contended that flexibility and goodwill are not uniformly observable across MAP practice. Burnett even asserts that political enmities

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<sup>158</sup> Kollmann and Turcan (n 58) 28; Burnett (n 77) 179.

<sup>159</sup> Burnett (n 77) 179.

<sup>160</sup> David R Tillinghast, ‘Issues in the Implementation of the Arbitration of Disputes Arising under Income Tax Treaties’ (2002) 56 *Bulletin for International Fiscal Documentation* 90, 91; Burnett (n 77) 179.

<sup>161</sup> Kollmann and Turcan (n 58) 37; Terr and others (n 25) 473–475.

<sup>162</sup> Kollmann and Turcan (n 58) 26–27.

<sup>163</sup> Burnett (n 77) 176.

<sup>164</sup> *ibid.*

<sup>165</sup> *ibid.*

independent of tax may creep into MAP negotiations.<sup>166</sup> As to the competent authorities' experiences or expertise in the MAP, it is simply "a standard argument in favour of the status quo in any debate about institutional change".<sup>167</sup>

## **2.2.2 Defense of the MAP**

Despite the overwhelming criticisms of the MAP, the mechanism has its proponents, which, though, are in the absolute minority. Several representative comments in defence of the MAP deserve special attention.

### **2.2.2.1 1975 study by Madere**

Madere's study examines the commonly expressed concerns about the MAP at that time, including the lack of guiding rules regarding the access to the MAP and the length and inefficiency of the procedure.<sup>168</sup> The author then argues that, based on the US-Canada MAP experience, many of these concerns are only imaginary.<sup>169</sup> Specifically, as to the issue of accessibility, the actual policy of the then US competent authority was to accept every case in which the taxpayer had exercised due diligence.<sup>170</sup> The US-Canada MAP experience also showed that most MAP cases up to that time had been resolved successfully.<sup>171</sup> These successes could be attributed to several factors, including the cooperative spirit in which negotiations were conducted, the sufficient authority granted to the competent authorities, and the tendency of the negotiators to work out consistent rules as guidelines for future negotiations.<sup>172</sup> In Madere's view, the real shortcoming of the MAP is its

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<sup>166</sup> *ibid* 180.

<sup>167</sup> *ibid* 176.

<sup>168</sup> Madere (n 148) 130–131.

<sup>169</sup> *ibid*.

<sup>170</sup> *ibid* 130.

<sup>171</sup> *ibid*.

<sup>172</sup> *ibid* 131; see also Altman (n 29) 77.

bilateral nature and limited scope.<sup>173</sup>

The deficiency of Madere's study is obvious: it is solely based on the limited example of the US-Canada treaty practice.

#### 2.2.2.2 2008 study by Farah

Farah's article argues that the MAP has obtained positive results despite no duty to negotiate or settle.<sup>174</sup> Interestingly, it attributes the success of the MAP to the consensual and voluntary character of the procedure. States favour MAP, argues Farah, this is why competent authorities generally take a positive attitude toward taxpayers' MAP requests.<sup>175</sup> Like Madere, Farah's appraisal of the MAP is also based on the US-Canada experience. Farah's study, which also discusses the shortcomings of tax arbitration, will be revisited below (Section 2.3.2.2).

#### 2.2.2.3 2015 study by Brown

Brown was the first researcher to conduct an in-depth analysis of the OECD MAP statistics. The study shows an increasing use of the MAP, and reveals that the average completion time for MAP cases has remained at approximately two years, which is consistent with the time frame recommended in the MEMAP.<sup>176</sup> The author further reviews the statistical reports for individual countries, confirming that a relatively large number of cases were resolved within about two years, and that numerous countries had very good record of MAP practices in certain years.<sup>177</sup> Therefore, argues the author, the MAP can, and in many cases does, work well.<sup>178</sup> This

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<sup>173</sup> Madere (n 148) 130; Altman (n 29) 76.

<sup>174</sup> Ehab Farah, 'Mandatory Arbitration of International Tax Disputes: A Solution in Search of a Problem' (2008) 9 Fla. Tax Rev. 1, 24.

<sup>175</sup> *ibid.*

<sup>176</sup> Brown (n 11) 90–91.

<sup>177</sup> *ibid.* 91–97.

<sup>178</sup> *ibid.* 97; see also Jasmin Kollmann and others, 'Arbitration in International Tax Matters' (2015) 77 Tax Notes Int'l 1189, 1190.

challenges the common perception that the MAP is fundamentally broken.<sup>179</sup> That being said, Brown does admit that many MAPs have taken too much time to resolve or have simply languished.<sup>180</sup> Therefore, she does not oppose the adoption of tax arbitration, but insists that the arbitral procedure should be designed in a way that can supplement and enhance the MAP.<sup>181</sup>

## **2.3 Literature on tax arbitration**

### **2.3.1 Arguments for tax arbitration**

In the orthodox literature, tax arbitration is contrasted with the MAP and portrayed as a preferred means of resolving tax disputes. The procedure is said to provide assurance of finality, since an arbitral panel is bound to deliver a final decision.<sup>182</sup> The mandatory feature of the arbitration clause under the OECD Model Convention increases the autonomy of the arbitral procedure, since the submission of a case does not depend on a prior authorisation by the competent authorities.<sup>183</sup> Many believe that the simple inclusion of an arbitration clause in a tax treaty may affect the MAP process in a positive way: competent authorities may be pressured to take the MAP more seriously and expedite the process so as to avoid the “hassle” of arbitration.<sup>184</sup> Compared with the MAP, arbitral procedure also improves the status of the taxpayers concerned, which may present their positions to an arbitration board, or even attend arbitral hearings.<sup>185</sup> Moreover, inasmuch as the tax arbitrators make an objective assessment of the fact and law at issue, the procedure ensures a more reasoned and principled approach to the interpretation and application

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<sup>179</sup> Kollmann and others (n 178) 1190.

<sup>180</sup> Brown (n 11) 97.

<sup>181</sup> *ibid* 107–108.

<sup>182</sup> Burnett (n 77) 180; Altman (n 29) 335.

<sup>183</sup> Kollmann and Turcan (n 58) 38; Burnett (n 77) 180.

<sup>184</sup> Kollmann and Turcan (n 58) 37.

<sup>185</sup> *ibid* 37–38; Altman (n 29) 339–340; Burnett (n 77) 180.

of tax treaties.<sup>186</sup>

Commentators also go to great lengths to explore various aspects of the procedure, including, *inter alia*, the mandatory or optional nature of tax arbitration,<sup>187</sup> the composition and establishment of arbitral panels,<sup>188</sup> taxpayer participation,<sup>189</sup> the choice between final-offer and conventional arbitration modes,<sup>190</sup> the publication of arbitral awards,<sup>191</sup> the implementation and review of arbitral awards,<sup>192</sup> the choice between ad hoc and institutional arbitration,<sup>193</sup> and the relationship between tax arbitration and domestic laws.<sup>194</sup> Many of these issues will be revisited in later chapters, along with an assessment of relevant literature.

On the surface, two divergent tendencies can be identified in the literature on the rule design of tax arbitration. One tendency favours more revolutionary plans, such as stand-alone arbitration that is independent of the MAP, full taxpayer participation, full-fledged arbitral procedures featuring oral hearings, and the installation of an appellate mechanism.<sup>195</sup> Some even propose to establish an ITC,<sup>196</sup> or International Tax Organisation (ITO).<sup>197</sup> Others

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<sup>186</sup> Kollmann and Turcan (n 58) 37; Altman (n 29) 338–339.

<sup>187</sup> Park (n 154) 811–812; Ault (n 154) 144–145.

<sup>188</sup> Park (n 154) 813–816; Burnett (n 77) 183; Ault (n 154) 148–149.

<sup>189</sup> Katerina Perrou, *Taxpayer Participation in Tax Treaty Dispute Resolution* (IBFD 2014); Terr and others (n 25) 493–494; Burnett (n 77) 182.

<sup>190</sup> Raffaele Petruzzi, Petra Koch and Laura Turcan, 'Baseball Arbitration in Comparison to Other Types of Arbitration' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015); Ault (n 154) 149.

<sup>191</sup> John F Avery Jones, 'Arbitration and Publication of Decisions' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015); Terr and others (n 25) 491.

<sup>192</sup> Gaëtan Zeyen, 'When Taxation Meets Arbitration: Recent Initiatives to Introduce and Promote Arbitration in International and European Taxation' (2017) 45 *Intertax* 722, 728–729; J Scott Wilkie, 'Implementation of Arbitration Decisions in Domestic Law' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015); Park (n 154) 838–850; Ault (n 154) 147.

<sup>193</sup> Hugh J Ault and Alicja Majdanska, 'Arbitration and International Institutions' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015); Jeffrey Owens, Arno E Gildemeister and Laura Turcan, 'Proposal for a New Institutional Framework for Mandatory Dispute Resolution' (2016) 82 *Tax Notes International* 1001.

<sup>194</sup> Park (n 154) 851–854.

<sup>195</sup> For representative articles, see Perrou (n 189); Tatiana Falcao, 'Granting Juridical Autonomy to Article 25 (5) of the Tax Treaty Model' [2017] *British Tax Review* 453; Jeffrey Owens and others, 'What Can the Tax Community Learn from Dispute Resolution Procedures in Non-Tax Agreements' [2015] *Bulletin for International Taxation*.

<sup>196</sup> Philip Baker, 'Establishing a New International Framework' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015).

<sup>197</sup> Adrian John Sawyer, 'Is an International Tax Organisation an Appropriate Forum for Administering

suggest having tax disputes being resolved under the World Trade Organisation (WTO)<sup>198</sup>, or the fora of international investment disputes.<sup>199</sup> The major rationale for these ambitious proposals is the protection of taxpayer rights and the guarantee of legal certainty. By contrast, the other tendency reflects a more conservative approach that generally accepts the built-in manner of tax arbitration. However, for many commentators in this camp, their conservatism largely reflects a pragmatic consideration in light of sovereignty concerns. In this regard, Burnett's attitude is representative: "International tax arbitration even in a limited form is a good thing. Further, apart from being good or bad, the development of international tax arbitration may be inevitable, perhaps as a step on the way to another paradigm."<sup>200</sup> By "another paradigm", Burnett means a more legalistic mode of ITDR, such as the ITC.<sup>201</sup>

### **2.3.2 Critical reflections on tax arbitration**

In general, critical reflections on tax arbitration can be divided into two categories. The first criticizes the current mode of tax arbitration as being too conservative. These criticisms and the above-mentioned revolutionary approach are actually two sides of one coin. The second category raises concerns about the effectiveness of a legalistic approach in resolving tax disputes. The most commonly cited shortcoming of tax arbitration is related to sovereignty concerns.<sup>202</sup> The adoption of such a procedure "would represent an unacceptable surrender of fiscal sovereignty".<sup>203</sup> Another common concern is the procedural costs of the mechanism. Specifically, tax arbitration

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Binding Rulings and APAs?' (2004) 2 e-Journal of Taxation Research 8.

<sup>198</sup> Yariv Brauner, 'International Trade and Tax Agreements May Be Coordinated, but Not Reconciled' (2005) 25 Va. Tax Rev. 251.

<sup>199</sup> LJ de Heer and PRC Kraan, 'Legal Protection in International Tax Disputes: How Investment Protection Agreements Address Arbitration' (2012) 52 European taxation 3.

<sup>200</sup> Burnett (n 77) 182.

<sup>201</sup> *ibid.*

<sup>202</sup> Altman (n 29) 319; Kollmann and Turcan (n 58) 42–43; Farah (n 174) 7; OECD, 'Transfer Pricing and Multinational Enterprises: Three Taxation Issues' (OECD 1984) 39.

<sup>203</sup> OECD, 'Transfer Pricing and Multinational Enterprises: Three Taxation Issues' (n 202) 39.

involves arbitrators and probably legal counsel, who may incur substantial fees; there are also logistical expenses in administering the procedure.<sup>204</sup> In addition to these common concerns, the following commentators raise different criticisms about a legalistic approach to ITDR.

#### 2.3.2.1 1999 study by Green

Green's study begins with what seems a puzzling observation: while tax treaties and trade agreements share the same goal of facilitating international trade and investment, and they use analogous rules to achieve that goal, they employ radically different methods of dispute settlement.<sup>205</sup> Specifically, the trade regime, particularly the WTO system, employs a legalistic method of dispute resolution, whereas most tax treaties rely exclusively on negotiation for dispute settlement.<sup>206</sup> The author refutes the rhetoric that tax-policy conflicts are matters of sovereignty prerogatives and hence not subject to legalistic dispute resolution. The argument is that trade-policy disputes also have sovereignty implications.<sup>207</sup> How can sovereignty, contends Green, account for the radically different treatments of such conflicts under the two regimes?<sup>208</sup>

Instead, the author approaches the question from a functional perspective of dispute-settlement systems, drawing on the insights from international relations (IR) theory.<sup>209</sup> This theory views intergovernmental dispute-settlement systems not as a means for dictating outcomes, but as devices for facilitating international cooperation.<sup>210</sup> In short, explains Green, the international trade regime rests upon retaliatory strategies by states, and the function of a legalistic dispute-settlement system is to manage such

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<sup>204</sup> Kollmann and Turcan (n 58) 46–47; Altman (n 29) 326–327.

<sup>205</sup> Green (n 13) 80.

<sup>206</sup> *ibid* 81, 82–103.

<sup>207</sup> *ibid* 104.

<sup>208</sup> *ibid*.

<sup>209</sup> *ibid* 80.

<sup>210</sup> *ibid*.

retaliatory strategies and keep them from breaking down.<sup>211</sup> By contrast, retaliatory strategies are rarely used in international tax cooperation.<sup>212</sup> The adoption of retaliatory strategies in trade regimes and their implications for the trade-dispute settlement system will be further discussed later in this thesis.<sup>213</sup>

After examining the functional aspect, or benefit side, of dispute-settlement systems, Green goes on to evaluate the cost side of the equation. Such costs, writes Green, include not only the obvious costs of administering the systems, but more significantly, the damage to the stability of the cooperative regimes.<sup>214</sup> Specifically, legalistic dispute-settlement procedures are more confrontational, and thus more likely to “poison the atmosphere”.<sup>215</sup> They may elicit noncompliance and hence undermine the credibility of the systems.<sup>216</sup> There might be legitimacy concerns, as international dispute settlement typically involves adjudicators from third countries who might have little understanding of the particular situation of the disputing countries.<sup>217</sup> Another concern is the inflexibility of the legalistic method. Some seemingly discriminatory tax measures, writes Green, may serve legitimate purposes, such as constraining tax avoidances. Yet legalistic dispute settlement may regard such anti-avoidance measures as discriminatory policies that should be banned.<sup>218</sup>

To sum up Green’s argument, while legalistic dispute settlement methods imply costs for both trade and tax regimes, they provide fewer benefits to international tax regimes than to trade regimes. Therefore, Green concludes, the trade-dispute settlement system is not an ideal model for resolving tax

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<sup>211</sup> *ibid* 109–110.

<sup>212</sup> *ibid* 118–119.

<sup>213</sup> See below, Chapter 3, Section 3.1.3; Chapter 4, Section 3.1.2.

<sup>214</sup> Green (n 13) 130.

<sup>215</sup> *ibid*.

<sup>216</sup> *ibid* 131.

<sup>217</sup> *ibid* 133–134.

<sup>218</sup> *ibid* 134.

disputes.<sup>219</sup>

To this author's knowledge, Green's article is the first study in the field of ITDR that adopts an interdisciplinary approach.<sup>220</sup> The cost-benefit framework in the article is also informative, providing much inspiration for this thesis. In particular, Green highlights the role of a dispute-settlement system in facilitating international cooperation as a whole, whereas the traditional literature on dispute resolution has a narrow focus on the procedural costs of the system itself.

Despite Green's insights, a substantial flaw of the study is that it mainly concerns policy-level conflicts.<sup>221</sup> Green also admits that for transfer-pricing disputes and other fact-specific cases, legalistic methods may be helpful.<sup>222</sup> However, most double-taxation disputes are case-specific, arising from divergent interpretations of treaty provisions or legal facts. It is very doubtful that the retaliation theory can provide any sound basis for the analysis of such case-level conflicts.

However, Green does raise an intriguing aspect: at policy level, the use of retaliatory strategy is extremely rare in international tax regimes. Indeed, as many others observe, not only retaliation, but even the initial breach of treaty obligation with respect to the prevention of double taxation is very unusual among states.<sup>223</sup> To the contrary, tax conflicts at the policy level are more likely to concern the issue of under-taxation or tax competition: states use tax cuts, tax breaks, tax loopholes, or tax subsidies to compete for

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<sup>219</sup> *ibid* 139.

<sup>220</sup> See also Altman (n 29) 81.

<sup>221</sup> See *ibid* 379.

<sup>222</sup> Green (n 13) 102.

<sup>223</sup> Arthur J Cockfield, 'The Limits of the International Tax Regime as a Commitment Projector' (2013) 33 *Va. Tax Rev.* 59, 83 ("observers generally assert that the system has worked and that government commitments regarding overtaxation are reasonably reliable."); see also Thomas Rixen, 'From Double Tax Avoidance to Tax Competition: Explaining the Institutional Trajectory of International Tax Governance' (2011) 18 *Review of International Political Economy* 197.

investments.<sup>224</sup> Later in this thesis this author will argue that this particular feature of the tax regime does have far-reaching effects on the dynamics of ITDR.<sup>225</sup>

Another deficiency of Green's study is that its cost analysis is not really about the costs of the system. For instance, the risk of "poisoning the atmosphere" actually concerns the effect of legalistic dispute resolution on the investor-government relationship. In the cost-benefit analysis conducted in this thesis, all the potential impacts of a dispute-settlement system upon the entire international cooperation, positive or negative, will be categorised as the benefit side of the system. The cost side of the equation will be confined to the expenses and burdens associated with the establishment and operation of the system itself.

#### 2.3.2.2 2008 study by Farah

Farah questions the effectiveness of mandatory tax arbitration.<sup>226</sup> The author reasons that, given the built-in manner of tax arbitration and the diplomatic nature of the MAP, a competent authority that does not want a certain tax dispute to be arbitrated may block the arbitration by denying the access to the MAP in the first place.<sup>227</sup>

Farah's another concern about tax arbitration is related to the issue of under-taxation or double non-taxation.<sup>228</sup> The argument is that an arbitration panel will base its case decision primarily on the wording of relevant tax treaties.<sup>229</sup> Consequently, "in the same manner that taxpayers utilize the

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<sup>224</sup> Vanessa Houlder, 'OECD Countries in Bout of Corporate Tax Competition' (*Financial Times*, 13 September 2017) <<https://www.ft.com/content/8b4ed20c-9866-11e7-a652-cde3f882dd7b>> accessed 11 May 2019; Thomas Rixen, 'Tax Competition and Inequality: The Case for Global Tax Governance' (2011) 17 *Global governance* 447.

<sup>225</sup> See below, Chapter 3, Section 3.1.3; Chapter 4, Section 3.1.1.1.

<sup>226</sup> Farah (n 174) 6–8.

<sup>227</sup> *ibid* 26–28.

<sup>228</sup> *ibid* 30–31.

<sup>229</sup> *ibid*.

ITTs [international tax treaties] to achieve double non-taxation they will be able to utilize the mandatory and binding arbitration to enforce double non-taxation”.<sup>230</sup>

Based on these reasoning, Farah concludes that the current mechanism of mandatory tax arbitration will not be able to serve the two primary goals of tax treaties: preventing both double taxation and double non-taxation.<sup>231</sup>

In Section 5.3 of Chapter 4, this author will demonstrate that Farah’s worry about the procedural obstruction by competent authorities in respect of MAP access is overstated. Farah’s second concern, the issue of double non-taxation, corresponds to Green’s notion that legalistic dispute resolution may lack flexibility in interpretation and application of anti-avoidance rules. The issue also concerns this author, and will be elaborated on in Section 3.4.2.3 of Chapter 3.

## **2.4 Literature on tax mediation**

Compared with the MAP and tax arbitration, the literature on international tax mediation is relatively meagre, albeit with a slight increase more recently.<sup>232</sup> In general, commentators value this mechanism highly. On the one hand, the procedure is helpful in facilitating MAP negotiations.<sup>233</sup> On the other hand, its non-binding nature mitigates countries’ concerns about the loss of sovereignty, as in the case of tax arbitration.<sup>234</sup> Some commentators have cited the experience of domestic tax mediation, concluding that the procedure in many countries not only expedites the dispute settlement, but also

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<sup>230</sup> *ibid* 31.

<sup>231</sup> *ibid* 37–39.

<sup>232</sup> For representative studies on the theme, see Dalton (n 140); Peter Nias, ‘International Tax Dispute Resolution: Breaking the Impasse’ (2016) 27 *Int’l Tax Rev.* 2; Diana van Hout, ‘Is Mediation the Panacea to the Profusion of Tax Disputes?’ (2018) 10 *World Tax Journal: WTJ* 43; Kollmann and Turcan (n 58) 67–68.

<sup>233</sup> Nias (n 232).

<sup>234</sup> *ibid*.

enhances the mutual trust between taxpayers and tax administrations.<sup>235</sup>

Some have noticed the fact that mediation has been overlooked in the international tax context. Nias writes that in a 2015 OECD meeting on the Action 14 draft recommendations, a senior OECD official suggested that mediation had no place in ITDR, as evidenced by the fact that it had attracted little, if any, use.<sup>236</sup> Nias counters this, writing, “If you do not know what mediation is, do not know how it can benefit you and do not know where to turn to for the assistance, the opportunities (and benefits) are likely to pass you by.”<sup>237</sup> Dalton, an editor of *International Tax Review*, provides some interesting perspectives based on his interviews with several leading experts on tax mediation, including Nias.<sup>238</sup> First, countries may find it difficult to concede tax matters to a foreign mediator due to sovereignty concerns.<sup>239</sup> This point is, in this author’s view, a bit weak, considering the non-binding character of mediation. Second, it may be difficult for countries, particularly small ones, to reach out to the pools of international tax mediators.<sup>240</sup> Third, it is suggested that the nature of the competent-authority relationship may restrict the efficacy of tax mediation.<sup>241</sup> Specifically, explains an expert interviewed by Dalton, competent authorities handling MAP cases are not necessarily operating from an individual case perspective, “but often from a much broader perspective about the whole relationship between country A and country B”.<sup>242</sup> The competent authorities come together to achieve resolution “in the knowledge that what they give way on for one issue, they are likely to claw back on another issue”.<sup>243</sup> From this broader perspective, having a mediator for one case may miss the overall balance of relevant

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<sup>235</sup> Kollmann and Turcan (n 58) 67.

<sup>236</sup> Nias (n 232) 2–3.

<sup>237</sup> *ibid* 3.

<sup>238</sup> Dalton (n 140).

<sup>239</sup> *ibid* 16.

<sup>240</sup> *ibid*.

<sup>241</sup> *ibid*.

<sup>242</sup> *ibid*.

<sup>243</sup> *ibid*.

interests.<sup>244</sup>

## 2.5 Holistic approaches

Both legalistic and antilegalistic approaches have a binary feature, with the balance tilted either to arbitration (or adjudication) or to the MAP (and sometimes mediation). In contrast, a few other commentators try a more balanced and holistic approach to the study of ITDR. Below are several representative studies.

### 2.5.1 2005 study by Altman

In this heavily referenced monograph, Altman makes an extensive and in-depth evaluation of the ITDR system, drawing, like Green, on the IR theory as well as political science.<sup>245</sup> Altman also conducts a cost-benefit analysis respectively for both the MAP and tax arbitration, concluding that both mechanisms have their pros and cons.<sup>246</sup> He therefore proposes a multi-pronged, somewhat complicated structure featuring a new ITO.<sup>247</sup> To put it simply, the new structure will retain the MAP as the starting point of ITDR.<sup>248</sup> This is because the MAP provides taxpayers and tax administrations with benefits which are not easily replicated by legalistic methods, i.e., “a pleasant, informal, flexible, forward-looking process based on the good will of the parties”.<sup>249</sup> If the MAP fails, the matter will proceed to the ITO, with factual issues arbitrated by a panel of experts and legal issues adjudicated by a permanent International Tax Tribunal (ITT) under the ITO.<sup>250</sup> No matter whether the dispute is settled through the MAP, arbitration or adjudication, the ITO will refer the final agreement or decision to the relevant

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<sup>244</sup> *ibid.*

<sup>245</sup> Altman (n 29) 6.

<sup>246</sup> *ibid* 243–350.

<sup>247</sup> *ibid* 393–396.

<sup>248</sup> *ibid* 394.

<sup>249</sup> *ibid* 393.

<sup>250</sup> *ibid* 394.

national courts for implementation.<sup>251</sup> The domestic court can decline to enforce an ITO opinion, yet must explain the reasons for its noncompliance.<sup>252</sup> Altman further proposes ways to improve the MAP and tax arbitration, involving issues of procedural timelines, taxpayer participation, confidentiality, appointment of arbitrators, etc.<sup>253</sup>

The proposed ITO and its interaction with domestic courts were inspired by the institutional arrangement of the Court of Justice of the European Union (CJEU).<sup>254</sup> Under the CJEU system, national courts refer questions of EU law to the CJEU for authoritative interpretation, and it is ultimately for the national courts to apply the resulting interpretation to given cases.<sup>255</sup> The intervention of the ITO, according to Altman, increases the level to which states comply with ITDR processes.<sup>256</sup> Meanwhile, the fact that domestic courts possess the ultimate authority of implementing ITO opinions accommodates the states' sovereignty interests.<sup>257</sup> The role of trans-national institutions in balancing the tension between international cooperation, on the one hand, and sovereignty concerns, on the other, is at the core of Liberal Institutionalism, a major school of IR theory. Altman went to great lengths to discuss the Liberal Institutionalism theory and its implications for ITDR.<sup>258</sup>

This author doubts the necessity of having an international organisation referring ITDR agreements or decisions to domestic courts for enforcement. As will be argued later, implementation of MAP agreements or tax-arbitration decisions can be well-regulated under the current legal framework.<sup>259</sup> This author does acknowledge that the ITO or other ITDR institutions can help

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<sup>251</sup> *ibid* 394–395.

<sup>252</sup> *ibid* 395.

<sup>253</sup> *ibid* 417–431.

<sup>254</sup> *ibid* 367–368.

<sup>255</sup> *ibid*.

<sup>256</sup> *ibid* 454.

<sup>257</sup> *ibid*.

<sup>258</sup> *ibid* 215–241.

<sup>259</sup> See below, Chapter 3, Section 5.3.

streamline and strengthen ITDR procedures. However, such operational benefits carry very limited weight in Altman's vision of the ITO. This could be attributed to the fact that Liberal Institutionalism primarily concerns the "big picture" of ITDR, such as the issues of international cooperation and sovereignty concerns.

Altman's insistence on having a permanent body of judges in an ITT to decide legal questions reflects his emphasis on the rule-making function of the ITDR system. "Such a body is the most capable of generating the *lex tributum* so desperately needed for the efficient administration of tax treaties."<sup>260</sup> By "*lex tributum*", Altman means an international law of taxes. This body of law, argues Altman, will provide the disputing parties with a common legal framework, help the expectations of the parties to converge even before any dispute materialises, and provide guidance for tax administrations in their deliberations on tax cases.<sup>261</sup> In later chapters, this author will argue: (a) *lex tributum* plays a rather limited role in the current international tax regime; and (b) an antilegalistic mode of dispute settlement can also perform the rule-making function, albeit partially.<sup>262</sup>

### **2.5.2 2012 study by Terr et al.**

Terr et al.'s study was largely spurred by the observation that there was a proliferation of tax disputes and the current system of ITDR was under significant strain.<sup>263</sup> In particular, after examining the OECD MAP statistics, the authors warn that, absent a fundamental transformation of the status quo, the "fiscal Armageddon" will be approaching.<sup>264</sup> Instead of favouring any particular ITDR mechanism, the authors stress the following parameters

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<sup>260</sup> Altman (n 29) 432.

<sup>261</sup> *ibid* 435–436.

<sup>262</sup> See below, Chapter 8, Section 3.2.

<sup>263</sup> Terr and others (n 25) 437.

<sup>264</sup> *ibid*.

against which the entire ITDR system can be assessed:

- (1) Publication of ITDR resolutions;
- (2) Adaptability of ITDR procedures to multilateral tax disputes;
- (3) Applicability of the procedures to non-treaty countries;
- (4) Sufficiency of taxpayer participation in the procedures; and
- (5) Adequacy of governmental resources invested in the system.<sup>265</sup>

The authors then make a detailed evaluation of the major ITDR mechanisms, including the Advance Pricing Agreement (APA), the MAP, and tax arbitration, against these five parameters. The analysis reveals that all three mechanisms have deficiencies. The author therefore concludes that the current ITDR system needs fundamental changes in light of the above parameters.<sup>266</sup>

The article does not provide any theoretical ground for the five parameters. It is therefore unclear why and how these five aspects play such an overarching role in the entire ITDR system, and whether they are conclusive. This author also doubts the viability of a uniform standard for different ITDR mechanisms. For instance, it is sensible to infer that both the publishing of ITDR resolutions and taxpayer participation may vary in their characteristics and significance from one ITDR mechanism to another.

Terr et al.'s study also covers the APA, which refers to a binding written agreement between taxpayers and the relevant tax administrations.<sup>267</sup> In a bilateral APA, both countries agree in advance that the pricing policy adopted by an MNE with respect to its intra-company transactions are in accordance

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<sup>265</sup> *ibid* 438–441.

<sup>266</sup> *ibid* 495–496.

<sup>267</sup> Oats, Miller and Mulligan (n 124) 472–473.

with the arm's-length principle.<sup>268</sup> The APA is essentially a dispute-prevention mechanism, and thus will not be elaborated on in this thesis except where its direct relation to ITDR is concerned.

### **2.5.3 2016 proposal by Owens et al.**

Owen et al.'s article proposes a new dispute-settlement framework that is intended as an alternative to Article 25 of the UN Model.<sup>269</sup> The research was part of a three-year project, "International Tax Disputes: Improving MAP and Mandatory Dispute Settlement", which brings together contributions from leading academics, private-sector experts, practitioners, and policymakers.<sup>270</sup>

Similar to Altman's research, the framework proposed by Owens et al. also features a multi-pronged approach that considers the MAP as its first step.<sup>271</sup> If the case cannot be resolved within 20 months from the starting date of the MAP, the competent authorities should, unless they otherwise agree, submit the issues to an ADR panel, which will provide a non-binding means of dispute settlement, including mediation, conciliation, or expert evaluation, to the competent authorities.<sup>272</sup>

If the ADR procedure failed to resolve the entire case within the allotted time, or if the competent authorities did not agree to use the ADR in the first place, the unresolved issues would be referred to arbitration.<sup>273</sup> After the arbitral panel released its final decision, the two competent authorities would have six months to agree on a different solution before being bound by the decision.<sup>274</sup> Both the ADR and arbitration procedure would be administered by a self-standing ITDR body under the auspices of the UN or other competent

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<sup>268</sup> *ibid.*

<sup>269</sup> Owens, Gildemeister and Turcan (n 193) 1001.

<sup>270</sup> *ibid.*

<sup>271</sup> *ibid* 1003.

<sup>272</sup> *ibid* 1003–1004.

<sup>273</sup> *ibid* 1003.

<sup>274</sup> *ibid.*

organisations. This body would maintain a list of independent experts from which the arbitrators could be drawn.<sup>275</sup> It would also provide training programs for developing countries.<sup>276</sup>

The article is basically a policy proposal intended as a basis for further discussion on the establishment of a new ITDR framework.<sup>277</sup> It does not provide any theoretical underpinning for the proposed framework. Given that the proposal is built on contributions from not just academics but also practitioners and policymakers, it is reasonable to infer that it largely represents a compromise approach that accommodates sovereignty concerns.

#### **2.5.4 2016 study by Carolis**

Carolis's study was inspired by Altman, who draws on the theory of Liberal Institutionalism in arguing for the establishment of an ITO.<sup>278</sup> However, Carolis further develops Altman's approach in that he extends Liberal Institutionalism to the entire ITDR topic in proposing a new approach to the ITDRP.<sup>279</sup>

Liberal Institutionalism, writes Carolis, aims to explain how international cooperation through certain regimes (such as trade, investment, or tax) is possible in an anarchic world.<sup>280</sup> According to the theory, continues Carolis, international regimes allow states to maximise their self-interests more efficiently.<sup>281</sup> Carolis enumerates the advantages of an international regime as follows:

- (1) Reducing negotiation costs through institutionalising cooperation and

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<sup>275</sup> *ibid* 1006,1011.

<sup>276</sup> *ibid* 1007.

<sup>277</sup> *ibid* 1001.

<sup>278</sup> Carolis (n 9) 392.

<sup>279</sup> *ibid*.

<sup>280</sup> *ibid*.

<sup>281</sup> *ibid*.

thereby decreasing the costs of future agreements;

(2) Detecting and exposing non-compliant members and increasing reputational costs for such free-riding states; and

(3) Developing best practices related to the implementation of the regime.<sup>282</sup>

Carolis demonstrates that this interdisciplinary approach has both analytical and comparative strengths.<sup>283</sup> In terms of analytical strengths, the author argues that the approach illuminates several aspects of ITDR that are not immediately evident from a legal analysis alone.<sup>284</sup> He uses as an example the role of OECD (as well as UN) Model Convention in the tax regime.<sup>285</sup> While traditional lawyers may doubt the viability of the Model Convention for its non-binding nature, from the perspective of Liberal Institutionalism, the Model Convention represents a reasonable balance between the high sovereignty and negotiation costs a traditional multilateral treaty would entail, on the one hand, and the need to ensure a coordinated approach to international tax rules on the other.<sup>286</sup> By laying down a common basis for future tax agreements, the Model Convention reduces the costs of treaty negotiations.<sup>287</sup>

With respect to the comparative strengths of his interdisciplinary approach, Carolis develops a common cost-benefit framework for comparative studies of ITDR. This attempt, declares the author, is partly motivated by the observation that most research on ITDR seeks to compare the ITDR system with the dispute-settlement systems of other domains, such as the International Centre for Settlement of Investment Disputes (ICSID), the WTO

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<sup>282</sup> *ibid* 392–393.

<sup>283</sup> *ibid* 391.

<sup>284</sup> *ibid* 393.

<sup>285</sup> *ibid* 393–394.

<sup>286</sup> *ibid*.

<sup>287</sup> *ibid*.

and the North American Free Trade Agreement (“NAFTA”), on a purely legal basis.<sup>288</sup> The author contends the soundness of such legally oriented comparisons, as different dispute-settlement systems are, in a legal sense, extremely different, pertaining to different domains and using different terminologies.<sup>289</sup> In contrast, the comparative framework based on Liberal Institutionalism features considerable generality, which would allow an evaluation of various solutions in other domains and their utilities to ITDR.<sup>290</sup> Specifically, the cost side of the framework includes sovereignty costs, negotiation costs, and reputation damages; while the benefit side mainly refers to the capacity of certain dispute settlement systems to satisfy the “interests and objectives underlying ITDRs”.<sup>291</sup> Carolis further explains the interests and objectives underlying ITDRs: while the main objective is the elimination of double taxation, there are other underlying, and often conflicting, interests of tax authorities and taxpayers.<sup>292</sup> Specifically, tax authorities may prefer to safeguard the national tax base and their control over tax policies and dispute-settlement processes, whereas taxpayers may favour eliminating double taxation and preserving the hard law systems securing predictability, certainty, and full protection of their rights.<sup>293</sup>

Carolis further put forward five key dimensions of dispute-settlement systems, along which the above cost-benefit analysis and comparison can proceed.<sup>294</sup> These dimensions, which Carolis terms “international relations variables as comparability factors”, include private parties’ access to dispute-settlement procedures, the selection and composition of deciding bodies, the decision-making methods, the transparency/confidentiality of the procedures,

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<sup>288</sup> *ibid* 396.

<sup>289</sup> *ibid*.

<sup>290</sup> Altman (n 29) 398.

<sup>291</sup> *ibid*.

<sup>292</sup> Carolis (n 9) 398–399.

<sup>293</sup> *ibid* 398–400.

<sup>294</sup> *ibid* 398.

and the level of enforcement of the decisions.<sup>295</sup>

The five comparability factors are informative in that they are neutral to the legal forms of various dispute-settlement systems, and hence acquire a universal applicability. However, the content of the cost-benefit framework is somewhat perplexing. First, while the cost side of the framework seems to be solely related to sovereign states, the benefit side involves the different and often conflicting interests of both tax authorities and taxpayers. This raises the question of how the framework can be applied in a coherent, consistent, and refutable manner. Comparatively, the cost-benefit framework in Altman's study seems more orderly in that each of the ITDR mechanisms (the MAP and tax arbitration) is assessed twice, one from the perspective of tax authorities and the other from that of taxpayers, although Altman's approach still leaves questions as to how to reconcile these different perspectives, and which perspective governs in case of contradiction. Second, it seems the sovereignty damage on the cost side and the tax authority's preference on the benefit side are overlapping. Another – and subtler – problem concerns the sovereignty cost itself. The major purpose of IR theory is to explain how sovereign states are willing to relinquish part of their sovereignty by entering international regimes. Placing sovereignty cost into this explanatory framework again seems to be a tautology. Sovereignty cost also plays a critical role in Altman's analytical framework.

In contrast, Green carefully avoids these issues in his cost-benefit analysis of ITDR. First, Green excludes the sovereignty element in the first place. Second, his analysis focuses on the costs and benefits of the entire system rather than on the perspective of any particular participant in the system. This is congruent with the economic approach to cost-benefit analysis.<sup>296</sup> That

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<sup>295</sup> *ibid.*

<sup>296</sup> See below, Chapter 3, Section 4.1.

being said, as examined above (Section 2.3.2.1), Green's framework has its own problems.

## **2.6 Comments on the literature**

Carolis claims that the existing literature of ITDR is laying a substantial foundation for a new discipline: the ITDRP.<sup>297</sup> While this author also takes an optimistic view about the development of the ITDRP, the concern is that the foundation of the ITDRP is still very delicate. In particular, two major gaps in the past studies on the topic can be identified.

### **2.6.1 Excessive focus on legalistic method**

Given that the current system of ITDR is predominated by the MAP, which does have deficiencies, the preference for a legalistic dispute-settlement method is justified for its own sake. Nonetheless, the literature of ITDR is characterised by an excessive preoccupation with this legalistic approach. Accordingly, there is a paucity of scholarship devoted to the MAP and other non-binding methods.<sup>298</sup> This situation has not changed even after the release of the MEMAP, which recommends a variety of measures to strengthen the MAP. Some doubt the effectiveness of the MEMAP, arguing that while it may go some way towards fixing the shortcomings of the MAP, many of those shortcomings are inherent in the MAP's nature.<sup>299</sup> Indeed, many tend to believe that the MAP is fundamentally broken and needs to be replaced.

However, the reality is that the MAP has been playing, and will continue to play, a pivotal role in resolving tax disputes. This trend has been further reinforced by the OECD's failure to promote a universal adoption of tax

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<sup>297</sup> Carolis (n 9) 391.

<sup>298</sup> Altman (n 29) 94.

<sup>299</sup> Burnett (n 77) 180.

arbitration among countries.<sup>300</sup> Therefore, a caveat is that an excessive focus on a legalistic approach may miss the opportunity of cross-fertilisation between ITDR practice and scholarship.

One might contend that the predominance of the MAP merely reflects states' sovereignty concerns, which may gradually fade away along with the process of economic globalisation. However, sovereignty can hardly account for the recent amendment to the tie-break rule, which uses the MAP in the first instance to decide the substantive matters regarding dual residency of corporate taxpayers. Nor can sovereignty explain the dormancy of international tax mediation, which is ordinarily regarded as less threatening to sovereignty interests. Additionally, at least the early history of ITDR during the time of the League of Nations showed that sovereignty played a trivial role in the policy debate on the choice between binding and non-binding dispute-settlement methods.<sup>301</sup> Lastly, as will be discussed later, the sovereignty argument itself is subject to a variety of challenges.

One might again argue that the mere adoption of arbitration clauses could enhance the speed and effectiveness of the MAP, hence MAP practice actually benefits from the scholarship of tax arbitration. Yet this proposition is largely premised on the assumption that the failure or protraction of the MAP solely results from bureaucracy or strategic behaviours on the part of competent authorities. Incapacity of countries or *bona fide* disagreements between competent authorities in MAP negotiations can hardly be addressed merely by the prospect of tax arbitration. Indeed, tax arbitration may pose severer capacity challenge to many developing countries.<sup>302</sup>

In this connection, the antilegalistic arguments exemplified in the studies examined above are informative. Nevertheless, scholars favouring this

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<sup>300</sup> See above, this chapter, Section 1.7.1.

<sup>301</sup> See above, this chapter, Section 1.2.

<sup>302</sup> See below, Chapter 5, Section 4.6.

approach are in the minority, and more efforts need to be built along this line.

### 2.6.2 Insufficiency of theoretical approaches

In addition to its legalistic character, another prominent feature of the existing literature of ITDR is its “physical” approach: studies in this arena overwhelmingly focus on concrete rules of ITDR, whereas the theoretical foundation, or the “metaphysical” aspect of the system, has largely been neglected. Arguably, Carolis’s observation that students of ITDR tend to compare it with dispute-settlement systems in trade and investment regimes reflects the very fact that ITDR lacks its own self-sufficient theoretical foundation. Meanwhile, the paucity of theoretical reflection and the plethora of the comparative approach reinforce the legalistic tendency in the ITDR literature, since both trade and investment regimes feature legalistic dispute-resolution systems, in which negotiation or consultation plays only a very limited role.<sup>303</sup>

If Carolis is correct in declaring that a new discipline, i.e. the ITDRP, is emerging, then a theoretical approach to the discipline is a must, as it is common sense that a discipline without a theoretical basis would be like a house built on sand.<sup>304</sup> As Coase writes in criticising the writers of old institutional economics, “they were anti-theoretical, and without a theory to bind together their collection of facts, they had very little that they were able to pass on”.<sup>305</sup> Also noteworthy is that theorists working on the topic of general conflict settlement,<sup>306</sup> dispute resolution in other domains,<sup>307</sup> and the topic of

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<sup>303</sup> See below, Chapter 4, Section 2.3.

<sup>304</sup> Cai and Zhang (n 12) 884.

<sup>305</sup> Ronald Harry Coase, ‘The New Institutional Economics’ (1998) 88 *The American Economic Review* 72, 72.

<sup>306</sup> For representative works in this regard, see Roy J Lewicki, Stephen E Weiss and David Lewin, ‘Models of Conflict, Negotiation and Third Party Intervention: A Review and Synthesis’ (1992) 13 *Journal of organizational behavior* 209; Carrie Menkel-Meadow, ‘From Legal Disputes to Conflict Resolution and Human Problem Solving: Legal Dispute Resolution in a Multidisciplinary Context’ (2004) 54 *Journal of Legal Education* 7; Robert. Cooter, *Law and Economics* (Sixth edition., Pearson : Addison Wesley Longman 2012) 419–453.

<sup>307</sup> For representative works in this regard, see Andrew Guzman and Beth A Simmons, ‘To Settle or

international tax regime,<sup>308</sup> have all achieved robust theoretical constructions in their respective fields.

Given the significance and scarcity of the theoretical approach in ITDR, the attempts undertaken by Green, Altman, Carolis and a few others are illuminating. These efforts combine the study of ITDR with IR theory (mainly Liberal Institutionalism), and shed light on the “international” aspect of ITDR. Students in this area can therefore acquire a better understanding of the major drives for and obstacles to international cooperation on ITDR. Nonetheless, the subject of ITDR is multi-faceted, presenting not only an “international” aspect, but also “tax” and “dispute resolution” aspects. Consider those technical issues of dispute settlement, such as the choice between oral hearings and documentary methods, it is rather doubtful how IR theory can help. Indeed, Green’s inability to extend his arguments to case-level tax disputes reflects the very limitation of the IR-oriented approach. Another shortcoming of this approach is related to its cost-benefit framework. As was discussed above (Section 2.5.4), the treatment of the costs and benefits of the ITDR system by these authors is inconsistent and at times contradictory. Given the narrow scope of the IR-oriented approach, the question arises of whether it is possible to have a more general and comprehensive analytical framework for the study of ITDR.

## **2.7 Comments on the sovereignty argument**

It could be seen that the past studies of ITDR have been considerably shaped by the sovereignty argument: taxation is the lifeblood of fiscal sovereignty; therefore, countries want to take control of the resolution of tax disputes.

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Empanel? An Empirical Analysis of Litigation and Settlement at the World Trade Organization’ (2002) 31 *The Journal of Legal Studies* S205; Anne Van Aaken, ‘International Investment Law Between Commitment and Flexibility: A Contract Theory Analysis’ (2009) 12 *Journal of International Economic Law* 507.

<sup>308</sup> For representative works in this regard, see Ring (n 35); Rixen, ‘From Double Tax Avoidance to Tax Competition’ (n 223); Cockfield (n 223).

Intuitively, sovereignty concerns feel real and concrete, particularly for developing countries. Cruz observes that fiscal sovereignty has been widely used in South American countries as grounds against arbitration in international tax matters.<sup>309</sup> In a recent G20 meeting, Nirmala Sitaraman, India's Minister of Finance, also resorted to the sovereignty argument in denouncing the OECD's proposal – as part of BEPS Action 14 – of introducing mandatory and binding MAP arbitration in tax treaties.<sup>310</sup> She alleged that tax arbitration “not only impinges on the sovereign rights of developing countries in taxation, but will also limit the ability of the developing countries to apply their domestic laws for taxing non-residents and foreign companies”.<sup>311</sup>

### 2.7.1 Meaning of sovereignty

The meaning of sovereignty is multi-faceted, partly because the concept has been raised in a variety of contexts, and different disciplines approach the concept from different perspectives.<sup>312</sup> In its original sense, sovereignty is related to the principle of non-intervention, which was first formally established in the Treaty of Westphalia in 1648.<sup>313</sup> In the fiscal context, this Westphalian sovereignty mainly refers to a country's autonomy in deciding its own fiscal policies free from external intervention.<sup>314</sup> However, in reality, absolute sovereignty is at best an “organized hypocrisy”.<sup>315</sup> This is not just because history since the Westphalian era has been littered with incidences of intervention, but also because nations have long been willing to give up

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<sup>309</sup> Natalia Quiñones Cruz, 'International Tax Arbitration and the Sovereignty Objection: The South American Perspective' [2008] *Tax Notes International* 533, 533–534.

<sup>310</sup> Remya Nair, 'India Opposes Global Plan to Make Tax Arbitration Binding' (<https://www.livemint.com>, 23 September 2014)

<<https://www.livemint.com/Politics/rutMHggqQOm2htzcr19K7I/India-opposes-global-plan-to-make-tax-arbitration-binding.html>> accessed 20 May 2019.

<sup>311</sup> *ibid.*

<sup>312</sup> Peter Dietsch, 'Rethinking Sovereignty in International Fiscal Policy' (2011) 37 *Review of international studies* 2107, 2109.

<sup>313</sup> *ibid.*

<sup>314</sup> *ibid.*

<sup>315</sup> Stephen D Krasner, *Sovereignty: Organized Hypocrisy* (Princeton University Press 1999) 220.

part of their sovereignty when they see fit to do so.<sup>316</sup> This is evidenced in the proliferation of various international regimes such as the UN, EU, WTO, and ICSID, many of which feature a substantial curtailment of national sovereignty. Indeed, many countries that resist tax arbitration have agreed to subject other types of economic disputes to various supranational fora.<sup>317</sup>

Lee identifies two types of sovereignty: de jure and de facto. In short, de jure sovereignty is a matter of competence or right, whereas de facto sovereignty is a matter of actual ability.<sup>318</sup> The implication of this classification is that even if states manage to secure their de jure sovereignty, their de facto sovereignty is inevitably eroded by the force of globalisation.<sup>319</sup> This is particularly the case in the fiscal area, where increased capital mobility weakens an individual state's ability to exercise its domestic fiscal policy independently.<sup>320</sup> It follows that a certain level of fiscal cooperation among states may enhance, rather than undermine, national sovereignty interests.<sup>321</sup>

Therefore, the concept of sovereignty is rather amorphous. Both international cooperation and its breakdown can be explained by it. As a result, it is not unusual to see that in many issue areas, groups on all sides of a debate mobilise the concept for their own purposes to such an extent that some even regard sovereignty as an empty shell.<sup>322</sup> Arguments based on such an empty shell can hardly generate any consistent and refutable conclusion. The situation can be illustrated by an analogy with economics or sociology, both of which concern interactions among individuals. Certainly individuals' ability to choose between cooperation and defect is preconditioned on their capacity of

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<sup>316</sup> *ibid* 7–9; Julian Ku and John Yoo, 'Globalization and Sovereignty' (2013) 31 *Berkeley J. Int'l L.* 210, 228.

<sup>317</sup> Brown (n 11) 105.

<sup>318</sup> Steven Lee, 'A Puzzle of Sovereignty' (1997) 27 *Cal.W.Int'l L.J.* 241, 248.

<sup>319</sup> Dietsch (n 312) 2109.

<sup>320</sup> *ibid*.

<sup>321</sup> *ibid* 2108.

<sup>322</sup> Michael Waibel, Liz Kyo-Hwa Chung and Claire Balchin, 'The Backlash against Investment Arbitration: Perceptions and Reality' in Michael Waibel (ed), *The backlash against investment arbitration: perceptions and reality* (Kluwer Law International 2010) xvii.

self-determination, which can perhaps be called individual sovereignty. As Friedman notes, a fundamental condition for market exchange is that individuals are effectively free to enter or not to enter into any particular transaction.<sup>323</sup> Nevertheless, individual sovereignty itself is helpless in predicting how a person will choose its strategy on a particular occasion.

### **2.7.2 Instrumental perspective**

From a normative perspective, sovereignty has been increasingly viewed as an instrument with which to realise or advance more-fundamental values.<sup>324</sup> Sovereignty, scholars argue, is justified simply because according to the principle of subsidiarity, multitudes of sovereign states can serve the needs of global citizens better than can a supranational power.<sup>325</sup> Related to this instrumental view is the notion of “popular sovereignty”, which indicates that the ultimate source of a sovereignty power does not lie with a nation’s government, but with its people.<sup>326</sup> Therefore, in the modern world, it becomes increasingly difficult for a country to justify its noncompliance with treaty obligations merely by citing sovereignty. In contrast, where collaborative actions among countries on certain issues – such as the countermeasures against global climate change – are believed to be welfare-enhancing for citizens around the world, the instrumental perspective of sovereignty would require states to concede part of their prerogatives so as to facilitate international cooperation on the issues.

### **2.7.3 Summary**

The deficiencies of the sovereignty argument will be revisited repeatedly in the remaining chapters. Suffice it to conclude from the above critical review

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<sup>323</sup> Milton Friedman, *Capitalism and Freedom* (University of Chicago Press 1962) 14.

<sup>324</sup> Dietsch (n 312) 2114–2115.

<sup>325</sup> *ibid* 2114.

<sup>326</sup> Ku and Yoo (n 316) 233.

that in an era of accelerated globalisation, the notion of sovereignty has become increasingly irrelevant.<sup>327</sup> In this connection, a natural question would arise as to what really accounts in explaining the success or failure of international cooperation in certain issue areas. To put it differently, what did Ms. Sitaraman (India's Minister of Finance) really mean when she announced that tax arbitration impinges on national sovereignty? Simply to declare that taxation is of paramount importance is unhelpful, as many other types of international conflict also involve vital national interests. For example, international trade and investment conflicts usually involve issues like public order, health and morality, essential security interests, or even civil revolution, all of which can be more politically sensitive than tax disputes.<sup>328</sup> As was discussed above (Section 1.2), Altman attributes the antilegalistic shift in the League of Nations that was reflected in the 1933 draft convention to efficiency considerations rather than sovereignty concerns. This hints that economic insights can be useful in the ITDR research.

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<sup>327</sup> Sawyer (n 197) 26 ("sovereignty, as a result of the contemporary realities of global affairs has ... become irrelevant, and anachronistic notion"); Qiang Cai, 'Behind Sovereignty: Concerns About International Tax Arbitration and How They May Be Addressed' [2018] *British Tax Review* 441, 445.

<sup>328</sup> Green (n 13) 104; William W Burke - White and Andreas Von Staden, 'Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties' (2008) 48 *Virginia Journal of International Law* 307, 371.

## Chapter 2. Introduction to TC Theory

### 1. Cases for the marriage between ITDR and TC theory

#### 1.1 Overview

In Chapter 1, this author highlighted the significance of a theoretical approach in the ITDR research. The next question is, then, to decide which theory to choose. This thesis adopts a law-and-economic approach. In particular, it looks into TC theory, which is the bedrock of the New Institutional Economics (NIE).

#### 1.2 Law-and-economic tradition

Economic approaches to law are not new. Classic economists, such as Adam Smith, the founder of modern economics, and Karl Marx, all shed economic light on legal systems.<sup>329</sup> For example, Smith's *Wealth of Nations* spent three chapters on a discussion of the tax system of the Commonwealth, and another nine chapters on its system of political economy.<sup>330</sup> Since then, however, the marriage between law and economics has largely disintegrated, partly because economists after Smith increasingly focused on the price mechanism in the marketplace.<sup>331</sup> This disciplinary division persisted until the 1960s, when a new law-and-economic movement emerged.<sup>332</sup> The movement comprised numerous separate but related efforts of extending formal economic theory to explain the nature and effects of legal

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<sup>329</sup> Cento Veljanovski, *The Economics of Law* (Second edition., Institute of Economic Affairs 2006) 27.

<sup>330</sup> Adam Smith, *Wealth of Nations* (Electric Book Company 2000)

<<http://ebookcentral.proquest.com/lib/ed/detail.action?docID=3008435>> accessed 31 May 2019.

<sup>331</sup> Veljanovski (n 329) 28–29; Nicholas Mercurio and Steven G Medema, *Economics and the Law: From Posner to Post-Modernism* (Princeton University Press 1998) 102; Thrainn Eggertsson, *Economic Behavior and Institutions: Principles of Neoinstitutional Economics* (Cambridge University Press 1990) 4.

<sup>332</sup> Veljanovski (n 329) 30; Robert. Cooter (n 306) 1.

regulations.<sup>333</sup> Currently, the law-and-economic tradition has evolved as a substantial and important body of thought within both economics and law.<sup>334</sup>

In large part, the success of economics in penetrating non-market areas – this penetration is often termed as economic imperialism – can be attributed to the rigor, relevance, and generality of the theory.<sup>335</sup> Economics is built upon three fundamental and interrelated concepts: maximisation, equilibrium and efficiency.<sup>336</sup> Specifically, individuals (and firms) are assumed to engage in maximising rational behaviour under constraints.<sup>337</sup> An implication of the assumption is that there are always trade-offs at the margin.<sup>338</sup> Maximising behaviour tends to push these individuals toward a point of rest, known as equilibrium.<sup>339</sup> Economic activities are said to attain efficiency if resources cannot be reallocated so as to make one individual better off without making someone else worse off.<sup>340</sup> Based on these three building blocks, a well-defined and universal behavioural model can be derived to produce refutable predictions not only in the market context, but also in non-marketing settings. For instance, legal rules or sanctions resemble the price or other constraints; therefore, rational individuals respond to these rules or sanctions much as they respond to the price.<sup>341</sup> The prediction of the behavioural effects of certain rules or sanctions can further be tested by empirical evidence. Moreover, concepts like maximisation, margin, and equilibrium are particularly amenable to mathematical modelling, as they were originally borrowed from the disciplines of mathematics and physics.<sup>342</sup> As a result, economics has developed an abstract but rigorous language that allows

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<sup>333</sup> Veljanovski (n 329) 30.

<sup>334</sup> Mercurio and Medema (n 331) 4.

<sup>335</sup> Edward P Lazear, 'Economic Imperialism' (2000) 115 *The Quarterly Journal of Economics* 99, 99.

<sup>336</sup> Robert. Cooter (n 306) 12–14; Lazear (n 335) 100–103.

<sup>337</sup> Robert. Cooter (n 306) 13; Lazear (n 335) 100.

<sup>338</sup> Robert. Cooter (n 306) 13; Lazear (n 335) 101.

<sup>339</sup> Robert. Cooter (n 306) 13; Lazear (n 335) 101.

<sup>340</sup> Robert. Cooter (n 306) 13–14; Lazear (n 335) 101–102; Mercurio and Medema (n 331) 14.

<sup>341</sup> Robert. Cooter (n 306) 3.

<sup>342</sup> *ibid* 13,14-18.

economists to strip away complexity.<sup>343</sup> Many claim that economics is the premier social science.<sup>344</sup> In Chapter 1, this author has already argued that to some extent, the theoretical construction by Green, Altman, Carolis, and other researchers falls short of generality and consistency. In particular, IR-based theories focus narrowly on the international aspects of ITDR, and the cost-benefit framework needs to be clearly and consistently defined.<sup>345</sup>

### 1.3 NIE and TC theory

NIE started with Coase's seminal introduction of transaction cost into the economic analysis in *The Nature of the Firm* (1937).<sup>346</sup> It derived further strengths from a host of different but related contributions, including, *inter alia*, the property-rights theory led by Demsetz, Cheung, and others; the contractual theory by Cheung, Williamson, and others; the public-choice theory by Buchanan and Tullock; and transaction cost economics (TCE) by Williamson.<sup>347</sup>

#### 1.3.1 Main thrust of NIE

NIE largely emerged as a critique of the mainstream economics, also known as neoclassic economics. Neoclassic economics emphasises the role of relative prices in economic decision-making, considering institutions to play virtually no role at all.<sup>348</sup> The belief is that social welfare will be maximised by ensuring that production and allocation satisfy optimality conditions, regardless of the institutional environment.<sup>349</sup> Within this context, NIE delivers a revolutionary message: institutions matter for economic

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<sup>343</sup> Lazear (n 335) 99.

<sup>344</sup> *ibid*; see also Eggertsson (n 331) 4 ("in terms of both analytical power and empirical relevance, economics overshadows all other ... social sciences").

<sup>345</sup> See above. Chapter 1, Sections 2.5.4 and 2.6.2.

<sup>346</sup> Coase (n 305) 72.

<sup>347</sup> *ibid*; Mercurio and Medema (n 331) 130.

<sup>348</sup> Eirik G Furubotn and Rudolf Richter, *Institutions and Economic Theory: The Contribution of the New Institutional Economics* (University of Michigan Press 2010) 1.

<sup>349</sup> *ibid*.

performance.<sup>350</sup> Here “institution” means “the rules of the game in a society”, including not only formal legal instruments, such as the law and other governmental rules, but also informal mechanisms, such as customs and conventions.<sup>351</sup> NIE theorists maintain that (a) different sets of social rules and economic organisations affect behaviour and economic outcome; and (b) there is an economic logic underlying the variation of those social rules and economic organisations.<sup>352</sup>

That being said, NIE does not seek to abandon the core elements of the neoclassic tradition, which includes, *inter alia*, the three fundamental concepts of neoclassic economics discussed above (Section 1.2); the theoretical approach characterised by the rational-choice model and marginal analysis; and a strong individualist orientation.<sup>353</sup> Rather, new institutionalists extend neoclassic economics to cover a full range of institutions in diverse cultures and epochs.<sup>354</sup> This distinguishes NIE from the old institutional economics that emerged during the early 20th century and persists today. While the old institutional economists also emphasise the institutional elements of the economic life, they reject any theoretical and abstract approach.<sup>355</sup>

On the surface, NIE does make some changes to one of the three fundamentals of neoclassic economics: the assumption that individuals engage in rational maximisation. The first modification is that individuals only have bounded rationality.<sup>356</sup> It is contended that decision-makers are not omniscient, but have real difficulties understanding complicated issues.<sup>357</sup>

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<sup>350</sup> *ibid.*

<sup>351</sup> Mercuro and Medema (n 331) 131.

<sup>352</sup> Eggertsson (n 331) 4–5.

<sup>353</sup> *ibid.* 5.

<sup>354</sup> Richard A Posner, ‘The New Institutional Economics Meets Law and Economics’ [1993] *Journal of Institutional and Theoretical Economics* 73, 75.

<sup>355</sup> Furubotn and Richter (n 348) 2.

<sup>356</sup> *ibid.* 4.

<sup>357</sup> *ibid.*

Thus, human behaviour is “intendedly rational, but limitedly so”.<sup>358</sup> A major implication of this modified assumption is related to the notion of contractual incompleteness: given the bounded rationality, all complex contracts are unavoidably incomplete.<sup>359</sup> The second modification is that individuals are assumed to have a propensity not only toward maximisation but also toward perpetrating opportunistic behaviours.<sup>360</sup> Individuals are likely to be dishonest; they may disguise preferences, distort data, or deliberately confuse issues.<sup>361</sup> Assumption of human opportunism also has a bearing on contractual incompleteness. After all, if contractual parties are wholly trustworthy, even incomplete contracts can be relied on.<sup>362</sup> In contrast, given that human beings are “self-seeking with guile”, some safeguard mechanisms, or so-called governance structure, for the contract will be necessary to protect the contractual interests from opportunistic exploitation by the parties.<sup>363</sup>

That being said, these two modifications should not be taken as a fundamental departure from the basic assumptions of neoclassic economics. As Posner points out, the assumption of bounded rationality is nothing more than the recognition of transaction costs – because acquisition of information is costly, it is rational for a person to have certain extent of ignorance about the transaction.<sup>364</sup> Likewise, the concept of opportunism does not really add much to the assumption that individuals are inclined to maximise their own utility even by taking advantage of others.<sup>365</sup>

### **1.3.2 Relevance of NIE**

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<sup>358</sup> Oliver E Williamson, ‘The Theory of the Firm as Governance Structure: From Choice to Contract’ (2002) 16 *Journal of economic perspectives* 171, 174.

<sup>359</sup> Furubotn and Richter (n 348) 5; Williamson, ‘The Theory of the Firm as Governance Structure’ (n 358) 174.

<sup>360</sup> Furubotn and Richter (n 348) 5.

<sup>361</sup> *ibid.*

<sup>362</sup> *ibid.*

<sup>363</sup> *ibid.*; Oliver E Williamson, ‘Transaction-Cost Economics: The Governance of Contractual Relations’ (1979) 22 *The journal of Law and Economics* 233, 241–242.

<sup>364</sup> Posner (n 354) 80.

<sup>365</sup> *ibid.*

It is widely recognised that NIE provides the most important contribution to the law-and-economic approach.<sup>366</sup> Before the advent of NIE, Law and Economics were confined to limited domains such as antitrust law, regulated industries, and taxation.<sup>367</sup> The focus was on the effect of certain rules or institutions on market activities, rather than on the dynamics of the rules and institutions themselves. In particular, the topic of taxation was reduced to the category and scale of taxes, with the administrative or institutional aspects being largely overlooked.<sup>368</sup> It was only with NIE that scholars of Law and Economics began to explore legal rules and institutions in a more concrete manner.<sup>369</sup> This new approach informed by NIE has greater relevance to this thesis, because the research question of the thesis is not the effect of international taxation on market performance, but the assessment of alternative ITDR mechanisms and the quest for their optimal institutional design. Indeed, the Liberal Institutionalism on which Altman and Carolis relied was substantially inspired by NIE.<sup>370</sup> In this sense, by employing NIE, this thesis does not entirely alienate itself from the earlier interdisciplinary attempts in the ITDR literature.

Besides Liberal Institutionalism, a variety of other subjects has been reshaped by NIE, including those domains that are quite adjacent to ITDR. For instance, Rixen (2008, 2011), and Dietsch and Rixen (2014) explore the economic logic underlying the institutional trajectory of international tax governance.<sup>371</sup> Cockfield (2013) conceptualises the international tax regime as a political and legal system striving to address transaction-cost challenges

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<sup>366</sup> Veljanovski (n 329) 35–36.

<sup>367</sup> Robert. Cooter (n 306) 1.

<sup>368</sup> *ibid.*

<sup>369</sup> Posner (n 354) 76.

<sup>370</sup> See below, Chapter 7, Section 2.

<sup>371</sup> Thomas Rixen, *The Political Economy of International Tax Governance* (Springer 2008); Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223); Rixen, 'Tax Competition and Inequality' (n 224); Peter Dietsch and Thomas Rixen, 'Tax Competition and Global Background Justice' (2014) 22 *Journal of political philosophy* 150; Peter Dietsch and Thomas Rixen, *Global Tax Governance* (ECPR Press 2017).

– as will be explained below (Section 1.3.3), transaction cost is the core concept of NIE.<sup>372</sup> Gebken et al. (2006) evaluate the magnitude of transaction costs that the dispute-resolution system in the construction industry may entail, and propose the notion of dispute management.<sup>373</sup> Therefore, it is safe to conclude that the time is now ripe for the combination between NIE and ITDR.

### **1.3.3 Bedrock of NIE: TC theory**

During the past few decades, NIE has developed several major branches, including, *inter alia*, TC theory, property-rights theory, public-choice theory, contractual theory, game theory, and historical and comparative institutional analysis.<sup>374</sup> Nevertheless, the main core of the discipline remains TC theory.<sup>375</sup> As discussed below (Sections 2.3.3, 3), theories of property rights and contracts are enormously influenced by TC theory. Accordingly, the theoretical construction in this thesis will primarily be based on TC theory, although other theories (particularly property-rights theory, contractual theory and game theory) will also be touched on insofar as they specify or enrich TC theory in certain aspects.

In general, TC theory can be further divided into two branches: classic TC theory, founded by Coase, and TCE, founded by Williamson. Both theories are relevant to the analysis in this thesis, and will be synthesised into one theoretical framework.

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<sup>372</sup> Cockfield (n 223).

<sup>373</sup> Richard J Gebken and G Edward Gibson, 'Quantification of Costs for Dispute Resolution Procedures in the Construction Industry' (2006) 132 *Journal of professional issues in engineering education and practice* 264.

<sup>374</sup> Furubotn and Richter (n 348) 36–40.

<sup>375</sup> Eggertsson (n 331) 14.

## 2. Classic TC theory

### 2.1 Overview

Under neoclassic economics, cost theories mainly concern the production process, and market transactions are generally assumed to be costless.<sup>376</sup> In his ground-breaking work *The Nature of the Firm* (1937), Coase starts with a seemingly obvious reality: resource allocation in capitalist economies takes place not only through autonomous market exchanges, but also through entrepreneurial decisions or administrative orders within firms.<sup>377</sup> Coase then raises a famous question: in light of the then-orthodox view that coordination will emerge through the price mechanism underlying the market exchange, why is the firm or any other type of organisation necessary?<sup>378</sup> The reason is, continues Coase, that the use of the price mechanism implies transaction costs, and the firm helps to reduce such costs.<sup>379</sup> According to Coase, the transaction costs of market exchanges include, *inter alia*, the cost of discovering the relative prices and of negotiating and concluding a separate contract for each transaction that takes place in a market.<sup>380</sup> In contrast, through the use of the firm, there is no need for the owners of productive factors to contract with each other to realise gains from collaborative production.<sup>381</sup> Instead, each factor owner concludes only one contract with the central entrepreneur, and the number of contracts that must be concluded between parties is greatly reduced.<sup>382</sup>

#### 2.1.1 Definition and deconstruction of transaction cost

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<sup>376</sup> Furubotn and Richter (n 348) 12; Eggertsson (n 331) 14.

<sup>377</sup> Ronald Harry Coase, 'The Nature of the Firm' (1937) 4 *economica* 386, 387–388.

<sup>378</sup> *ibid* 388.

<sup>379</sup> *ibid* 390–391.

<sup>380</sup> *ibid*.

<sup>381</sup> *ibid* 391.

<sup>382</sup> *ibid*.

A clear-cut definition of transaction cost does not exist, partly because these costs exist in different contexts, and scholars approach them from different perspectives. In its narrowest sense, transaction costs have been defined as the costs of using price mechanisms.<sup>383</sup> More broadly, transaction costs are associated with property rights, defined as the costs of establishing, maintaining, transferring, and protecting property rights.<sup>384</sup> In the broadest manner, transaction costs are the costs of running the economic system.<sup>385</sup> Furubotn and Richter categorise various types of transaction cost into three groups according to the contexts in which those costs are incurred:

(1) Market transaction costs, defined as the costs of using the market. These arise primarily due to the need for information and bargaining processes that characterise the use of the market. They consist of: (a) the costs of preparing contracts (search and information costs); (b) the costs of concluding contracts (costs of bargaining and decision-making); and (c) the costs of monitoring and enforcing the contractual obligations.<sup>386</sup>

(2) Managerial transaction costs, which are the costs of organising activities within a firm. These include: (a) the costs of setting up, maintaining, or changing an organisational design; and (b) the costs of running an organisation.<sup>387</sup>

(3) Political transaction costs, which are associated with the costs of using political institutions. These are understood as: (a) the costs of setting up, maintaining, or changing a political system; and (b) the costs of running such a system.<sup>388</sup>

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<sup>383</sup> Maliti Musole, 'Property Rights, Transaction Costs and Institutional Change: Conceptual Framework and Literature Review' (2009) 71 *Progress in Planning* 43, 46.

<sup>384</sup> *ibid.*

<sup>385</sup> Furubotn and Richter (n 348) 48.

<sup>386</sup> *ibid* 51–54.

<sup>387</sup> *ibid* 54–55.

<sup>388</sup> *ibid* 55–57.

By identifying the managerial and political transaction costs, NIE theorists can extend their analysis from traditional market activities to the managerial and political fields, in which the topic of ITDR is typically situated. Be that as it may, the emphasis on contextual variation might risk obscuring the common nature of transaction costs. In this sense, Cheung's definition is more general and fundamental. Transaction costs, writes Cheung, mainly include the costs "of contracting and negotiating..., of measuring and policing property rights, of engaging in politics for power, of monitoring performances, and of organizing activities".<sup>389</sup> Cheung's definition highlights three common sources of transaction costs: the agency problem, the bargaining problem, and the administrative problem. It has greater generality and broader applicability than other definitions of transaction costs. For example, while a typical market exchange consists of negotiating a contract (bargaining problem), organising execution of the contract (administrative burden), and monitoring the performance of the contract (agency problem), establishing and running a business or political institution also involves the process of bargaining, coordination and monitoring. These three components of transaction cost – agency cost, bargaining cost, and administrative cost – will be discussed in detail in subsequent sections.

### **2.1.2 Significance of transaction cost**

While transaction costs are pervasive in the real world, it is widely agreed that lower transaction costs are generally desirable.<sup>390</sup> High transaction costs can limit or prevent otherwise advantageous exchanges, and contrarily, reduction in these costs may facilitate more trade and greater specialisation, thereby bringing increased welfare, except for the case of illegal trade and

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<sup>389</sup> Steven NS Cheung, 'On the New Institutional Economics' in Lars Werin and Hans Wijkander (eds), *Contract Economics* (Blackwell 1992) 51.

<sup>390</sup> Musole (n 383) 49.

production.<sup>391</sup> At the micro level, such as in an enterprise or project, the reduction of transaction costs ordinarily leads to higher profits. In this sense, the minimisation of transaction costs and wealth maximisation are often the two sides of a coin. Accordingly, in the tax context, the optimal system of ITDR must also be the most cost-efficient system. This further justifies the TC approach to ITDR.

### **2.1.3 Methods of measuring transaction costs**

Given the multifaceted feature of transaction costs and the complexity of institutional phenomena, it is no surprise that the measurement of transaction costs becomes a thorny question.<sup>392</sup> In general, approaches to this empirical inquiry in the existing literature of NIE can be divided into two categories: cardinal and ordinal.<sup>393</sup> The cardinal approach tries to measure the absolute value of transaction costs, usually with reference to market prices.<sup>394</sup> For example, one scholar measures the market transaction costs by reference to the difference between production costs and the final price of the commodity, and concludes that in the year 1959, the average market transaction costs were 49% of the final consumer price.<sup>395</sup> Another scholar concludes that in 1993, the total market transaction costs were about 28% of the GDP.<sup>396</sup>

In contrast, the ordinal method questions the feasibility of arriving at reliable quantitative estimates about the cardinal size of transaction costs, and seeks to work out an ordinal ranking of such costs for different institutions.<sup>397</sup> This approach is congruent with the central task of NIE: to compare the relative efficiency of alternative institutional arrangements.<sup>398</sup> As a leading NIE

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<sup>391</sup> Eggertsson (n 331) 16; Musole (n 383) 49–50.

<sup>392</sup> Musole (n 383) 50–51.

<sup>393</sup> *ibid.* 51.

<sup>394</sup> *ibid.*

<sup>395</sup> Furubotn and Richter (n 348) 59.

<sup>396</sup> *ibid.*

<sup>397</sup> Musole (n 383) 51.

<sup>398</sup> *ibid.*

theorist states,

*If we are able to say, ceteris paribus, that a particular type of transaction cost is higher in Situation A than in Situation B, and that different individuals consistently specify the same ranking whenever the two situations are observed, it would follow that transaction costs are measurable, at least at the margin.*<sup>399</sup>

Under this approach, transaction costs do not necessarily have to be expressed as monetary values, but can also be approximated by time, energy, efforts, or other proxies.<sup>400</sup> The key point is to make sure that the measurement is observable and consistent. In particular, the most commonly used proxy for transaction costs is the time spent on a particular transaction under examination.<sup>401</sup> For example, a team of researchers undertook a survey on the transaction costs of establishing a business in Lima, Peru. Detailed notes and a time log were kept. The results showed that a person of modest means would have to spend 289 days in these procedures to set up a factory legally.<sup>402</sup> In contrast, another survey based in Tampa, Florida, showed that it took only two hours to obtain a permit to open a small business. Thus the time cost in Peru was over 1,000 times as high as in Florida.<sup>403</sup> This thesis will adopt the ordinal approach in measuring transaction costs of alternative ITDR mechanisms.

## **2.1.4 General determinants of transaction costs**

Various factors may affect the magnitude of transaction costs. Those factors

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<sup>399</sup> Steven NS Cheung, 'The Transaction Costs Paradigm 1998 Presidential Address Western Economic Association' (1998) 36 *Economic Inquiry* 514, 516.

<sup>400</sup> Musole (n 383) 51.

<sup>401</sup> Furubotn and Richter (n 348) 48.

<sup>402</sup> Hernando de Soto, *The Other Path: The Invisible Revolution in the Third World* (Harper & Row 1989) 133–134; see also Alexandra Benham and Lee Benham, 'Measuring the Costs of Exchange' in Claude Ménard (ed), *Institutions, Contracts and Organizations: Perspectives from New Institutional Economics* (Edward Elgar Publishing Limited 2000) 371–372.

<sup>403</sup> Benham and Benham (n 402) 371–372.

that have particular bearings on agency, bargaining or administrative costs will be elaborated on in subsequent sections. This subsection examines only the general determinants of transaction costs.

(1) Institutions. It is institutions that largely determine how costly it is to transact.<sup>404</sup> Eggertsson shows how the institutional environment – in the form of national policies – may influence the overall magnitude of transaction costs:

*When a state introduces and enforces the rule of law in a lawless area, it thereby lowers transaction costs and stimulates trade. When it prohibits trade in certain commodities – for example, heroin or antigovernment literature – it raises the cost of exchanging the restricted goods, perhaps to a point where trade is sharply reduced or abandoned altogether.*<sup>405</sup>

At the micro level, the impact of various institutional arrangements on transaction costs is more obvious. For example, different ownership structures of firms – e.g., whether they are private or public companies – may entail different transaction costs and lead to different economic outcomes.<sup>406</sup>

(2) Technology. Technical changes exert far-reaching influences on the magnitude of transaction costs, although the direction of such influences is complicated. On the one hand, new technologies help to ease the business process, thereby reducing transaction costs of the business; on the other hand, they may also give rise to new business patterns that are more complex and hence more costly to handle.<sup>407</sup> Eggertsson asserts that technical changes have a net effect of increasing transaction costs.<sup>408</sup>

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<sup>404</sup> Musole (n 383) 49.

<sup>405</sup> Eggertsson (n 331) 16.

<sup>406</sup> See *ibid* 130–153.

<sup>407</sup> *ibid* 16.

<sup>408</sup> *ibid*.

Arguably, Eggertsson's assertion largely concerns the macro level of a society. For specific transactions at the micro level, since the evolution of the general business pattern in a society is stable in the short run, technical innovation usually has the net effect of saving transaction costs. This is particularly reflected in the field of dispute settlement. On the one hand, technical changes, particularly the development of information technology (IT), have given rise to new types of conflict, and increased the frequency and complexity of traditional ones, for the whole society (the macro level). On the other hand, IT has created new tools that can facilitate dispute resolution processes (the micro level).<sup>409</sup>

(3) Number of parties involved. It is conceivable that a larger number of parties involved in a transaction may bring more friction to the process. After all, transaction costs are by nature costs of human interaction, or "the costs which do not exist in a Robinson Crusoe economy".<sup>410</sup> The effect of party number on transaction costs will be examined in more detail in later sections.<sup>411</sup>

(4) Transaction costs and economies of scale. Despite the difference between the transaction costs in NIE and the production costs in neoclassic economics, several economic rules about the production costs may also apply to transaction costs.<sup>412</sup> Among others, the rule of economies of scale (or scale economies) is of particular relevance for the purpose of this thesis. According to neoclassic economics, economies of scale refer to the phenomenon in which total average cost per output unit falls as the output rises.<sup>413</sup> Multiple factors may account for the economies of scale. For example, higher output can lead to better

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<sup>409</sup> Alejandro López Ortiz, 'Arbitration and IT' (2005) 21 *Arbitration International* 343, 343.

<sup>410</sup> Musole (n 383) 47.

<sup>411</sup> For instance, see below, this chapter, Sections 2.2.3, 2.3.3; Chapter 3, Section 4.6.

<sup>412</sup> Furubotn and Richter (n 348) 64–72.

<sup>413</sup> David KH Begg, *Foundations of Economics* (2nd edn, McGraw-Hill Education 2003) 45–46.

specialisation in production activities and better use of machinery.<sup>414</sup> For an established firm, overhead expenses for premises, equipment, management, etc., have nevertheless occurred even without any output, and increasing output from an initial low level allows those overhead costs to be spread over more product units.<sup>415</sup> Likewise, for those transactions facilitated by certain institutional frameworks such as legal or monetary systems, transaction costs of establishing and running such frameworks can be diluted as the number of transactions using such frameworks increases.

## 2.2 Agency costs

The costs of “monitoring performance” specified in Cheung’s definition of transaction costs are largely associated with the agency costs. A principal-agency relation is established where one party (the principal) delegates the work to another (the agent).<sup>416</sup> Such relations pervade the modern society. Examples include worker-boss, physician-patient, landlord-tenant, voter-politician, etc.<sup>417</sup> The central problem of the agency relation is that the agent may pursue its own interest instead of being loyal to the principal.<sup>418</sup> This agency problem is further compounded by the fact that it is usually difficult or expensive for the principal to verify what the agent is actually doing.<sup>419</sup> Normally the agent knows better than the principal about the details of the task assigned to it, and about its own actions, abilities, and preferences.<sup>420</sup>

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<sup>414</sup> *ibid.*

<sup>415</sup> *ibid.*

<sup>416</sup> Eggertsson (n 331) 40–41.

<sup>417</sup> BM Mitnick, ‘The Theory of Agency: The Policing “Paradox” and Regulatory Behavior’ [1975] *Public Choice* 27, 27; Eggertsson (n 331) 41.

<sup>418</sup> Eggertsson (n 331) 40–41.

<sup>419</sup> Kathleen M Eisenhardt, ‘Agency Theory: An Assessment and Review’ (1989) 14 *Academy of management review* 57, 58.

<sup>420</sup> Eggertsson (n 331) 40–41.

The literature on agency theory has identified several factors that would affect the magnitude of the agency problem.

### **2.2.1 Extent of interest divergence**

The divergence between the interests of the principal and those of the agent is the primary root of the agency problem. Accordingly, the extent of interest divergence is positively related to the size of the agency cost.<sup>421</sup> For instance, if a company is managed by the owner, the manager and the owner become the same person, and that person will operate the business in a diligent manner so as to maximise the return for the company.<sup>422</sup> In contrast, as the owner-manager sells his or her equity shares to outside shareholders, agency costs will be generated by the divergence between his or her interests and those of the outside shareholders.<sup>423</sup> Consequently, as his or her fraction of the equity falls, he or she would be increasingly encouraged to shirk in duty performing, and meanwhile to appropriate company resources, e.g., in the form of duty consumption.<sup>424</sup>

### **2.2.2 Information asymmetry**

Information asymmetry is positively related to the magnitude of the agency problem. The rationale is that since the information system informs the principal about the agent's performance, the agent will realize that it cannot deceive its principal.<sup>425</sup> Two types of information are the most relevant in the agency relation: the information about the agent's behaviour, and the detail of the task assigned to the agent.<sup>426</sup>

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<sup>421</sup> Eisenhardt (n 419) 62.

<sup>422</sup> Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of financial economics* 305, 312.

<sup>423</sup> *ibid.*

<sup>424</sup> *ibid.*

<sup>425</sup> Eisenhardt (n 419) 60.

<sup>426</sup> Eggertsson (n 331) 41.

### 2.2.3 Measurability of agents' performance

Measurability of the agent's performance is negatively related to the magnitude of the agency problem. The argument is similar to that of the information system: if it is easy for the principal to measure the agent's performance, there will be less scope for the agent to act in an aberrant manner.<sup>427</sup> A particular problem of measuring the agent's performance concerns teamwork or joint production, in which the contributions of multiple agents are mixed.<sup>428</sup> Cheung instances the measuring problem of joint production by reference to the flashlight manufacturing in Hong Kong.<sup>429</sup> When the flashlights are electroplated, Chung writes, "one worker monitors the tank of chemicals, another rotates the article in the solution, and a third rinses them as they are handed to him on a hanger. The relative contribution of each worker is thus difficult to separate".<sup>430</sup> Therefore, says Cheung, they are paid in the form of an hourly wage, which entails more scope for the workers to "shirk".<sup>431</sup> In contrast, another lot of workers, who insert switches, are paid by piece, as their contributions are relatively easy to separate and measure.<sup>432</sup> This example demonstrates that the efficacy of a monitoring system for a process of joint production depends on the extent to which the individual agent's contribution to the joint outcome can be isolated and measured.

The problem of measurability in relation to joint production provides another rationale for the existence of the firm that is slightly different from Coase's firm theory. The reasoning begins with the common belief that the joint output of a team is usually greater than the sum of individual contributions made in

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<sup>427</sup> Eisenhardt (n 419) 62.

<sup>428</sup> *ibid.*

<sup>429</sup> Steven NS Cheung, 'The Contractual Nature of the Firm' (1983) 26 *Journal of Law & Economics* 1, 15; see also Eggertsson (n 331) 51.

<sup>430</sup> Cheung, 'The Contractual Nature of the Firm' (n 429) 15.

<sup>431</sup> *ibid.*

<sup>432</sup> *ibid.*

isolation.<sup>433</sup> However, a problem with the teamwork is that individuals may “shirk” in the production, as it is difficult to measure the marginal product of each team member.<sup>434</sup> In order to prevent excessive shirking, which may ultimately lead to the dissolution of the team, the members of the coalition employ a central agent and give it the right to hire, fire, and monitor the team members.<sup>435</sup> While it is true that the central agent itself may commit opportunistic conduct, the problem can be solved by giving it the claim over the firm’s residual income.<sup>436</sup>

### 2.3 Bargaining costs

The costs of “contracting and negotiating” in Cheung’s account include different types of transaction costs. In a technical sense, these costs include logistical expenses of organising the *activities* of contracting and negotiation, and the communication burden between the parties (such as those due to language differences). As will be discussed in the next section, these expenses can be classified as administrative costs. However, in many cases, even if such administrative costs are trivial, the negotiation may still break down for the reasons of distributive conflict. For example, Cooter et al. report that around 15-20% of divorces involving children ended up in court owing to the failure of the couples to achieve settlements on the partitioning of the property at stake.<sup>437</sup> For these cases, negotiations should be relatively costless in a technical sense, as the processes are bilateral and between the two people who used to live under the same roof. Nevertheless, there can be great difficulties for the parties to agree on how to distribute the stake at issue. The difficulty for the parties to solve distributive conflict is termed bargaining

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<sup>433</sup> Armen A Alchian and Harold Demsetz, ‘Production, Information Costs, and Economic Organization’ (1972) 62 *The American economic review* 777, 779; see also Eggertsson (n 331) 164.

<sup>434</sup> Alchian and Demsetz (n 433) 779–781.

<sup>435</sup> *ibid* 781–783.

<sup>436</sup> *ibid* 783.

<sup>437</sup> Robert Cooter, Stephen Marks and Robert Mnookin, ‘Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior’ (1982) 11 *The Journal of Legal Studies* 225, 243.

costs, which is the theme of this subsection. The dynamic of bargaining costs has been explored in multiple contexts within NIE and related disciplines such as game theory and law-and-economic theory. It is desirable to synthesise these different, and usually mutual-enlightened, perspectives.

### 2.3.1 Game-theory approach

#### 2.3.1.1 Battle-of-sexes (BOS) game

In the literature of game theory, the bargaining problem is typically modelled as the BOS game. Consider a young couple planning a date one evening. Whereas one spouse prefers to watch the football game, the other would rather go to the opera. However, both would prefer to go to the same place rather than to different ones, because after all, it is pointless to stay apart for a date. As the payoff matrix illustrates, the unmatched sets of choices, either opera-football (upper-right corner) or football-opera (lower-left corner), yield zero gain, meaning that the date is simply ruined. By contrast, the matched sets of choices, opera-opera (upper-left corner) and football-football (lower-right corner), yield a positive gain, denoted as (2, 3) and (3, 2), respectively.

**Table 1: The BOS game**

		Spouse B	
		Opera	Football
Spouse A	Opera	2, 3	0, 0
	Football	0, 0	3, 2

Table derived from Joel Watson, *Strategy: An Introduction to Game Theory* (WWNorton 2002)

31–32.

In this case, both players would prefer to cooperate with each other, and once they have achieved an agreement on a specific method of cooperation, they will have little incentive to defect. The problem is, however, that the game involves two equally efficient outcomes, and each outcome has a different distributive effect for the two players, with the opera-opera outcome favouring Spouse B and the football-football favouring Spouse A. If the distributive effect is large enough, the couple may trigger “the battle of the sexes” and ultimately ruin their date unless they find a way to compromise effectively.<sup>438</sup>

### 2.3.1.2 Comparison between the BOS game and the Prisoner’s Dilemma (PD) game

The BOS game is often compared with the PD game, which also has important implications for the theoretical construction in this thesis.<sup>439</sup> The PD game considers that A and B are arrested and imprisoned for suspected felony, with no means of communicating with each other. The prosecutors lack sufficient evidence to convict the pair on the principal charge, but they have enough to convict both on a lesser charge. The prosecutors offer each prisoner a bargain: if A and B betray each other, both of them will serve two years in prison, which could be modelled as the payoff vector of (-2, -2). If A betrays B but B remains silent, A will be set free and B will serve three years in prison (and vice versa), respectively denoted as (0, -3) and (-3,0). If both A and B remain silent, both of them will only serve one year in prison (on the lesser charge), denoted as (-1, -1).<sup>440</sup>

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<sup>438</sup> See Joel Watson, *Strategy: An Introduction to Game Theory* (WWNorton 2002) 31–32.

<sup>439</sup> See below, Chapter 4, Section 3.1.1.1.

<sup>440</sup> Richard H McAdams, ‘Beyond the Prisoners’ Dilemma: Coordination, Game Theory, and Law’ (2008) 82 *Southern California Law Review* 209, 215.

**Table 2: The PD game**

		Player B	
		Silence	Betray
Player A	Silence	-1, -1	-3, 0
	Betray	0, -3	-2, -2

Table derived from Richard H. McAdams, 'Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law', 82 S. CAL. L. REV. 209, 215 (2008).

With the above payoffs, if B keeps silent, A is better off betraying (receiving the payoff of 0) than by silence (receiving -1). If B betrays, A is still better off betraying (-2) than silent (-3). Therefore, betrayal is A's dominant strategy in this game, regardless of B's choice. Because the positions of A and B are symmetric, B has the same dominant strategy: betrayal. It follows that the only equilibrium outcome, also known as the Nash Equilibrium, of the game is betray/betray, which is worse than the possible outcome of silent/ silent.<sup>441</sup> In this game, by pursuing their own individual rewards, both parties ultimately receive the worst outcome overall. The teamwork or joint production, as discussed in Section 2.2.3, represents a PD situation: each member in the team free-rides on its peers, and the outcome is poor performance of the team.<sup>442</sup>

McAdams enunciates the difference between the BOS and PD games as follows:

*Though being the only one to defect in a PD is the best outcome, being the*

<sup>441</sup> *ibid* 215–216.

<sup>442</sup> Essays, UK, 'Tragedy of the Commons and Collective Action' (November 2013) <<https://www.ukessays.com/essays/politics/tragedy-commons-collective-action-3344.php>> accessed 3 December 2018; Elinor Ostrom, 'Analyzing Collective Action' (2010) 41 *Agricultural Economics* 155.

*only one to withhold agreement in a bargaining situation is not the best outcome, because it prevents the gain of the bargain. Instead, the problem is one of coordination because there is more than one way to conclude agreement and each party shares the desire to avoid an impasse that may result when each party presses for its preferred distribution.*<sup>443</sup>

Indeed, with mild distributive conflict, a BOS game becomes purely a coordination game that will hardly cause any impasse or enforcement problem. Such a coordination game is typified in negotiations on “rules of the road”, such as – in the context of transnational cooperation – the international rules established for air transport, marine navigation and the distribution of radio frequencies.<sup>444</sup> It is fairly easy for countries to achieve agreements on these issues, and coercive enforcement of these agreements is usually not needed.<sup>445</sup>

### 2.3.1.3 Solutions to the BOS game

For the BOS game, given the multiple equilibriums in the game, players’ strategic choice cannot be solely determined by the payoffs of the game, but helped by factors outside the game.<sup>446</sup> These other factors, also known as “focal points”, can direct the parties toward one of the equilibriums.<sup>447</sup> One factor that is particularly relevant to the purpose of this thesis is third-party intervention.<sup>448</sup> A third party can recommend that the individuals coordinate in a particular way, thereby creating self-fulfilling expectations among those individuals that the recommended behaviour will occur.<sup>449</sup> One example is a

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<sup>443</sup> McAdams (n 440) 236.

<sup>444</sup> Abram Chayes, Antonia Handler Chayes and Ronald B Mitchell, ‘Managing Compliance: A Comparative Perspective’ [1998] *Engaging Countries: Strengthening Compliance with International Environmental Accords* 39, 43–44; Andreas Hasenclever, *Theories of International Regimes* (Cambridge University Press 1997) 46–47.

<sup>445</sup> Chayes, Chayes and Mitchell (n 444) 43–44; Hasenclever (n 444) 46–47.

<sup>446</sup> McAdams (n 440) 231.

<sup>447</sup> *ibid.*

<sup>448</sup> *ibid.* 233–234.

<sup>449</sup> *ibid.*

scenario where the traffic light fails at a busy intersection and a bystander steps in to direct the traffic.<sup>450</sup> At the same time, two drivers approach from different directions; each prefers to proceed ahead of the other, but both regard a collision as the worst outcome that must be avoided.<sup>451</sup> In this typical BOS situation, the bystander's intervention would influence the drivers' behaviour even though the bystander is not a police officer.<sup>452</sup> "If hand signals [of the bystanders] are in full view of both drivers, then the driver motioned to stop will now have stronger reason to expect that the other driver will proceed (and vice versa)."<sup>453</sup> In a broader sense, legal expression is also a form of third-party intervention.<sup>454</sup> If the government in a new society announces that drivers should drive on the right side of the road, the announcement is quite likely to create a focal point with which the people readily comply even if the government does not specify any repercussions of noncompliance.<sup>455</sup>

In addition to third-party intervention, precedents also help to create a focal point for the BOS game. "Precedent" mainly refers to history or culture. What is focal depends on what the people in the situation believe about how their peers have solved or would solve the same or analogous situations.<sup>456</sup> In an experiment, a team of game theorists asked people to name a place and time of day they would go to meet another person in New York City if they had planned a day to meet, yet had failed to pin down a particular place and time.<sup>457</sup> A majority identified Grand Central Station and almost everyone selected noon.<sup>458</sup> The outcome of this coordination game demonstrates the power of culture – people chose Grand Central Station because they

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<sup>450</sup> *ibid* 234.

<sup>451</sup> *ibid*.

<sup>452</sup> *ibid*.

<sup>453</sup> *ibid*.

<sup>454</sup> *ibid* 234–235.

<sup>455</sup> *ibid* 234.

<sup>456</sup> *ibid* 232.

<sup>457</sup> *ibid*.

<sup>458</sup> *ibid*.

frequently arrived in New York City at that location, and noon is the middle of the day.<sup>459</sup>

### 2.3.2 Law-and-economic approach

In the Law and Economics literature, bargaining is usually discussed in conjunction with the topic of pre-trial settlement in a domestic context.<sup>460</sup> The pre-trial settlement is typically described as a game played in the shadow of the law.<sup>461</sup> The court encourages private settlement through negotiation but stands ready to step out of the shadow and resolve the dispute by coercion if the negotiation breaks down.<sup>462</sup> This gives rise to a BOS situation: on the one hand, the parties have a mutual interest in settling the case so as to avoid costly litigation; on the other hand, the competition over the stake of the case between them dulls the prospect of a pre-trial settlement.<sup>463</sup>

According to the Law and Economics literature, the failure to settle usually results from information asymmetry.<sup>464</sup> In particular, if both parties are optimistic about their prospect of winning a favourable award in the litigation, there will be no way that a settlement can be reached.<sup>465</sup> For illustration, if both parties expect the court to award damages of \$1,000 (to the plaintiff) and the trial costs are expected to be \$200 for each party, the plaintiff will refuse to settle for less than \$800, and the defendant will refuse to pay more than \$1,200.<sup>466</sup> As a result, any out-of-court settlement in which the defendant pays the plaintiff at least \$800 but less than \$1,200 makes both parties better off than going to trial. Accordingly, the size of the settlement range of this case

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<sup>459</sup> *ibid.*

<sup>460</sup> Guzman and Simmons (n 307) 208.

<sup>461</sup> Cooter, Marks and Mnookin (n 437) 225.

<sup>462</sup> *ibid.*

<sup>463</sup> Robert Cooter, 'The Cost of Coase' (1982) 11 *The Journal of Legal Studies* 1, 17 ("bargaining games are games in which production is contingent upon agreement about distribution.").

<sup>464</sup> A Mitchell Polinsky, *An Introduction to Law and Economics* (Second edition., Little, Brown 1989) 107–113; see also Guzman and Simmons (n 307) 208.

<sup>465</sup> Polinsky (n 464) 111.

<sup>466</sup> Guzman and Simmons (n 307) 209.

is \$400 (\$1,200 minus \$800).<sup>467</sup> If the plaintiff expects to be awarded \$1,300 and the defendant expects the award to be only \$700, the plaintiff will refuse to accept any amount less than \$1,100, and the defendant will refuse to pay more than \$900.<sup>468</sup> The upshot is that the settlement range disappears altogether.<sup>469</sup>

The over-optimism from both parties usually results from the different sources of information on which they rely.<sup>470</sup> One way to mitigate this information asymmetry and over-optimism, as some suggest, is for the parties to seek help from legal counsel.<sup>471</sup> Lawyers are more experienced in dealing with similar situations, and can therefore be more realistic in predicting the outcome of a trial.<sup>472</sup>

### **2.3.3 Property-rights approach**

The discussion of the bargaining problem in the property-rights literature is mostly associated with the topic of institutional evolution regarding property-rights regimes. The discussion typically starts with the question of why certain property-rights regimes that seem obviously inefficient still persist.<sup>473</sup> The principle answer is that even though stakeholders may agree on the overall benefits from the reform of the inefficient property-rights arrangement, conflict arises over the distribution of such benefits.<sup>474</sup> Each party seeks to push for their private net gains, with the resulting bargaining impasse likely to prevent the otherwise productive institutional change.<sup>475</sup>

The situation can be illustrated by the example of oil-field unitisation. In the

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<sup>467</sup> *ibid.*

<sup>468</sup> *ibid.*

<sup>469</sup> *ibid.*

<sup>470</sup> Polinsky (n 464) 109.

<sup>471</sup> Cooter, Marks and Mnookin (n 437) 232–233.

<sup>472</sup> *ibid.*

<sup>473</sup> Gary D Libecap, *Contracting for Property Rights* (Cambridge university press 1993) 2.

<sup>474</sup> *ibid.* 116.

<sup>475</sup> *ibid.*

USA, oil reservoirs are usually exploited by multiple operators, with each operator owning a section of the surface over a reservoir.<sup>476</sup> Efficient oil extraction necessitates the maintenance of an appropriate level of reservoir pressure so that oil and gas can be pushed out of rocks.<sup>477</sup> However, an oil reservoir is like a common pool: oil is migratory and can hardly be fully partitioned simply by delineating the surface over the oil reservoir.<sup>478</sup> Specifically, each landowner can drill a well on their land and drain oil from their neighbours without economic liability.<sup>479</sup> Since each owner will seek to maximise his or her own output, the result is a competitive drilling among these owners, leading to insufficient reservoir pressure.<sup>480</sup> One of the solutions to this common pool problem is the unitisation strategy: a single firm is designated by all other neighbouring oil firms as a united operator to extract the oil reservoir as a whole.<sup>481</sup> Unitisation is economically desirable because the single operator has an incentive to protect the reservoir so as to maximise the aggregate value of the entire resource rather than overexploiting it as in the case of individual leases.<sup>482</sup> However, before any such unitisation can be carried out, individual owners must first overcome distributive conflict to agree to a rule of sharing the output from the proposed unitisation.<sup>483</sup> Theorists have identified several major factors that may reinforce the bargaining problem among the parties:

- (1) Vested interests of the parties. In considering whether or not to support a proposed change in a property-rights regime at any time, the bargaining parties will compare their expected income stream under the status quo

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<sup>476</sup> Jongwook Kim and Joseph T Mahoney, 'Property Rights Theory, Transaction Costs Theory, and Agency Theory: An Organizational Economics Approach to Strategic Management' (2005) 26 *Managerial and decision economics* 223, 229.

<sup>477</sup> *ibid.*

<sup>478</sup> *ibid.*

<sup>479</sup> *ibid.*

<sup>480</sup> *ibid.*

<sup>481</sup> *ibid.*

<sup>482</sup> *ibid.*

<sup>483</sup> *ibid* 233.

with that offered by the new arrangement.<sup>484</sup> Parties predicting that their vested interests would be undermined by the new property-rights regime tend to perpetuate the status quo.<sup>485</sup> Accordingly, both the initial assignment of property rights, and the expected distribution will affect the individual efforts of contracting parties in promoting (or blocking) an institutional change.<sup>486</sup>

(2) The number and heterogeneity of the parties. The greater the number of competing interest groups with a stake in the reform of a property-rights regime, the more claims need to be addressed to achieve a consensus on the reform.<sup>487</sup> The heterogeneity of the parties also contributes to bargaining difficulties, as the parties' divergent interests mean that any simplified or uniform solution of an institutional change may benefit some parties while disrupting others.<sup>488</sup> In the oil-unitisation case, the number of independently owned tracts of land on an oil field is large, and the economic incentives of large and small firms differ substantially.<sup>489</sup> These all contribute to the difficulties of achieving consensus on the unitisation strategy.<sup>490</sup>

(3) Information shortage or asymmetry. As discussed above, in deciding whether to support a proposed institutional change, individual parties will evaluate their initial position and the expected distribution. However, such assessment may encounter serious problems in the event of information shortages or asymmetries.<sup>491</sup> In the case of oil-field unitisation, information asymmetry and technical uncertainty make accurate economic valuation of individual leases difficult, thereby increasing

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<sup>484</sup> Libecap (n 473) 19.

<sup>485</sup> *ibid* 5.

<sup>486</sup> Kim and Mahoney (n 476) 226.

<sup>487</sup> Libecap (n 473) 21. Also see above Section 2.1.4.

<sup>488</sup> *ibid* 22–23.

<sup>489</sup> Kim and Mahoney (n 476) 233.

<sup>490</sup> *ibid*.

<sup>491</sup> Libecap (n 473) 23–24.

bargaining costs considerably.<sup>492</sup> Occasionally, information shortage or asymmetry may even occur over the aggregate benefits of a proposed institutional change, so that not all parties agree on the legitimacy of the reform in the first place regardless of the share formula.<sup>493</sup>

## **2.4 Administrative costs**

Administrative costs refer in Cheung's definition to the costs of organising activities. Eggertsson distinguishes the administrative cost from the agency cost by stating that "even when agents are loyal and do not shirk, principals are still faced with the task of coordinating their activities, which is yet another cost of transaction".<sup>494</sup> In addition to the costs of organising activities, administrative costs also include cognitive burdens, such as the costs of communication, case analysis, and the use of expertise. Indeed, administrative costs can be so broad that they almost contain any transaction costs that cannot be subsumed under agency or bargaining costs – they can be termed residual costs.

Administration costs are prevalent in human society, particularly within bureaucratic systems. According to Furubotn and Richter, the greatest proportion of political transaction costs is incurred by the administration of justice, education, and other public affairs.<sup>495</sup> Unlike the agency and bargaining costs, administrative costs need to be approached in a contextual manner, as a general theory about this type of cost has yet to be developed in the field of economics.

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<sup>492</sup> Kim and Mahoney (n 476) 235.

<sup>493</sup> Libecap (n 473) 5.

<sup>494</sup> Eggertsson (n 331) 45.

<sup>495</sup> Furubotn and Richter (n 348) 56.

## **2.5 Additional comments on the three components of transaction costs**

The above three components of transaction costs and the theories associated with them apply to a variety of contexts, including both micro-level transactions, such as a specific pre-trial settlement, and macro-level policies or regimes, such as the evolution of economic institutions. These components are largely interdependent. For instance, governmental bureaucracy, which is a typical agency problem, can be exacerbated by staff shortages or heavy workloads, which are an administrative problem. Moreover, reduction of one type of transaction costs may frequently increase the size of other types. For example, measures to address the agency problem, such as the establishment and maintenance of a monitoring system, may incur administrative costs. In the literature on agency theory, the costs of monitoring are also classified as part of agency costs. Thus, the total agency costs are the sum of the investments made in monitoring agents' opportunistic behaviour, plus the residual loss due to the remaining shirking by the agents.<sup>496</sup> For the sake of simplification, in this thesis, the agency costs include only the residual loss caused by agents' shirking, whereas the costs of monitoring those agents will be classified as administrative costs.

## **3. Transaction-cost economics (TCE)**

### **3.1 Overview**

TCE comes as a critique of classic TC theory. Williamson argues that despite the growing recognition that transaction costs are central to the study of economics, the concept needs specification.<sup>497</sup> In particular, while classic TC

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<sup>496</sup> Eggertsson (n 331) 44.

<sup>497</sup> Williamson, 'Transaction-Cost Economics' (n 363) 233.

theory points out that the choice among various economic institutions depends on the variation in the transaction costs that attend each institution, it is unclear which factors are responsible for such cost variation.<sup>498</sup> “There is a suspicion that almost anything can be rationalized by invoking suitably specified transaction costs.”<sup>499</sup> In this connection, TCE aims to operationalise transaction costs by specifying critical dimensions with respect to which transaction costs differ and alternative institutional arrangements are warranted to economise those costs.<sup>500</sup> The central message delivered by TCE is that transaction costs can be economised by matching governance structures to the attributes of transactions in a discriminating way.<sup>501</sup>

### **3.2 Economic institutions as modes of contractual governance**

TCE features a remarkable contractual orientation, maintaining that every exchange relation can be formulated as a contracting problem.<sup>502</sup> Thus, various economic institutions such as markets and firms are regarded as different structures of contractual governance.<sup>503</sup> According to Williamson, there are four main types of governance structure: market, trilateral, bilateral, and unified.<sup>504</sup>

#### **3.2.1 Market governance**

Market governance represents the simplest view of transactions: “sharp in by clear agreement; sharp out by clear performance”.<sup>505</sup> Under the market governance, discrete, autonomous market exchanges are instantaneously

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<sup>498</sup> Oliver E Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (The Free Press 1985) 4.

<sup>499</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 233.

<sup>500</sup> *ibid* 234.

<sup>501</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 68.

<sup>502</sup> *ibid* 17. This is why some literature on NIE classifies TCE under the rubric of contractual theory.

<sup>503</sup> *ibid* 17, 68; Furubotn and Richter (n 348) 180–181.

<sup>504</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 73–79; see also Furubotn and Richter (n 348) 183–185.

<sup>505</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 235.

consummated under the aegis of fully specified contracts.<sup>506</sup> Even where contractual performance is not instantaneous, future contingencies are fully anticipated in the present contract.<sup>507</sup> It follows that under market governance, relational considerations are principally absent.<sup>508</sup> Market governance is not merely a theoretical fiction, but very common for those on-spot transactions or transactions in thick markets in which substitute trading partners are easy to find.<sup>509</sup> Market governance is supported within the legal framework of classic contract law.<sup>510</sup> The major characteristics of classic contract law are that it:

- (1) Treats the identity of the contracting parties as irrelevant;
- (2) Emphasises clearly spelled-out contractual terms and provides rigorous court enforcement of these terms, although litigation is rarely triggered because the consequence of non-performance is predictable; and
- (3) Provides a well-defined body of law to deal with matters not specifically covered in a contract.<sup>511</sup>

### 3.2.2 Trilateral governance

Moving from market governance, contracts increasingly assume continuing and relational quality, and begin to enter the paradigm of trilateral governance. The legal counterpart of trilateral governance is “neoclassical contract law”.<sup>512</sup> This type of law has two prominent characteristics. First, the *ex ante* planning of the contract is inherently incomplete, and hence subject to various gaps.<sup>513</sup>

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<sup>506</sup> Mercuro and Medema (n 331) 151.

<sup>507</sup> *ibid.*

<sup>508</sup> *ibid.*; Williamson, ‘Transaction-Cost Economics’ (n 363) 249.

<sup>509</sup> Mercuro and Medema (n 331) 151.

<sup>510</sup> *ibid.* 151–152; Williamson, ‘Transaction-Cost Economics’ (n 363) 236–237.

<sup>511</sup> Mercuro and Medema (n 331) 151–152; Williamson, ‘Transaction-Cost Economics’ (n 363) 236–237.

<sup>512</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 237, 249.

<sup>513</sup> *ibid.* 237.

Second, the contracting parties use a range of *ex post* techniques to allow for flexibility.<sup>514</sup> In particular, third-party assistance such as arbitration or mediation is preferred over litigation as means of dispute settlement in case the contract maladapt.<sup>515</sup>

### 3.2.3 Bilateral governance

Bilateral governance features a more specialised and relational mechanism of adjusting contractual maladaptations.<sup>516</sup> While under trilateral governance (and neoclassic contract law), the original contract largely remains as the reference basis for effecting contractual adaptation, the significance of the original agreement decreases substantially under the bilateral governance.<sup>517</sup> What matters more for bilateral governance is that the parties develop a relationship and that the dispute settlement under this paradigm is of an “ongoing-administrative kind”.<sup>518</sup>

Bilateral as well as trilateral governance can be illustrated by the following contractual provision, which is extracted from a 32-year coal-supply agreement between the Nevada Power Company and the Northwest Trading Company:

*In the event an inequitable condition occurs which adversely affects one Party, it shall then be the joint and equal responsibility of both Parties to act promptly and in good faith to determine the action required to cure or adjust for the inequity and effectively to implement such action. Upon written claim of inequity served by one Party upon the other, the Parties shall act jointly to reach an agreement concerning the claimed inequity within sixty days of the date of such written claim. ---. If the Parties cannot reach agreement within*

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<sup>514</sup> *ibid.*

<sup>515</sup> *ibid.*

<sup>516</sup> *ibid* 238, 250–252.

<sup>517</sup> *ibid* 238.

<sup>518</sup> *ibid.*

*sixty days the matter shall be submitted to arbitration.*<sup>519</sup>

The provision contains a mutual negotiation procedure (bilateral governance structure), which is further supplemented by an arbitration mechanism (trilateral governance structure) in case the negotiation goes awry. This provision is quite akin to Article 25 of the OECD Model (post-2008 version).

### **3.2.4 Unified governance**

Under this governance structure, the otherwise independent contracting parties are now integrated into a single entity.<sup>520</sup> Administrative control dominates the relationship between the parties, and disputes between them will largely be resolved internally through administrative means.<sup>521</sup> The most common form of unified governance is the firm. Within a firm, information is more easily acquired, less formal documentation is necessary, direct costs of using more formal mechanisms (such as lawyers, courts, and arbitration mechanisms) can be avoided, disputes can be resolved in a more timely fashion, and the potential for defection is reduced.<sup>522</sup>

This description shows that as a contract moves from market governance to unified governance, the mechanism governing the contract becomes increasingly specialised, personalised, flexible, or, in Green's word, antilegalistic. From a TCE perspective, there are rational economic reasons for organising some transactions one way and other transactions another.<sup>523</sup> The question is, however, which go where and for what reason? The answer is determined by the characteristics of the specific transactions at issue.<sup>524</sup>

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<sup>519</sup> Oliver E Williamson, 'Comparative Economic Organization: The Analysis of Discrete Structural Alternatives' [1991] *Administrative science quarterly* 269, 272; see also Mercurio and Medema (n 331) 153.

<sup>520</sup> Mercurio and Medema (n 331) 154.

<sup>521</sup> *ibid.*

<sup>522</sup> *ibid.*; Williamson, 'Comparative Economic Organization' (n 519) 280.

<sup>523</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 52.

<sup>524</sup> *ibid.*

### 3.3 Key attributes of transactions and the implications for governance structures

TCE identifies three key attributes of a transaction that distinguish different types of transaction costs and the attendant governance structures: investment specificity, frequency of transactions, and uncertainty.<sup>525</sup> The basic point is that transactions with specialised investments, high frequency, and high level of uncertainty are more suited to a specialised governance structure.<sup>526</sup>

#### 3.3.1 Asset specificity

Among the three attributes of transactions, investment specificity, or asset specificity, is of paramount importance.<sup>527</sup> Investment can be either general or specific.<sup>528</sup> Transactions over general items pose few hazards, since buyers and suppliers in these circumstances can easily switch to alternative options in the market.<sup>529</sup> Problems arise when transaction-specific expenses are incurred.<sup>530</sup>

##### 3.3.1.1 Transaction-specific investments

Transaction-specific investments are the investments that, once committed, cannot be transferred to alternative uses without a loss in value.<sup>531</sup> Such specialised investments may take the following forms:

- (1) Specialised physical assets, such as a die for stamping out distinctive metal shapes;

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<sup>525</sup> *ibid*; Furubotn and Richter (n 348) 182.

<sup>526</sup> Williamson, 'Transaction-Cost Economics' (n 363) 248.

<sup>527</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 52.

<sup>528</sup> Eggertsson (n 331) 171.

<sup>529</sup> Williamson, 'Transaction-Cost Economics' (n 363) 239.

<sup>530</sup> *ibid* 239–240.

<sup>531</sup> Eggertsson (n 331) 171–172.

- (2) Site specificity, such as an investment in mining ore;
- (3) Specialised human assets that arise from firm-specific training or learning by doing; and
- (4) Brand-name capital.<sup>532</sup>

For transactions with specialised investments, or high degree of asset specificity, the assurance of a continuing relation between the contracting parties is needed to encourage such investments from both parties.<sup>533</sup> This is because by definition, transaction-specific investments can best be reimbursed and appreciated by staying in their current use.<sup>534</sup> For example, a buyer may induce a supplier to invest in specialised physical capital of a transaction-specific kind. Inasmuch as the value of this capital in other uses is much smaller than the use for which it has been originally intended, the supplier is effectively “locked into” the transaction.<sup>535</sup> The process is often symmetrical in that the buyer may also find it difficult to reach alternative sources of supply and acquire the item for favourable terms because the item is not standardised.<sup>536</sup> Therefore, when transaction-specific investments are at stake, parties usually have a strong incentive to craft a long-term and relational contract to protect these investments.

### 3.3.1.2 Contractual incompleteness

For long-term contracts, which provide the optimal legal framework for transactions with a high degree of asset specificity, contractual incompleteness is a fundamental reality. Because of bounded rationality, contracting parties can hardly anticipate and specify all the future

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<sup>532</sup> Williamson, ‘The Theory of the Firm as Governance Structure’ (n 358) 176.

<sup>533</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 241.

<sup>534</sup> Eggertsson (n 331) 172.

<sup>535</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 240.

<sup>536</sup> *ibid.*

contingencies relevant to the contract.<sup>537</sup> Furthermore, it will be rational for the parties to “wait and see what happens” rather than to try to cover a large number of individually unlikely eventualities.<sup>538</sup> The same rule applies to the process of law-making, where a rational lawmaker does not try to regulate everything to the last detail.<sup>539</sup>

Given the *ex ante* contractual incompleteness, it becomes desirable for the parties to *ex post* adapt the contract to the unfolded contingencies. However, such adaptation is vulnerable to opportunistic exploitation by the contracting parties, which are assumed to be “self-seeking with guile”.<sup>540</sup> Specifically, although parties have a long-term interest in effecting adaptations that will generate joint gains, each also has an interest in exploiting as much of the gains as they can on each adaptation.<sup>541</sup> As a result, such opportunistic exploitation or costly haggling by the parties would either block the otherwise productive adaptations or dissipate the gains from those adaptations.<sup>542</sup>

### 3.3.1.3 Specialised governance structures

Contractual incompleteness together with human opportunism highlights the significance of contractual governance. For contracts with high level of asset specificity, the recommendation of TCE is that a specialised and flexible governance structure is superior to a rigid and legalistic one.<sup>543</sup> The legal translation of this proposition is that for relational contracts, the optimal mechanism for resolving contractual disputes is negotiation, mediation, or other “private-ordering” methods, rather than litigation. The main rationales for this proposition are twofold:

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<sup>537</sup> Furubotn and Richter (n 348) 21.

<sup>538</sup> *ibid.*

<sup>539</sup> *ibid.*

<sup>540</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 241–242.

<sup>541</sup> *ibid.* 242.

<sup>542</sup> *ibid.*

<sup>543</sup> *ibid.* 247–248.

First, as an incomplete contract evolves as events unfolded, the original wording of the contract becomes increasingly obsolete. It follows that a strict reliance on the original contractual text, as is the case in most litigation processes, may risk missing the point.<sup>544</sup> By contrast, private settlements, such as negotiation, mediation and arbitration, permits greater latitudes for the parties or the mediator/arbitrator to realise the true spirit, rather than the original text, of the contract.<sup>545</sup>

Second, even if adjudicatory review leads to a correct decision in a legal sense, it risks disrupting the ongoing relationship between the parties.<sup>546</sup> As Justice Rehnquist comments, “the litigation of an individual’s claim of deprivation of a right would bring parties who must remain in a continuing relationship into the adversarial atmosphere of a courtroom”.<sup>547</sup> The examples offered by the Justice include courts’ reluctance to intervene in collective-bargaining disputes and family disputes.<sup>548</sup> These controversies, writes Williamson, all involve transactions with highly specialised human capital.<sup>549</sup> The assurance of an ongoing relationship is critical for these transactions because there are no adequate substitutes for these idiosyncratic relations.<sup>550</sup>

Williamson further relies on the notion of specialised language in defending the fitness of specialised governance structures for relational contracts, although in this author’s view, the argument can be woven into the above two rationales. For those recurrent transactions, says Williamson, a specialised language between the parties develops as familiarity between them grows

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<sup>544</sup> *ibid* 240.

<sup>545</sup> Mercurio and Medema (n 331) 152.

<sup>546</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 244.

<sup>547</sup> William H Rehnquist, ‘The Adversary Society: Keynote Address of the Third Annual Baron de Hirsch Meyer Lecture Series’ (1978) 33 U. Miami L. Rev. 1, 14; see also Williamson, ‘Transaction-Cost Economics’ (n 363) 244.

<sup>548</sup> Rehnquist (n 547) 5–8; cited by Williamson, ‘Transaction-Cost Economics’ (n 363) 244.

<sup>549</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 244.

<sup>550</sup> *ibid*.

and experiences accumulate.<sup>551</sup> Such specialised language, which is a special form of transaction-specific human capital, have two major effects on the choice of governance structures. First, while specialised investment in physical assets gives rise to some *institutional trust* between the contracting parties, specialised language between the parties may develop into a degree of *personal trust*. As a result, the relational character of the contract is reinforced by the development of specialised language, thereby further justifying a flexible governance structure. Second, the specialized language between the parties also downplays the cost-efficiency of a legalistic governance structure. This is because a judge who is exogenous to the transaction may have difficulties grasping the real spirit of that language.<sup>552</sup> “Different vocabularies for the interpretation of things divide men into groups which cannot understand each other’s way of seeing things and acting upon them”.<sup>553</sup>

### 3.3.2 Frequency of transactions

Compared with the market governance of contracts, which relies on pre-existing market mechanisms, specialised governance structures for relational contracts may come at substantial setup costs.<sup>554</sup> However, if transactions of a recurring kind are involved, such costs will be easier to recover due to the economies of scale.<sup>555</sup> Therefore, transactions of high frequency are more able to afford specialised governance structures.

### 3.3.3 Uncertainty

For transactions with specialised investments, increasing the degree of

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<sup>551</sup> *ibid* 240.

<sup>552</sup> *ibid* 240, 243.

<sup>553</sup> Michael Polanyi, ‘Personal Knowledge: Towards a Post-Critical Philosophy’ [1958] University Of Chicago Press (August 15, 1974) 118; see also Williamson, ‘Transaction-Cost Economics’ (n 363) 243.

<sup>554</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 60–61.

<sup>555</sup> *ibid* 60.

uncertainty makes it more imperative for the parties to devise a specialised and flexible machinery to “work things out”, as contractual gaps will be larger in the light of uncertainty.<sup>556</sup>

According to TCE, the attributes of frequency and uncertainty only become relevant when investment specificity comes into play.<sup>557</sup> As discussed above, for transactions on standardised items, regardless of their frequency or level of uncertainty, the market governance would suffice.

### **3.4 Governance matrix**

The following chart developed by Williamson is a governance matrix that summarises the connection between the attributes of transactions and the governance structures attending each transaction. The matrix assumes a given magnitude of uncertainty, and therefore only considers the remaining two attributes: investment specificity and frequency.<sup>558</sup> Frequency is categorised as occasional and recurrent, while investments are classified as nonspecific, mixed, and idiosyncratic (highly specific).<sup>559</sup> Then, depending on the frequency-specificity configurations, the four types of governance structure discussed above can be placed in the matrix.

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<sup>556</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 254.

<sup>557</sup> *ibid.*

<sup>558</sup> *ibid* 246.

<sup>559</sup> *ibid.*

**Table 3: Matrix of efficient governance**

		Investment Characteristics		
		Non-specific	Mixed	Idiosyncratic
Frequency	Occasional	Market governance (classic contract law)	Trilateral governance (neoclassic contract law)	
	Recurrent		Bilateral governance (relational contract)	Unified governance

Oliver E Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (The Free Press 1985) 79.

(1) Transactions with non-specific investments dictate market governance supported by classic contract law, regardless of whether those transactions are occasional (e.g. purchasing standard equipment) or recurrent (e.g. purchasing standard material).<sup>560</sup>

(2) Occasional transactions with mixed investments, such as the purchase of customised equipment, warrant trilateral governance supported by neoclassic contract law.<sup>561</sup>

(3) Frequent transactions with mixed investments, such as the purchase of customised material, warrant bilateral governance supported by

<sup>560</sup> ibid 248–249.

<sup>561</sup> ibid 249–250.

relational contract law.<sup>562</sup>

(4) Transactions with idiosyncratic investments are primarily subject to unified governance (firm) unless the frequency of such transactions is very low (constructing a plant).<sup>563</sup>

As was discussed above (Section 3.2.3), the dispute-settlement provision in the coal-supply agreement between the Nevada Power Company and the Northwest Trading Company reflects a combination of trilateral and bilateral governance structures. This is consonant with the characteristics of the contract: specialised investments and high frequency of purchasing.

### 3.5 Critical reflection

TCE has direct relevance to the topic of this thesis, as the theory places much reliance on the notions of contract law, contractual governance, and dispute resolution. Traditionally, economic studies of dispute settlement focus on the cost side of the process. “When a dispute is actually settled out of court, it is because a would-be plaintiff has perceived this alternative to be of a lower cost than settling in court.”<sup>564</sup> In contrast, TCE mainly concerns the benefit side of the equation. It maintains that a proper dispute-resolution system economises transaction costs primarily in two ways: (a) it saves the expenses of *ex ante* writing a complex contract, and (b) it *ex post* safeguards the transaction in question against the hazards of opportunism.<sup>565</sup> Here the emphasis is on the entire transaction or contractual relation, rather than on the dispute settlement itself. This is analogous to Green’s approach, which regards trade-dispute settlement as a device to facilitate trade regimes.<sup>566</sup> TCE’s emphasis on the benefit side of a dispute-settlement system is justified

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<sup>562</sup> *ibid* 250–252.

<sup>563</sup> *ibid* 252–253.

<sup>564</sup> Yoram Barzel, *Economic Analysis of Property Rights* (Cambridge university press 1997) 97–98.

<sup>565</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 245–246.

<sup>566</sup> See above, Chapter 1, Section 2.3.2.1.

for its own sake, since the theory mainly concerns the “big picture” (general pattern) of institutional transformation. However, for the purpose of assessing a particular, micro-level dispute-settlement system, both benefit and cost sides matter. It is true that the dimension of frequency proposed in TCE is more about the cost side of a dispute-settlement system. But mere frequency is insufficient to account for the entire cost analysis. By contrast, the framework developed in Section 2, which is based on classic TC theory, provides a more comprehensive and specified analytical framework to evaluate the cost side of a dispute-resolution system. This framework can also contain the dimension of frequency in TCE. In the benefit-cost analysis of the ITDR system to be conducted in the next chapter, the benefit analysis will be largely based on TCE, particularly with respect to the dimension of asset specificity, whereas the cost analysis will be based mostly on classic TC theory.

## **Chapter 3. Applying the Theory: Benefit-Cost Analysis of ITDR Mechanisms**

### **1. Introduction**

This chapter begins to apply TC theories to the topic of ITDR. In particular, a benefit-cost framework will be developed to evaluate ITDR mechanisms. In principle, the benefit analysis will be based on TCE, and the major question is about which type of ITDR system suits the current international tax regime best. For the cost analysis, classic TC theory governs, and the core task is to explore the most cost-efficient mode of ITDR. The benefit-cost analysis will be followed by a data analysis on countries' ITDR practice.

### **2. Behavioural patterns of major ITDR players**

Before starting the evaluation, it is necessary to first identify the major players of ITDR and their behavioural patterns. As Chapter 2 indicates, a consistent and refutable law-and-economic approach rests upon clearly defined behavioural assumptions. Three major types of players can be identified: taxpayers, states, and tax authorities. For taxpayers, most of whom are individuals or firms, the assumption of rational maximisation applies directly without the need of adaptation. An implication of this assumption is that taxpayers have a natural incentive to minimise their tax liabilities wherever possible.

Contrary to individual taxpayers, both states and competent authorities are collective concepts. Conventional political theorists adopt an organic view of states and governments, and even when they sometimes consider the conduct of individual governmental officials, they tend to assume that these

officials act for the common good.<sup>567</sup> The law-and-economic approach refuses this organic and benign picture, contending instead that states and governments are governed by people – politicians, judges, bureaucrats, and others – and that these people act in their own interests.<sup>568</sup> Specifically, it is sensible to posit that states are run by politicians, and governmental departments by public employees (bureaucrats). All these politicians and governmental employees have their own interests, albeit with different implications. For politicians, what matters most are powers and the attached prestige and influences.<sup>569</sup> To achieve such power, they tend to maximise votes by catering to the preferences of their constituencies.<sup>570</sup> While those preferences may vary from one group of voters to another, “in the end, elections usually come back to the economy – to jobs, wages, taxes, imports and exports, the price of goods and the cost of an education”.<sup>571</sup> Even totalitarian regimes have a strong interest in strengthening their economic muscles.<sup>572</sup> Accordingly, states are assumed to maximise their national wealth.<sup>573</sup> It should be borne in mind that wealth-maximisation does not necessarily equal revenue-maximisation, as states recognise that a predatory tax policy would ultimately stifle their economies. How the goal of wealth-maximisation influences states’ policy on international taxation will be elaborated below (Section 3.1.3).

Likewise, public employees who run administrative bodies are assumed to maximise their personal interests such as regulatory power, reputation, and

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<sup>567</sup> Mercurio and Medema (n 331) 85.

<sup>568</sup> Harvey S. Rosen, *Public Finance* (Ninth edition., McGraw-Hill/Higher Education 2010) 118.

<sup>569</sup> John G Cullis, *Public Finance and Public Choice: Analytical Perspectives* (McGraw-Hill 1992) 104.

<sup>570</sup> *ibid.*

<sup>571</sup> ‘Where They Stand on Economic Issues - WSJ.Com’  
<<http://graphics.wsj.com/elections/2016/donald-trump-hillary-clinton-on-the-economy/>> accessed 1 October 2019.

<sup>572</sup> See Mark Harrison, ‘Communism and Economic Modernization’ [2012] CAGE.

<sup>573</sup> See also Rixen, ‘From Double Tax Avoidance to Tax Competition’ (n 223) 200 (“all governments set their international tax policies with the aim of maximizing national welfare”).

perquisites.<sup>574</sup> One implication of this assumption is that public staff tend to prioritise their departmental interests over public goods, because the personal interests of bureaucrats are closely related to the power and budget of the departments they serve.<sup>575</sup> It is true that in a normative sense, administrative bodies are instituted in a democratic polity to implement and advance politicians' agendas. In reality, however, each department has its own special focus and responsibility. For instance, the mission of the US Internal Revenue Service (IRS) is to determine, assess, and collect internal revenue.<sup>576</sup> Consequently, while wealth-maximising states tend to have more balanced tax policies, their tax administrations may have a greater emphasis on revenue maximisation. This behavioural assumption for tax administrations has a substantial impact on the ITDR process, as the competent-authority function is routinely performed by those administrations.<sup>577</sup> It is true that frequently tax treaties designate "the Minister of Finance or his authorised representative" or "the Secretary of the Treasury or his delegate" as the Contracting States' competent authority.<sup>578</sup> Nevertheless, the subsequent delegation of the competent-authority function usually happens within a country's tax administration.<sup>579</sup>

### **3. Benefit analysis: TCE perspective**

#### **3.1 Nature of the international tax regime: a relational contract**

##### **3.1.1 International taxation as part of international investment contracts**

Tax constitutes the price that an investor pays to the invested state for being

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<sup>574</sup> Harvey S. Rosen (n 568) 121.

<sup>575</sup> *ibid.*

<sup>576</sup> 'Bureaus | US Department of the Treasury' <<https://home.treasury.gov/about/bureaus>> accessed 1 October 2019.

<sup>577</sup> OECD, 'MEMAP' (n 1) 11(Section 1.3); 39 (Section 5.1).

<sup>578</sup> *ibid.*

<sup>579</sup> *ibid.*

allowed to operate in its territory.<sup>580</sup> Economists often compare taxation with the sharecropping agreement between a landlord and a tenant.<sup>581</sup> Under the sharecropping arrangement, the landowner (state) allows the tenant (taxpayer) to use the land (investments by the taxpayer in the state) in return for a share of the property rights over the crops (income) produced by the tenant.<sup>582</sup> Such contracts need not be explicitly spelled out: once an investor obtains the permission to access a state's market, there emerges an implied investment contract, within which the legal system, including the state's tax rules (further including the tax treaties entered into by the state), will be automatically incorporated.

By the same token, international taxation arises from transnational investments. For example, an investor in one country (home state) extends its operation to another country (host state); it makes investments in both countries. While the investor respectively contracts with each country, there could be interplay between the two contracts with respect to the tax part of the contracts. Specifically, most countries simultaneously maintain two basic types of tax jurisdiction: the residence jurisdiction and the source jurisdiction. Residence jurisdiction mandates that a country preserve the right of taxing its residents on their worldwide income and gains (residence tax). In contrast, source jurisdiction allows a country to tax the income and gains arising within its jurisdiction (source tax).<sup>583</sup> Consider an investor resident in Country A that acquires income or wealth in Country B. Absent coordination between the two states, the residence jurisdiction of Country A and the source jurisdiction of Country B may overlap and juridical double taxation may occur.<sup>584</sup> Even supposing the investor in Country A sets up a subsidiary in Country B, which,

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<sup>580</sup> Thomas Walde and Abba Kolo, 'Investor-State Disputes: The Interface Between Treat-Based International Investment Protection and Fiscal Sovereignty' (2007) 35 *Intertax* 424, 424.

<sup>581</sup> Barzel (n 564) 34..

<sup>582</sup> *ibid.*

<sup>583</sup> Oats, Miller and Mulligan (n 124) 22.

<sup>584</sup> See Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 200.

by the law of B, is regarded as a resident of B, the tax claims of the two countries may still overlap. For instance, Country A may challenge the investor with respect to its pricing policies over intra-company transactions and make an upward adjustment of the taxable income regarding the subsidiary in A, whereas Country B refuses to make a corresponding downward-adjustment for the subsidiary in B. As a result, economic double taxation ensues.<sup>585</sup>

### 3.1.2 Asset specificity of investment contracts

A typical process of investment, whether national or international, can be divided into five steps. Specifically, the firm (a) decides to invest; (b) raises funds to finance its investment; (c) uses these funds to hire inputs needed to build factories, warehouses, and the like; (d) after the investment is completed, ends up with a larger stock of capital; and (e) uses the capital (along with other inputs) either to expand production or to reduce costs.<sup>586</sup> At the outset, the firm's decision on where to locate the planned investment is primarily subject to market forces. The investment has not been committed or devoted, and the investor is largely free to shop for the most attractive place to operate. It is at this point that states compete for investments by engaging in tax competition. In particular, states compete for foreign Direct Investment (FDI) for multiple reasons.<sup>587</sup> FDI provides financial resources for host states.<sup>588</sup> In a number of developing countries, FDI is the principal source of external capital.<sup>589</sup> FDI provides the host states with accesses to

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<sup>585</sup> See Oats, Miller and Mulligan (n 124) 412.

<sup>586</sup> William J. Baumol, *Economics: Principles and Policy* (Eleventh edition., South-Western Cengage Learning 2010) 401.

<sup>587</sup> Dietsch and Rixen, 'Tax Competition and Global Background Justice' (n 371) 153–154; Robert Pritchard, 'Introduction: The Contemporary Challenges of Economic Development' in Robert Pritchard, *Economic Development, Foreign Investment and the Law: Issues of Private Sector Involvement, Foreign Investment and the Rule of Law in a New Era* (the Kluwer Law International, International Bar Association 1996) 4–5.

<sup>588</sup> Oral Williams and Sheila Williams, 'The Impact of Foreign Direct Investment Flows to the Eastern Caribbean Central Bank Unified Currency Area' [1999] *Savings and Development* 131, 132.

<sup>589</sup> *ibid.*

new technologies as well as management techniques.<sup>590</sup> It offers opportunities for local firms by developing its supply chains in the host country.<sup>591</sup> In general, it stimulates the host country's economic growth through mobilising domestic resources.<sup>592</sup> It is said that in China as well as Hong Kong, the Republic of Korea, Taipei, and other economies, FDI has been a locomotive for economic prosperity.<sup>593</sup>

From the third step of the investment process, however, the firm begins to commit itself to a specific investment project by using the funds to hire inputs and build the project. The money sunk into the project cannot be used subsequently at another location without significant losses, because the machinery and installations are specifically designed for and tied to the particular project and location. Compared with their domestic equivalents, international investments feature a higher degree and greater scale of asset specificity – after all, it would be pointless for investors to enter a foreign market merely for trivial profits or routine business. “Often, the business plan of a [foreign] investor is to sink substantial resources into the project at the outset of the investment, with the expectation of recouping this amount plus an acceptable rate of return during the subsequent period of investment, sometimes running up to 30 years or more”.<sup>594</sup>

The accrual of asset specificity in investment contracts is a two-way process, though not necessarily symmetric. In other words, not only do investors deploy location- and business-specific resources in the investment, the destination states incur firm-specific expenses as well. Specifically, local labours hired as part of an invested project will develop skills, experiences, and even emotional affinities that are specific to the project. In a broader

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<sup>590</sup> *ibid*; Pritchard (n 587) 5.

<sup>591</sup> Williams and Williams (n 588) 133.

<sup>592</sup> *ibid*.

<sup>593</sup> *ibid*.

<sup>594</sup> Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2nd edn, Oxford University Press, Incorporated 2012) 21.

sense, the dynamics of local public services such as infrastructures, regional supply chains, and even the culture of the local communities will be reshaped by the investment, depending on its importance and scale. For illustration, Boeing's decision to move its corporate headquarter out of Seattle caused dramatic shock to the region. Politicians and public figures in the region described the news as a "blow to our entire community", which "leaves a void in our economic and cultural life".<sup>595</sup> Studies also confirm that the sudden departure of FDI, depending on their scale, may cause disruptions to the host states.<sup>596</sup> Therefore, there is a mutual dependency between investors and the invested states.

The notion of asset specificity or mutual dependency (between the investors and the invested states) is also at the core of international tax rules. Since the 1928 draft convention by the League of Nations, which was the precedent to the OECD and UN Model Conventions, allocation of tax rights among countries has been based on two basic principles: the benefit principle and the single-tax principle.<sup>597</sup> The benefit principle states that active (business) income should be taxed primarily by the source country, and passive (investment) income should be taxed primarily by the residence country.<sup>598</sup> The single-tax principle states that cross-border income should be taxed once at the rate determined by the benefit principle.<sup>599</sup> The single-tax principle merely confirms the purpose of tax treaties: the prevention of double taxation and double non-taxation.<sup>600</sup> It is the benefit principle that reflects the element of asset specificity. The acquisition of active income usually necessitates

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<sup>595</sup> Sam Howe Verhovek With Laurence Zuckerman, 'Boeing, Jolting Seattle, Will Move Headquarters' *The New York Times* (22 March 2001)

<<https://www.nytimes.com/2001/03/22/us/boeing-jolting-seattle-will-move-headquarters.html>> accessed 14 December 2018.

<sup>596</sup> Williams and Williams (n 588) 134.

<sup>597</sup> Reuven S Avi-Yonah, 'Who Invented the Single Tax Principle: An Essay on the History of US Treaty Policy' (2014) 59 *NYL Sch. L. Rev.* 305, 306.

<sup>598</sup> *ibid.*

<sup>599</sup> *ibid.*

<sup>600</sup> OECD, 'MEMAP' (n 1) 7.

material business operations by the earners of such income in the source country.<sup>601</sup> Accordingly, there is a mutual dependency between the earners of active income and the source country. On the other hand, passive income is primarily earned by individuals, most of whom are residents in a particular country.<sup>602</sup> As Avi-Yonah points out, residence usually overlaps with political allegiance.<sup>603</sup> Thus, there is a mutual dependency between the earners of passive income and the residence country. It could be seen that the benefit principle enshrines the notion of economic allegiance, which is a more fundamental basis on which international tax regime rests.<sup>604</sup> Economic allegiance refers to the existence and extent of the economic relationships between a particular state and the income or person to be taxed.<sup>605</sup> Arguably, this notion is another way of expressing mutual dependency or bilateral asset specificity between the investors and the invested states.

The above analysis mainly focuses on the asset specificity embodied in investor-state relationships. Indeed, a substantial degree of mutual dependency, mainly in the form of specialised language, may also develop between tax authorities. This type of asset specificity will be elaborated in the cost analysis below (Section 4.4.2.2). In short, through routine interactions over the specific allocation of cross-border tax bases, tax administrations in different countries may develop a common (professional) language. As Williamson writes, such specialised language helps to foster some personal trust between the contractual parties.<sup>606</sup>

### 3.1.3 Ongoing feature of international tax relationships

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<sup>601</sup> Reuven S Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge University Press 2007) 11–12.

<sup>602</sup> *ibid* 11.

<sup>603</sup> *ibid*.

<sup>604</sup> OECD, 'Addressing the Tax Challenges of the Digital Economy, Action 1 Final Report' (2015) 24-25 (para.28)

<[https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report\\_9789264241046-en](https://read.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en)> accessed 5 June 2019.

<sup>605</sup> *ibid* 24-25 (para.28).

<sup>606</sup> See above, Chapter 2, Section 3.3.1.3.

According to the TCE, for transactions with a high degree of asset specificity, long-term cooperation is crucial for both the investors and the invested states. To be sure, an individual investor may be more vulnerable than the invested state to the risks (commercial and political) associated with the invested project, thereby having a greater stake in securing an ongoing investor-state relationship. However, states' stake in maintaining such relationships is also critical, not only because of the bilateral asset-specificity with respect to the existing investments, but also for the extra pressure of competing with each other for future investments. Obviously, a stable and congenial tax climate is vital for a country to attract FDI.

The priority states give to maintaining stable and agreeable tax relationships over collecting short-term revenue is manifested in the historic evolution of the international tax regime. As discussed at the beginning of this section, the tax claims of different countries may overlap with respect to international investments. Originally, international investments were subject to double taxation, since all jurisdictions exerted their tax rights to the full.<sup>607</sup> Double taxation distorts the cross-border flow of investments and hampers the growth of international economies.<sup>608</sup> As a result, states commonly coordinate their competing tax rights by entering into bilateral tax treaties.<sup>609</sup> Many states even unilaterally provide tax credit or exemption for their residents who acquire income from abroad.<sup>610</sup>

That being said, international cooperation on the prevention of double taxation embodies distributive conflicts. Specifically, source countries normally favour higher source tax, whereas residence countries favour residence tax and prefer to limit source tax.<sup>611</sup> Note that all countries are

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<sup>607</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 200.

<sup>608</sup> Oats, Miller and Mulligan (n 124) 25.

<sup>609</sup> Ring (n 35) 119; Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 207.

<sup>610</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 200–201; Ring (n 35) 118–119.

<sup>611</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 201.

simultaneously residence and source countries, yet to different degrees.<sup>612</sup> Thus their distributive interests hinge upon their relative investment positions: net capital importers have a stronger interest in source tax, whereas net capital exporters have a greater preference for residence tax.<sup>613</sup> Therefore, international tax cooperation is a typical coordination game with distributive conflicts, or a BOS game.<sup>614</sup> Fortunately, international institutions such as the League of Nations, the OECD, and the UN have continuously engaged in providing focal points for this game by developing model tax conventions.<sup>615</sup> In particular, the OECD Model Convention is the most successful in fostering a convergence of states' expectations regarding the acceptable ways of allocating tax rights among them.<sup>616</sup> Income tax treaties around the world are remarkably similar to each other, mostly being based on the OECD Model, although the Model is not binding in a strict legal sense.<sup>617</sup> "One can pick up any modern tax treaty and immediately find one's way around, often even down to the article number".<sup>618</sup> This fact testifies to the theory of the BOS game: once a focal point is provided and the distributive conflict solved, parties will have no incentive to defect.<sup>619</sup> Some writers further suggest that in the game of international tax cooperation, the coordination aspect outweighs the conflict aspect, considering that many countries unilaterally provide tax credit or exemption for their residents doing business abroad.<sup>620</sup> As a result, scholars generally confirm that the double-taxation regime is remarkably successful and stable.<sup>621</sup>

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<sup>612</sup> *ibid.*

<sup>613</sup> *ibid.*

<sup>614</sup> *ibid.*; Ring (n 35) 137–139.

<sup>615</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 207.

<sup>616</sup> *ibid.*

<sup>617</sup> Avi-Yonah, *International Tax as International Law* (n 601) 3.

<sup>618</sup> John F Avery Jones, 'The David R. Tillinghast Lecture—Are Tax Treaties Necessary' (1999) 53 *Tax L. Rev.* 1, 2.

<sup>619</sup> See above, Chapter 2, Section 2.3.1.

<sup>620</sup> Ring (n 35) 139 ("the coordination game seems a relatively strong description of the nature of the interactions"); see also Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 201.

<sup>621</sup> Ring (n 35) 139; Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 207–208; Cockfield (n 223) 59.

The correlation between asset specificity in international investments, on the one hand, and the ongoing nature of international tax relationships, on the other, has already been indirectly touched on by Green, who points out that whereas retaliation is widely used in trade regimes, it is rarely employed in tax domains.<sup>622</sup> Even the initial breach of tax-treaty obligations that may trigger treaty partners' retaliation is extremely rare.<sup>623</sup> An important reason for this fact, argues Green, is that unlike trade restrictions, which can target a narrowly defined industry of a foreign country, tax restrictions may have a broader effect on the domestic market of the country taking such disruptive measures.<sup>624</sup> Not only foreign investors, but also domestic labour will be adversely affected.<sup>625</sup> This argument confirms the point that FDI is so embedded in the host state that any punitive measures by the host state targeting those investments will likely backfire on that state. In this sense, despite the headlines of tax war or tax battles, as mentioned in the Introduction, the real fiscal world has not entered such conflicts on a large scale. In contrast, the prospect of a global trade war does seem to loom large.<sup>626</sup> The institutional comparison between ITDR and trade dispute resolution will be further discussed in Chapter 4.<sup>627</sup>

### **3.2 Contractual incompleteness**

According to TCE, relational investment contracts are bound to be imperfect, owing to positive transaction costs, or bounded rationality.<sup>628</sup> Such contractual incompleteness becomes particularly severe where the tax component of the investment contracts is concerned. Specifically, as

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<sup>622</sup> Green (n 13) 118–119; See also above, Chapter 1, section 2.3.2.1.

<sup>623</sup> Green (n 13) 119.

<sup>624</sup> *ibid* 118.

<sup>625</sup> *ibid*.

<sup>626</sup> 'Are We Heading for a Global Trade War?'

<<https://www.brewin.co.uk/individuals/insights/further-thinking/are-we-heading-for-a-global-trade-war/>> accessed 15 July 2019.

<sup>627</sup> See below, Chapter 4, Section 3.1.1.1.

<sup>628</sup> See above, Chapter 2, Section 3.3.1.2.

discussed above (Section 3.1.1), the tax components of most investment contracts are automatically taken from tax law and tax treaties applicable in Contracting States rather than being negotiated on an ad hoc basis. The wholesale application of tax law and treaties adds extra incompleteness to investment contracts in a number of ways.

### **3.2.1 Vagueness of legal rules**

Often the language used in laws and treaties is ambiguous and unclear, as they are intended to be applied to a wider scope of people compared with private contracts.<sup>629</sup> This is particularly the case in tax laws, which “applies to nearly all economic activities, all individuals and all business enterprises, each with different attributes”.<sup>630</sup> Relative to domestic tax laws, international tax treaties can be more ambiguous. This is not just because of the general fact that treaties often reflect compromises to reconcile wide differences among the Contracting States,<sup>631</sup> but also because of the unique process of negotiating tax treaties. As was explained above (Section 3.1.3), most countries use the OECD Model as the template for the negotiation of their tax treaties; thus most tax treaties are quite similar to one another. The similarity of tax treaties contributes to extra incompleteness of the international tax regime, as those treaties are less able to accommodate the particular circumstances or concerns of individual countries.<sup>632</sup>

### **3.2.2 Supplementary nature of tax treaties**

Tax treaties mostly lack operative provisions of law; they do not create any new taxation independent of national tax systems, nor do they seek to unify

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<sup>629</sup> Dale McFadzean, *Legal Method* (Dundee University Press 2010) 65.

<sup>630</sup> Rebecca M Kysar, ‘Interpreting Tax Treaties’ (2015) 101 *Iowa L. Rev.* 1387, 1414.

<sup>631</sup> Anthony Aust, *Modern Treaty Law and Practice* (Third edition., Cambridge University Press 2013) 205.

<sup>632</sup> Kysar (n 630) 1417–1418.

those systems.<sup>633</sup> Instead, states have original jurisdictions to tax, and by concluding tax treaties they agree to restrict their tax laws in one way or another so as to avoid double taxation.<sup>634</sup> In principle, the restriction of a state's domestic tax law takes two forms: the waiver of the state's tax claim in favour of its treaty partner (exemption method) and the grant of a credit against its tax for taxes paid in the other state (credit method).<sup>635</sup> The task of deciding which state can exercise its tax claims and which state should provide tax exemption or credit hinges upon the distributive rules stipulated in tax treaties.<sup>636</sup> For example, business profits are normally solely taxed in the residence state, whereas business profit from a PE are taxed by both of the Contracting States, with the residence state giving double tax relief for taxes levied by the source state.<sup>637</sup> Capital gains are normally taxed in the residence state, while the sales of shares connected to immovable property situated in the other state should be taxed in that other state, subject to certain threshold requirements.<sup>638</sup> Once an international tax base has been disentangled and assigned to relevant states, those states apply their own laws to exercise tax rights. Therefore, tax treaties only regulate the interface of national tax systems, performing the role as the "rules of limitation of law" rather than the rules of substantive law.<sup>639</sup> Accordingly, the so-called international tax regime is not a global tax levied by a transnational power, but rather comprised of domestic tax laws as limited by tax treaties. However, since national tax systems (and other relevant national laws) vary from country to country, the supplementary nature of tax treaties renders the international tax regime intrinsically incomplete.

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<sup>633</sup> *ibid* 1411.

<sup>634</sup> Klaus Vogel, 'Double Tax Treaties and Their Interpretation' (1986) 4 *Int'l Tax & Bus. Law* 1, 22.

<sup>635</sup> *ibid* 23.

<sup>636</sup> OECD, 'Action 1 Final Report' (n 604) 26 (para.33).

<sup>637</sup> Oats, Miller and Mulligan (n 124) 159.

<sup>638</sup> *ibid* 173.

<sup>639</sup> Kysar (n 630) 1411; Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 206.

### 3.2.3 Separate-entity approach to the taxation of MNEs

Related to the supplementary nature of tax treaties as described above, another feature of the international tax regime is the separate-entity approach to the taxation of MNEs. Under this approach, various affiliates of an MNE are treated as if they were independent of each other, and each country's tax legislation is then applied to each part of the MNE.<sup>640</sup> While the approach allows each state to retain its autonomy in enacting and implementing tax policies, an MNE is in reality a unified whole, and hence can manipulate the flow of resources and profits among its affiliates. As Rixen writes, "transnational tax bases are not givens that sit still and wait to be carved up between national tax authorities."<sup>641</sup> This is quite analogous to the oil-extraction case discussed previously: while each country owns an "area of the surface" of an international tax base by reference to the legal form of an MNE and its affiliates, the migratory nature of the tax base gives rise to a common-pool problem.<sup>642</sup> Therefore, the separate-entity approach leads to incomplete delineation of trans-border tax bases among states.

### 3.2.4 Bilateral character of tax treaties

In addition to their supplementary nature, most tax treaties also have a bilateral character: each is concluded between a pair of Contracting States.<sup>643</sup> Accordingly, the tax concessions granted in a tax treaty, such as reduced withholding-tax rates, are intended to benefit only the persons who are residents in either country that is a party to the treaty.<sup>644</sup> The bilateral allocation of international tax bases is unavoidably imperfect given the fact that MNEs increasingly extend their reach to multiple countries. Consider a

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<sup>640</sup> Jean-Pierre Vidal, 'The Achilles' Heel of the Arm's Length Principle and the Canadian GlaxoSmithKline Case' (2009) 37 *Intertax* 512, 512–513.

<sup>641</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 210.

<sup>642</sup> For discussion of the common pool problem, see above, Chapter 2, Section 2.3.3.

<sup>643</sup> Oats, Miller and Mulligan (n 124) 476.

<sup>644</sup> *ibid.*

property (e.g. mining ore) involving multiple parties; bilateral way of allocating this property may either cause the overlap of individual claims, or leave part of the resource in the public domain.

### 3.3 Base appropriation and the resulting economic losses

According to TCE, an incomplete contract gives rise to opportunistic appropriation by the contracting parties.<sup>645</sup> Likewise, incomplete rules on the delineation of tax bases also give rise to competitive appropriation of the bases (base appropriation) among the taxpayers and the relevant tax authorities. Such base appropriation is largely asymmetric. In the first place, the taxpayers have an information advantage regarding their own business and tax arrangements as compared with the relevant tax administrations.<sup>646</sup> Owing to this information advantage, the taxpayers may engage in various tax-avoidance schemes.<sup>647</sup> Such schemes usually take advantage of the separate-entity approach and the bilateral character of tax treaties. Specifically, the separate-entity approach allows an MNEs to manipulate the transfer pricing over its intra-company transactions so that income accrues in a low-tax jurisdiction and expenses in a high-tax one.<sup>648</sup> In a similar vein, the bilateral character of tax treaties encourages MNEs to engage in “treaty shopping”. The most common method of “treaty shopping” involves an MNE’s establishment of a subsidiary, usually a “letterbox” company, as a pass-through entity to reap the benefits of a particular tax treaty to which the MNE would otherwise have no access.<sup>649</sup>

Despite the taxpayers’ *ex ante* information advantage, states have *ex post* legal power to scrutinise taxpayers’ tax files and, in the event of tax evasion or

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<sup>645</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 242.

<sup>646</sup> Oats, Miller and Mulligan (n 124) 462.

<sup>647</sup> *ibid* 14.

<sup>648</sup> Rixen, ‘From Double Tax Avoidance to Tax Competition’ (n 223) 208.

<sup>649</sup> *ibid* 208–209.

unacceptable tax avoidance, challenge the taxpayers' position. It is true that as far as the tax administrations apply international tax rules correctly in revenue collection, they are reaping their fair share of tax bases. Nonetheless, since tax rules themselves are vague due to the contractual incompleteness, it becomes quite difficult for tax administrations to accurately discern the line between legitimate base allocation and problematic base appropriation. Frequently, tax administrations may push the line outward and overexploit the tax bases, thereby double taxing the taxpayers. In terms of frequency and magnitude, the most important source of double-taxation cases is associated with transfer-pricing adjustments.<sup>650</sup> Asymmetry also exists between the two (or more) Contracting States in base appropriation. Usually, the source state gains a "first-bite" privilege over the tax base due to its proximity to the source of income.<sup>651</sup>

As TCE suggests, contractual appropriation may cause the mutual gain from contractual adaptation to dissipate. In the context of international taxation, major economic losses resulting from base appropriation can be identified as described below.

### **3.3.1 Losses associated with international tax avoidance**

International tax avoidance causes the problem of BEPS for the affected countries. It is reported that a number of the most influential MNEs have planned their businesses in such a way that they have ultimately paid very little tax.<sup>652</sup> According to the OECD (2015), at 2014 levels, the net loss of global corporate tax revenues caused by BEPS amounted to US \$100-240 billion, or 4-10% of the total corporate tax revenues.<sup>653</sup> Alvarez-Martinez et al. (2018) estimate that for the year 2012, there was a loss of €36 billion in

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<sup>650</sup> Burnett (n 77) 174.

<sup>651</sup> Avi-Yonah, *International Tax as International Law* (n 601) 12.

<sup>652</sup> Oats, Miller and Mulligan (n 124) 636.

<sup>653</sup> OECD, 'Measuring and Monitoring BEPS, Action 11 Final Report' (OECD 2015) 101 (para. 174).

corporate tax revenue among EU countries due to BEPS activities.<sup>654</sup> For the US, the total revenue loss is estimated at €100.8 billion, including € 96.8 billion accruing to tax heavens.<sup>655</sup> Japan is estimated to have lost €24 billion in corporate tax revenue, of which €23.3 billion went to tax havens.<sup>656</sup> Henry (2012) reveals that some \$ 21 trillion was cloaked by wealthy elites in secretive offshore jurisdictions to avoid taxes in their home countries.<sup>657</sup> Various other empirical studies also point to the proliferation and severity of BEPS.<sup>658</sup>

Concerns have been raised about the adverse impact of BEPS. First, BEPS undermines the fairness and integrity of tax systems and relevant legal rules.<sup>659</sup> Specifically, it grants businesses that operate across borders an unfair competitive advantage over their domestic rivals, thereby undermining the spirit of fair play.<sup>660</sup> It also erodes the sense of corporate social responsibility, and thus places corporation's reputation at risk.<sup>661</sup> Second, it shifts fiscal burdens to those more inert tax bases such as domestic labours, as countries have to make up for the revenue losses caused by BEPS.<sup>662</sup> Third, tax-avoidance activities per se incur expenses. Complex tax-planning schemes usually involve "armies of bankers, lawyers and accountants who ensure that even though the letter of the law is respected, increasingly immoral ways are found of perverting the spirit of the law to ensure that tax is avoided".<sup>663</sup> In return, these tax-shelter promoters are highly paid by their

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<sup>654</sup> Maria Alvarez-Martinez and others, 'How Large Is the Corporate Tax Base Erosion and Profit Shifting? A General Equilibrium Approach (Working Paper)' [2018] Center for Economic Studies and Ifo Institute 4.

<sup>655</sup> *ibid.*

<sup>656</sup> *ibid.*

<sup>657</sup> James S Henry, 'The Price of Offshore Revisited' (2012) 22 Tax Justice Network 57, 5.

<sup>658</sup> OECD, 'Action 11 Final Report' (n 653) 103–106; Alvarez-Martinez and others (n 654) 4–8.

<sup>659</sup> 'About - OECD BEPS' <<http://www.oecd.org/tax/beps/about/>> accessed 1 October 2019.

<sup>660</sup> *ibid.*

<sup>661</sup> Jasmine M Fisher, 'Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility' (2014) 94 BUL Rev. 337, 354–356.

<sup>662</sup> *ibid.* 357.

<sup>663</sup> 'Financial Crime: Legislation - Hansard' column 375

<<https://hansard.parliament.uk/Lords/2011-03-17/debates/11031761000398/FinancialCrimeLegislation>> accessed 12 October 2019; Prem Sikka and Hugh Willmott, 'The Tax Avoidance Industry:

clients. It is reported that the annual revenue of the Big Four firms has continued to swell, and in particular, they generate around £1 billion in fees each year from commercial tax planning and artificial-avoidance schemes.<sup>664</sup> Lastly, BEPS forces tax administrations to deploy extra resources in developing and implementing anti-avoidance measures, such as tax audit and transfer-pricing documentation.<sup>665</sup> For example, starting from 2005, the Canadian Minister of Finance has increased by CA \$30 million per annum the resources devoted to tackling aggressive international tax plans.<sup>666</sup> It should be noted that the anti-avoidance measures taken by tax authorities would in turn increase the compliance costs for taxpayers.<sup>667</sup>

### 3.3.2 Losses associated with double taxation and tax disputes

As the MEMAP notes, double taxation has a detrimental effect on the movements of capital, technology, and persons, and on the exchange of goods and services.<sup>668</sup> In particular, it distorts investment decisions, as international investments become less profitable compared with domestic ones due to the high tax burden.<sup>669</sup> Sometimes double taxation increases the real tax rate to such a high level that international investments are stifled.<sup>670</sup> In addition, the resolution of double-taxation disputes also implies costs, and a core theme of this research is to explore ways to economise these costs.

### 3.4 Specialised dispute-settlement system

Given the *ex ante* incompleteness of the international tax regime (as part of

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Accountancy Firms on the Make' (2013) 9 Critical perspectives on international business 415, 417.

<sup>664</sup> Sikka and Willmott (n 663) 418.

<sup>665</sup> Oats, Miller and Mulligan (n 124) 462–463.

<sup>666</sup> 'Status Report of the Auditor General of Canada' (February 2007) 6

<[http://www.oag-bvg.gc.ca/internet/English/parl\\_oag\\_200702\\_07\\_e\\_17473.html](http://www.oag-bvg.gc.ca/internet/English/parl_oag_200702_07_e_17473.html)> accessed 18 October 2019; see also Vidal (n 640) 513.

<sup>667</sup> Oats, Miller and Mulligan (n 124) 462.

<sup>668</sup> OECD, 'MEMAP' (n 1) 8 (Section 1.1.2).

<sup>669</sup> For the efficiency implication of double taxation, see Oats, Miller and Mulligan (n 124) 25.

<sup>670</sup> Avi-Yonah, *International Tax as International Law* (n 601) 10.

investment contracts) and the resulting base appropriation, the significance of *ex post* dispute settlement becomes salient. Specifically, an appropriate ITDR system can economise the international tax regime by both saving states the costs of *ex ante* drafting perfect tax laws and treaties and attenuating the *ex post* base appropriation among the taxpayers and relevant states.<sup>671</sup>

According to TCE, a relational contract requires a more flexible dispute-settlement system, as the otherwise legalistic mode may: (a) undermine the ongoing relationship between the contracting parties; and (b) lead to unpalatable decisions on the case due to the adjudicator's failure to capture the spirit of the contractual relation. These arguments also apply to the choice of ITDR modes.

### **3.4.1 Effect on international tax relationships**

In general, legalistic dispute-settlement procedures are more confrontational and adversarial than negotiation or consultation, thus more likely to spoil the relationship between the contractual parties.<sup>672</sup> Accordingly, it is widely accepted that litigation is far more likely to occur where there is no ongoing relationship between the parties or where such a relationship has definitively terminated.<sup>673</sup>

In the context of ITDR, it is said that in French, the MAP is translated as a "friendly procedure".<sup>674</sup> This term is a reminder of the ongoing relationships between tax authorities, and between those authorities and taxpayers.<sup>675</sup> Indeed, the appreciation of congenial tax relationships is reflected in the entire process of tax administration. In 2002, the OECD established the Forum on Tax Administration (FTA), which has become a unique forum for the

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<sup>671</sup> See Williamson, 'Transaction-Cost Economics' (n 363) 246.

<sup>672</sup> Green (n 13) 130.

<sup>673</sup> *ibid.*

<sup>674</sup> Brown (n 11) 86.

<sup>675</sup> *ibid.*

cooperation between and among revenue bodies at a Commissioner-level, with participation from 53 OECD and non-OECD countries.<sup>676</sup> In 2014, the FTA published the *Multilateral Strategic Plan on Mutual Agreement Procedures*, which notes that the success of the MAP “critically depends on strong, collegial relationships, grounded in mutual trust, between and among competent authorities around the world.”<sup>677</sup> With respect to the relationship between taxpayers and tax administrations, the FTA has developed a cooperative-compliance framework, whereby revenue bodies are encouraged to establish relationships with businesses based on trust and cooperation.<sup>678</sup> A growing number of countries have implemented this cooperative-compliance approach.<sup>679</sup>

### 3.4.2 Effect on treaty application

As discussed previously, as early as the time of the League of Nations, treaty drafters began to recognise that tax treaties can only be applied with flexibility, considering “the diversity of national laws and the extreme complexity and variety of the individual cases that arise”.<sup>680</sup> The proposition carries even more weight today. Specifically, the supplementary and bilateral nature of tax treaties and the separate-entity approach to the taxation of MNEs have perpetuated since the League of Nations. At the same time, international tax bases have been increasingly mobile due to the liberalisation of international economics and the development of ICT. All these factors make it more difficult for legalistic methods of dispute settlement to render viable decisions on tax

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<sup>676</sup> ‘About - Forum on Tax Administration’

<<https://www.oecd.org/tax/forum-on-tax-administration/about/>> accessed 9 September 2019.

<sup>677</sup> OECD FTA, ‘Multilateral Strategic Plan on Mutual Agreement Procedures: A Vision For Continuous Map Improvement’ para 15; ‘OECD Mutual Agreement Procedure (MAP) Statistics - Blogs - Tax News - ICAEW Blogs and Discussions’

<<https://ion.icaew.com/taxfaculty/b/weblog/posts/oecdmutualagreementproceduremapstatistics>> accessed 12 October 2019; Brown (n 11) 107.

<sup>678</sup> ‘Co-Operative Compliance: A Framework’ (OECD) 13

<[https://read.oecd-ilibrary.org/taxation/co-operative-compliance-a-framework\\_9789264200852-en](https://read.oecd-ilibrary.org/taxation/co-operative-compliance-a-framework_9789264200852-en)> accessed 9 September 2019; Kollmann and Turcan (n 58) 68–69.

<sup>679</sup> Kollmann and Turcan (n 58) 68.

<sup>680</sup> See above, Chapter 1, Section 1.2.

cases.

#### 3.4.2.1 Difficulties in treaty interpretation

As discussed above (Section 3.2.2), tax treaties mainly function as limitations on domestic tax laws rather than as substantive tax rules. Consequently, those treaties often refer to or “piggyback” on domestic concepts.<sup>681</sup> For example, pursuant to Article 7 of the OECD Model, if a non-resident enterprise carries out business in the host state through a PE situated in that host state, the host state has the primary right to tax the enterprise on its *business profits* that are attributable to the PE.<sup>682</sup> The residence state may still tax the enterprise for its worldwide income, but has to grant tax credit for the tax levied by the host state.<sup>683</sup> However, the term “business profits” in Article 7 is not defined by the treaty itself, and it is highly likely that the source and the residence states employ different methods of calculating business profits attributable to a PE.<sup>684</sup> Many believe that this difference is a major source of double taxation or double non-taxation in the taxation of business profits with respect to PE.<sup>685</sup>

To be sure, tax treaties do contain a handful of defined terms, many of which are related to distributive rules.<sup>686</sup> Nevertheless, many of these terms are insufficiently defined, and thus need further clarification.<sup>687</sup> The Boulez case offers an example: a German resident, Pierre Boulez, received a payment from a US company for his performance as a music conductor in the US.<sup>688</sup> There was a question as to whether the payment constituted a royalty, which was only taxable in Germany pursuant to the then US-Germany tax treaty, or

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<sup>681</sup> Kysar (n 630) 1411.

<sup>682</sup> OECD Model Convention (2014) Art.7; see also Oats, Miller and Mulligan (n 124) 226.

<sup>683</sup> OECD Model Convention (2014) Art.7.

<sup>684</sup> Celeste Black, ‘The Attribution of Profits to Permanent Establishments: Testing the Interaction of Domestic Taxation Laws and Tax Treaties in Practice’ [2017] British Tax Review 172.

<sup>685</sup> *ibid* 173.

<sup>686</sup> For example, see OECD Model Convention (2014) Arts.3 (1), 4, 5.

<sup>687</sup> Kysar (n 630) 1412.

<sup>688</sup> *Boulez v Commissioner* (1984) 83 TC (US) 584, 584–585.

service income, which was only taxable in the US, according to the same treaty.<sup>689</sup> Although the treaty in question defines “royalties” in Article VIII (3), the definition is incomplete and requires further clarification.<sup>690</sup> The two competent authorities interpreted the term differently, and the taxpayer was ultimately double taxed.<sup>691</sup>

In this connection, Article 3(2) of the OECD Model provides a gap-filling mechanism by prescribing that terms that are not defined by the treaty are given meaning under the law of the state that is applying the treaty.<sup>692</sup> This method, sometimes also known as the *lex fori* approach, does carry some pragmatic wisdom in a domestic context, since a domestic court or authority standing to apply a tax treaty knows its own law best.<sup>693</sup> Nonetheless, the method becomes largely irrelevant in the ITDR context, which should be neutral to either Contracting State. Furthermore, even in a domestic context, it is widely recognised that the *lex fori* method may lead to double taxation or double non-taxation, since Contracting States may apply the treaty differently given the variation of domestic laws.<sup>694</sup> In both the Boulez case and the example of PE taxation, the outcome of double taxation results from the very fact that the source and the residence states each applies its own laws in interpreting the questioned treaty terms.

In this vein, it seems quite necessary to develop an autonomous method of treaty interpretation in the context of legalistic ITDR. In particular, in the event that double taxation results from divergent treaty interpretations by the two Contracting States based on their own domestic laws, a tax arbitrator/adjudicator must decide which interpretation prevails. However, this task is quite difficult, if not impossible, because each state is justified in

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<sup>689</sup> *ibid* 584.

<sup>690</sup> Vogel (n 634) 65; *Boulez*, 83 TC (1984) (n 688) 590–591.

<sup>691</sup> Vogel (n 634) 65; *Boulez*, 83 TC (1984) (n 688) 588.

<sup>692</sup> OECD Model Convention (2014) Art.3(2); see also Kysar (n 630) 1411.

<sup>693</sup> Vogel (n 634) 63.

<sup>694</sup> *ibid*; Kysar (n 630) 1424.

choosing its own way of defining certain concepts in its domestic law based on its own social and economic circumstances or policies. Given the non-substantive nature of tax treaties, these domestic concepts constitute equal parts of a double-taxation regime upon the two Contracting States. As a result, any decision (from a legalistic approach to ITDR) claiming that the interpretation of a particular treaty term by one state is superior to that of the other may encounter legitimacy challenges from the losing state or the wider public.

Several commentators recommend that one way of ensuring uniformity of treaty interpretation while avoiding controversy is to uniformly base treaty interpretation upon the law of either the source or the residence country.<sup>695</sup> Nonetheless, the choice between the two approaches is not an easy task. Consider the above-mentioned example of calculating business profits attributable to a PE. On the one hand, the source country has a “first-bite” privilege to tax the profits attributable to the PE, and hence is entitled to adopt the source-country approach to treaty interpretation.<sup>696</sup> On the other hand, since the residence country must apply its own foreign tax credit rules in crediting the tax levied by the source country, the residence-country approach is also relevant in this case.<sup>697</sup> Moreover, in many cases, the identification of source country or residence country rests upon ascertaining the residency status of the taxpayer concerned, which in itself could be extremely controversial. It is true that the term of residence is to some extent defined in tax treaties. For example, as discussed above, the traditional tie-breaker rule hinges the determination of corporate residency – in the case of dual residency – upon the notion of “place of effective management”.<sup>698</sup> However,

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<sup>695</sup> Vogel (n 634) 64–65; Kysar (n 630) 1423–1424; John F Avery Jones and others, ‘The Interpretation of Tax Treaties with Particular Reference to Article 3 (2) of the OECD Model-II’ [1984] *British Tax Review* 90.

<sup>696</sup> Kysar (n 630) 1424.

<sup>697</sup> *ibid.*

<sup>698</sup> See above, Chapter 1, Section 1.7.1.

the application of this notion is far from straightforward. In particular, two different approaches can be identified: the Anglo-American concept of “central management and control” and the Continental European “place of management”.<sup>699</sup> Each of the two approaches may lead to more than one residence for a particular company.<sup>700</sup> Dual residency status is an important source of double taxation, as, based on the residence jurisdiction, a country has the right to tax its residents over their worldwide income.<sup>701</sup> Meanwhile, companies sometimes deliberately acquire dual residence as part of their tax-planning schemes.<sup>702</sup> This concern about tax avoidance motivates the recent amendment to the traditional tie-breaker rule, which will be revisited below (Section 3.4.2.3).

#### 3.4.2.2 Difficulties in establishing arm’s-length prices

As was discussed above (Section 3.3.1), the separate-entity approach to the partitioning of international tax bases among countries and the bilateral nature of tax treaties may give rise to aggressive tax planning. To tackle this problem and ensure that each state can collect a fair share of corporate tax, tax treaties and domestic tax laws introduce the arm’s-length principle. Specifically, the pricing of transactions between associated enterprises within an MNE group should be determined as if those enterprises were arm’s-length parties.<sup>703</sup> The most common method of establishing arm’s-length prices is to compare the questioned transfer price with the comparable uncontrolled price (CUP) of the transactions between independent parties.<sup>704</sup> However, the main problem with the CUP method is the difficulty in establishing the comparability between the uncontrolled

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<sup>699</sup> Eva Burgstaller and Katharina Haslinger, ‘Place of Effective Management as a Tie-Breaker-Rule-Concept, Developments and Prospects’ (2004) 32 *Intertax* 376, 377.

<sup>700</sup> *ibid* 379.

<sup>701</sup> Oats, Miller and Mulligan (n 124) 76.

<sup>702</sup> *ibid* 90.

<sup>703</sup> Vidal (n 640) 512–513.

<sup>704</sup> Avi-Yonah, *International Tax as International Law* (n 601) 104.

transactions and the intra-company transactions at issue.<sup>705</sup> More often than not, the internal prices within companies are invariably different from those charged between independent parties.<sup>706</sup> The identification of the CUP becomes more difficult when it comes to the transfer pricing of intangible assets, which are unique by nature.<sup>707</sup>

The problem with the CUP is exemplified in the *Glaxo* case.<sup>708</sup> Glaxo Canada was a subsidiary of a UK corporation, Glaxo Group Ltd. It purchased an active ingredient (ranitidine) to make and distribute Zantac in Canada. During the relevant period, Glaxo Canada purchased its active ingredient from Adechsa SA, a Swiss subsidiary of the Glaxo Group. This Swiss affiliation was a middleman, with the ingredient being manufactured by a Singapore subsidiary of the same group. The Glaxo Group had patented the manufacturing method of ranitidine, yet during the year under examination, the patent had expired and several generic versions of the material were available in the market. Glaxo Canada was paying around CA\$ 1,500 per kilo to the Swiss company during the examined period, while the generic versions were traded at the price between CA\$ 194 and \$304 per kilo. The Canadian tax authority suspected that the transfer pricing adopted by Glaxo Canada (and the entire group) mainly served the purpose of shifting the group profits from Canada to Singapore, in which the Glaxo's Singapore affiliation did not pay income tax for 10 years before being subject to an income tax rate of only 10%. The tax authority then used the price of generic ranitidine as the CUP and sought to adjust the taxable income of Glaxo Canada upward. The Tax Court of Canada found for the tax authority, ruling that the reasonable transfer price of Glaxo Canada should be the highest price for the generic product,

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<sup>705</sup> Oats, Miller and Mulligan (n 124) 424.

<sup>706</sup> *ibid* 419; Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 210.

<sup>707</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 210.

<sup>708</sup> *GlaxoSmithKine Inc v The Queen* [2008] TCC (Canada) 324; see also Vidal (n 640) 515–516; Oats, Miller and Mulligan (n 124) 435–436.

subject to a small upward adjustment.<sup>709</sup> The decision was overturned by the Federal Court of Appeal, which referred the case back for redetermination.<sup>710</sup> The Court of Appeal reasoned that business realities should be taken into consideration when deciding the reasonable price.<sup>711</sup> The case was then appealed to the Supreme Court of Canada, which upheld the Court of Appeal's decision to remit the case for retrial.<sup>712</sup> On the eve of the second Tax Court trial on the matter, scheduled to commence on January 12, 2015, Glaxo achieved a settlement with the Canadian tax authority.<sup>713</sup>

The taxpayer's major defence, which is also supported by many commentators, was that the market condition of generic ranitidine was not really comparable to that of Glaxo Group, which had deployed significant outlay in researching and developing the ingredient.<sup>714</sup> Among other things, the quality of the generic ranitidine could not be assured and was not comparable to that manufactured by Glaxo Singapore.<sup>715</sup> Market reputation also plays a part. As one writer comments, "there is always this idea that the original product is 'the true product', whereas the copies can only be 'copies'".<sup>716</sup> The *Glaxo* case therefore posed a dilemma. On the one hand, the judgement of market comparability could not dispense with the consideration of major economic variables that have substantial impacts on the pricing; on the other hand, if all the major economic variables had been taken into account, the judge would have been left with no comparable to establish the arm's-length price.<sup>717</sup>

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<sup>709</sup> *Glaxo, TCC (2008)* (n 708) paras 161, 177.

<sup>710</sup> *GlaxoSmithKline Inc v The Queen* [2010] FCA (Canada) 201, para.84.

<sup>711</sup> *ibid* para.76; see also Oats, Miller and Mulligan (n 124) 436.

<sup>712</sup> *Canada v GlaxoSmithKline Inc* [2012] SCC (Canada) 52; see also Oats, Miller and Mulligan (n 124) 435–436.

<sup>713</sup> Legal Post, 'GlaxoSmithKline Transfer Pricing Case Settled | Financial Post' (12 January 2015) <<https://financialpost.com/legal-post/glaxosmithkline-transfer-pricing-case-settled>> accessed 3 October 2019.

<sup>714</sup> Oats, Miller and Mulligan (n 124) 435; Vidal (n 640) 519–523.

<sup>715</sup> Oats, Miller and Mulligan (n 124) 435.

<sup>716</sup> Vidal (n 640) 522.

<sup>717</sup> *ibid* 519.

In light of these difficulties in identifying CUPs, the OECD and numerous states have introduced alternative methods of establishing the arm's-length price including, *inter alia*, resale price minus, cost plus, and transactional net margin. A common feature of these other methods is to shift the focus more or less from the comparable price to the comparable margin (gross profit) of the transaction under examination.<sup>718</sup> However, the establishment of the comparable margin still hinges upon the analysis of market comparability; thus the dilemma posed by the *Glaxo* case persists. Furthermore, the more one moves toward the approach of comparable margin as opposed to comparable price, the less accurate the arm's-length price will become. This is because transactional margin is determined not only by the price of a transaction but also by a multitude of other factors, such as numerous cost items of the transaction.<sup>719</sup>

It should be noted that the difficulties in establishing the arm's-length price are not just because of the increasing sophistication of commercial transactions or the complexity of the business environment – after all, one of the functions of legalistic dispute resolution is to clarify the ambiguity around the legal issues and provide a basic level of certainty both for the litigants and the public in an uncertain world. Rather, the difficulty should be more ascribed to the fundamental fact that the arm's-length price is in itself a legal fiction rather than a reality. Each MNE is actually an integrated whole, and, “ironically, MNEs exist because of the absence or imperfections of an arm's length market.”<sup>720</sup> It follows that any third-party determination of an arm's-length price may be susceptible to being challenged for its arbitrariness. As one commentator writes, while there is no doubt that a judge can always render a judgment on an arm's-length price, the judgment may raise important political

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<sup>718</sup> Avi-Yonah, *International Tax as International Law* (n 601) 102–118.

<sup>719</sup> *ibid* 117.

<sup>720</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 210.

questions.<sup>721</sup> Such political questions were manifested in the proceeding history of the Glaxo case: while the disputed transactions took place between 1990 and 1993, the case was finally settled out of court in 2015, winding up decades of uncertainties for the taxpayer as well as the tax authority.<sup>722</sup> The nuisances arising from the *Glaxo* case should not be taken as an anomaly. In the US, the jurisprudence on transfer-pricing cases has long been subject to criticisms.<sup>723</sup> It is observed that in establishing arm's-length prices, the domestic courts largely rely on "approximations, compromises and rule of thumb" rather than providing principled guidance.<sup>724</sup> As a result, both taxpayers and governments increasingly bypass the courts in their attempts to resolve tax disputes.<sup>725</sup>

#### 3.4.2.3 Issue of double non-taxation

According to TCE, as a relational contract evolves, its original text becomes increasingly obsolete, thereby giving rise to more loopholes. Consequently, there is a possibility that one or both parties may appropriate the contractual gains by relying on the literal letter of the contract.<sup>726</sup> This proposition carries more weight in the tax world, in which taxpayers are always one step ahead of tax treaties, both because of the vagueness of the treaties and the ever-changing business environment.<sup>727</sup> As a result, national governments may fear that a legalistic ITDR system, which is characterised by an adherence to hard rules, may provide a sword for taxpayers to "poach" the national fiscal base by employing aggressive tax-planning schemes.<sup>728</sup> For example, a taxpayer may perpetrate treaty shopping and achieve double

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<sup>721</sup> Vidal (n 640) 526.

<sup>722</sup> Post (n 713); see also Oats, Miller and Mulligan (n 124) 435.

<sup>723</sup> Avi-Yonah, *International Tax as International Law* (n 601) 104; Yariv Brauner, 'Tax Treaty Disputes in the United States' in Eduardo Baistrocchi (ed), *A Global Analysis of Tax Treaty Disputes* (Cambridge University Press 2017) 60–62.

<sup>724</sup> Brauner (n 723) 61.

<sup>725</sup> *ibid* 62.

<sup>726</sup> Williamson, 'Transaction-Cost Economics' (n 363) 240.

<sup>727</sup> Kysar (n 630) 1422.

<sup>728</sup> Cai (n 327) 454.

non-taxation by taking advantage of the text of a particular tax treaty. The concern is, as argued by Farah, that in the same manner, that taxpayer will be able to use legalist ITDR methods to enforce the outcome of double non-taxation.<sup>729</sup>

To be sure, concerns about BEPS under the legalistic ITDR method can be relieved by the fact that currently most domestic tax laws or tax treaties have in place anti-avoidance rules. By applying such rules, tax adjudicators may override the plain wording of tax laws and treaties. Nevertheless, anti-avoidance rules should not be taken as a panacea. Specifically, a majority of anti-abuse rules in tax treaties rely on objective tests to establish the existence of treaty abuse. For example, the most widely used anti-abuse method in tax treaties is the limitation-on-benefits rule, which provides that a resident of a Contracting State would be entitled to the treaty benefits only when it is a “qualified person” as defined by the treaty. In principle, a taxpayer can be identified as a qualified person only where there is some nexus between the taxpayer and the relevant Contracting State.<sup>730</sup> Nonetheless, for any objective anti-avoidance rules, there is always a possibility that innovative taxpayers will invent new transaction forms to circumvent them.<sup>731</sup> In this connection, BEPS Action 6 recommends a general anti-abuse rule based on a subjective test. The rule states that if one of the principal purposes of a transaction in question is to reap the tax benefits of the treaty concerned, the taxpayer undertaking the transaction will be denied that benefits.<sup>732</sup> Numerous states have incorporated such general anti-avoidance rules in their domestic tax laws.<sup>733</sup> The problem with this approach is that the task of proving the principle purpose of a transaction could be as thorny as, if not

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<sup>729</sup> Farah (n 174) 31.

<sup>730</sup> US-UK Tax Treaty (2001) Art. 23; Kysar (n 630) 1420; Oats, Miller and Mulligan (n 124) 512–513.

<sup>731</sup> Kysar (n 630) 1420.

<sup>732</sup> OECD, ‘Action 6 Final Report’ (n 122) 9; Oats, Miller and Mulligan (n 124) 513–516.

<sup>733</sup> Oats, Miller and Mulligan (n 124) 485–486.

more than, the establishment of an arm's-length price.<sup>734</sup> While a detailed examination of anti-avoidance rules is beyond the scope of this thesis, suffice it to point out that national courts' attitudes vary toward the application of such rules.<sup>735</sup> At least in several major developed countries, domestic courts are more cautious about disregarding the plain wording of tax treaties for anti-avoidance reasons. For example, Cockfield reports that Canada sees very few cases where tax administrations have succeeded in challenging the treaty shopping as a violation of Canada's general anti-avoidance rules.<sup>736</sup> In the case of *MIL (Investments) v. The Queen*, the court opines in obiter dicta that there is nothing inherently abusive about treaty shopping.<sup>737</sup> Canada, the court reasons, "if concerned with the preferable tax rates of any of its treaty partners, instead of applying section 245 [Canadian anti-avoidance rules, this author added], should seek recourse by attempting to renegotiate selected tax treaties".<sup>738</sup> Avi-Yonah concludes that in the US, taxpayers have had an "enviable" record of victory in big transfer-pricing litigations, even though several of the tax arrangements obviously involved aggressive tax-avoidance schemes.<sup>739</sup> In Germany, it is observed that tax courts take a rather generous attitude toward taxpayers' use of letterbox companies.<sup>740</sup> So long as there is a minimum infrastructure of personnel and assets installed in the companies, the taxpayers establishing such companies will not be found by the courts as having engaged in treaty abuse even though the companies have little active business function.<sup>741</sup>

The concern about double non-taxation and its implications for the function of

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<sup>734</sup> See *ibid* 485–487.

<sup>735</sup> Eduardo Baistrocchi, *A Global Analysis of Tax Treaty Disputes* (Cambridge University Press 2017).

<sup>736</sup> Arthur J. Cockfield, 'Tax Treaty Disputes in Canada' in Eduardo Baistrocchi (ed), *A Global Analysis of Tax Treaty Disputes* (Cambridge University Press 2017) 155; see also Michael N Kandev, 'Treaty Shopping in Canada: The Door Is (Still) Open' (2008) 62 *Bulletin for International Taxation*.

<sup>737</sup> *MIL (Investments) v The Queen* [2006] TCC (Canada) 460, para.72; see also Cockfield (n 736) 155.

<sup>738</sup> *MIL Investment, TCC (2006)* (n 737) para.74.

<sup>739</sup> Avi-Yonah, *International Tax as International Law* (n 601) 106.

<sup>740</sup> Werner Haslehner, 'Tax Treaty Disputes in Germany' in Eduardo Baistrocchi (ed), *A Global Analysis of Tax Treaty Disputes* (Cambridge University Press 2017) 315–316.

<sup>741</sup> *Id.* at 315–316.

ITDR are most vividly exemplified in the recent amendment to the tie-breaker rule under BEPS Action 6. Specifically, the notion of “place of effective management”, upon which the traditional tie-breaker rule rests, has become increasingly obsolete in light of the ever-changing business world. For example, the development of modern ICT makes it possible for company directors to be located all over the world, making and communicating their decisions through digital means.<sup>742</sup> Moreover, modern businesses tend to be organised in a less hierarchical manner, and there are growing instances where multiple headquarters or centres co-exist for a single company.<sup>743</sup> As a result, any predetermined tie-breaker rule will be vulnerable to abuse. A company may deliberately set itself up as a dual-resident taxpayer so as to reap tax benefits – such as offsetting the same tax loss against taxable profits twice in each of the Contracting States – to which it is otherwise not entitled.<sup>744</sup> In this connection, BEPS Action 6 proposes the MAP as a substitution for the predetermined tie-breaker rule in solving the dual-residency issue, recognising that “there had been a number of tax avoidance cases involving dual resident companies” and that “better solution to the issue of dual residency of entities other than individuals was to deal with such situations on a case-by-case basis”.<sup>745</sup> The new tie-breaker rule and the underlying rationale correspond to Williamson’s caveat about the use of legalistic dispute settlement in relational contracts:

*Where personal integrity is believed to be operative, individuals located at the interfaces may refuse to be a part of opportunistic efforts to take advantage of (rely on) the letter of the contract when the spirit of the exchange is emasculated.*<sup>746</sup>

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<sup>742</sup> Burgstaller and Haslinger (n 699) 381.

<sup>743</sup> *ibid.*

<sup>744</sup> Oats, Miller and Mulligan (n 124) 518.

<sup>745</sup> OECD, ‘Action 6 Final Report’ (n 122) p73 (para. 48).

<sup>746</sup> Williamson, ‘Transaction-Cost Economics’ (n 363) 240.

### 3.5 A digression on the formulary approach and its implications for ITDR

The above analysis shows that most of the obstacles to the legalistic method of ITDR, particularly in relation to transfer-pricing cases, are associated with the separate-entity approach to taxation on the revenue of MNEs. This approach also accounts for base appropriation and the attendant welfare losses in the first place, as was explained above (Section 3.3). In this connection, scholars have extensively discussed an alternative means of apportioning international tax bases among countries: the formulary apportionment approach. Under this approach, an MNE's profit is determined through a combined report and then attributed to each part of the enterprise based on a predetermined formula.<sup>747</sup> The formula should reflect the economic substance of each part of the MNE, typically by reference to a combination of factors such as property, sales, and payroll.<sup>748</sup> In some major aspects, the formulary approach is reminiscent of the unitisation strategy in the oil industry discussed previously.<sup>749</sup> By using the combined report of a MNE as the starting point of assessing tax liability, the formulary approach pools a transnational tax base together before apportioning it among jurisdictions. Because the tax base is pooled, there is far less scope for the MNE to relocate its paper profits among jurisdictions.<sup>750</sup> Furthermore, since the formulary approach features a uniform standard of calculating and apportioning tax bases, a legalistic method of dispute settlement could be instrumental in clarifying this common standard, and could avoid the difficulties of establishing arm's-length price. In a few countries such as Spain and Switzerland, and in some US states, the formulary method has already

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<sup>747</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 211.

<sup>748</sup> *ibid.*

<sup>749</sup> See above, Chapter 2, Section 2.3.3.

<sup>750</sup> Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 211.

been implemented at a domestic level.<sup>751</sup>

Given the theoretical advantage of the formulary approach over separate-entity approach, it is natural to ask why countries do not agree on this approach as an alternative transfer-pricing regime. The clue to answering this question goes back to the starting point of TCE: because of transaction costs, or the bounded rationality of contractual parties, relational contracts are bound to be imperfect. Specifically, the global formulary approach entails multilateral efforts, which could be prohibitively costly compared with a bilateral approach to treaty negotiation. Such multilateral efforts, as the OECD recognises in the *Transfer Pricing Guidelines*, require substantial international coordination and consensus on the predetermined formula to be used, the composition of the MNE group in question, the use of a common accounting system, and so on, and reaching such agreement would be time consuming and extremely difficult.<sup>752</sup> In particular, the negotiation of the formula will encounter considerable bargaining problems, since each country would have a strong incentive to devise the formula weights in its own favour to maximise its revenue.<sup>753</sup> Furthermore, similar to the design of tie-breaker rule discussed above, any predetermined formula could be arbitrary and would likely encourage abusive planning by taxpayers, albeit to a lesser extent than the legal-entity approach.<sup>754</sup> A variety of other concerns about the formulary approach have also been discussed in the Guidelines.<sup>755</sup>

Despite many countries' rejection of the formulary approach as the basis of their transfer-pricing regimes, the OECD acknowledges that the method has already been used selectively at the case level, "such as might be used in a

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<sup>751</sup> *ibid* 212.

<sup>752</sup> OECD, 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (OECD 2017) 40 (para. 1.22)

<[https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017/the-arm-s-length-principle\\_tpg-2017-5-en](https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017/the-arm-s-length-principle_tpg-2017-5-en)> accessed 24 June 2019.

<sup>753</sup> *ibid* 40 (para. 1.23); Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 212.

<sup>754</sup> OECD, 'Transfer Pricing Guidelines' (n 752) 41 (para. 1.25).

<sup>755</sup> *ibid* 39-43 (paras 1.19–1.31).

mutual agreement procedure, advance pricing agreement, or other bilateral or multilateral determination".<sup>756</sup> Here the apportionment formulae are not predetermined, but negotiated on a case-by-case basis by the competent authorities of the treaty partners together with, in the case of APA, the MNEs concerned.<sup>757</sup> In this way, the competent authorities avoid the hazards of establishing arm's-length prices while at the same time keeping the potential risks associated with the formulary approach under control. Such experimentation can hardly be possible under a legalistic ITDR system, in which deviation from hard rules would be strictly scrutinised. Therefore, the case of the formulary approach actually further buttresses TCE's proposition that a flexible dispute-settlement system economises the transaction costs of *ex ante* drafting a complete contract and *ex post* attenuating contractual appropriation.<sup>758</sup>

## **4. Cost analysis: classic TC theory perspective**

### **4.1 Overview**

The cost-side evaluation of the ITDR system will be built upon Cheung's account of transaction costs and the three categories of such costs: agency costs, bargaining costs, and administrative costs. A particular issue of this evaluation is about whose perspective one should take. As discussed previously, a number of writers on the cost-benefit analysis of the ITDR system attempt an eclectic approach, in which the payoffs facing each of the ITDR players are analysed respectively.<sup>759</sup> This thesis primarily concerns the social (global) welfare effect of the system. This is because: (a) the eclectic approach may lead to conflicting conclusions, with one party's benefit being

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<sup>756</sup> *ibid* 39 (para. 1.18).

<sup>757</sup> *ibid*.

<sup>758</sup> See above, Chapter 2, Section 3.5.

<sup>759</sup> See above, Chapter 1, Section 2.5.4.

the other's cost; and (b) the global perspective is in line with the law-and-economic approach under which social welfare ordinarily outweighs private payoffs. For instance, economists typically regard free-trade regimes as cost-efficient and welfare-enhancing for the global economic development, although certain countries or interest groups may benefit from protectionist policies.<sup>760</sup> The global perspective is also congruous with the normative perspective of sovereignty, which is viewed as an instrument to advance the welfare of global citizens.<sup>761</sup>

## 4.2 Agency costs

On the one hand, the major goal of the ITDR system is to eliminate double taxation for taxpayers.<sup>762</sup> The latest version of the OECD Model Convention even urges that competent authorities are "obliged" to seek to resolve tax disputes in a fair and objective manner.<sup>763</sup> On the other hand, the ITDR process, either the MAP or tax arbitration, is dominated by the two competent authorities and – when the implementation of ITDR resolutions is concerned – relevant tax administrations, while the taxpayers are largely excluded from the process. It follows that an agency relationship emerges in the ITDR process, with the competent authorities being the agent and the relevant taxpayers principal.<sup>764</sup> Because a tax administration, to which the competent authority is typically affiliated, is assumed to pursue its own priorities, such as revenue maximisation or better working conditions, the interests of the principal and the agent can diverge.<sup>765</sup> Consequently, there is a risk of agency problem arising from the relationship.<sup>766</sup> For instance, either

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<sup>760</sup> William J. Baumol (n 586) 725–731; 734; Eggertsson (n 331) 62–64.

<sup>761</sup> See above, Chapter 1, Section 2.7.2.

<sup>762</sup> OECD, 'MEMAP' (n 1) 7 (Section 1.1.1).

<sup>763</sup> OECD Model Convention(2017) Commentary on Art.25, 429 (para.5.1).

<sup>764</sup> Cai and Zhang (n 12) 874–875.

<sup>765</sup> *ibid*; Altman (n 29) 203–206, 279.

<sup>766</sup> See also Altman (n 29) 279.

competent authority in an ITDR process may fail to exercise due diligence.<sup>767</sup> More seriously, they may engage in aggressive tactics, such as strategically delaying or blocking an ITDR process.<sup>768</sup> The agency problem, real or perceived, can be particularly acute for competent authorities that initiate the audit and adjustment and hence stand in a defending position (henceforth referred to as defending competent authority).

In third-party procedures of ITDR, particularly tax arbitration, the relationship between the third-party neutral on the one hand and the parties (competent authorities as well as the taxpayer concerned) on the other hand may give rise to another type of agency concern: once the third party neutral is selected, he may become the master of his own and thus behave in a way that undermines the public confidence in the procedure.<sup>769</sup>

#### **4.2.1 Agency costs of the MAP**

Since the entire process of the MAP is primarily in the hands of competent authorities, the agency problem may occur at any stage of the process, including the initiation of the procedure, the implementation of MAP agreements and the stages in between.

(1) Initiation of the procedure. While Article 25 (1) of the OECD Model provides the taxpayer with the right to seek MAP assistances, Article 25 (2) leaves it to the first competent authority to decide whether the case is justifiable for further pursuance.<sup>770</sup> Through this filter mechanism, cases that apparently lack merit will be prevented from the process at an early stage, and thus transaction costs related to the subsequent stages of the procedure can be saved. However, competent authorities may abuse their

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<sup>767</sup> Cai and Zhang (n 12) 874–875.

<sup>768</sup> *ibid.*

<sup>769</sup> Margaret L. Moses, *The Principles and Practice of International Commercial Arbitration* (Second edition., Cambridge University Press 2012) 152.

<sup>770</sup> Farah (n 174) 13–14.

discretion in deciding the admissibility of MAP requests with a view to blocking the processes from the outset.

(2) Implementation of MAP agreements. The implementation of MAP agreements is typically left to the relevant tax administrations. These administrations, particularly the “losing parties”, may delay or even decline the implementation process.

(3) Intermediate stages. One or both competent authorities may fail to exercise their endeavour in MAP negotiations, or even engage in strategic behaviours to hinder the process. For instance, a competent authority, usually the defending party, may simply disagree about any proposal on a particular case from the other side or remain inactive during the negotiation.

Arguably, of the entire MAP process, the intermediate stages imply the highest level of agency costs. Specifically, the MAP negotiation is akin to a process of teamwork or joint production in that the successful settlement of a dispute relies on the mutual endeavour of the two parties. As discussed previously, the process of joint production is subject to a measuring problem: each competent authority’s contribution to the outcome of the MAP is intermingled and thus hard to gauge.<sup>771</sup> For any lengthy MAP case, it is difficult to tell which party should be blamed for the delay; competent authorities may even pass the buck back and forth.<sup>772</sup> According to agency theory, the lower measurability of a mutual negotiation leads to a lower accountability of the competent authorities, which may “shirk” in the process.<sup>773</sup> This agency perspective reveals the deficiency of the orthodox view that the delay of the MAP results from the soft wording of tax treaties, which only require competent authorities to “endeavour” to resolve tax

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<sup>771</sup> See above, Chapter 2, Section 2.2.3.

<sup>772</sup> Cai and Zhang (n 12) 877.

<sup>773</sup> See above, Chapter 2, Section 2.2.3.

disputes.<sup>774</sup> In this author's view, the word "endeavour" is not intrinsically soft. The Commentary on Article 25 unequivocally states that "the undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is *an integral part of the obligations* assumed by a Contracting State in entering into a tax treaty and *must* be performed in good faith".<sup>775</sup> The real problem of the MAP is its joint-production character and the resulting measurability problem, which in turn, leads to low accountability from the competent authorities. As the Commentary acknowledges, "as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result".<sup>776</sup>

Comparatively, the other two stages of the MAP – access to the procedure and the implementation of MAP agreements – imply a lower level of agency problem. The judgement of the admissibility of a MAP request only involves the input of the first competent authority, thus is more observable and measurable. The measurability of the implementation stage is even higher, since the rights and obligations of the tax authorities to a particular dispute have already been clearly defined by the MAP agreement to be implemented.

#### **4.2.2 Agency costs of tax arbitration**

Two types of agency costs need to be considered in the context of tax arbitration. The first type concerns the tax authority – taxpayer relationship; the second involves the arbitrator – party relationship.

The first type of agency costs will be substantially constrained under tax arbitration, where an arbitral panel will largely take over the procedure and be bound to issue a binding arbitral decision within a given time frame. Many

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<sup>774</sup> See above, Chapter 1, Section 2.2.1.

<sup>775</sup> OECD Model Convention(2017) Commentary on Art. 25 429 (para. 5.1).

<sup>776</sup> OECD Model Convention (2014) Commentary on Art.25, 381 (para.37).

believe that mere inclusion of an arbitration provision in tax treaties may spur competent authorities to put more efforts in accelerating the resolution of MAP cases.<sup>777</sup> Depending on the extent of procedural robustness, there may still be some room for recalcitrant competent authorities to engage in statesmanship in arbitral proceedings.<sup>778</sup> The issue of procedural abuse in arbitral procedures has been extensively discussed in the literature of commercial arbitration, and will be revisited later.<sup>779</sup> Suffice it to point out that compared with the MAP, the room for statesmanship in tax arbitration should be moderate, since the procedure is monitored by an arbitral panel. For example, parties to a tax dispute will realise that the overuse of strategic actions during the arbitral proceedings may undermine their own credibility before the panel.<sup>780</sup>

It should be noted that the arbitrators' intervention in an ITDR process begins from the point when the arbitral panel has been successfully established. Before this point, even an arbitral proceeding is still largely a bilateral process governed by party autonomy. Consequently, the pre-panel proceedings, particularly the process of appointing arbitrators, are more vulnerable to party abuse than post-panel proceedings. For instance, either competent authority may delay the appointment of an arbitrator, or keep challenging the proposed appointments by the other side.<sup>781</sup> Nonetheless, most arbitral rules provide for an appointing authority that will intervene if the parties fail to agree on an appointment in a timely manner.<sup>782</sup> Therefore, the agency costs associated with panel establishment are generally controllable.

As to the agency problem associated with the arbitrator – party relationship,

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<sup>777</sup> Kollmann and Turcan (n 58) 37; Terr and others (n 25) 493.

<sup>778</sup> See below, Chapter 6, Section 3.

<sup>779</sup> *ibid.*

<sup>780</sup> Margaret L. Moses (n 769) 148.

<sup>781</sup> See *ibid* 133; Rashda Rana, *International Commercial Arbitration* (Lawbook Co 2011) 145; Cedric Harris, 'Abuse of the Arbitration Process-Delaying Tactics and Disruptions' [1992] *A Respondents Guid J. INT'L ARE.*, June 87, 88.

<sup>782</sup> Margaret L. Moses (n 769) 133; Rana (n 781) 145.

there is voluminous literature in commercial arbitration that deals with the topic of arbitrator behaviour.<sup>783</sup> The most common complaint in this literature is that arbitrators fail to manage the proceedings efficiently.<sup>784</sup> “Anecdotal tales abound of an arbitrator waiting over a year to schedule the preliminary conference, or waiting for more than three years after the conclusion of the arbitration to render an award.”<sup>785</sup> More seriously, an arbitrator may behave in a way that raises doubts about their impartiality or integrity. For instance, according to the US Federal Arbitration Act, one of the grounds for vacating an arbitral award is that “there was evident partiality or corruption in the arbitrator”.<sup>786</sup> Nevertheless, the risk of arbitrator-misconduct should not be overstated. This is because, although the panel takes over an arbitral proceeding, the parties still participate in and have substantial influence on the process, thereby effectively monitoring the panel. Furthermore, it is not unusual in commercial arbitration that the parties successfully challenge an arbitrator for conflict of interest or improper conduct.<sup>787</sup> Therefore, it is reasonable to conclude that in principle, tax arbitration implies lower agency costs than the MAP.

#### 4.2.3 Agency costs of tax mediation

By definition, mediation is of a non-binding nature. A mediator has no decision-making authority, and the procedure is characterised by party autonomy, as is with the MAP.<sup>788</sup> In this sense, tax mediation imposes much weaker monitoring pressure on the competent authorities than does tax

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<sup>783</sup> Margaret L. Moses (n 769) 151–152; Orley C Ashenfelter and David E Bloom, *Models of Arbitrator Behavior: Theory and Evidence* (National Bureau of Economic Research Cambridge, Mass, USA 1983); David E Bloom, *Empirical Models of Arbitrator Behavior under Conventional Arbitration* (National Bureau of Economic Research Cambridge, Mass, USA 1986); Henry S Farber and Max Bazerman, *The General Basis of Arbitrator Behavior: An Empirical Analysis of Conventional and Final-Offer Arbitration* (National Bureau of Economic Research Cambridge, Mass, USA 1984).

<sup>784</sup> Margaret L. Moses (n 769) 151–152.

<sup>785</sup> *ibid* 152.

<sup>786</sup> US Federal Arbitration Act, 9 USC. §10 (a).

<sup>787</sup> Margaret L. Moses (n 769) 147.

<sup>788</sup> Susan Nauss Exon, ‘The Effects That Mediator Styles Impose on Neutrality and Impartiality Requirements of Mediation’ (2007) 42 USFL Rev. 577, 578,582.

arbitration. It is said that in a domestic context some parties may use mediation as a tactic to stall the litigation process.<sup>789</sup> In the end, successful mediation depends upon the parties' willingness to enter the process in good faith.<sup>790</sup>

That said, the involvement of a mediator increases the transparency of the dispute-settlement process relative to the MAP. Arguably, parties may feel the pressure of being "watched" and morally judged by the mediator, who usually has a good understanding of the tactics that would be used in negotiations.<sup>791</sup> In this way, the opportunistic tendency of the competent authorities will be more constrained in mediation than in the MAP.

Like arbitration, a mediation process also implies agency costs associated with the relationship between the third-party neutral and the parties. On the one hand, the impartiality and integrity of a mediator plays a critical role in engaging parties in full disclosure and open communication, both of which are vital to the success of mediation.<sup>792</sup> On the other hand, the mediator-misconduct could be more difficult to detect given the informality and flexibility of the procedure. For example, whereas an arbitrator's *ex parte* communication with one of the parties may constitute a ground for the other party to challenge the arbitrator's impartiality, such separate communication is a common technique in mediation.<sup>793</sup> Nonetheless, given the principle of party autonomy in the mediation process, the potential damage caused by the mediator's opportunism should not be overestimated.

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<sup>789</sup> Jacqueline M Nolan-Haley, *Alternative Dispute Resolution in a Nutshell* (West PubCo 1992) 60.

<sup>790</sup> *ibid.*

<sup>791</sup> Susan H Blake, *A Practical Approach to Alternative Dispute Resolution* (Fifth edition., Oxford University Press 2018) 225.

<sup>792</sup> Gregory P Mathews, 'Using Negotiation, Mediation, and Arbitration to Resolve IRS-Taxpayer Disputes' (2003) 19 Ohio St. J. on Disp. Resol. 709, 717–718.

<sup>793</sup> Margaret L. Moses (n 769) 147; Laurence Boulle, *Mediation: Principles Process Practice* (Tottel Pub 2009) 201; Blake (n 791) 30.

### 4.3 Bargaining costs

Bargaining costs of the ITDR process refer to competent authorities' difficulties in achieving consensus on substantive as well as procedural issues arising from the process.<sup>794</sup> The ITDR process is a typical BOS game, "with one state's fiscal gain being the other's fiscal loss".<sup>795</sup> It is true that the failure of negotiations between competent authorities frequently results from genuine disagreements on the interpretation of certain treaty provisions. Nonetheless, if the disagreements were to make little difference to the distribution (or redistribution) of a tax base, it is doubtful that those authorities would so cling to their positions.

It is worth noting that the division between bargaining costs and agency costs is not watertight in the ITDR context, given the triangular structure of ITDR relationships. As Figure 1 illustrates, in a typical ITDR relationship, the interaction between the two competent authorities constitutes a bargaining relationship. Meanwhile, each authority forms its own principal-agency relationship with the taxpayer concerned.<sup>796</sup> Thus, it is sometimes quite difficult to classify competent authorities' strategic actions in the ITDR process as either an agency problem or a bargaining problem. From the competent authorities' perspective, such conduct is a typical bargaining tactic. Yet from the viewpoint of the taxpayers, wilful delay or obstruction of a dispute-resolution procedure by the competent authorities amounts to opportunistic conduct. In addition, the two problems are often interdependent. On the one hand, the pursuit of departmental interests by the competent authorities contributes to the distributive conflicts of a dispute-settlement process. On the other hand, the bargaining problem may intensify the

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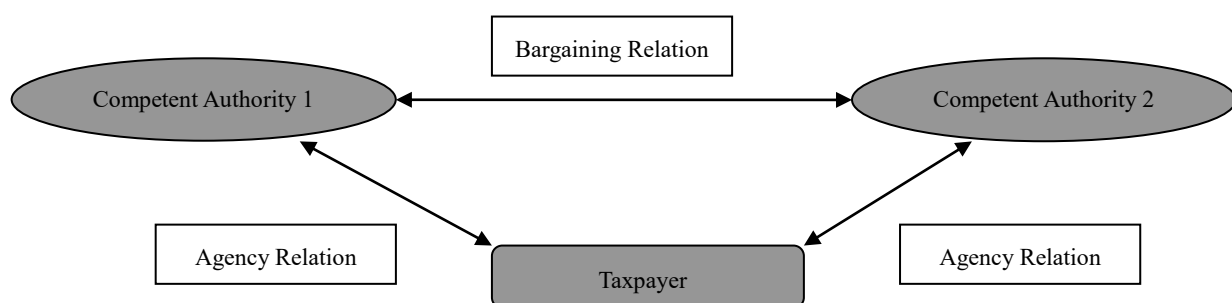
<sup>794</sup> Qiang Cai, 'A Package Deal Is Not a Bad Deal: Reassessing the Method of Package Negotiation Under the Mutual Agreement Procedure' (2018) 46 *Intertax* 744, 746–747.

<sup>795</sup> Burnett (n 77) 178.

<sup>796</sup> See Ismer and Piotrowski (n 151) 351.

competent authorities' tendency to "play hardball" in the process.

**Figure 1: Triangular relationship in a typical MAP process**



That being said, the bargaining problem in the ITDR process is a standing-alone existence vis-à-vis the agency problem. Specifically, even assuming that two competent authorities conduct an ITDR process in good faith, they may still get entrenched in their own positions.<sup>797</sup> This corresponds with the core message of the BOS game: while both parties have a strong incentive to establish and maintain cooperation on a particular issue, they encounter difficulties in solving the distributive conflict over the issue.<sup>798</sup> Occasionally, the bargaining problem can be observed independently. For example, in a MAP case stalemated under two competent authorities that have a good track record of MAP performance, it is more likely that the failure to reach an agreement stems from the bargaining problem.

#### **4.3.1 Bargaining costs of the MAP**

As its name indicates, the bargaining problem is intrinsically associated with the negotiation process, where the principle of party autonomy governs.

<sup>797</sup> Cai (n 794) 746–747.

<sup>798</sup> See above, Chapter 2, Section 2.3.1.1.

Therefore, it is safe to conclude that among alternative ITDR mechanisms, the MAP implies the highest level of bargaining costs. Considerable delay may be caused by disagreements between competent authorities on the interpretation of certain treaty provisions or the establishment of an arm's-length price, even though the parties enter the negotiation in good faith. After all, the purpose of double-taxation relief enshrined in tax treaties does not, and should not, oblige a state to give up its fair share of a trans-border tax base in order to resolve the dispute, unless states willingly offer to concede their interests in the negotiation.

For many MAPs that encounter bargaining problems, the relevant tax treaties, the OECD (and UN) Model Convention and the Commentaries, as well as common international practices in similar tax issues, may help coordinate the viewpoints of competent authorities. As bargaining theory indicates, legal expressions and precedents provide focal points for BOS games.<sup>799</sup> Nonetheless, such focal points are not always readily identifiable across the board. Specifically, the fundamental incompleteness of the international tax regime indicates that model tax conventions and commentaries are frequently less helpful for certain cases in question. Common international practices may also become irrelevant insofar as particular tax disputes with unique facts are concerned. In many other instances, information asymmetry and bounded rationality prevent parties from taking a realistic view about their own positions.<sup>800</sup>

#### **4.3.2 Bargaining costs of tax arbitration**

Similar to the reasoning on the agency costs of tax arbitration (Section 4.2.2), binding arbitration provides an effective means of breaking impasses of MAP

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<sup>799</sup> See above, Chapter 2, Section 2.3.1.3.

<sup>800</sup> See above, Chapter 2, Section 2.3.3.

cases and moving the processes forward.<sup>801</sup> Accordingly, it could also be said that tax arbitration provides a compulsory focal point for the bargaining parties.

Section 4.2.2 also discussed the issue of procedural abuse in tax arbitration. Frequently, a procedural impasse in arbitration may result from *bona fide* disagreements between the parties rather than from strategic abuse.<sup>802</sup> Since a panel oversees the functioning of an arbitral procedure, the bargaining problem over procedural matters will also be mild and controllable, as is with the case of procedural abuse. Moreover, compared with substantive issues, negotiation over procedural matters generally implies less distributive conflict. As discussed previously, parties are more likely to achieve consensus over issues with less-extensive distributive conflict, such as the rules of the road.<sup>803</sup> Therefore, parties who are acting in good faith will usually be able to solve their disagreements on procedural matters quickly and smoothly. The issue of bargaining over procedural matters will be revisited in Section 3 of Chapter 6.

### **4.3.3 Bargaining costs of tax mediation**

The primary role of mediation is to facilitate parties' attempt to solve their bargaining impasses.<sup>804</sup> A mediator can: (a) help the parties to present their own cases more effectively to the other side; and (b) examine the merit of each side anew.<sup>805</sup> In this way, the problem of over-optimism discussed previously can be effectively mitigated.<sup>806</sup> In the case of evaluative mediation, the mediator will, in addition to facilitating the parties' negotiation, further offer an opinion on the likely outcome of the case, and hence provide a focal point

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<sup>801</sup> Kollmann and Turcan (n 58) 38.

<sup>802</sup> Donahey M Scott, 'Defending the Arbitration against Sabotage' (1996) 1 Journal of International Arbitration 93, 94.

<sup>803</sup> See above, Chapter 2, Section 2.3.1.2.

<sup>804</sup> Nolan-Haley (n 789) 54.

<sup>805</sup> Blake (n 791) 225; Mathews (n 792) 719.

<sup>806</sup> See above, Chapter 2, Section 2.3.2.

to the bargaining problem.<sup>807</sup> In the context of ITDR, the merit of using mediation has been confirmed by the MEMAP:

*A mediator's role may offer an opportunity for the competent authorities to view a specific case, or the MAP process itself, from a much different perspective. This perspective, perhaps acquired through the mediator's restatement of the positions or of the critical issues, may illuminate elements of a case or of the MAP process that are not perceptible when viewed from the standpoint of an administration defending an adjustment or one that is being asked to provide relief.*<sup>808</sup>

Despite the above benefits of mediation, given its non-binding nature, there is no guarantee that the parties will achieve any agreement. In this sense, mediation is less robust than arbitration in breaking impasses arising from MAP negotiations.

#### **4.4 Administrative costs**

As discussed previously, administrative costs can only be approached in a contextual manner, as studies of the topic have yet to produce any general economic rules.<sup>809</sup> Nevertheless, in the context of dispute settlement, a general principle can be drawn from the literature in this domain: the administrative costs of a particular dispute-settlement mechanism are positively correlated to the formality of this mechanism. This principle manifested itself in the ADR movement that emerged in the US and then spread to the world in the 1980s.<sup>810</sup> The movement was largely fuelled by dissatisfaction with the formal litigation procedure at the time, which had

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<sup>807</sup> Blake (n 791) 241.

<sup>808</sup> OECD, 'MEMAP' (n 1) 28 (Section 3.5.2).

<sup>809</sup> See above, Chapter 2, Section 2.4.

<sup>810</sup> See Harry T Edwards, 'Hopes and Fears for Alternative Disputes Resolution' (1985) 21 Willamette L. Rev. 425, 427–429.

increasingly been criticised for its delay, rigidity, and high procedural costs.<sup>811</sup> In this connection, proponents of ADR argue that informal dispute-resolution mechanisms are more efficient than formal ones, saving both time and money.<sup>812</sup> The following analysis starts with the most formal mechanism of ITDR: tax arbitration.

#### 4.4.1 Administrative costs of tax arbitration

Studies on the procedural costs of commercial arbitration abound.<sup>813</sup> A common perception is that commercial arbitration processes, particularly those in an international context, are becoming increasingly expensive and time-consuming as they grow more formal.<sup>814</sup> As a practitioner describes, “there is now broader discovery, larger damages requests, longer briefing schedules, much bigger briefs, far greater reliance on experts and their testimony, and more procedural challenges to the arbitration”.<sup>815</sup>

More often than not, writers on commercial arbitration tend to focus on the monetary expenses of arbitral procedures.<sup>816</sup> Under this approach, arbitration costs are divided into two main categories.<sup>817</sup> The first is the tribunal costs, which include the arbitrators’ remuneration, the registration fee of the arbitral institute (if applicable), and the charges for any other assistance

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<sup>811</sup> See *ibid.*

<sup>812</sup> Richard Delgado and others, ‘Fairness and Formality: Minimizing the Risk of Prejudice in Alternative Dispute Resolution’ [1985] *Wis. L. Rev.* 1359, 1366.

<sup>813</sup> For representative works, see ICC, ‘Techniques for Controlling Time and Costs in Arbitration’ (2012) <<https://iccwbo.org/publication/icc-arbitration-commission-report-on-techniques-for-controlling-time-and-costs-in-arbitration/>>; ICC, ‘Effective Management of Arbitration – A Guide for In-House Counsel and Other Party Representatives’ <<https://iccwbo.org/publication/effective-management-of-arbitration-a-guide-for-in-house-counsel-and-other-party-representatives/>>; David W Rivkin and Samantha J Rowe, ‘The Role of the Tribunal in Controlling Arbitral Costs’ (2015) 81 *Arbitration* 116.

<sup>814</sup> *ABA Journal*, ‘International Arbitration Loses Its Grip’ (*ABA Journal*) <[http://www.abajournal.com/magazine/article/international\\_arbitration\\_loses\\_its\\_grip/](http://www.abajournal.com/magazine/article/international_arbitration_loses_its_grip/)> accessed 5 May 2018.

<sup>815</sup> *ibid.*

<sup>816</sup> Rana (n 781) 285; Alan Redfern, *Law and Practice of International Commercial Arbitration*. (Fourth edition / by Alan Redfern . [et al.], Sweet & Maxwell 2004) 469–470; ‘GAR Chapter: Costs’ <<https://globalarbitrationreview.com/chapter/1076624/costs>> accessed 5 July 2019.

<sup>817</sup> Rana (n 781) 285; Redfern (n 816) 469–470; ‘GAR Chapter: Costs’ (n 816).

required by the arbitral tribunal.<sup>818</sup> The second category consists of party costs, which include the fees for legal counsel, party-appointed experts, witnesses, translators, etc.; the transportation and accommodation expenses related to hearings; and other party-inflicting costs.<sup>819</sup> In the context of tax arbitration, insofar as the taxpayers concerned also participate in the procedures, the expenses resulted from such participation can also be classified as party-related costs.

Nonetheless, the administrative costs of arbitration are broader than mere monetary expenses. In particular, where ad hoc arbitration is concerned, considerable time and effort are needed to search for and appoint arbitrators, organise arbitral hearings and/or other arbitral meetings, and so on. These inputs, though hard to price, certainly constitute the substantial bulk of the administrative costs. In addition, the parties' "in-house" inputs, such as the time and effort devoted by the parties' own staff in researching and preparing the cases, attending the procedures, and communicating with the panels and/or the other side, also contribute to administrative costs. The communication cost not just concerns language translation, which can be covered in translator fees, but also cultural and professional divergence, which is a typical non-monetary cost. Again, taxpayer participation in the procedure will also incur non-monetary expenses.

#### **4.4.2 Administrative costs of the MAP**

##### **4.4.2.1 Procedural flexibility**

In the orthodox literature of ITDR, most of positive comments about the MAP, if any, are focused on the administrative costs of the mechanism. Specifically, the monetary expenses, including the tribunal costs and party costs of arbitral

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<sup>818</sup> 'GAR Chapter: Costs' (n 816).

<sup>819</sup> *ibid.*

proceedings, will largely be avoided under the MAP. The non-monetary costs such as those associated with the establishment of arbitral panels will also be saved in the MAP. It is true that MAPs are no free lunch. The process demands efforts from competent authority staff on case research and communication. The face-to-face meetings between competent authorities, where applicable, also incur substantial costs, both monetary and non-monetary. As the MEMAP notes:

*The competent authority function needs sufficient human (skilled personnel), financial (in particular to pay for translations and travel/accommodation expenses for face-to-face meetings with other competent authorities) and other resources (access to company databases, industry data and foreign tax laws) to be able to meet its obligations under the Convention.*<sup>820</sup>

Nonetheless, these costs also occur, usually with greater scale, with tax arbitration, which entails more formalised meetings (e.g. pre-trial meetings and hearings) and greater efforts on case analysis.

These advantages of the MAP can be largely attributed to the procedural flexibility of the mechanism. For example, a MAP case with simple facts and low monetary value at stake may only require a few telephone calls or emails between the competent authorities to settle the dispute. Moreover, the MAP also allows for the method of package negotiation, whereby a pair of competent authorities resolves numerous cases at the same time. This method and its advantages will be revisited later.<sup>821</sup>

#### 4.4.2.2 Human-asset specificity

In addition to the MAP's procedural flexibility, the notion of asset specificity also plays a critical role in explaining its low level of administrative costs. The

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<sup>820</sup> OECD, 'MEMAP' (n 1) 39 (Section 5.2).

<sup>821</sup> See below, Chapter 5, Section 3.2.

central argument is that competent authorities have over time gained extensive knowledge of and experiences with tax matters, including MAP practices, and that such specialised human assets constitute valuable “procedural capital” for functioning of the mechanism.<sup>822</sup> Accordingly, there is a quasi-rent for tax disputes to be resolved by competent authorities in the first place, rather than by an outsider such as an arbitrator. Burnett contends that the reference to established experiences of competent authorities is rather a mundane rhetoric in favour of the status quo in any debate about institutional change.<sup>823</sup> In this author’s view, Burnett underestimates the significance of human-asset specificity in the ITDR process. Such significance is connected to two related facts about ITDR. First, tax disputes are highly specialised and complicated. Even Albert Einstein once complained that “the hardest thing in the world to understand is the Income Tax”.<sup>824</sup> Over the years, international tax matters have become increasingly complicated with inputs from skilful lawyers and economists.<sup>825</sup> As a result, persons engaging in ITDR processes or other international tax matters are more likely to gain specialised knowledge on these matters through special training and adaptive learning.

Second, tax administrations, with which competent authorities are affiliated, acquire specialised human assets in relation to ITDR not only through their experiences of dispute settlement, but also their daily implementation of tax policies even before any tax dispute materialises. Furthermore, tax administrations not only engage in general implementation of tax law or policies, but also take part in specific allocation of trans-border tax bases. For example, if an enterprise of one country carries out its business in another

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<sup>822</sup> Burnett (n 77) 176.

<sup>823</sup> *ibid.*

<sup>824</sup> ‘The Hardest Thing in the World to Understand Is Income Taxes – Quote Investigator’ <<https://quoteinvestigator.com/2011/03/07/einstein-income-taxes/>> accessed 26 January 2019.

<sup>825</sup> Sikka and Willmott (n 663) 417.

country through a PE situated in that host country, while the tax administration of the host country would assess the tax liability of the non-resident enterprise that is attributable to the PE, such assessment would also be carried out in the residence country so as to figure out the amount of tax credit granted to the enterprise. Therefore, tax administrations acquire specialised knowledge on tax matters at both the policy and case levels. In particular, through routine interactions at the case level, these administrations also develop a common (professional) language, which helps reduce the communication cost between the parties. It is true that according to agency theory, the competent-authority function should be independent from the audit department of the same tax administration.<sup>826</sup> Nevertheless, considering that internal staff-shift is common within tax administrations, the stock of specialised human assets of a tax administration is shared across all its sections.

#### 4.4.2.3 Insights from domestic administrative laws

The elements of procedural flexibility and human-asset specificity and their implications for dispute settlement are also reflected in domestic laws, particularly with respect to a well-established doctrine in administrative law: the exhaustion of administrative remedies.<sup>827</sup> The exhaustion doctrine states that no one is entitled to judicial relief for an alleged injury until the prescribed administrative remedy has been exhausted.<sup>828</sup> In a broader sense, the doctrine reflects judicial deference to administration determination.<sup>829</sup> While such deference can be justified on multiple grounds, economic considerations play a critical part.<sup>830</sup> First, administrative resolution is more economical than

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<sup>826</sup> See below, Chapter 5, Section.2.1.1.

<sup>827</sup> Marcia R Gelpe, 'Exhaustion of Administrative Remedies: Lessons from Environmental Cases' (1984) 53 Geo. Wash. L. Rev. 1; Ralph F Fuchs, 'Prerequisites to Judicial Review of Administrative Agency Action' (1975) 51 Ind. LJ 817.

<sup>828</sup> *McKart v US* (1969) 395 US 185, 193; see also Gelpe (n 827) 3.

<sup>829</sup> Gelpe (n 827) 22.

<sup>830</sup> *ibid* 10–11.

judicial resolution in that administrative proceedings are less formal, and thus less expensive.<sup>831</sup> Second, administrators with greater technical backgrounds can reach factually accurate decisions more quickly.<sup>832</sup> “The agency’s experts can gather, digest, and evaluate information more quickly and, therefore, more economically than a court.”<sup>833</sup> Accordingly, when technical expertise not possessed by the courts enters into agency determinations, “this expertness should be drawn upon prior to judicial review”.<sup>834</sup>

Arguably, the MAP is essentially a special form of administrative appeal procedure – albeit with an international character. In contrast, tax arbitration or other legalistic methods of ITDR are more analogous to litigation in a domestic context. Therefore, considering the technicality of tax issues and the expertise of tax administrations, the exhaustion doctrine also carries weight in the debate about ITDR models, and similar deference should be accorded to the MAP as well.

#### **4.4.3 Administrative costs of tax mediation**

It is commonly recognised that mediation is a cost-efficient means of dispute settlement, whether in a domestic or international context.<sup>835</sup> This is mainly because mediation is more flexible and less adversarial than arbitration and litigation.<sup>836</sup> Nonetheless, mediation still implies a higher level of administrative costs than does the MAP. The extra costs can mainly be attributed to the involvement of the third-party neutral, as well as the logistical burden of organising face-to-face meetings, which are essential for the success of a mediation process. In particular, as Dalton’s survey indicates,

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<sup>831</sup> *McKart*, 395 US (1969) (n 828) 195; Gelpe (n 827) 12.

<sup>832</sup> Gelpe (n 827) 12.

<sup>833</sup> *ibid* 17.

<sup>834</sup> Fuchs (n 827) 866.

<sup>835</sup> Blake (n 791) 225.

<sup>836</sup> *ibid* 224.

one of the reasons underlying the dormancy of tax mediation is the difficulty for competent authorities to access the pool of international tax mediators, who are expected not only to be professional in tax matters, but also skilful in communication and persuasion.<sup>837</sup>

#### **4.5 Overall assessment**

Three conclusions can be drawn from the above evaluation of the transaction costs of ITDR. First, the MAP is superior to the other two ITDR mechanisms in saving administrative costs. Accordingly, where competent authorities handle tax disputes in good faith and are always ready to compromise in the process, the MAP will be the most cost-efficient means of dispute settlement. Second, tax arbitration has the advantage of being a way to manage agency and bargaining problems. In particular, the procedure usually guarantees finality for dispute settlement. Therefore, for those ITDR processes fraught with bureaucracy, bargaining impasses, or political enmity, tax arbitration represents the most robust solution. Third, tax mediation occupies a middle ground between the MAP and tax arbitration with respect to the three types of transaction costs. However, this middle ground could be construed as a disadvantage, as it is more expensive than the MAP in terms of administrative costs, while less effective than tax arbitration in curbing agency and bargaining problems. This partly explains the dormancy of tax mediation in ITDR practice.

Given the proposition that the MAP excels in economising administrative costs of the ITDR process while tax arbitration is more effective in addressing issues of bureaucracy, statesmanship, impasses, and political volatility, the question remains: is the ITDR process functioning (or malfunctioning) in Locke's world, which "is a condition of peace, goodwill, mutual assistance and

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<sup>837</sup> See above, Chapter 1, Section 2.4.

preservation”,<sup>838</sup> or in a Hobbesian world, where “every man is enemy to every man”?<sup>839</sup> Intuitively, Hobbes’s version of the fiscal world seems more congruent with the assumption of rational maximisation or human opportunism. Nonetheless, as discussed above (Section 2), a wealth-maximising country usually avoids revenue-maximising policies on the postulation that a predatory fiscal policy could ultimately stifle economic development. In particular, it has already been established above (Section 3.1.3) that the international tax regime is essentially a coordination game with limited distributive conflict. Therefore, although the process of ITDR may be affected by agency and bargaining problems, these problems are not insurmountable given the political goodwill among countries regarding the prevention of double taxation. In particular, the agency problem in the ITDR process will largely be an issue of bureaucratic exigencies or capacity limitation rather than political statesmanship. Indeed, it should be no surprise to see that states may frequently side with taxpayers in monitoring tax authorities’ performance on ITDR practice.<sup>840</sup> To summarise, as far as the international tax regime and its dispute-settlement system are concerned, Locke’s view of the world is the most prevalent and influential. Accordingly, the MAP is more cost-efficient overall than tax arbitration and mediation.

#### **4.6 Resolution of multilateral tax disputes**

While the above section established the superiority of the MAP among ITDR mechanisms, the conclusion could be slightly different where the resolution of *multilateral* tax disputes is concerned. As explained previously, the number of parties involved in a dispute-settlement process is positively correlated to the magnitude of all three types of transaction costs the process may entail.<sup>841</sup>

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<sup>838</sup> John W Yolton, *A Locke Dictionary* (Blackwell 1993) 278–279.

<sup>839</sup> Aloysius Martinich, *A Hobbes Dictionary* (Blackwell Pub 2005) 292.

<sup>840</sup> See below, Chapter 5, Section 2.1.2.

<sup>841</sup> See above, Chapter 2, Section 2.1.4.

Specifically, as the number of parties increases, MAP negotiations would be more akin to a process of joint production, which implies higher agency costs. It also becomes more difficult for the parties to find a commonly accepted solution to solve their distributive conflict, thereby reinforcing the risk of a bargaining impasse. The administrative costs of a multilateral MAP would also increase because it is more difficult to coordinate and manage the conduct of multiple parties in the process. In this connection, the value of the third-party neutral in coordinating and monitoring the conduct of the parties, and providing focal points to the distributive conflicts among them, becomes more prominent. To some extent, that third-party neutral is reminiscent of a firm in organising productive activities among a multitude of resource owners. Therefore, as tax disputes become multilateral, the case for the use of tax arbitration as well as mediation becomes stronger. That being said, the resolution of multilateral tax disputes does not necessarily dictate the complete replacement of the MAP with arbitration (and/or mediation). Given the political goodwill surrounding the ITDR process, the MAP can still be a generally effective means to resolve multilateral tax disputes. The prospect of successful multilateral MAPs can be further improved with some institutional facilitation, as will be discussed later.<sup>842</sup>

## **5. Evaluation of the current ITDR practice: data analysis**

### **5.1 Overview**

The data to be analysed in this section includes the OECD MAP statistics, peer-review reports under BEPS Action 14, and a case study. While this data mainly pertains to the cost dynamics of ITDR processes, the benefit side of the equation can also be illuminated.

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<sup>842</sup> See below, Chapter 7, Section 4.

## 5.2 OECD MAP statistics

Starting in 2006, the OECD began to compile and disseminate MAP statistics for its member countries and several partner jurisdictions. The statistics cover the following indicators: opening and closing inventory of MAP cases; the number of cases initiated during the year; the number of cases completed during the year; the number of cases withdrawn or closed during the year without full resolution of double taxation; and the average time for cases completed, closed, or withdrawn during the year. Among these indicators, the average time taken for cases completed, closed, or withdrawn is the most pertinent proxy for measuring the transaction costs of the MAP, as in general, the longer the proceedings, the more expensive a dispute-resolution process will be.<sup>843</sup>

In 2016, this statistical system was superseded by a new system, which will be elaborated in Section 4.5 of Chapter 5. The following analysis will be largely based on the old statistics.

### 5.2.1 Lengthy MAPs

The most common criticism of the MAP concerns the protraction of the process. Table 4 collects the data on the average time for the completion of MAP cases in a number of OECD countries that have recorded a notable protraction in their MAP operation for certain years. For these 10 countries, 139 cases had endured for more than 24 months. Of these cases, 37 had lasted for more than five years, 35 for more than six years, and 19 cases more than seven years. Numerous cases present extreme delays. For instance, in 2009 or prior, Belgium had completed eight cases with non-OECD economies, taking on average 116 months per case. During the same period, Norway closed a case that had lasted for 126 months, and

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<sup>843</sup> ICC, 'Techniques for Controlling Time and Costs in Arbitration' (n 813) 6.

Luxembourg closed a case that had lasted for 196 months.

**Table 4: OECD countries that record extraordinarily long average time for MAP cases completed, closed, or withdrawn for certain years**

Country	Year	Completed cases		Closed or withdrawn with double taxation		Average time (month) for cases completed, closed or withdrawn	
		OECD	non-OECD	OECD	non-OECD	OECD	non-OECD
Belgium	2009 or prior	7	7	0	1	82	116
	2010	35	3	0	0	56	55
Portugal	2009 or prior	1				94	
	2011	4				46	
Norway	2009 or prior	2		1	1	82	126
UK	2009 or prior	6		0	2	95.3	102
	2010	3		1	1	57.8	59
	2011	5				45.2	
Canada	2009 or prior	3		0		76.78	
	2010	9		2		58.89	
	2011	13		1		46.26	
Greece	2010			1		60	
	2011			1		48	

Luxemburg	2009 or prior			1		196	
	2010	2				56	
	2011	1				45	
Mexico	2009 or prior			1		77	
	2012			1		43	
Netherlands	2009 or prior	1				70	
	2010	3				56	
	2011	2				52	
Sweden	2009 or prior	2				75	
	2010	1				59	
	2011	7				50	
	2012	6			1	34	35
Total		113	10	10	6		

Derived from the OECD MAP Statistics (2006-2015),

<https://www.oecd.org/ctp/dispute/map-statistics-2006-2015.htm> (accessed 9 July 2019)

### 5.2.2 “Success stories”

Despite such extremely slow MAPs, the statistics also tell quite a few success stories, which have largely been neglected by commentators.<sup>844</sup> Table 5 collects the most expeditious MAPs. In 2015, Canada completed 14 MAP cases with an average time per case of only 4.85 months. In the same year, Belgium resolved 185 cases, with each case taking an average of four months each, and Luxembourg resolved 149 cases at an average of two months each. This is quite a favourable result measured against the two-year time frame recommended in the MEMAP, and much more so in comparison with the data in Table 4.<sup>845</sup>

Note that several countries, such as Belgium, Luxembourg, and Sweden, appear in both Table 4 (lengthy MAPs) and Table 5 (expeditious MAPs). In her analysis about MAP statistics, Brown also observes that “some countries show some dramatic swings”, and wonders whether “there were changes in personnel or other external factors that would explain these different results”.<sup>846</sup> As will be shown in the next chapter, at least the changes in Belgium and Luxembourg’s statistics can largely be attributed to the countries’ innovative ways of conducting MAPs.<sup>847</sup>

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<sup>844</sup> For in-depth analysis of OECD MAP statistics, see also Brown (n 11) 90–97.

<sup>845</sup> OECD, ‘MEMAP’ (n 1) 31 (Section 3.9).

<sup>846</sup> Brown (n 11) 96–97.

<sup>847</sup> See below, Chapter 5, Section 3.2.2. The Belgian MAP performance may have also been influenced by the US-Belgium tax treaty signed in 2006. The treaty ties a benefit – i.e. the elimination of withholding tax on dividends paid from a subsidiary to a parent entity – to the effective implementation of the MAP mechanism. See the US-Belgium Tax Treaty (2006), Art. 10 (3), (4), (12).

**Table 5: OECD countries that record short average time for cases completed for certain years**

Country	Year	Completed cases		Average time for cases completed	
		OECD	non-OECD	OECD	non-OECD
Australia	2014	4	2	6.9	9.5
Belgium	2015	185	0	4	0
Canada	2015	14		4.85	
Luxembourg	2014	36		5	
	2015	149		2	
Denmark	2015	11		3	
Netherlands	2014	22	0	10	0
	2015	18	0	4	0
Sweden	2014	18	0	10	
	2015	36	2	1	1

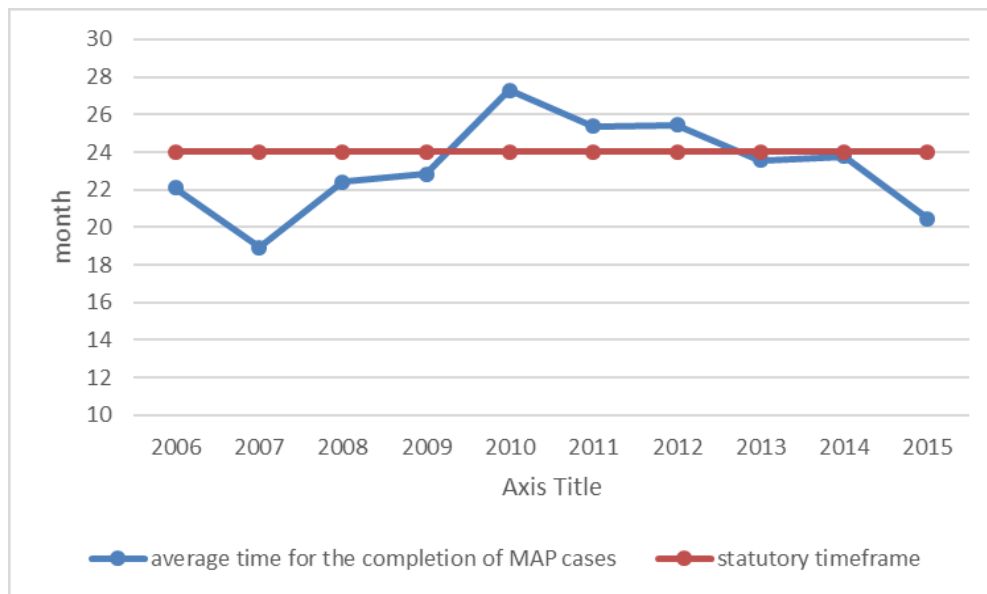
Derived from the OECD MAP Statistics (2006-2015),

<https://www.oecd.org/ctp/dispute/map-statistics-2006-2015.htm> (accessed 9 July 2019)

### 5.2.3 Overall performance

Tables 4 and 5 represent two extremes of MAP practices. Therefore, it is desirable to also examine the overall statistics for all OECD countries. As is shown in Figure 2, the average time for MAP cases in all the OECD countries from 2006 to 2015 was about two years. More specifically, the average time reached an historical low of around 19 months for the year 2007. It then rose through to 2010, when it reached 27 months. Since then, it has moved steadily downward, reaching 20 months in 2015.

**Figure 2: Average time in OECD countries for completion of MAP cases, 2006-2015**



Source: Centre for Tax Policy and Administration, OECD,

<https://www.oecd.org/ctp/dispute/map-statistics-2006-2015.htm> (accessed 9 July 2019)

However, these numbers should be read with caution.<sup>848</sup> First, numerous countries failed to report their statistics for certain years.<sup>849</sup> Second, according to the OECD statistics report framework, the indicator of average time only covers completed (which also includes closed and withdrawn) MAP cases, while the still pending cases are not included. In this sense, a country that has had most of its MAP cases stalemated by the time the statistics are gathered may report a nil average time for their MAPs. Third, the use of averages obscures the fluctuations in the data. For example, extremely stalemated MAPs may be cloaked under the two-year average time.

#### **5.2.4 Evolution of MAP caseloads**

Indicators of MAP caseloads, including the opening inventory of MAP cases, the number of new MAP cases, and the ending inventory, though less pertinent than the average time for the completion of MAP cases in measuring the transaction costs of the MAP, nevertheless provide insights on the efficacy and sustainability of the mechanism. Figure 3 demonstrates the changing trend of two variables: the number of new cases initiated in any given year (the lower line) and the number of inventory cases at the end of that same year (the upper line). Both variables saw substantial growth from 2006 to 2015.

The increase in new MAP cases is more difficult to interpret. On the one hand, this trend may signify the growing tension between taxpayers and tax administrations in competing for trans-border tax bases. On the other hand, this could also indicate the increasing popularity of the MAP mechanism among taxpayers, perhaps owing to the states' continuing effort to enhance the accessibility and effectiveness of the mechanism. Nonetheless, the

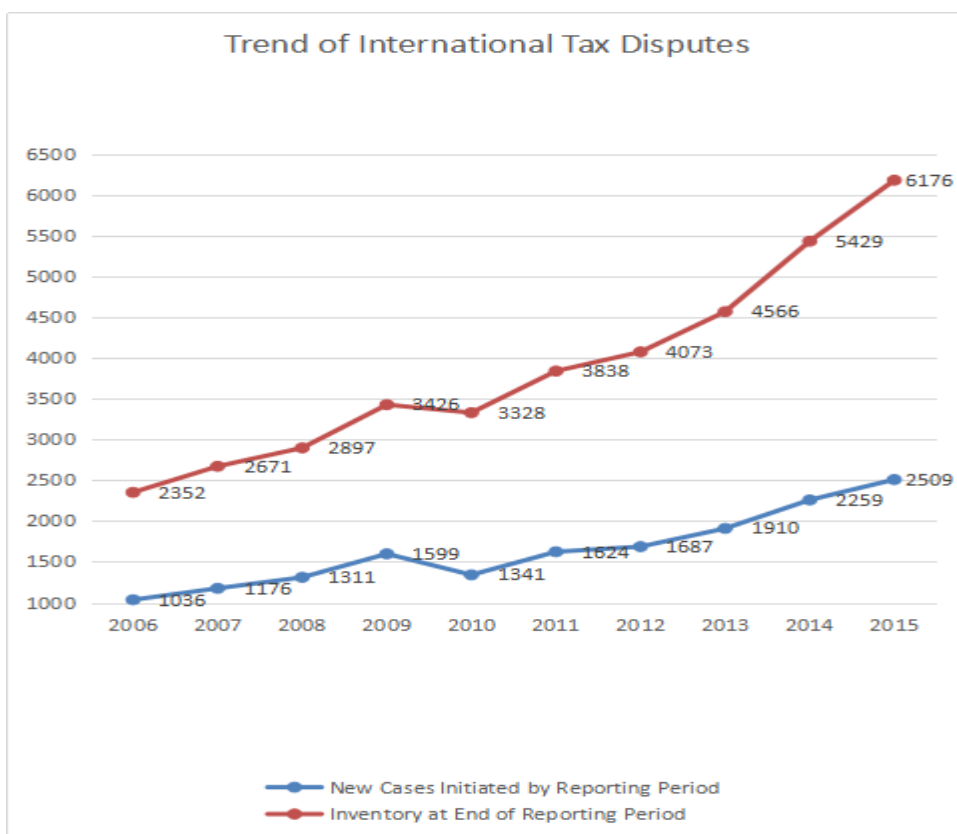
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<sup>848</sup> Brown (n 11) 91.

<sup>849</sup> For instance, see statistics of Austria, Chile, and Finland. 'Mutual Agreement Procedure Statistics (2006-2015)' (n 3).

widening “scissors gap” between the two lines in the figure delivers a more definite message: the current MAP mechanism is increasingly under strain. The mathematic relationship between the two lines is simple: the inventory of MAP cases by the end of any given year equals the inventory at the end of the preceding year plus the number of newly initiated cases for this year minus the number of completed cases for the given year. Therefore, the widening “scissors gap” between the two lines indicates that the number of completed MAP cases for OECD countries in any given year could not catch up with the number of new cases that year. This suggests an increasing stress on the MAP mechanism among OECD countries, and increasing risks that more cases will languish. This trend could be exacerbated, at least in the near future, due to the BEPS project.<sup>850</sup>

**Figure 3: The trend of MAP cases for OECD members**



Source: Centre for Tax Policy and Administration, OECD,

<sup>850</sup> See above, Chapter1, Section 1.7.1.

### **5.2.5 Comments on the statistics**

The extremely lengthy MAPs in Table 4 seem to support a pessimistic view about the mechanism for its lack of efficiency and finality. Nonetheless, the success stories told by the same statistics indicate that perhaps length and inefficiency are not intrinsic to the MAP. As Brown comments, “When the MAP works, it works well”.<sup>851</sup> The statistics on the overall average time further indicate the general effectiveness of the MAP. That being said, the data on MAP caseloads suggests that the mechanism is increasingly under strain.

### **5.3 Action 14 peer-review reports**

As will be introduced later, BEPS Action 14 provides a peer-review process that evaluates participating countries against the minimum standard of the MAP established in the Action.<sup>852</sup> The process is conducted in two stages. Stage 1 assesses countries’ compliance with the standard; Stage 2 monitors the follow-up of any recommendations put forth in each country’s Stage 1 peer review.<sup>853</sup> At the time this thesis was completed (15 November 2019), Stage 1 assessment had largely been finished, with 45 country reports being produced; Stage 2 is still ongoing.<sup>854</sup> This section focuses on the Stage 1 reports.

#### **5.3.1 Outline of Stage 1 reports**

The period being reviewed started from 1 January 2016, when the members’ commitment to the minimum standard began. Nevertheless, most countries

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<sup>851</sup> Brown (n 11) 97.

<sup>852</sup> See below, Chapter 5, Section 4.

<sup>853</sup> ‘Action 14 - OECD BEPS’ 14 <<https://www.oecd.org/tax/beps/beps-actions/action14/>> accessed 18 August 2019.

<sup>854</sup> ‘Action 14 - OECD BEPS’ (n 853).

also offered to provide information on a few years' "look-back period" before 1 January 2016.<sup>855</sup> Accordingly, Stage 1 reports provide valuable information for the evaluation of countries' MAP practices before the BEPS Project. The drafting of the reports was mainly based on the following information sources:

- (1) Inputs provided by the assessed jurisdiction through the questionnaire;
- (2) Inputs from the peer questionnaires;
- (3) Responses from the assessed jurisdiction to peer and taxpayer inputs;
- (4) Information in the assessed jurisdiction's MAP profile, which is published on public platforms; and
- (5) Statistics reported by the assessed jurisdiction pursuant to the agreed reporting framework.<sup>856</sup>

This information can be categorized into two main types. The first concerns the legal and administrative framework for the MAP regime of the assessed jurisdictions, and the second concerns the actual application of this framework.<sup>857</sup> As this thesis mainly concerns the transaction costs of the ITDR process in operation, the second type of information will be the main focus of this section. Accordingly, the peer inputs, which shed much light on the ITDR operation, will be the focus of the following analysis.

The Stage 1 report is structured into four main parts. Part A covers preventing disputes; Part B covers availability of and access to the MAP; Part C covers the resolution of MAP cases; and Part D covers the implementation of MAP agreements. This section will focus on the last three parts of the report. The three tables in the Appendices of this thesis summarise the 45 Stage 1 reports.

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<sup>855</sup> For instance, see Report on Belgium, 12.

<sup>856</sup> OECD, 'BEPS Action 14 on More Effective Dispute Resolution Mechanisms Peer Review Documents' (OECD) 23.

<sup>857</sup> *ibid.*

### 5.3.2 Access to the MAP

As shown in Table 7 (in the Appendices), most countries that were surveyed ensured that taxpayers were granted easy access to the MAP. Specifically, 24 countries accepted all MAP requests during the assessed period.<sup>858</sup> Several other countries only denied access to the MAP in a very small number of cases and on reasonable grounds.<sup>859</sup> For example, Finland reported that as from 1 January 2016, its competent authority had considered in only one case that the objection raised by the taxpayer in the MAP request was not justifiable. Finland had discussed the decision with its treaty partner.<sup>860</sup> Another example is Belgium, which denied access in three cases on the grounds that insufficient information was provided. In these cases, the taxpayers were given several opportunities to provide the required information, and access was denied only after they were seen to be unwilling to provide it.<sup>861</sup>

Several countries seem to have a relatively strict standard in determining the admissibility of MAP requests.<sup>862</sup> For example, France denied access in 18 cases on the grounds of unjustifiable objection, and 16 cases for insufficient information. Nevertheless, the peers and taxpayers did not raise any issue with those decisions.<sup>863</sup> In the latter 16 cases, the French competent authority sent letters to the taxpayers concerned asking them to complete their requests.<sup>864</sup>

That being said, several members' practice in MAP access did attract

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<sup>858</sup> Canada, Chile, Colombia, Czech Republic, Estonia, Greece, Hungary, Iceland, India, Ireland, Japan, Korea, Latvia, Lithuania, Malta, Mexico, New Zealand, Romania, Singapore, Slovak Republic, South Africa, Switzerland, Turkey, and the UK.

<sup>859</sup> Austria, Belgium, Finland, Liechtenstein, Luxemburg, Norway, Portugal, Slovenia, Spain, Sweden, the US.

<sup>860</sup> Report on Finland, 26-27 (para.38).

<sup>861</sup> Report on Belgium, 28 (para.53).

<sup>862</sup> France, Israel, the Netherlands, Poland.

<sup>863</sup> Report on France, 23 (para.25), 27 (para.48).

<sup>864</sup> *ibid.*

substantial criticisms from peers and/or taxpayers. In Australia, Germany, and Italy, taxpayers were allegedly compelled by the relevant tax administrations, usually audit departments, to waive their access to the MAP in advance, in exchange for a relatively favourable audit settlement.<sup>865</sup> In Denmark, the competent authority denied access to the MAP in four cases for insufficient information during the assessed period.<sup>866</sup> Three of the cases were then appealed by the taxpayers concerned to the Danish Western High Court, and the court ruled for the complainants.<sup>867</sup>

### 5.3.3 Resolution of MAP cases

Resolution of MAP cases mainly concerns countries' endeavour in seeking to resolve MAP cases within a 24-month time frame, and their working relationships with their peers. In this regard, as shown in Table 9 (in the Appendices), the 45 assessed jurisdictions can be categorised into four groups. Specifically, 33 members received overall positive comments from peers.<sup>868</sup> Among these, 12 received some extraordinary compliments from peers.<sup>869</sup> Six members received some mixed feedback.<sup>870</sup> Two were negatively commented.<sup>871</sup> The remaining four countries received too few inputs to draw any conclusive conclusion about their performance.<sup>872</sup> It should be noted that this categorisation is mainly based on the peers' statements, thus unavoidably susceptible to subjectivity.

Those positive peer comments, particularly the compliments peers paid to the

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<sup>865</sup> Report on Australia, 35 (paras 69, 70); Germany, 34-35 (para.65); Italy, 32 (paras 58, 59).

<sup>866</sup> Report on Denmark, 35-36 (paras 72, 73).

<sup>867</sup> *ibid.*

<sup>868</sup> Australia, Austria, Belgium, Canada, Chile, Croatia, Czech Republic, Denmark, Estonia, Finland, Germany, Iceland, Ireland, Israel, Japan, Latvia, Lithuania, Luxembourg, The Netherlands, New Zealand, Norway, Portugal, Romania, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, the UK, and the USA.

<sup>869</sup> Australia, Canada, Ireland, Japan, Lithuania, the Netherlands, New Zealand, Slovak Republic, Slovenia, Switzerland, the UK, and the US.

<sup>870</sup> France, Hungary, India, Korea, Mexico, Poland.

<sup>871</sup> Greece, Italy.

<sup>872</sup> Argentina, Colombia, Liechtenstein, Malta.

12 jurisdictions, were generally centred on the following aspects:

(1) Responsiveness and diligence. The competent authorities were responsive and cooperative, and had consistently met promised due dates, or at least had the intent to resolve MAP cases in a timely and effective manner.<sup>873</sup>

(2) Constructive approach. The competent authorities took a realistic, constructive, pragmatic and solution-oriented approach in MAP negotiations.<sup>874</sup> In the Report on the US, some peers particularly appreciated that although the official MAP guidance in the US has strict requirements for the content of a MAP, “its competent authority is flexible and cooperative once cases are in the MAP and negotiations have started”.<sup>875</sup>

(3) Adequate resources. The competent authorities deployed adequate resources on the MAP.<sup>876</sup> The personnel dealing with MAPs in those competent authorities were well-trained and professional.<sup>877</sup>

In contrast, the negative comments, including not only those on the generally “poor” jurisdictions, but also on those “good” countries but with respect to certain aspects of their MAP practice, were centred upon several major aspects. First, 20 jurisdictions were reported that their competent authorities had not always met the expected timeframe for certain intermediate steps of MAP processes, such as presenting a position paper to the other competent authority or responding to the position paper from the other side.<sup>878</sup> The

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<sup>873</sup> For instance, see Reports on the US, 49 (para.120); Netherlands, 48 (para.103); Austria, 45 (paras 112, 113); Sweden, 46-47 (paras 115,116).

<sup>874</sup> For instance, see Reports on the US, 51 (para.125); the UK., 47-48 (para.108).

<sup>875</sup> Report on the US, 51 (para.125).

<sup>876</sup> For instance, see Reports on the US, 51 (para.127); the UK., 47-48 (para.108); Canada, 46 (para.107).

<sup>877</sup> For instance, see Reports on the UK., 48 (para.109); Canada, 46 (para.108); Sweden, 47 (para.116).

<sup>878</sup> Argentina, Belgium, Canada, Colombia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, India, Italy, Korea, Luxembourg, Mexico, Norway, Poland, Portugal, Spain.

problem was more severe for those countries that received general negative or mixed comments from peers/taxpayers. For instance, several peers reported that with one jurisdiction, meeting intermediate target time frames within 24 months was “very difficult”.<sup>879</sup> Peers further noted that for several jurisdictions, there was a discrepancy in the competent authorities’ responsiveness between those cases where initial adjustments were made by those jurisdictions and those where such adjustments were made by their treaty partners.<sup>880</sup> For these jurisdictions, their competent authorities’ lack of responsiveness was particularly notable in the cases where the adjustments were made by them.

Second, 11 jurisdictions were reported by peers that their competent authorities tended to take a rigid stance in negotiations, at least for certain cases.<sup>881</sup> For example, several competent authorities were observed to be less willing to make concessions,<sup>882</sup> “lacks willingness to find an agreement when the initial positions of the competent authorities differ”,<sup>883</sup> or “less flexibility in resolving cases, especially when high amounts are at stake”.<sup>884</sup> For several jurisdictions, the rigidity reflected the competent authorities’ lack of independence from the audit departments. For instance, peers observed that for one competent authority, all adjustments made by the tax administration were strongly defended.<sup>885</sup> Sometimes the rigid stance taken by a competent authority was associated with domestic legal hindrances. Specifically, several competent authorities were not willing to discuss certain cases either because a judicial procedure was pending on the case<sup>886</sup> or

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<sup>879</sup> Report on Italy, 48-49 (para.119).

<sup>880</sup> Canada, France, Italy.

<sup>881</sup> Australia, Canada, Czech Republic, Germany, Hungary, India Italy, Korea, Poland, Spain, and Sweden.

<sup>882</sup> Report on Canada, 43 (para.93).

<sup>883</sup> Report on Czech Republic, 47 (para.128).

<sup>884</sup> Report on Spain, 58 (para.147).

<sup>885</sup> *ibid.*

<sup>886</sup> Report on Italy, 48 (para.117).

because a case was filed after the expiration of a domestic time limit.<sup>887</sup>

Third, in four reports, peers or the assessed jurisdictions mentioned that the difficulty in achieving an agreement could be attributed to the complexity of the case.<sup>888</sup> For example, in responding to certain criticisms from a particular peer, Korea explained that some of the delays that this peer encountered in the resolution of MAP cases were not due to an inefficient allocation of resources or the other reasons cited by the peer, but merely to the complexity and the importance of the case under review.<sup>889</sup>

Lastly, eight jurisdictions left an impression on peers that their competent authorities were not equipped with adequate resources.<sup>890</sup> As is shown in Figure 4, this group of countries overlapped substantially with the group that received generally negative or mixed feedback from peers. Coupled with this observation is that none of those 12 “very good” countries was within this group. Another intriguing aspect is that among these eight jurisdictions, peers observed that the competent authorities of four had undergone some staff change, which had caused significant disruption to their MAP processes.<sup>891</sup>

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<sup>887</sup> Report on Hungary, 54 (para.137).

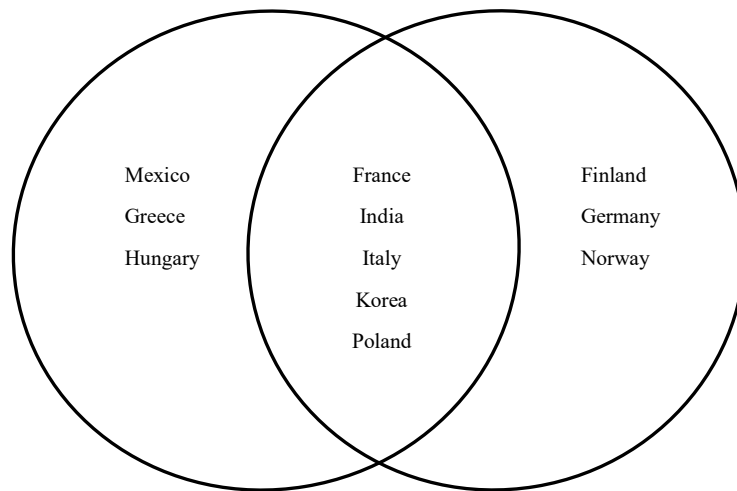
<sup>888</sup> Finland, Germany, Japan, Korea, and the Netherlands.

<sup>889</sup> Report on Korea, 57-58 (para.150).

<sup>890</sup> Finland, France, Germany, India, Italy, Korea, Norway, Poland.

<sup>891</sup> Finland, France, Germany, Korea.

**Figure 4: Overlap between the group being negatively commented and the group with inadequate resources**



**Competent authorities receiving  
negative or mixed comments**

**Competent authorities reportedly  
with inadequate resources**

Aside from these positive and negative comments, peers and taxpayers also provided rich inputs on the use of modern means of communication in the MAP process.<sup>892</sup>

### **5.3.4 Implementation of MAP agreements**

In general, peers and taxpayers did not indicate any substantial issue with the assessed competent authorities regarding their timely implementation of MAP agreements. Only three jurisdictions have been reported that a small number of cases took a relatively long time for implementation.<sup>893</sup> This achievement is somewhat surprising because at the same time, as shown in Table 9, the

<sup>892</sup> See below, Appendices, Table 11.

<sup>893</sup> Finland, France, Italy.

majority of the assessed jurisdictions did not have in place any administrative framework or timeframe for the monitoring of the implementation process.

### **5.3.5 Comments**

The Stage 1 reports open a “peephole” on the black-box of MAP practice. Traditionally, academic evaluation on the practice was largely based on anecdotes, hypotheses or personal experiences, owing to the lack of transparency in this area. It is true that the MAP statistics for OECD members examined above provide some objective information in this respect. Nevertheless, statistics usually cannot reveal causation. Nor can they isolate the performance of individual competent authorities owing to the joint nature of the MAP process, as explained above (Section 4.2.1). As a result, “no one seems quite sure why some [MAP] cases fall into a ditch while others do not”.<sup>894</sup> Two major insights can be drawn from the reports.

#### **5.3.5.1 Transaction costs of the MAP**

The Stage 1 reports, particularly the parts covering peer (taxpayer) inputs, illuminate the reasons underlying the delay or failure of MAP processes. To a significant extent, these inputs substantiate the assertion made in this chapter that the agency problem, the bargaining problem, and the administrative burden constitute the major sources of the transaction costs an ITDR process may entail.

(1) Agency costs. The obstruction of access to the MAP, and the late or lack of response on the part of the assessed competent authorities largely reflect the agency problem in the ITDR process: tax administrations care more about revenue collection than about dispute resolution and the elimination of double taxation. The delay or lack of responsiveness may

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<sup>894</sup> Park (n 154) 809.

also result from general bureaucracy, which is another type of agency problem common to most public agencies. While peers didn't refer to bureaucracy openly, they did, in their compliments to those "very good" tax authorities, attribute the timeliness of MAP processes to the cooperative and diligent attitude of those authorities.<sup>895</sup>

It is worth noting that complaints from peers and taxpayers primarily concerned the intermediate stages of the MAP process, and, to a much lesser extent, the accessibility of the procedure. By contrast, the implementation stage raised very few concerns. This fact supports the hypothesis in Section 4.2.1 of this chapter, as well as the proposition that lower measurability of agents' behaviour, particularly with respect to the process of joint production, implies higher risks of opportunism.<sup>896</sup>

(2) Bargaining costs. Even for those jurisdictions that received extraordinarily positive peer comments, MAP cases were not always resolved in a timely manner. This reflects the bargaining difficulties in the MAP process. According to the peer (taxpayer) inputs, both positive and negative, the magnitude of bargaining costs is closely connected to the size of distributive conflict, the complexity of the disputes, and the parties' willingness to cooperate and ability to find innovative solutions. Occasionally, the bargaining and agency costs are intermingled. For example, the competent authorities' adherence to the position of their audit departments may reflect both their natural tendency to compete for a greater share of the cake in the dispute resolution process, which is a bargaining problem, and their making revenue collection a priority, which can be subsumed under the agency problem.

(3) Administrative costs. The issues of resource constraint and staff

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<sup>895</sup> For instance, see Report on Sweden, 46-47 (para.115).

<sup>896</sup> See above, Chapter2, Section 2.2.3.

change, and the intensive attention paid by peers to the use of ICT, all reflect the administrative aspect of the MAP process. Moreover, the dispute-settlement process can be seriously disrupted by staff changes or departures within competent authorities; this is more prominent in ITDR than in dispute-settlement systems in other regimes. This has two implications. First, numerous competent authorities are under-resourced in light of the heavy caseload of MAP cases. Second, as discussed above (Section 4.4.2.2), human-asset specificity plays a significant role in the ITDR process.

#### 5.3.5.2 Effectiveness of the MAP

Despite the negative comments about countries' MAP practice, the central message delivered by the Stage 1 reports is positive: the MAP process is not fundamentally broken; it is still an effective means of resolving tax disputes. Specifically, most of the assessed jurisdictions have maintained congenial working relationships with their treaty partners in seeking timely resolution of tax disputes. Furthermore, there is no hint at all in peer (taxpayer) inputs that the ITDR process has ever been disrupted by political enmity, as was asserted by Burnett.<sup>897</sup> In the Report on Japan, one peer's comment on the Japanese competent authority exemplifies the solid political ground of the ITDR system and the underlying mutual dependency (i.e. high level of asset specificity) characterising international tax relationships:

*One peer qualified its relationship with Japan's competent authority as robust, productive and cooperative, reflecting their countries' deep, longstanding commercial and cultural ties.*<sup>898</sup>

This peer seemed to emphasise its particular relationship with Japan,

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<sup>897</sup> Burnett (n 77) 180; see also above, Chapter 1, Section 2.2.1.

<sup>898</sup> Report on Japan, 64 (para.167).

perhaps in the light of some historical tradition between the two countries. However, the compliments paid to the Japanese competent authority by many other peers and the prevailing positive comments about a majority of the jurisdictions indicate that the commercial ties between the countries and investors, and among the countries themselves, are rather pervasive.

Even for those countries that have recorded relatively poor MAP performance, it becomes clear now that the problem mainly concerns resource constraints or administrative bureaucracy rather than political capriciousness. For example, the report on Italy, a country that has been vehemently criticised by peers for its significant lack of responsiveness in MAP processes, states:

*In response, in order to support the process of resolving MAP cases in a timely manner, Italy performed an internal reorganization as already noted in the Introduction, inter alia aiming at providing adequate resources to the MAP function.... According to Italy, this represents a clear signal of its strong effort to improve its dispute resolution mechanism.*<sup>899</sup>

Comparatively, the report on India established a clearer correlation between resource constraint and the delays in the country's MAP processes. Peers providing input in the report could be divided into two groups. The first group has a large number of MAPs with India, while the second group does not.<sup>900</sup> In general, the second group provided rather constructive input on their experiences with India concerning the resolution of MAP cases.<sup>901</sup> It is mainly the first group that raised some criticisms of India's MAP practice.<sup>902</sup> However, even this first group effusively appreciated India's endeavour and good faith in MAP negotiation.<sup>903</sup> Arguably, it is mainly the lack of resources, such as staff shortage, that accounts for its delays in MAP processes,

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<sup>899</sup> Report on Italy, 53 (para.135).

<sup>900</sup> Report on India, 62 (para.170)

<sup>901</sup> *ibid* 62 (para.171)

<sup>902</sup> *ibid* 62-65 (paras 171-176)

<sup>903</sup> *Ibid* 62-63 (para.172)

particularly when a large number of MAPs is concerned.<sup>904</sup>

Furthermore, somewhat surprisingly, most of those countries that have received negative or mixed comments about the timely resolution of MAP processes, have good records on the accessibility of the MAP and excellent records on the timely implementation of MAP agreements. The latter further vindicates the BOS nature of international tax regime: once the distributive conflict has been resolved through an agreement, states would have no incentive to defect from the agreement.<sup>905</sup>

The stable political environment surrounding the international tax regime affects ITDR in two ways. First, it further demonstrates the instrumental value of a MAP-based ITDR system in facilitating the entire regime, thereby vindicating the benefit analysis of the ITDR system. Second, it implies that the agency and bargaining problems in the MAP process are generally controllable, and thereby bolster the MAP-based ITDR system from a cost perspective.

That being said, political goodwill alone does not guarantee the effectiveness of the MAP, and those negative peer inputs strongly suggest that the mechanism needs to be strengthened.

## **5.4 Data about tax arbitration: Electrolux case**

### **5.4.1 Overview**

Data about international tax arbitration is quite scant. First, the mechanism is significantly underused. Very few cases have been reportedly channelled through tax arbitration in the context of the OECD Model Convention.<sup>906</sup> In the context of EU Arbitration Convention, it is said that by the end of 2012,

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<sup>904</sup> Ibid 66 (para.179)

<sup>905</sup> See above, Chapter2, Section 2.3.1.

<sup>906</sup> Burnett (n 77) 181–182; Terr and others (n 25) 485–486.

while there were 848 tax disputes still pending in the MAP, only a handful cases were settled through arbitration.<sup>907</sup> Many scholars, with whom this author concurs, believe that the underuse of the mechanism simply indicates that the current ad hoc method of tax arbitration is so unattractive that taxpayers do not rely on it.<sup>908</sup> Second, even for those actual cases of tax arbitration, there is a paucity of case information due to confidentiality requirements. Notwithstanding these, one tax arbitration case, which involves Electrolux affiliates (Electrolux case), did enter the public domain when the French tax administration shared its experience on this case at a meeting held by the EU Joint Transfer Pricing Forum (JTPF).<sup>909</sup>

The MAP for the case was initiated between French and Italian competent authorities in 1997, and ended up with several issues unresolved.<sup>910</sup> In 2000, the French competent authority approached its Italian counterpart to start the arbitration phase.<sup>911</sup> The authorities then took a year and a half to set up the Advisory Commission.<sup>912</sup> The first meeting of the Commission took place in November 2002.<sup>913</sup> The Commission delivered its opinion on 19 May 2003, within six months from the date of its first meeting.<sup>914</sup>

#### **5.4.2 Key aspects of the case**

(1) Establishment of the Advisory Commission. The delay in establishing the Advisory Commission mainly resulted from the parties' difficulty in

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<sup>907</sup> Kollmann and others (n 178) 1191.

<sup>908</sup> *ibid.*

<sup>909</sup> JTPF, 'Draft Summary Record of The Third Meeting of The EU JTPF' (EU Commission 2003) para.11

<[https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/forum4/minutes02apr\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/forum4/minutes02apr_en.pdf)> accessed 2 February 2018.

<sup>910</sup> *ibid* para.12.

<sup>911</sup> *ibid.*

<sup>912</sup> *ibid* para.15.

<sup>913</sup> *ibid* para.11.

<sup>914</sup> JTPF, 'Draft Summary Record of The Fourth Meeting of The EU JTPF' (EU Commission 2003) para.11

<[https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/forum4/minutes02apr\\_en.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/forum4/minutes02apr_en.pdf)> accessed 2 February 2018.

finding a Chair for the Commission. First, the list of independent persons maintained by the EU Commission was at that time incomplete and out of date.<sup>915</sup> Second, some independent persons of standing had declined the request to be the Chair because of the time needed for studying the documents of the case and for the meetings of the Advisory Commission.

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(2) Establishment of the secretariat. After the Advisory Commission was established, the competent authorities decided to set up a secretariat to be responsible to the Advisory Commission.<sup>917</sup> The role of a secretariat is not mentioned in the EU Arbitration Convention. Perhaps the Advisory Commission and the parties all thought it helpful to have a secretariat facilitating the arbitral procedure. However, this secretariat role was performed by a member of the tax administration which had made the transfer-pricing adjustment.<sup>918</sup>

(3) Evidentiary issues. The case raised several evidentiary issues. First, both competent authorities agreed that all their correspondence concerning the case should be made available to the Advisory Commission.<sup>919</sup> The quantity and quality of documents depended critically on how well the competent authorities had communicated with each other during the MAP negotiation.<sup>920</sup> Second, the Chair of the Advisory Commission requested the position of the enterprise on the proposed transfer-pricing adjustment, i.e. whether it agreed or disagree with the adjustment and for what reason.<sup>921</sup> Third, the Advisory Commission had inquired whether the competent authorities had initiated

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<sup>915</sup> JTPF (n 909) para.15.

<sup>916</sup> *ibid.*

<sup>917</sup> *ibid* para.16.

<sup>918</sup> *ibid.*

<sup>919</sup> *ibid* para.17.

<sup>920</sup> *ibid* 17.

<sup>921</sup> *ibid* para.18.

MAPs on the case with competent authorities of other Contracting States – the case seemed to involve multiple jurisdictions – and if so whether an agreement had been reached.<sup>922</sup> This raised the question of whether the Advisory Commission should have access to the correspondence with a third competent authority.<sup>923</sup>

(4) Taxpayer participation. The taxpayer was informed of the arbitration procedure and was invited to be present during the procedure.<sup>924</sup> However, the taxpayer declined the invitation.<sup>925</sup> This is another intriguing fact about the Electrolux case, considering that a major advantage of tax arbitration is the improved status of taxpayers in arbitral procedures compared to the MAP.<sup>926</sup> Perhaps the taxpayer noticed that its confrontation with the competent authorities in an arbitral proceeding might cause disruption to its long-term relationship with one or both tax authorities.

(5) Logistical issues. The two competent authorities decided that the Contracting State that had made the transfer-pricing adjustment would arrange for the panel meetings.<sup>927</sup> They also agreed that the arbitral proceedings should be conducted in the official language of that adjusting state with consecutive translation into the other state's official language.<sup>928</sup> All costs associated with the Advisory Commission, including the fees and expenses of the independent persons of standing, travel and translation expenses etc., should be shared equally by both countries.<sup>929</sup>

### 5.4.3 Comments

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<sup>922</sup> *ibid* para.19.

<sup>923</sup> *ibid*.

<sup>924</sup> *ibid* para.21.

<sup>925</sup> *ibid*.

<sup>926</sup> See above, Chapter 1, Section 2.3.1.

<sup>927</sup> JTPF (n 909) para.13.

<sup>928</sup> *ibid* para.14.

<sup>929</sup> *ibid*.

In general, the Electrolux case reveals an unsatisfactory aspect of the arbitral procedure: it took almost three years to complete. To a large extent, the protraction of the process reflects the high administrative costs of the procedure. As Burnett observes, “issues of costs, logistics and travel seemed to have dominated the procedure [of the Electrolux case]”.<sup>930</sup> This observation corresponds to the proposition that tax arbitration implies higher administrative costs than the MAP. In particular, the fact that several potential arbitrators were deterred by the volume of document reading and the frequency and length of meetings vindicates the above notion of human-asset specificity and its implication for the choice of ITDR modes (Section 4.4.2.2): given the complexity of tax disputes, it is advantageous to have tax authorities resolving such disputes in the first instance.

One commentator suggests that the lengthy establishment of the Advisory Commission may also result from an agency problem: competent authorities had exploited the gaps in the EU Arbitration Convention, which fails to prescribe the time frame for the establishment of an Advisory Commission.<sup>931</sup> This inference, though not adequately substantiated by the case itself, supports the above proposition (Section 4.2.2) that arbitral procedure, particularly with respect to the stages before the establishment of a panel, will still be vulnerable to the agency problem. In addition, the debate about whether the Advisory Commission should have access to correspondence with a third competent authority intimates that there may also be a bargaining problem during the arbitral proceedings.

Despite all the above nuisances of the proceedings, the fact that the case was concluded within six months after the Advisory Commission took over still indicates the effectiveness of tax arbitration in providing finality for the ITDR

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<sup>930</sup> Burnett (n 77) 182.

<sup>931</sup> Bernath (n 68) 95.

process.

## **5.5 Summary of the data analysis**

It should be admitted that the above data analysis is inconclusive. Aside from the fact that the Electrolux case is the only publicised case of tax arbitration practice, the MAP statistics are largely confined to the OECD members. Comparatively, the peer-review process covers a wider group of members; yet peer/taxpayer comments could be “tainted” with personal bias or emotional appealing. Nevertheless, the above data still provides valuable information about ITDR practice and substantiates the theoretical evaluation in this chapter. Specifically, the MAP statistics indicate the general effectiveness of the MAP, albeit with deviations among individual cases. While numerous stalemated cases suggest the shortcomings of the MAP, those “fast runners” indicate that the mechanism is not inherently time-consuming. The examination of Stage 1 reports largely underpins the statistical analysis. Specifically, the peer inputs demonstrate that the three sources of transaction costs – the agency problem, the bargaining impasse, and the administrative burden – contribute to the protraction of MAP processes. That being said, the magnitude of agency and bargaining costs should not be overestimated given the general goodwill at the political level. The Electrolux case exemplifies the transaction costs of tax arbitration. On the one hand, the mechanism implies higher administrative costs than does a typical MAP process; on the other hand, it is more effective in providing finality for ITDR.

## **6. Conclusion of the chapter**

This chapter conducted a benefit-cost analysis on the ITDR system. The benefit analysis indicates that a flexible and collaborative ITDR system is

instrumental for the maintenance of a congenial international tax (and investment) relationship, which is crucial to protect specialised assets in international investments. Such a flexible system also avoids nuisances with respect to legal application in the field of international taxation. Obviously, among various ITDR mechanisms, the MAP represents the most flexible and collaborative method. From the cost perspective, the MAP also represents the most cost-efficient option among ITDR mechanisms. In particular, the procedure implies the lowest administrative costs owing to its procedural flexibility and high level of human-asset specificity. It is true that agency and bargaining problems frequently cause delays to MAP processes. Nevertheless, the particular nature of the international tax regime, as explained in the benefit analysis, indicates that the risks of political capriciousness or bargaining hassle are relatively low and controllable in most MAP cases, although a certain level of bureaucracy, strategic conduct, and *bona fide* disagreements may still plague the processes. The benefit-cost analysis in this chapter corresponds to Altman's explanation of the antilegalistic shift by the League of Nations regarding the ITDR mode. According to him, two major factors accounted for the shift: (a) the special character of international tax rules and the resulting difficulties in treaty application; and (b) the high procedural costs of legalistic dispute-resolution methods.<sup>932</sup>

On balance, this chapter established that a MAP-based system of ITDR can generate the highest net benefit for the global welfare. This explains, at least partially, the reality that by far most tax disputes have been finalised through the MAP. On the other hand, given that ITDR processes are still susceptible to agency and bargaining risks, the MAP needs to be strengthened from both within and without. In particular, for those stalemated MAPs, the use of

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<sup>932</sup> See above, Chapter 1, Section 1.2.

third-party procedures, including arbitration and mediation, can help to break the impasses and move the processes forward. Accordingly, tax arbitration and mediation still play an important part in this MAP-based ITDR system, albeit in a supplementary manner.

The analysis in this chapter also showed that the benefit and cost analyses are not entirely segregated. First, the characteristics of the international tax regime not only determine the choice of ITDR mode, which is the core theme of the benefit analysis, but also influence the cost dynamics of a given ITDR mode, which belongs to the cost analysis. Moreover, the notion of asset specificity affects both benefit and cost analyses. From the benefit perspective, asset specificity constitutes one of the key regime characteristics that, in turn, determine the mode of dispute-settlement system. This is also how the concept is typically used in TCE. In the cost analysis, the notion is more associated with the management question of how to make full use of specialised assets.<sup>933</sup> Specifically, given the human-asset specificity in tax-administration processes, it is desirable for competent authorities to resolve tax disputes in the first instance.

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<sup>933</sup> Linda V Ruchala, 'Managing and Controlling Specialized Assets' (1997) 79 *Strategic Finance* 20.



## Chapter 4. Testing the Theory: Comparing ITDR with Trade and Investment Dispute Settlement

### 1. Overview

The preceding chapter established, through a benefit-cost analysis, that a MAP-based dispute-settlement system represents the most efficient mode of contractual governance for the international tax regime. To further test the validity of this proposition and the underlying arguments, it is beneficial to compare ITDR with trade and investment dispute resolution. Intuitively, the three regimes – international tax, trade and investment – have much in common. In particular, they all serve the role of liberalising the international economy, and by using very similar methods. Accordingly, one would expect that the arguments for a flexible and collaborative dispute-settlement system that were put forth in the last chapter should also apply to the trade and investment regimes. Nonetheless, the truth is that the latter two regimes have developed a legalistic method of dispute resolution that differs markedly from the current ITDR system. As discussed previously, writers of ITDR tend to take those legalistic dispute-settlement systems, particularly those under the WTO and ICSID, as role models for ITDR.<sup>934</sup> Numerous commentators even suggest bringing tax disputes under the jurisdictions of the WTO or investment-arbitration fora.<sup>935</sup>

Section 2 contains an outline of the dispute-settlement systems under trade and investment regimes, demonstrating the legalistic character of these systems as opposed to ITDR. Section 3 reveals the fundamental differences between the tax regime on the one hand and trade and investment regimes

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<sup>934</sup> See above, Chapter 1, Section 2.6.

<sup>935</sup> See above, Chapter 1, Section 2.3.1.

on the other hand. The section also demonstrates how these differences affect the dispute-settlement method under those regimes. In the preceding chapter, the benefit-cost analysis of the ITDR system centres on several key dimensions of the international tax regime and the ITDR process. The analysis in section 3 will also proceed alongside those dimensions. Section 4 concludes.

## 2. Outline of trade/investment dispute-settlement systems

### 2.1 Trade dispute settlement

The WTO is the only transnational organisation dealing with the rules of trade between nations.<sup>936</sup> The goal of the WTO is to ensure smooth, predictable, and free flow of trade.<sup>937</sup> The WTO was preceded by the General Agreement on Tariffs and Trade (GATT), which started in 1947.<sup>938</sup> In the GATT context, there were eight rounds of trade talks aiming at trade liberalisation.<sup>939</sup> The Uruguay Round, which was the final GATT Round, established the WTO as a substitute for the GATT, a move that marked the biggest reform of the international trade regime since the end of World War II.<sup>940</sup>

The WTO's unique contribution to the stability of global trade is its dispute-settlement mechanism, which is also regarded as a central pillar of the multilateral trading system.<sup>941</sup> The old GATT also had a procedure for settling disputes, but this was perceived as being too soft.<sup>942</sup> The GATT dispute-settlement procedure had no fixed timetable; the initiation of the

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<sup>936</sup> 'WTO | About the Organization' <[https://www.wto.org/english/thewto\\_e/thewto\\_e.htm](https://www.wto.org/english/thewto_e/thewto_e.htm)> accessed 13 April 2019.

<sup>937</sup> *ibid.*

<sup>938</sup> 'A Brief History of the WTO | D+C - Development + Cooperation' <<https://www.dandc.eu/en/article/brief-history-wto>> accessed 13 April 2019; see also 'WTO | About the Organization' (n 936).

<sup>939</sup> 'A Brief History of the WTO' (n 938); see also 'WTO | About the Organization' (n 936).

<sup>940</sup> 'A Brief History of the WTO' (n 938).

<sup>941</sup> 'WTO | Understanding the WTO - A Unique Contribution' <[https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/disp1\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm)> accessed 13 April 2019.

<sup>942</sup> *ibid.*

procedure and the rulings were easy to block; and many cases stalemated for a long time inconclusively.<sup>943</sup> In this context, the Uruguay Round introduced for the WTO a more structured and disciplined mechanism for dispute settlement, with a more detailed procedure and timetable.<sup>944</sup> It also established the Dispute Settlement Body (DSB) to administer these procedures.<sup>945</sup>

According to the Dispute settlement Understanding (DSU) under the WTO, a typical process of trade dispute settlement includes several phases: consultation, panel investigation and report, appellate review, decision adoption and implementation.<sup>946</sup>

(1) Consultations. When a dispute arises between WTO Member States, either party may request a consultation, which is essentially a negotiation between the two parties with a view to reaching a mutually satisfactory solution.<sup>947</sup>

(2) Panel proceedings. The complaining party may request the establishment of a panel if: (a) the responding party does not respond within 10 days after the request of consultations; (b) the responding party does not enter into consultations within 30 days of such request; and (c) the consultations fail to yield a settlement within 60 days after the request is made.<sup>948</sup> The request for arbitration should be made to the DSB, which can refuse the request only by consensus.<sup>949</sup> Since the parties to a dispute also participate in decisions taken by the DSB with respect to that dispute, there is effectively a “right to a panel” for a complaining party.<sup>950</sup> A

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<sup>943</sup> *ibid.*

<sup>944</sup> *ibid.*

<sup>945</sup> Understanding on Rules and Procedures Governing the Settlement of Disputes (WTO) Article 2(1).

<sup>946</sup> Guzman and Simmons (n 307) 207.

<sup>947</sup> WTO DSU Article 4; see also Guzman and Simmons (n 307) 207.

<sup>948</sup> WTO DSU Article 4 (3), (7); see also Guzman and Simmons (n 307) 207.

<sup>949</sup> WTO DSU Art.6 (1).

<sup>950</sup> *ibid* Article 2(1); see also Merrills (n 141) 202.

panel typically consists of three people, but may also be composed of five, if the parties so agree.<sup>951</sup> Panellists are proposed by the Secretariat, and the parties may only object them for compelling reasons.<sup>952</sup> In the event of disagreement over the composition of a panel, the Director-General of the WTO is authorised to decide the issue upon the request of either party.<sup>953</sup> The panel is required to make an objective assessment of the facts and law.<sup>954</sup> In normal circumstances, a panel is required to deliver a final report on the dispute within six months after the panel's composition and terms of reference have been agreed upon, and three months in cases of urgency.<sup>955</sup> Once issued, a panel report is considered for adoption by the DSB.<sup>956</sup> The report should be adopted within 60 days of its issuance, unless the DSB agrees otherwise or one of the parties notifies the DSB of its intention to appeal.<sup>957</sup> Note that a panel procedure does not close the consultation between the parties, which can settle the case through mutual consent at any point in the dispute-settlement process.<sup>958</sup>

(3) Appellate review. If one or both parties appeal a panel report, a three-person appellate panel will be established.<sup>959</sup> The appeal is limited to issues of law covered in the panel report and legal interpretations developed by the panel.<sup>960</sup> The appellate panel is normally required to deliver its report within 60 days from the date of appeal.<sup>961</sup> Such appellate-body report is to be adopted by the DSB and unconditionally accepted by the disputing parties unless the DSB decides by consensus

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<sup>951</sup> WTO DSU Article 8 (5).

<sup>952</sup> *ibid* Article 8 (6).

<sup>953</sup> *ibid* Article 8(7).

<sup>954</sup> *ibid* Article 11.

<sup>955</sup> *ibid* Article 12 (8).

<sup>956</sup> *ibid* Article 16 (1).

<sup>957</sup> *ibid* Article 16 (4); see also Guzman and Simmons (n 307) 207.

<sup>958</sup> Guzman and Simmons (n 307) 208.

<sup>959</sup> WTO DSU Article 17.

<sup>960</sup> *ibid* Article 17 (6).

<sup>961</sup> *ibid* Article 17 (5).

not to adopt it within 30 days after its issuance.<sup>962</sup>

The entire process, from the establishment of a panel to the adoption of the panel report or appellate body report by the DSB, is to take place within nine months if there is no appeal, and 12 months if there is an appeal.<sup>963</sup>

(4) Implementation of rulings and recommendations. Where a panel or an appellate body finds that a measure is inconsistent with a covered agreement, it shall recommend that the member concerned bring the measure into conformity with that agreement.<sup>964</sup> It may also suggest ways for the member to implement the recommendation.<sup>965</sup> The DSU further specifies detailed procedures and timetables for monitoring the implementation of the recommendations and rulings.<sup>966</sup>

## 2.2 Investment dispute settlement

Trans-border investment is a critical component of the world's economy, and it has become common practice for countries to enter into international investment agreements.<sup>967</sup> As of April 2019, there were 2,932 bilateral investment treaties and 387 treaties with investment provisions.<sup>968</sup> These investment agreements have two fundamental innovations as opposed to previous international agreements.<sup>969</sup> First, they accord investors with a series of substantive rights such as fair and equitable treatment, full protection and security, protection against uncompensated expropriation or

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<sup>962</sup> *ibid* Article 17 (14).

<sup>963</sup> *ibid* Article 20; Guzman and Simmons (n 307) 207.

<sup>964</sup> WTO DSU Article 19 (1).

<sup>965</sup> *ibid*.

<sup>966</sup> *ibid* Article 21, 22.

<sup>967</sup> Margaret L. Moses (n 769) 231; see also Susan D Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law through Inconsistent Decisions' (2004) 73 *Fordham L. Rev.* 1521, 1527, 1528.

<sup>968</sup> 'International Investment Agreements Navigator' <<https://investmentpolicyhubold.unctad.org/IIA>> accessed 18 April 2019.

<sup>969</sup> Franck (n 967) 1529.

nationalisation, and national treatment.<sup>970</sup> Second, they grant investors direct access to arbitration with the host states for the violation of their treaty rights by the host states.<sup>971</sup> Under traditional international law, individuals normally had no direct cause of action against a sovereign country for the violation of their rights.<sup>972</sup>

According to the dispute-settlement clause of a particular investment agreement, arbitration between a host state and a foreign investor may take place in the framework of a variety of institutions or rules.<sup>973</sup> Practically, the majority of cases were brought under the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, also known as the ICSID Convention.<sup>974</sup> The Convention, which entered into force on 14 October 1966, had been ratified by 154 countries as of April 2019.<sup>975</sup> It created the ICSID, which has now become the major forum for the settlement of investment disputes.<sup>976</sup> The Convention also provides that ICSID awards are recognised as final in all Contracting States of the Convention and not subject to review except under the narrow conditions provided by the Convention itself.<sup>977</sup> A typical ICSID procedure can be outlined as follows:

(1) Initiation of the procedure. The procedure begins with a request for arbitration directed to the Secretary-General of the ICSID.<sup>978</sup> The Secretary-General will register the request unless he or she finds that the dispute is manifestly outside the ICSID's jurisdiction.<sup>979</sup>

(2) Establishment of a tribunal. Most tribunals consist of three arbitrators,

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<sup>970</sup> *ibid*; see also Margaret L. Moses (n 769) 240–241.

<sup>971</sup> Franck (n 967) 1529.

<sup>972</sup> Dolzer and Schreuer (n 594) 232.

<sup>973</sup> *ibid* 238.

<sup>974</sup> *ibid*.

<sup>975</sup> ICSID Convention.

<sup>976</sup> *ibid*; see also Dolzer and Schreuer (n 594) 238.

<sup>977</sup> ICSID Convention Art.53(1); see also Dolzer and Schreuer (n 594) 239.

<sup>978</sup> ICSID Convention Art. 36(1).

<sup>979</sup> *ibid* Art.36 (3).

with the co-arbitrators appointed by each party and the president of the tribunal agreed on by both parties.<sup>980</sup> If the tribunal is not constituted within 90 days after the registration of the request, either party may request the Chairman of the Administrative Council to make any outstanding appointments.<sup>981</sup>

(3) Tribunal proceedings. The remainder of the procedure is quite similar to a typical commercial arbitration, which includes procedural meetings; memorials and replies; interim relief; evidence presentation; hearings; deliberation by the tribunal, etc.<sup>982</sup> After the deliberation, the tribunal decides questions by a majority of the votes of all its members and then delivers an award.<sup>983</sup>

(4) Arbitral award. ICSID awards are subject to annulment, in which an ad hoc committee may annul the award upon either party's request.<sup>984</sup> Annulment is different from an appeal. The former is only concerned with the legitimacy of the procedure and not with the substantive correctness of the decision, whereas the latter is concerned with both.<sup>985</sup> There are five grounds for annulment: (a) the tribunal was not properly constituted; (b) the tribunal manifestly exceeded its powers; (c) there was corruption on the part of a member of the tribunal; (d) there was a serious departure from a fundamental rule of procedure; and (e) the award did not state the reasons on which it is based.<sup>986</sup>

The ICSID Convention also contains the mechanism of conciliation, whereby parties can seek a non-binding opinion from a conciliation commission.<sup>987</sup>

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<sup>980</sup> *ibid* Art.37.

<sup>981</sup> *ibid* Art.38.

<sup>982</sup> Rules of Procedure for Arbitration Proceedings (Arbitration Rules), see also Franck (n 967) 1543–1544.

<sup>983</sup> ICSID Convention Art.48.

<sup>984</sup> *ibid* Art.52.

<sup>985</sup> Dolzer and Schreuer (n 594) 302.

<sup>986</sup> ICSID Convention Art.52(1).

<sup>987</sup> *ibid* Arts 29-35.

The composition, qualification, and appointment of a conciliation commission are similar to those of arbitral tribunals.<sup>988</sup> The commission is required to clarify the issues in dispute between the parties and to endeavour to bring about agreement upon mutually acceptable terms.<sup>989</sup> The ICSID Convention treats conciliation and arbitration as equivalent alternatives; yet in reality, conciliation is rarely used.<sup>990</sup> As of December 31, 2018, ICSID had registered 706 cases, of which only 11 were conciliation cases.<sup>991</sup>

For investment arbitration outside the purview of the ICSID Convention, the enforcement of arbitral awards may be subject to review by domestic courts, as is the case with most international commercial arbitration. In this regard, the Convention on Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention, requires courts of Contracting States to enforce arbitration awards, albeit subject to a limited number of grounds for non-enforcement.<sup>992</sup>

## **2.3 The differences between the ITDR system and trade/investment dispute settlement systems**

From the above outline, several key differences between the ITDR system and trade/investment dispute settlement systems can be drawn as follows.

### **2.3.1 Use of binding and non-binding methods of dispute settlement**

The three dispute-settlement systems all encourage parties to use amicable methods of dispute resolution, such as negotiation, consultation, and conciliation. Nevertheless, the real practice of trade and investment dispute settlement has significantly gravitated toward binding methods such as the

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<sup>988</sup> *ibid* Arts 29-31.

<sup>989</sup> *ibid* Art 34 (1).

<sup>990</sup> Dolzer and Schreuer (n 594) 236–237.

<sup>991</sup> ICSID, 'The ICSID Caseload Statistics (Issue 2019-1)' 7–8

<<https://icsid.worldbank.org/en/Pages/resources/ICSID-Caseload-Statistics.aspx>>.

<sup>992</sup> Margaret L. Moses (n 769) 211–212.

panel procedure under the WTO and the arbitration mechanism under most investment agreements. By contrast, there is a very low adoption of an arbitration clause in tax treaties. Even for those tax treaties that have incorporated arbitration clauses, such clauses have been significantly underused.<sup>993</sup> As a result, most tax disputes have been channelled through the MAP.

### **2.3.2 Structure of the dispute-resolution procedure**

Like tax arbitration, the DSU under the WTO and the arbitration provision of a few investment agreements also place non-binding solutions such as consultation and conciliation as a procedural prerequisite for the phase of arbitration or adjudication. Nonetheless, whereas tax arbitration is widely perceived as an integral part of the MAP, the panel procedure under investment and trade dispute settlement acquires much more independence and significance. First, whereas tax arbitration only deals with issues that fail to be resolved in the MAP phase, panels of trade and investment dispute settlement typically have a full jurisdiction over the entire cases. Second, the time frame for the non-binding procedure under the DSU (WTO) and several investment agreements is typically six months,<sup>994</sup> which is significantly shorter than that of the MAP. The longer timetable of the MAP signifies treaty drafters' intention to settle most tax disputes by mutual agreement, and to use tax arbitration merely as the last resort or as a stimulus to the timely resolution of MAP cases.

### **2.3.3 Methods of adjudication**

Both panel procedures under the DSU and arbitration under investment agreements adopt a conventional approach to adjudication, in which a

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<sup>993</sup> See above, Chapter 1, Section 1.8.

<sup>994</sup> Margaret L. Moses (n 769).

third-party neutral makes an independent assessment of the facts and law, and issues an award with full reasoning. Indeed, in the context of the ICSID Convention, the lack of reasoning in an arbitral award constitutes a ground for the annulment of the award.<sup>995</sup> In contrast, the OECD and UN Model Convention provide two options: final-offer arbitration and the conventional approach. Under final-offer arbitration, the panel is only allowed to choose between the two solutions proposed by the parties. The arbitral decision only states the outcome of that choice, usually a number, without specifying the rationale underlying the decision.<sup>996</sup> The adoption of final-offer arbitration in the ITDR process indicates that the major purpose of tax arbitration is to break the impasse of the MAP negotiation and move the procedure forward.

### **2.3.4 Review of panel decisions**

The final decisions of the DSB and investment arbitration are subject to some review mechanisms, either in the form of appeal review or an annulment procedure. Such a review mechanism is missing in tax arbitration. This also reflects the efficiency orientation of the ITDR system. Indeed, the existence of a final-offer approach in tax arbitration determines that numerous grounds for annulling a panel decision in the context of ICSID Convention, such as the lack of reasoning and the violation of due process, cannot apply to tax arbitration.

### **2.3.5 Enforcement of panel decisions**

Both trade and investment regimes give “teeth” to their dispute-settlement systems by having in place enforcement mechanisms. The rules on the implementation of panel decisions can be found in Articles 21 and 22 of the DSU, Articles 53-55 of the ICSID Convention, and the New York Convention.

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<sup>995</sup> ICSID Convention Art.52(1).

<sup>996</sup> See below, Chapter 6, Section 4.

In contrast, tax arbitration does not have similar enforcing rules. The lack of an enforcing mechanism in tax arbitration should not be construed as a careless omission. Rather, it reflects the very intention of treaty drafters that tax arbitration is instituted as an integral part of the MAP, rather than an independent alternative of dispute settlement. In the EU arbitration convention and the arbitration provision under the UN Model Convention, competent authorities may even deviate by mutual agreement from an arbitral decision. Again, this indicates that the major purpose of tax arbitration is to facilitate the MAP dialogue between competent authorities.

### **3. Comparison between the tax regime and trade/investment regimes**

On the surface, the tax regime resembles its trade and investment equivalents. Given these apparent similarities, there have been suggestions that the trade and investment dispute-settlement modes can be followed by the tax regime.<sup>997</sup> The affinity between tax treaties and trade agreements has already been discussed by Green and several other scholars.<sup>998</sup> In short, the two regimes not only have the same goal of facilitating the international flow of trade and investments, they also employ similar methods to achieve that goal.<sup>999</sup> For example, the GATT historically prohibited the use of income-tax preferences as a means of subsidising exports.<sup>1000</sup> Based on this prohibition, the GATT panel once struck down the income-tax rules of several countries.<sup>1001</sup> Compared with the trade regime, the investment regime is even more closely related to its tax equivalent. As discussed previously, the

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<sup>997</sup> See above, Chapter 1, Section 2.6.

<sup>998</sup> Green (n 13) 87–90; Reuven S Avi-Yonah, 'Treating Tax Issues through Trade Regimes' (2000) 26 *Brook. J. Int'l L.* 1683.

<sup>999</sup> Green (n 13) 87–88.

<sup>1000</sup> *ibid* 89.

<sup>1001</sup> *ibid*.

international tax regime forms an integral part of investment contracts.<sup>1002</sup> Governments frequently use taxation as a means of regulating foreign investments, sometimes in a manner detrimental to foreign investors' interests.<sup>1003</sup> Certain tax measures may either render a foreign investment uncompetitive vis-à-vis domestic investors, or undermine the economic function of the investment.<sup>1004</sup> As a result, international taxation is not solely governed by tax treaties, but also, in one way or another, regulated by investment treaties.<sup>1005</sup> Indeed, it is not unusual to see investors bring tax-related disputes to investment-arbitration fora.<sup>1006</sup>

Be that as it may, from a transaction-cost perspective, there are fundamental differences between the tax regime and its trade and investment equivalents.

### **3.1 Benefit aspects**

#### **3.1.1 Asset specificity and ongoing relationships**

It has already been established that for regimes that feature ongoing relationships among parties, a flexible and collaborative dispute-settlement system is more instrumental in facilitating the regimes.<sup>1007</sup> The stable and congenial quality of the international tax relationship was demonstrated in the last chapter.<sup>1008</sup> This section will argue that, compared with the tax regime, its international trade/investment equivalents are more reminiscent of a Hobbesian world.

##### **3.1.1.1 International trade relationships**

In the literature of international political economics, international cooperation

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<sup>1002</sup> See above, Chapter 3, Section 3.1.1.

<sup>1003</sup> Walde and Kolo (n 580) 424.

<sup>1004</sup> *ibid.*

<sup>1005</sup> *ibid.*

<sup>1006</sup> Julien Chaisse, 'Investor-State Arbitration in International Tax Dispute Resolution: A Cut above Dedicated Tax Dispute Resolution' (2015) 35 *Va. Tax Rev.* 149, 149.

<sup>1007</sup> See above, Chapter 2, Section 3.3.1.3; Chapter 3, Section 3.4.

<sup>1008</sup> See above, Chapter 3, Section 3.1.3.

on trade policies is most commonly modelled as a PD game.<sup>1009</sup> This indicates that the trade regime is “nastier” than its tax equivalent. Table 6 depicts the strategic interaction between two countries regarding their trade policies.<sup>1010</sup> As the PD game dictates, both countries have a dominant strategy of trade-protection policies, and the Nash Equilibrium is the profile of protection/protection, or a trade war.<sup>1011</sup>

**Table 6: Game of international trade policies**

		Country B	
		Free trade	Protection
Country A	Free trade	-1, -1	-3, 0
	Protection	0, -3	-2, -2

Derived from Paul R. Krugman, *International Economics: Theory and Policy* 228-229 (Fourth edition, Addison-Wesley 1997).

Fortunately, according to Green, international trade is not a single-play game, but rather a game of indefinitely repeated play.<sup>1012</sup> In such an iterated game, countries can adopt retaliatory strategies, of which the best known is “tit-for-tat”, to elicit and maintain cooperation.<sup>1013</sup> In this “tit-for-tat” strategy, a player cooperates on the first move and then mimics what the other player did in the previous move.<sup>1014</sup> If one player knows that the other player has

<sup>1009</sup> John Ravenhill, *Global Political Economy* (Fifth edition., Oxford University Press 2017) 58–59; Paul R Krugman, *International Economics: Theory and Policy* (Fourth edition., Addison-Wesley 1997) 228–229; Green (n 13) 105 For explanation of the PD game, see above, Chapter 2, section 2.3.1.2.

<sup>1010</sup> Krugman (n 1009) 228–229.

<sup>1011</sup> Ravenhill (n 1009) 59; See also above, Chapter 2, section 2.3.1.2.

<sup>1012</sup> Green (n 13) 108–109.

<sup>1013</sup> *ibid* 109.

<sup>1014</sup> *ibid*.

adopted this strategy, it will rationally adopt the strategy that can maximise its long-term interests, i.e. to liberalise its trade policies.<sup>1015</sup> However, the use of retaliatory strategies in trade policies may run into difficulties in practice.<sup>1016</sup> Among others, given the ambiguity of international trade rules, particularly the fact that trade policies are frequently entangled with environmental or health regulations, one country may not be able to discern the other's move accurately as cooperation, defection, or retaliation.<sup>1017</sup> Green proposes an example where Country A takes an action that it believes to be in compliance with relevant trade agreements.<sup>1018</sup> Country B, however, interprets A's action as a breach of an agreement, and therefore retaliates.<sup>1019</sup> A, believing that it has done nothing wrong, views B's action as a proactive violation of a treaty obligation and retaliates in turn.<sup>1020</sup> The process goes on until cooperation breaks down.<sup>1021</sup> In this context, a legalistic dispute-settlement mechanism will be helpful in managing retaliatory strategies.<sup>1022</sup> Such a mechanism can interpret actions as being in compliance or noncompliance with a particular treaty obligation, and to sanction retaliations in cases of noncompliance.<sup>1023</sup> It can also legitimise the use of retaliatory strategies; otherwise a government using unilateral retaliation would act as both prosecutor and judge simultaneously.<sup>1024</sup> To summarise, a legalistic dispute-settlement system helps prevent the escalation of trade battles.

One might still be left with a question of what makes the international trade regime so nasty compared to its tax equivalent. In other words, while the literature of international political economics widely model trade regimes as a

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<sup>1015</sup> *ibid.*

<sup>1016</sup> *ibid.*

<sup>1017</sup> *ibid.* 109–110.

<sup>1018</sup> *ibid.*

<sup>1019</sup> *ibid.*

<sup>1020</sup> *ibid.*

<sup>1021</sup> *ibid.*

<sup>1022</sup> *ibid.*

<sup>1023</sup> *ibid.*

<sup>1024</sup> *ibid.*

PD game and tax regimes as a BOS game, there has yet to be a general theory that can explain this difference in modelling. According to TCE, asset specificity constitutes the pivotal contractual characteristic, which in turn determines the governance structure of a contract.<sup>1025</sup> The last chapter further established the correlation between high asset specificity in international investment relationships on the one hand, and the BOS nature of the tax regime on the other hand.<sup>1026</sup> It is therefore desirable to examine the dynamics of asset specificity in the trade regime. In this author's view, the degree of asset specificity, particularly the dependence of a state upon foreign traders, is substantially lower in the trade regime than in its tax equivalent. Specifically, a foreign trader merely "preys" on the market of an importing country instead of investing in that country. Accordingly, that importing country has a lower stake in maintaining a long-term relationship with foreign traders.<sup>1027</sup> Note that the distinction between a foreign trader and a domestic enterprise hinges upon the location of the enterprise, rather than the nationality of the individual owners. For trade purposes, any investment located in a country will be regarded by that country as a domestic enterprise, even if the investment is owned by foreigners, as with FDI. Conversely, outbound investments from a country, although owned by its nationals, are deemed as foreign enterprises from that country's viewpoint. For instance, in the current US-China trade conflict, the US president, Mr. Donald Trump, urged that Apple, a company founded and owned by US investors but locating most of its manufacturing function in China, should return its production lines to the US "if it wants to avoid tariffs set to be placed on imports from China".<sup>1028</sup> By the same token, in 1970s, there was a rapid

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<sup>1025</sup> See above, Chapter 2, Section 3.3.1.

<sup>1026</sup> See above, Chapter 3, Sections 3.1.2, 3.1.3.

<sup>1027</sup> William J. Baumol (n 586) 726.

<sup>1028</sup> Colin Drury, 'Trump Tells Apple to Make Products in US If It Does Not Want to Be Hurt by His Tariffs | The Independent'

<<https://www.independent.co.uk/news/world/americas/donald-trump-apple-iphone-mac-us-products-china-warning-tariffs-a8529641.html>> accessed 14 July 2019.

increase of Japanese investors relocating their factories to the US and EU markets as a response to trade barriers the two regions had imposed.<sup>1029</sup> It could be seen that national governments generally prioritise domestically located investments over foreign traders. In this sense, the PD nature of the trade regime and the BOS nature of the tax regime both reflect the dependence of countries on the investments within their territories. Countries use both trade and tax policies to boost their domestic investments. Trade policies are more extroverted, mainly targeting foreign traders, whereas tax policies are introverted, mostly imposed on domestic enterprises. This explains the distinction between the characteristics of the two regimes: one is more aggressive and vulnerable while the other is more stable and benign.

The literature of international political economics tends to connect the PD nature of the trade regime to the factor of domestic political pressure. It is argued that trade protectionism arises out of the fact that national governments often succumb to the lobbying efforts of domestic interest groups, usually import-competing producers.<sup>1030</sup> In this author's view, such domestic political factors can be well contained in the theory of asset specificity. The lobbying power of the import-competing producers reflects the very fact that national governments prioritise domestic investments over foreign traders. It may also be useful to consider the above case of Japanese investors relocating their factories to the US and the EU. The factories' escaping from tariffs cannot be explained by lobbying pressure on the invested countries, as presumably, it is difficult for foreign investors to exercise direct political influence on a host state.

### 3.1.1.2 Relationships governed by international investment laws

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<sup>1029</sup> Fred N Burton and FH Saelens, 'Trade Barriers and Japanese Foreign Direct Investment in the Colour Television Industry' (1987) 8 *Managerial and Decision Economics* 285.

<sup>1030</sup> Green (n 13) 107–108.

On the surface, the tax and the investment regimes are two sides of one coin. As discussed previously, the ongoing nature of international tax relationships results from the very fact that international investments imply a high level of mutual dependency (or asset specificity) between investors and the invested states.<sup>1031</sup> Therefore, under normal circumstances, international investment relationships should also be stable and amicable, at least in general. Nonetheless, international investment law was originated not to address normal circumstances, but primarily as a response to political or social upheavals that may imperil foreign investments.<sup>1032</sup> Such upheavals were typically associated with civil unrest or ideological revolution, or both.<sup>1033</sup> It follows that the mutual dependency between the investors and the host states, particularly the states' dependence on foreign investments within their territories, could be overridden by political volatility or ideological change. Consequently, confiscation of foreign investments or even large-scale nationalisation became a real risk.<sup>1034</sup> Therefore, international investment law, at least in its origin, was focused on the nastiest aspect of international investment relationship. This explains why the title of this section particularly emphasises the “relationships governed by international investment law” instead of generally referring to “international investment relationships”.

In such nasty cases, foreign investors could hardly rely on the goodwill of the relevant states to resolve investment disputes. More often than not, the confrontation between a home state and a host state with respect to an investment dispute ended up with so-called gunboat diplomacy instead of a mutual agreement. For example, in 1833, US military forces were deployed in Buenos Aires to protect US investments during an insurrection in

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<sup>1031</sup> See above, Chapter 3, Section 3.1.

<sup>1032</sup> OT Johnson Jr and J Gimblett, 'From Gunboats to BITs: The Evolution of Modern International Investment Law' in Karl P Sauvant, *Yearbook on International Investment Law and Policy (2010–2011)* (KP Sauvant (red), Oxford 2011) 649–657.

<sup>1033</sup> *ibid* 649–652; Walde and Kolo (n 580) 425–426.

<sup>1034</sup> Walde and Kolo (n 580) 425–426.

Argentina.<sup>1035</sup> In 1838, France landed troops at Vera Cruz, a city in Mexico, to recover the debts owed to its nationals by the Mexican government.<sup>1036</sup> By the turn of the 20th century, joint military interventions by combined Western powers to protect their foreign investments became increasingly common.<sup>1037</sup> On the other hand, international society gradually accepted the idea of employing individual-state arbitration as a more peaceful alternative to the diplomatic or military resolution of investment disputes. Such arbitration is perceived as a means to depoliticise investment conflicts.<sup>1038</sup> For example, owing to the proliferation of investment arbitration in the past few decades, “the foreign ministries of capital-exporting countries very largely have gone out of the claims-settlement business, and the foreign ministries of capital importing countries have turned the claims of foreign investors over to their lawyers”.<sup>1039</sup> In this sense, while an antilegalistic dispute-settlement system suits regimes that feature ongoing contractual relationships between parties, for those regimes that are extremely vulnerable to political vagaries and capriciousness, a legalistic method has the merit of preventing the escalation of political enmity between countries. As discussed above (Section 3.1.1.1), the legalistic method is also helpful in preventing the escalation of trade disputes. Both cases support the proposition that legalistic methods of dispute settlement are more instrumental in regimes that are surrounded by political capriciousness and volatility.

The difference between international tax relationships and the relationships governed by international investment law is reflected in the treatment of tax matters by many investment agreements.<sup>1040</sup> Specifically, while tax matters

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<sup>1035</sup> Johnson Jr and Gimblett (n 1032) 652.

<sup>1036</sup> *ibid.*

<sup>1037</sup> *ibid.*

<sup>1038</sup> William W Park, ‘Private Disputes and the Public Good: Explaining Arbitration Law’ (2004) 20 *Am. U. Int’l L. Rev.* 903, 905.

<sup>1039</sup> Johnson Jr and Gimblett (n 1032) 690.

<sup>1040</sup> Ali Lazem and Ilias Bantekas, ‘The Treatment of Tax as Expropriation in International Investor–State Arbitration’ [2015] *Arbitration International* 1, 8.

are generally excluded from investment agreements, this exception does not apply to expropriation.<sup>1041</sup> Accordingly, a tax dispute is normally subject to an antilegalistic method of dispute resolution, unless it involves confiscation of an investment that risks terminating the ongoing investment relationship. The distinction between expropriatory and non-expropriatory tax measures and their implications are also reflected in the case law of investment arbitration. In *Yukos Universal Ltd (Isle of Man) v Russian Federation (Yukos)*, the dispute appears to be a transfer-pricing issue: the Russian government had undertaken an investigation of Yukos' alleged tax avoidance, and was later challenged by the company's foreign shareholders.<sup>1042</sup> Nonetheless, the real issue between the investors and the state does not concern the proper calculation of Yukos' profits that should accrue to Russia. Rather, it was about the arbitrary and harsh manner in which the Russian Government carried out its tax-auditing measures.<sup>1043</sup> The Tribunal holds that "the primary objective of the Russian Federation was not to collect taxes but rather to *bankrupt Yukos and appropriate its valuable assets*".<sup>1044</sup> Otherwise, "Yukos, its officers and employees, and its properties and facilities, would not have been treated, and mistreated, as in fact they were".<sup>1045</sup> The tribunal upheld the claimants' position. In contrast, the tribunal in *EnCana Corp v Republic of Ecuador (EnCana)* dismissed the investor's claim.<sup>1046</sup> The case arose out of an Ecuadorian reform to its tax regime.<sup>1047</sup> Prior to the reform, foreign oil companies operating in Ecuador, including the claimant, were entitled to

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<sup>1041</sup> For example, see 2012 US Model Bilateral Investment Treaty, Art. 21(2) ("Article 6 [Expropriation] shall apply to all taxation measures"), available at <http://investmentpolicyhub.unctad.org/IIA/CountryIris/223> [Accessed 3 September 2018]; see also Chaisse (n 1006) 162; Lazem and Bantekas (n 1040) 9.

<sup>1042</sup> *Yukos Universal Ltd (Isle of Man) v Russian Federation* [2014] PCA, AA227 (Final Award) 34 (para.109); see also Chaisse (n 1006) 189–194.

<sup>1043</sup> *Yukos, PCA, AA 227 (2014)* (n 1042) 497-498 (paras 1579-1585); see also Chaisse (n 1006) 189–194.

<sup>1044</sup> *Yukos, PCA, AA 227 (2014)* (n 1042) 487 (para. 1579).

<sup>1045</sup> *ibid*; see also Chaisse (n 1006) 193.

<sup>1046</sup> *EnCana Corp v Republic of Ecuador* [2006] LCIA UN3481 (Final Award) 49-56 (paras 171-199); see also Devashish Krishan, 'Introductory Note to Encana Corporation V Republic of Ecuador' (2006) 45 International Legal Materials 895.

<sup>1047</sup> Krishan (n 1046) 895.

refunds for VAT paid on inputs, like other exporting companies in the country.<sup>1048</sup> The reform denied those foreign oil companies such refunding rights.<sup>1049</sup> The claimant alleged that the reform amounted to an expropriation.<sup>1050</sup> Yet the court held that although taxation often leads to the loss of profit or other income, only those tax measures that are “extraordinary, punitive in amount or arbitrary in their incidence” could be considered as expropriation.<sup>1051</sup> The change in the Ecuadorian VAT laws was not expropriatory because it had not “brought the companies to a standstill”, and the claimant subsidiaries “were nonetheless able to *continue to function* profitably and to engage in the normal range of activities”.<sup>1052</sup> It could be seen that investment arbitrators are confident in claiming jurisdictions over tax-related cases only where ongoing relationships between the parties have been fundamentally disrupted by a state’s action. This is in line with the proposition made previously: litigation is far more likely to occur when there is no ongoing relationship between the parties or where such a relationship has definitively terminated.<sup>1053</sup>

A potential challenge to the above reasoning is related to a recent development in the investment regime: modern international investment agreements not only concern expropriation, but also impose upon host states a higher level of obligations such as fair and equitable treatment of investors. Many investment agreements also contain a so-called “umbrella clause”, whereby contractual obligations agreed in investment contracts between host states and foreign investors can be elevated into treaty obligations.<sup>1054</sup> Essentially, these new developments extend the scope of investment

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<sup>1048</sup> *EnCana, LCIA, UN3481 (2006)* (n 1046) 14-25 (paras 58-94); see also Krishan (n 1046) 895.

<sup>1049</sup> *EnCana, LCIA, UN3481 (2006)* (n 1046) 14-25 (paras 58-94); Krishan (n 1046) 895.

<sup>1050</sup> Krishan (n 1046) 48-56 (paras 169-200).

<sup>1051</sup> *EnCana, LCIA, UN3481 (2006)* (n 1046) 51 (para. 177); see also Lazem and Bantekas (n 1040) 26.

<sup>1052</sup> *EnCana, LCIA, UN3481 (2006)* (n 1046) 50 (para. 174); see also Lazem and Bantekas (n 1040) 26.

<sup>1053</sup> See above, Chapter 3, Section 3.4.1.

<sup>1054</sup> Van Aaken (n 307) 512–513.

protection and the attendant investment arbitration to those disputes that are relatively less fatal to investor-state relationships. In this sense, it seems that a legalistic method of dispute settlement also applies to cases where an ongoing relationship still survives. The response to this challenge is twofold. First, the investment dispute-settlement system embraced an arbitration mechanism at its early phase of development, when confiscation of foreign investments was a major concern for the then circle of international investment law. Once a particular institutional arrangement has been established, its evolution may be subject to path dependence. Second, the past few years do have witnessed a significant backlash against investment arbitration as well as investment law for their rigidity and harshness. Several members of the ICSID such as Argentina, Bolivia, Ecuador, etc. even withdrew or threatened to withdraw from the regime, manifesting how legalistic methods of dispute settlement may frustrate investment relationships.<sup>1055</sup> Among those criticisms of investment arbitration, a major complaint is that the mechanism unduly restricts the freedom of states to promote and implement investment policies that are *bona fide* and less destructive.<sup>1056</sup> Meanwhile, calls are increasingly being made for the use of more flexible and collaborative methods in resolving investment disputes. As one commentator writes, now is the right time to explore some low-cost, informal, expeditious, party-friendly, private, and non-disruptive ways, in which “foreign investors and ‘host’ states can resolve differences while *continuing their relationships with minimal disruption*”.<sup>1057</sup>

### 3.1.2 Treaty application

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<sup>1055</sup> Nicolas Boeglin, ‘ICSID and Latin America Criticism, Withdrawal and the Search for Alternatives « Network for Justice in Global Investment’ <<http://justinvestment.org/2013/12/icsid-and-latin-america-criticism-withdrawal-and-the-search-for-alternatives/>> accessed 27 June 2018.

<sup>1056</sup> Dolzer and Schreuer (n 594) 11.

<sup>1057</sup> Leon E Trakman, ‘The ICSID under Siege’ (2013) 45 Cornell Int’l LJ 603, 657.

As discussed previously, a particular issue of legalistic dispute settlement in the ITDR context is the difficulty of treaty application.<sup>1058</sup> To recapitulate, most tax treaties are bilateral; they overlay on domestic tax laws, functioning as a law of limitation. This bilateral and non-substantive nature of tax treaties causes considerable difficulties in treaty interpretation, and thereby limits the prospect of developing a coherent body of jurisprudence on international tax law through legalistic adjudication.<sup>1059</sup> In contrast, both trade and investment regimes have respectively developed substantive international rules that are largely independent from, and mostly superior to, national laws.

Under the trade regime, the most overarching institutional arrangement is the WTO law, principally the WTO Agreement.<sup>1060</sup> It consists of a short basic agreement and numerous other agreements included in the annexes to the basic agreement.<sup>1061</sup> Most substantive WTO laws can be found in the agreements contained in Annex 1.<sup>1062</sup> In short, four basic groups of substantive rules can be distinguished: (a) rules of non-discrimination; (b) rules on market access; (c) rules on unfair trade; and (d) rules on the balance between trade liberalisation and public interests.<sup>1063</sup> With regard to the relationship between national law and WTO law, Article XVI of the WTO agreement states: “Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements.”<sup>1064</sup>

Similar to the trade regime, international investment law has also evolved a common set of substantive rules on the treatment of foreign investments. Such rules can be traced back to state practice in the late 18th and 19th

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<sup>1058</sup> See above, Chapter 3, Section 3.4.2.

<sup>1059</sup> *ibid.*

<sup>1060</sup> Peter van den Bossche, *The Law and Policy of the World Trade Organization: Text, Cases and Materials* (Third edition., University Press 2013) 35, 40.

<sup>1061</sup> *ibid* 40–41.

<sup>1062</sup> *ibid* 41.

<sup>1063</sup> *ibid* 35.

<sup>1064</sup> Article XVI:4 WTO Agreement; see also *ibid* 63.

centuries, when major Western powers held the position that their nationals should not be subjected to a standard of treatment in a host state that fell below a certain international minimum, even if that minimum standard is preferable to the treatment accorded by the host states to their own nationals.<sup>1065</sup> This idea of a minimum standard was later developed into customary international law, and more recently embodied in the network of investment treaties.<sup>1066</sup> To be sure, the interplay between the relevant domestic rules of a host state and the applicable rules of international investment law is more complicated than the case of trade-dispute resolution. Specifically, whereas it is generally safe for WTO panels to place their legal analysis solely on the international plane, tribunals of investment arbitration must always be aware of the relevance of municipal law to the case at hand.<sup>1067</sup> In most cases the applicable substantive law in investment arbitration combines international law and the law of the host state.<sup>1068</sup> Nonetheless, in the event of any conflict between domestic law and international investment law, the latter prevails.<sup>1069</sup>

### **3.1.3 Power structure between disputing parties**

As discussed previously, another hurdle to the implementation of a legalistic method of ITDR is the concern about double non-taxation.<sup>1070</sup> Specifically, while the contractual incompleteness of the international tax regime may be exploited by both taxpayers and tax authorities, the taxpayers typically gain an advantage in the base appropriation as they know their own tax arrangements and business details better than tax administrations.<sup>1071</sup>

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<sup>1065</sup> Johnson Jr and Gimblett (n 1032) 650–651.

<sup>1066</sup> *ibid*; Dolzer and Schreuer (n 594) 3–8.

<sup>1067</sup> Dolzer and Schreuer (n 594) 288–293; Jan Asmus Bischoff, ‘Conflict of Laws and International Investment Arbitration’ 7 *European International Arbitration Review* 143.

<sup>1068</sup> Dolzer and Schreuer (n 594) 293.

<sup>1069</sup> J Christopher Thomas and Harpreet Kaur Dhillon, ‘Applicable Law under International Investment Treaties’ (2014) 26 *SAC LJ* 975, 985–986; Dolzer and Schreuer (n 594) 293.

<sup>1070</sup> See above, Chapter 3, Section 3.4.2.3.

<sup>1071</sup> See above, Chapter 3, Section 3.4.2.3.

Consequently, states may fear that a legalistic method of ITDR may become a sword, rather than a mere shield, for the taxpayers: they may take advantage of the wording of tax treaties and “poach” the fiscal base of the states.

In contrast, individuals are somewhat more “innocent” and vulnerable in trade and investment regimes, where the first move of contractual appropriation usually lies with the states. As discussed above, trade barriers are more often launched by countries to favour their domestic enterprises, particularly import-competing producers, rather than as a countermeasure against misconduct of foreign traders. It is true that trade barriers are frequently imposed in the name of important societal interests such as environmental protection or public security. Nevertheless, it is not unusual for countries to use such public interests merely as a shelter to hide their arbitrary or discriminatory trade restrictions.<sup>1072</sup>

Turning to investment regimes, the “first move” privilege in base appropriation lies even more clearly with the state. Dolzer and Schreuer discuss the risk allocation between investors and states as follows:

*Once these negotiations are concluded and the investor’s resources are sunk into the project, the dynamics of influence and power tend to shift in favour of the host state. The central political risk which henceforth arises for the foreign investor lies in a change of position of the host government that would alter the balance of burdens, risks, and benefits.*<sup>1073</sup>

Therefore, legalistic methods of dispute settlement in trade and investment regimes provide business communities a shield against political capriciousness.

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<sup>1072</sup> Appellate Body Report, US—shrimp, WT/DS58/AB/R (12 October 1998), para. 186; Appellate Body Report, US—Gasoline, WT/DS2/AB/R (29 April 1996), p.28-30; see also Bossche (n 1060) 580–582.

<sup>1073</sup> Dolzer and Schreuer (n 594) 22.

## 3.2 Cost aspects

### 3.2.1 Strategic actions and bargaining impasses

As demonstrated previously, the key characteristics of a certain regime not only determine the choice of dispute-settlement mode for the regime in general sense, but also affect the specific cost dynamics of a chosen mode.<sup>1074</sup> Specifically, the BOS nature of the tax regime indicates that the ITDR process is relatively less vulnerable to the agency problem, which usually takes the form of procedural abuse or other opportunistic actions by competent authorities.<sup>1075</sup> It is true that *bona fide* disagreements on a case may still cause a bargaining problem between the parties. Nevertheless, a flexible and problem-solving attitude from the parties will be of substantial help in overcoming bargaining impasses.

In contrast, given the nature of trade and investment regimes, as discussed above, processes of trade/investment dispute settlement are more vulnerable to strategic considerations and bargaining impasses. The creation of investment arbitration stemmed from the very fact that the use of diplomatic channels in resolving investment disputes in early times usually culminated in hostile confrontation or even gunboat diplomacy. Under modern investment regimes, while the ICSID convention and a few BITs provide consultation and conciliation as alternative paths to investment arbitration in dispute resolution, these antilegalistic mechanisms are rarely used. Considering that antilegalistic methods are less expensive – in terms of administrative costs – than legalistic methods, the underuse of consultation and conciliation presumably reflects users' concerns about the risk of procedural abuse and bargaining impasses in the process.

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<sup>1074</sup> See above, Chapter 3, Section 6.

<sup>1075</sup> See above, Chapter 3, Section 4.5.

In the WTO context, while consultation is a compulsory requirement for all WTO cases, around 60% of the disputes were ultimately channelled through the panel procedure.<sup>1076</sup> An experienced practitioner in WTO law observes that the consultation process is subject to strategic actions.<sup>1077</sup> Members in consultations usually do not admit error or guilt, and they often withhold some key information during the negotiation until the panel procedure begins.<sup>1078</sup> Other writers have researched the bargaining problems in the WTO consultation process.<sup>1079</sup>

Given the political volatility surrounding the trade/investment dispute settlement systems, a legalistic method is more desirable in breaking procedural impasses and enhancing the robustness of the system.

### **3.2.2 Technicality of issue areas and human-asset specificity**

Compared with the consultation process in trade/investment dispute settlement, the MAP implies not only fewer risks of strategic sabotage and bargaining impasses, but also lower administrative costs. As covered previously, tax administrations and the competent authorities thereunder have gained specialised knowledge and experience on ITDR matters, which are highly technical and complicated. Consequently, there is a quasi-rent to have competent authorities resolving tax disputes initially instead of having a third party involved from the outset.<sup>1080</sup>

By contrast, both the technicality and complexity of disputed issues and the specialised human assets of the competent authorities are far less prominent

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<sup>1076</sup> 'WTO | Dispute Settlement - Understanding WTO Dispute Settlement Statistics'

<[https://www.wto.org/english/tratop\\_e/dispu\\_e/dispustats\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/dispustats_e.htm)> accessed 29 January 2019.

<sup>1077</sup> Gary N Horlick, 'The Consultation Phase of WTO Dispute Resolution: A Private Practitioner's View', *Int'l L.* (HeinOnline 1998) 690.

<sup>1078</sup> *ibid.*

<sup>1079</sup> Guzman and Simmons (n 307); Dukgeun Ahn, Jihong Lee and Jee-Hyeong Park, 'Understanding Non-Litigated Disputes in the WTO Dispute Settlement System' (2013) 47 *Journal of World Trade* 985; Marc L Busch and Eric Reinhardt, 'Bargaining in the Shadow of the Law: Early Settlement in GATT/WTO Disputes' (2000) 24 *Fordham Int'l LJ* 158.

<sup>1080</sup> See above, Chapter 3, Section 4.4.2.

in the context of trade/investment dispute settlement. In terms of technicality and complexity, tax disputes are “one of the most specialized and technically demanding fields in American jurisprudence”.<sup>1081</sup> One commentator further notes that “the financial and economic matters that dominate the Internal Revenue Code are as incomprehensible as the scientific aspects inherent in many environmental, food and drug, or energy law issues.”<sup>1082</sup> With respect to the element of specialised human assets, the role of tax administrations in base allocation at the micro level can hardly find a counterpart in trade and investment regimes. In particular, regulations of international investments is ordinarily in the hands of the host states, and the home states’ involvement in such regulation is quite limited. It follows that the specialised language that develops between competent authorities in tax regimes does not exist between authorities in investment or trade regimes. It is true that states frequently hide their investment/trade restrictive measures under the veneer of taxation, environmental protection, or other technical issues.<sup>1083</sup> Nevertheless, investment/trade authorities do not necessarily possess the expertise in such technical issues, since they do not routinely handle regulations concerning environment, taxation, food, health, etc. Therefore, the economic value of having those authorities to handle trade/investment disputes in the first place is discounted as opposed to the case of ITDR.

### **3.2.3 Frequency of disputes**

The frequency of disputes has two major implications. First, a high frequency of disputes leads to heavy caseloads, which, in turn, spurs the need for more expeditious and cost-efficient methods of dispute resolution. For example, one of the major driving forces of the ADR movement in the US was the

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<sup>1081</sup> ‘Report of the Federal Courts Study Committee’ (1990) 70  
<<https://www.fjc.gov/content/report-federal-courts-study-committee-0>>.

<sup>1082</sup> Kristin E Hickman, ‘The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference’ (2005) 90 *Minn. L. Rev.* 1537, 1599.

<sup>1083</sup> Walde and Kolo (n 580) 424–425; Bossche (n 1060) 850–851.

heavy caseloads jamming the court system.<sup>1084</sup> Second, recurrent experience of dispute settlement by competent authorities generates specialised human assets, which is an important procedural capital for dispute resolution.

The frequency of tax disputes is strikingly higher than that for trade and investment. For illustration, since 1995, around 570 disputes have been brought to the WTO.<sup>1085</sup> From 1972 to 2018, around 700 cases were registered under the ICSID.<sup>1086</sup> By contrast, in 2015 alone, the OECD members reported 2,509 new MAP cases.<sup>1087</sup> In that year, the WTO registered 13 new cases<sup>1088</sup> and ICSID 52<sup>1089</sup>. Note that the WTO consists of 164 members (as of 29 July 2016),<sup>1090</sup> and the ICSID 154 members,<sup>1091</sup> whereas the OECD MAP statistics only cover 35 jurisdictions. The case inventory of OECD countries is even more striking, standing at 6,176.<sup>1092</sup> Among those countries, Switzerland reported an inventory of 328 MAP cases at the end of 2015; Italy reported 319; France, 566; Belgium, 632; the US, 998; and Germany, 1,147.<sup>1093</sup> It is difficult to imagine how such a caseload can be handled were every tax dispute resolved in a formalised, case-by-case manner as with arbitration.

#### 4. Conclusion of the chapter

This chapter compared ITDR with trade/investment dispute settlement, not

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<sup>1084</sup> Jethro K Lieberman and James F Henry, 'Lessons from the Alternative Dispute Resolution Movement' (1986) 53 *The University of Chicago Law Review* 424, 432.

<sup>1085</sup> 'WTO | Dispute Settlement - Dispute Settlement Activity — Some Figures' <[https://www.wto.org/english/tratop\\_e/dispu\\_e/dispustats\\_e.htm](https://www.wto.org/english/tratop_e/dispu_e/dispustats_e.htm)> accessed 3 October 2019.

<sup>1086</sup> ICSID (n 991) 7.

<sup>1087</sup> 'Mutual Agreement Procedure Statistics (2006-2015)' (n 3).

<sup>1088</sup> 'WTO | Dispute Settlement - Dispute Settlement Activity — Some Figures' (n 1085).

<sup>1089</sup> ICSID (n 991) 7.

<sup>1090</sup> 'WTO | About the Organization' (n 936).

<sup>1091</sup> 'Database of ICSID Member States'

<<https://icsid.worldbank.org/en/Pages/about/Database-of-Member-States.aspx>> accessed 3 October 2019.

<sup>1092</sup> 'Mutual Agreement Procedure Statistics (2006-2015)' (n 3).

<sup>1093</sup> *ibid.*

based on pure legal terms as is the case in the orthodox literature, but on the institutional characteristics of the regimes and the disputes that are compared. The comparison proceeded along the line of the benefit-cost framework developed in the preceding chapter. From the benefit perspective, the chapter demonstrated that in trade and investment regimes, both the ongoing character of investor (trader)-state relationships and the incompleteness of the regimes are less prominent. It follows that a flexible and collaborative dispute-settlement system becomes less instrumental to such regimes. On the contrary, the Hobbesian nature of trade/investment regimes warrants a legalistic method of dispute settlement so as to depoliticise the disputes arising from those regimes. Moreover, given the substantive nature of trade and investment law, the two regimes particularly lend themselves to the legalistic method.

From the cost perspective, the chapter demonstrated that negotiation yields the greatest cost-efficiency in tax regimes, in contrast to the trade/investment regimes. The preceding chapter attributed the cost-efficiency of the MAP mechanism to several factors, including the political stability of the tax regime, the procedural flexibility, and the high level of human-asset specificity in ITDR processes.<sup>1094</sup> This chapter demonstrated that trade/investment regimes are less stable than the tax regime, and that trade/investment dispute-settlement processes imply a lower level of human-asset specificity than does the ITDR process. The chapter found no significant difference in procedural flexibility between the MAP on the one hand and the consultation procedure under trade/investment dispute settlement on the other hand. Nevertheless, the high frequency of tax disputes indicates that the benefit of procedural flexibility is more valuable for the tax regime than for the trade/investment regimes.

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<sup>1094</sup> See above, Chapter 3, Section 4.

Therefore, the comparative study in this chapter strengthens the benefit-cost analysis in the last chapter. Specifically, while the preceding chapter derived the MAP-based dispute-settlement system as the optimal governance structure in light of the key characteristics of the tax regime and tax disputes, this chapter further demonstrates the pertinence of those key characteristics in determining the choice of dispute-settlement mode not only for the tax regime, but also for the trade/investment regimes.

## **Chapter 5. Economising the MAP Process**

### **1. Overview**

This chapter seeks to explore measures to economise the MAP process based on the theoretical framework developed in the preceding chapters. While the orthodox literature has left an impression that deficiencies of the MAP can only be cured by the adoption of an arbitration mechanism, this chapter will demonstrate that the MAP can also be strengthened from within. Section 2 explores possible ways to economise the agency costs, bargaining costs, and administrative costs of the MAP process, respectively. Section 3 focuses on two holistic issues about the MAP that encompass more than one type of transaction costs. Section 4 contains an assessment of BEPS Action 14, which primarily concerns the strengthening of the MAP mechanism. Several of the proposed measures have already been raised in the MEMAP and were recently confirmed in Action 14. Nevertheless, this chapter provides a theoretical underpinning for those proposals.

### **2. Measures of economising the transaction costs of the MAP process**

#### **2.1 Economising agency costs**

##### **2.1.1 Mitigating interest divergence**

The agency problem in the MAP process mainly results from the fact that the departmental interests of tax administrations, to which the competent authority function is customarily affiliated, are unaligned with taxpayers' interests in preventing double taxation. Altman recommends substituting the

department of justice for the tax department in performing the competent-authority function.<sup>1095</sup> The argument is that the department of justice is not in charge of revenue collection, thus is more impartial than tax administrations in handling tax disputes.<sup>1096</sup> In the US, Department of Justice does occasionally represent the government in some domestic tax-litigation procedures.<sup>1097</sup> Nonetheless, in this author's opinion, Altman's recommendation has three substantial drawbacks. First, the proposed institutional change would be too drastic to solicit any political consensus in the foreseeable future. In particular, tax administrations that are currently in charge of MAP affairs would have a vested interest in perpetuating the status quo. Second, as discussed previously, there are efficiency advantages for tax administrations to handle tax disputes in the first place.<sup>1098</sup> Third, tax administrations also play an important role in enacting tax policies and negotiating tax treaties.<sup>1099</sup> Their experience in handling tax disputes would be of great value in performing the policy-making duties.

Therefore, a limited independence of the competent authority is recommended. Specifically, while the competent-authority function may still be delegated to tax administrations, the specific department undertaking such function should be independent from the audit function of the tax administrations.<sup>1100</sup> A related issue is the performance assessment of a competent authority and its staff members.<sup>1101</sup> To ensure competent authorities' autonomy, their performance in relation to MAP programs should not be measured by the amount of sustained audit adjustment or tax revenue, but by the extent to which the treaty goal of eliminating double taxation is

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<sup>1095</sup> Altman (n 29) 210.

<sup>1096</sup> *ibid.*

<sup>1097</sup> *ibid.*

<sup>1098</sup> See above, Chapter 3, Section 4.4.2.

<sup>1099</sup> 'Update of the Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries' (UN 2018) 3

<<https://www.un.org/esa/ffd/publications/manual-bilateral-tax-treaties-update-2019.html>>.

<sup>1100</sup> OECD, 'MEMAP' (n 1) 41 (Section 5.2).

<sup>1101</sup> *ibid* 41-42 (Section 5.3).

achieved.<sup>1102</sup> In this regard, proper performance indicators may include the time taken to resolve a case, case outcomes, the peers and taxpayers' feedback, etc.<sup>1103</sup>

### **2.1.2 Monitoring the MAP process**

To constrain the risk of opportunism in an agency relationship, it is usually in the principal's interest to monitor the agent's conduct. Several ways of monitoring the MAP process can be envisaged.

(1) Scrutiny by taxpayers. The most straightforward way of monitoring a MAP process is to increase the involvement of the taxpayer concerned in the process. The issue of taxpayer participation will be analysed separately below (Section 3.1), as it affects not only agency costs, but also bargaining and administrative costs of the MAP process.

(2) Scrutiny by states. Given the BOS nature of the international tax regime, states also have an interest in monitoring their competent authorities in relation to the MAP process. In particular, domestic courts can play an important role in monitoring the process. Currently, the issue of judicial review of the MAP by domestic courts is mainly associated with the accessibility of the procedure. If a competent authority denies a taxpayer's request for MAP assistance, is the taxpayer entitled to judicial remedy? While the question involves the legal status of tax treaties in domestic law, a question beyond the scope of this thesis,<sup>1104</sup> suffice it to point out that national states increasingly accept the idea of bringing the issue of MAP access under judicial scrutiny.<sup>1105</sup> As mentioned previously, the Danish Western High Court once overruled the Danish

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<sup>1102</sup> *ibid.*

<sup>1103</sup> *ibid.*

<sup>1104</sup> See Farah (n 174) 12–23; Carlos Manuel Vazquez, 'Treaty-Based Rights and Remedies of Individuals' (1992) 92 Colum. L. Rev. 1082; cited by Paul C Rooney and Nelson Suit, 'Competent Authority' (1996) 49 *The Tax Lawyer* 675, 690.

<sup>1105</sup> Carolis (n 9) 395.

competent-authority's denial of access to the MAP in three cases.<sup>1106</sup> In 2015, the Italian Court of Cassation decided in two related cases that it has jurisdiction over disputes on MAP access.<sup>1107</sup> These two cases will be elaborated further subsequently (Section 2.1.4).

That the judicial review of the MAP is mostly related to the access stage of the procedure raises a further question of whether such judicial scrutiny can be extended to cover the entire MAP process. This involves the structuring of the MAP, which will be analysed subsequently (Section 2.1.4).

(3) Scrutiny by international organisations. A fundamental deficiency of states' scrutiny of the MAP process is that each state can only monitor its own competent authority, while the MAP process is by nature a joint endeavour between the competent authorities of treaty partners. Therefore, it becomes desirable for states to delegate part of their monitoring authorities to an international organisation. The role of international institutions in ITDR will be discussed in conjunction with the evaluation of BEPS Action 14 (Section 4).

(4) Checks and balances between competent authorities. As discussed previously, both competent authorities in a MAP process may engage in opportunistic actions. However, it is not necessarily the case that they shirk simultaneously and symmetrically. More often than not, the defending competent authority has a greater incentive to block an ITDR process. In this situation, the party with good faith may exert some monitoring pressure upon the other side. This mechanism of checks and

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<sup>1106</sup> See above, Chapter 3, Section 5.3.2.

<sup>1107</sup> Cassazione Civile, SS.UU, ordinanze 19/06/2015 n. 12759 and 12760; see also Daniele de Carolis, 'Jurisdiction of the Italian Tax Judge on Administrative Acts Denying Access to the Arbitration Convention on Transfer Pricing: Towards a Dispute Resolution Procedure Ever More Independent of State Control' (2016) 44 *Intertax* 180, 180. However, the Peer Review Report on Italy does not mention this case.

balances is particularly useful regarding the accessibility of the MAP. If the first competent authority denies access, a mechanism is needed whereby the taxpayer concerned can rely on the second competent authority to consult the first on the veto, or the taxpayer can directly resubmit the MAP request to that second competent authority.

### **2.1.3 Mitigating information asymmetry**

Another major contributor to the agency problem is information asymmetry,<sup>1108</sup> of which there are two types. The first is related to the information about the task assigned to the agent. If the agent is the only party who knows the requirements of the task, they would possess too much freedom to decide how the task should be performed, and are thus more likely to perpetrate opportunistic behaviours. As discussed previously, while it is legitimate to accord competent authorities with some discretion in deciding the admissibility of MAP requests, too much leeway in this regard may lead to arbitrary limitation of access to the MAP.<sup>1109</sup> One way to mitigate this asymmetry of task information is for national governments to publish specified MAP guidelines, including detailed criteria for the admissibility of MAP requests, on public platforms. The second type of information asymmetry is related to the information on the agent's performance. Individual taxpayers may have difficulty measuring competent authorities' performance on MAP processes. To address this issue, some reporting and data-collecting mechanisms are needed to verify competent authorities' performance.

### **2.1.4 Structuring the MAP process**

As discussed previously, a particular difficulty of measuring and monitoring competent authorities' MAP performance is related to the joint nature of a

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<sup>1108</sup> See above, Chapter 2, Section 2.2.2.

<sup>1109</sup> See above, Chapter 3, Section 4.2.1.

typical MAP process.<sup>1110</sup> The peer-review reports also reveal that significant delays mostly occur during the intermediate stages of the MAP process.<sup>1111</sup> Therefore, it is desirable to have a structured MAP, so that not only the entire MAP process, but also its key intermediate stages, will be regulated by a predetermined timetable. While the notion of a structured MAP has received very scant attention from academics,<sup>1112</sup> its value has already been recognised in the policy circle. For instance, the MEMAP recommends an ideal timeline for a typical MAP process.<sup>1113</sup> A more concise and clarified timetable can be seen in Canada’s MAP Program Report published by the Canadian Revenue Agency (CRA, the Canadian competent authority).

**Table 7: Structured timeframe for a MAP**

Stage	Action	Target Time Frame
Initiation of MAP request by taxpayer	Acknowledgement to taxpayer and request for additional information if submission is incomplete	Within 30 days after receipt of a complete MAP request from taxpayer
and preparation of position paper for foreign tax administration	Letter to foreign tax administration advising of the request and that CRA will send details of its position once the adjustments have been reviewed	Within 30 days after receipt of a complete MAP request from taxpayer

<sup>1110</sup> *ibid.*  
<sup>1111</sup> See above, Chapter 3, Section 5.3.5.1.  
<sup>1112</sup> Cai and Zhang (n 12).  
<sup>1113</sup> OECD, ‘MEMAP’ (n 1) Annex 1, 45.

	Review of information received from field, and preparation and submission of position paper to other competent authority	Within 6 months after receipt of a complete MAP request from taxpayer
Evaluation by other competent authority	Other competent authority's response to CRA position paper	Within 6 months from submission of a position paper
Negotiations with other competent authority and conclusion of a mutual agreement	Face-to-face meeting and/or exchange of correspondence or phone conversations, as required , to reach a mutual agreement	Within 24 months after receipt of a complete MAP request from taxpayer

CRA, *MAP Program Report 2012-2013*,

[https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/tx/nnrstdnts/cmp/mp\\_rprt\\_2012-2013-eng.pdf](https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/tx/nnrstdnts/cmp/mp_rprt_2012-2013-eng.pdf) (accessed 1 February 2018)

As Table 7 shows, the CRA timeframe identifies three intermediate milestones between the starting and ending dates of a typical MAP process: the date of deciding the admissibility of a MAP request, the date of presenting a position paper, and the date of presenting a responding paper by the other competent authority. In this way, the MAP process is divided into four stages: initiation of a MAP, preparation of a position paper, evaluation of the position (by the other competent authority), and negotiation. The target timeframes for the stages are one month, five months, six months, and 12 months, respectively.

Table 8 records the actual time spent on average on each of the above stages in comparison with the target timeline. Of the four stages, while the

negotiation stage still remains a joint endeavour, the other three are solely conducted by one of the competent authorities. It follows that any undue delay occurred in these three stages can easily be traced to an individual competent authority. Accordingly, a structured MAP process enhances the measurability of the process.

**Table 8: Average time (month) to complete various stages of MAPs in Canada**

	Initiation/ Acceptance	Preparing a position	Evaluating the position	Negotiation
Canadian- initiated	3.47	4.27	6.32	8.58
Foreign- initiated	3.59	8.30	2.20	16.81
Target	1.00	5.00	6.00	12.00

CRA, *MAP Program Report 2012-2013*,  
[https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/tx/nnrstdnts/cmp/mp\\_rprt\\_2012-2013-eng.pdf](https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/tx/nnrstdnts/cmp/mp_rprt_2012-2013-eng.pdf) (accessed 1 February 2018)

The idea of structuring the MAP process provides some economic insights to the judicial review of the procedure. This can be illustrated using the two Italian cases mentioned above.<sup>1114</sup> The cases were brought by two Italian companies, both of which belonged to the same international group. The Italian tax administration made a transfer-pricing adjustment against the

<sup>1114</sup> Cassazione Civile, SS.UU, ordinanze 19/06/2015 n. 12759 and 12760; see also Carolis (n 1107) 180.

group. In relation to the adjustment, the two companies submitted two requests to the Ministry of Finance (the competent authority in Italy) for MAP assistance under the EU Arbitration Convention. These requests were denied by the Ministry, and the two companies challenged the Ministry's decision through separate proceedings before the Tax Commission (the court of first instance for tax matters). Appearing before the court in both proceedings, the Ministry objected to the court's jurisdiction on the grounds that its decision on the admissibility of a MAP request was considered a phase of a MAP under the EU Arbitration Convention, and therefore was an international process subject to the rules of international treaties. The Ministry further contended that domestic jurisdiction over the MAP could amount to an undue interference with state sovereignty and an infringement of the principle of state immunity. The Court rejected the Ministry's argument by making a distinction between, on the one hand, the assessment of the admissibility of a MAP request by the Italian competent authority and, on the other hand, the subsequent mutual-agreement procedure. The Court reasoned that while the phase of mutual negotiation under the MAP involved a confrontation between competent authorities, involving the state's prominent interests and therefore subject to international law, the assessment of the admissibility of a MAP request was merely a preliminary phase of the MAP that fell completely within national law.<sup>1115</sup>

While the Court took a brave step to assert jurisdiction over disputes on the accessibility of the MAP, there is still substantial room for the Court to improve its reasoning.<sup>1116</sup> First, while the Court based its decision on the distinction between an international procedure and the preliminary stage of the procedure, it did not spell out the grounds or the criteria for such

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<sup>1115</sup> *Ibid.*

<sup>1116</sup> Cai and Zhang (n 12) 881–882.

distinction.<sup>1117</sup> As an illustration, one way for an obstinate competent authority to circumvent the court's ruling is to first admit a MAP request but then refuse to take any further action. Should this "post-admission inaction" be identified as having entered the international arena, or is it still within "the preliminary phase" of an international procedure?<sup>1118</sup> Second, the court didn't convincingly explain why an international procedure can preclude domestic review. The Court referred to the concept of state interest, reasoning that the confrontation between competent authorities may involve states' prominent interests and thereby preclude domestic judicial intervention. However, disputes with international implications have been routinely decided by domestic courts, although they may by all means involve vital national interests.<sup>1119</sup> Furthermore, if the court is right in asserting that states' prominent interests are at stake in the confrontation between competent authorities, they should also be at stake during the entire MAP process, including the so-called preliminary phase of the MAP.<sup>1120</sup>

In this author's view, a practical reason for many domestic courts to refrain from intervening in MAP cases is because of the joint character of MAP negotiations. It is difficult, if not impossible, for a domestic court to measure the performance of its fellow competent authority in a MAP.<sup>1121</sup> However, the idea of structuring the MAP makes it clear that at least the stage of initiating a MAP is solely the responsibility of the first competent authority, and is thus measurable from the standpoint of the fellow court of that authority.<sup>1122</sup>

Going further, not just the denial of MAP access, but also the inaction or undue delay during the presentation of a position (or responding) paper can

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<sup>1117</sup> *ibid.*

<sup>1118</sup> *ibid.*

<sup>1119</sup> *ibid.*

<sup>1120</sup> *ibid.*

<sup>1121</sup> *ibid* 882–883.

<sup>1122</sup> *ibid.*

also be assessed by respective domestic courts.<sup>1123</sup> Therefore, the above-mentioned tactic of “admitting (a MAP request) without proceeding” by the first competent authority can become a cause of action for the taxpayer concerned. By the same token, the implementation of MAP agreements is also amenable to judicial review, as the obligations of each competent authority regarding the elimination of double taxation has been delineated in the agreement. Article 25 (2) of the OECD Model also confirms that MAP agreements should be implemented notwithstanding any time limits in the domestic law of the Contracting States. The OECD Sample Procedure further notes that failure by tax authorities to implement MAP agreements constitutes a ground for the taxpayers concerned to seek relief through domestic legal remedies.<sup>1124</sup> It should be noted that the judicial remedy regarding the implementation of a MAP agreement may involve judicial scrutiny of the agreement itself, particularly when an agreement incorporates a decision of tax arbitration. This issue will be discussed in the next chapter.<sup>1125</sup>

## **2.2 Economising bargaining costs**

### **2.2.1 Side payments and issue linkage**

As explained previously, the bargaining problem mainly stems from distributive conflict between the parties.<sup>1126</sup> In particular, resolution of a single MAP case usually assumes an “all-or-nothing” character. One way of mitigating this distributive conflict is to use the method of issue linkage, whereby the parties engage in simultaneous discussion of two or more issues for joint settlement.<sup>1127</sup> At the policy level, the Uruguay Round of GATT negotiation is a good example of showing how issue linkage facilitates trade

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<sup>1123</sup> *ibid.*

<sup>1124</sup> OECD Model Convention (2014) Sample Procedure, 413 (para.42).

<sup>1125</sup> See below, Chapter 6, Section 7.3.

<sup>1126</sup> See above, Chapter 2, Section 2.3.1.

<sup>1127</sup> Paul Poast, 'Issue Linkage and International Cooperation: An Empirical Investigation' (2013) 30 *Conflict Management and Peace Science* 286, 287.

negotiations.<sup>1128</sup> In this round of negotiation, while developing countries such as Brazil and India were reluctant to discuss service-sector liberalisation and intellectual property rights as part of the Uruguay Round, they eventually agreed to participate because they expected their agricultural and textile products to be accepted by European states. An inverted trade-off incentive also existed for European states.<sup>1129</sup> In a similar vein, two competent authorities may elect to resolve a number of MAP cases together so as to create a scenario of “case-linkage”. This method is related to the topic of package deal, which will be further elaborated below (Section 3.2). Competent authorities can also establish a linkage between the MAP and the APA in relation to a particular taxpayer. For example, two authorities may decide, with the consent of the taxpayer concerned, not only to settle a transfer-pricing dispute of the past auditing years, but also to agree on transfer-pricing terms for the taxpayer in respect of future years. In this way, the two authorities transformed the dispute resolution process from a zero-sum game to a problem-solving scenario. In a few peer-review reports, peers particularly recommended the use of a mechanism that MAP agreements can be applied to future years where the facts and circumstances of the case have remained the same.<sup>1130</sup>

Related to issue linkage is another method called side payment, whereby one party who stands in an advantageous position in a transaction elects to offer the other party a payment that *per se* is not part of that transaction.<sup>1131</sup> Both side payment and issue linkage create a possibility that a party disadvantaged in a transaction may receive some compensation from outside that particular transaction. One commentator articulates the closeness

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<sup>1128</sup> Christina L Davis, ‘International Institutions and Issue Linkage: Building Support for Agricultural Trade Liberalization’ (2004) 98 *American Political Science Review* 153, 156.

<sup>1129</sup> *ibid.*

<sup>1130</sup> Peer Review Reports on Germany, 61 (para.144); India, 65 (para.178).

<sup>1131</sup> JN Hooker, ‘Side Payments’ [2008] *Encyclopedia of Business Ethics and Society* 1923, 1923.

between the two methods: “For international negotiation, side payments could be facilitated by linking one type of agreement with another”.<sup>1132</sup> Nonetheless, side payment is broader than issue linkage in the sense that the former also includes direct monetary payment made by one party to the other. For any single MAP case, it will be difficult to imagine that one competent authority directly pay its treaty partner to accept an adverse agreement. However, as will be shown below (Section 3.2.3.2), side payments do occur in package deals.

### **2.2.2 Suspension of disputed revenue-collection**

As explained previously, vested interests form a hurdle to successful negotiation between parties.<sup>1133</sup> In particular, the defending competent authority may have a vested interest in retaining its original audit adjustment. This vested interest will be further compounded by the fact that instigation of a MAP does not usually suspend the collection of disputed tax revenue. Indeed, it is not unusual for countries to require a taxpayer to pay the tax assessment as a condition of obtaining access to a MAP.<sup>1134</sup> Among other problems, such a requirement may cause delays in dispute resolution, because a country facing the prospect of refunding taxes already collected becomes less willing to enter into good-faith MAP discussions.<sup>1135</sup> The MEMAP therefore recommends that national governments should provide a procedure for the suspension or deferral of a revenue-collection that is the subject of a MAP request.<sup>1136</sup>

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<sup>1132</sup> Bård and Harstad, ‘Do Side Payments Help? Collective Decisions and Strategic Delegation’ (2008) 6 *Journal of the European Economic Association* 468, 469.

<sup>1133</sup> See above, Chapter 2, Section 2.3.3.

<sup>1134</sup> OECD, ‘MEMAP’ (n 1) 37 (Section 4.5.3).

<sup>1135</sup> *ibid.*

<sup>1136</sup> *ibid.*

## **2.3 Economising administrative costs**

Despite the advantages of the MAP vis-à-vis tax mediation and arbitration in terms of administrative costs, there is still much room to economise such costs. The peer-review reports also confirm that administrative issues, such as exchange of documents and organisation of face-to-face meetings, cause significant delay to the MAP process.<sup>1137</sup> While the optimisation of every specific administrative task is too operational to be covered in this thesis, systematic economising of the administrative costs of MAP processes can be facilitated by package negotiation, institutionalisation, and the use of ICT tools.<sup>1138</sup>

## **3. Holistic issues about the MAP**

### **3.1 Taxpayer participation**

#### **3.1.1 Current situation**

MAP discussions between competent authorities are a government-to-government process in which there is generally no direct involvement from the taxpayers.<sup>1139</sup> Once a MAP request has been officially accepted by a competent authority, the taxpayer concerned usually will not be actively involved in the remainder of the process, unless invited by either competent authority to present its position or to provide extra information.<sup>1140</sup>

#### **3.1.2 Literature review**

The proposal of increased taxpayer participation has both proponents and opponents, and arguments of both sides carry weight.<sup>1141</sup> Some of the

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<sup>1137</sup> See above, Chapter 3, Section 5.3.5.1.

<sup>1138</sup> See below, this chapter, Section 3; Chapter 7; Appendices, Table 11.

<sup>1139</sup> OECD, 'MEMAP' (n 1) 24 (Section 3.3.2).

<sup>1140</sup> Terr and others (n 25) 476.

<sup>1141</sup> *ibid* 477.

debates are placed at the human-rights plane, which is beyond the scope of the law-and-economic approach characterising this thesis.<sup>1142</sup> Most of the arguments are focused on practical considerations, and are thus amenable to a transaction-cost analysis.

(1) Agency-cost perspective. A common consensus is that greater taxpayer participation enhances transparency of a MAP procedure.<sup>1143</sup> According to agency theory, increased transparency of the MAP would in turn reduce the scope of bureaucracy, misconduct, or corruption on the part of competent authorities. Therefore, increased taxpayer participation imposes greater monitoring pressure upon competent authorities in handling MAP cases.

(2) Administrative-cost perspective. Apparently, greater taxpayer participation increases administrative burden for competent authorities in MAP processes. For example, it becomes more difficult to organise face-to-face meetings that fit the schedule of all three parties as opposed to a bilateral negotiation. Nonetheless, this administrative aspect seems to be overlooked by the literature. Perhaps the majority believe that such logistical expense is trivial. By contrast, some emphasise the merit of taxpayer participation in reducing information costs. As Terr et al. point out, increased taxpayer participation would better ensure that facts and economic analyses are available to government negotiators, “who are often juggling multiple factually complex cases with very limited staffing and other resources”.<sup>1144</sup> This point is substantiated in one of the peer-review reports, in which a peer concerned that the assessed competent authority might be fed insufficient or inaccurate information by

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<sup>1142</sup> For representative views, see Perrou (n 189); Baker (n 196) 467–470.

<sup>1143</sup> OECD, ‘MEMAP’ (n 1) 24-25 (Section 3.3.3); Terr and others (n 25) 476.

<sup>1144</sup> Terr and others (n 25) 441.

the audit department in respect of certain disputes.<sup>1145</sup>

(3) Bargaining-cost perspective. The debates over taxpayer participation are mostly centred on the bargaining aspect of the MAP process. There are two major rationales for excluding taxpayers from the process. First, taxpayer participation may introduce additional advocacy to the procedure. In particular, there are concerns that a taxpayer may align itself with one competent authority and “gang up” on the other.<sup>1146</sup> In contrast, the counterargument contends that given the non-binding nature of the MAP, a competent authority could simply withdraw or disagree if it felt that it had been “bullied” by the other two parties.<sup>1147</sup> More importantly, considering that a taxpayer usually has the greatest stake in resolving a tax dispute and maintaining good relationships with the relevant tax authorities, it would have a strong interest in encouraging a settlement between the competent authorities.<sup>1148</sup> Accordingly, the taxpayer may facilitate MAP negotiations by providing the competent authorities with its intimate understanding of the business arrangements in question.<sup>1149</sup> In this author’s view, the taxpayer may, to some extent, be analogous to a mediator in that both can provide focal points for a MAP negotiation.<sup>1150</sup> The second ground for supporting the status quo is the concern that increased tax participation would inhibit competent authorities’ ability to refer to other relevant disputes between them.<sup>1151</sup> This argument, which concerns the package deal that will be discussed below (Section 3.2), has not met forceful challenges.

(4) Overall transaction-cost perspective. Several other arguments for

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<sup>1145</sup> Report on Mexico, 56 (para.159).

<sup>1146</sup> Terr and others (n 25) 476.

<sup>1147</sup> Rooney and Suit (n 1104) 701.

<sup>1148</sup> *ibid.*

<sup>1149</sup> *ibid.*

<sup>1150</sup> See above, Chapter 2, Section 2.3.1.3.

<sup>1151</sup> Terr and others (n 25) 441.

increased taxpayer participation refer to the overall transaction costs of ITDR rather than any particular type of the costs. First, it is argued that if a taxpayer is fully involved in a MAP process, it would more likely accept the agreement reached by the competent authorities.<sup>1152</sup> If the taxpayer otherwise refuses a MAP agreement for the lack of transparency and fairness, and therefore litigates the case before a domestic court, the ensuing litigation costs could be significant. Second, some argue that through participation, a taxpayer can better understand the considerations underlying a MAP agreement and incorporate these considerations into its transfer-pricing policies to prevent future disputes.<sup>1153</sup> This latter argument, however, raises some doubts. Specifically, the nature of the MAP dictates that competent authorities are permitted, or even encouraged, to take a flexible and pragmatic approach in the MAP process rather than solely resorting to legalistic reasoning. Such pragmatic considerations can hardly provide consistent guidelines for taxpayers in designing their transfer-pricing policies. Moreover, anecdotal evidence even indicates that sometimes a barrier to the resolution of a MAP case is the reluctance on the part of either competent authority to create a precedent for future disputes.<sup>1154</sup>

### **3.1.3 Recommended minimum standard of taxpayer participation**

As Terr et al. point out, the debates over the topic of taxpayer participation somewhat reflect the failure among scholars to delineate the concept of “participation”.<sup>1155</sup> A taxpayer’s role in a MAP could take a variety of forms across a broad spectrum, with the status quo representing one end. At the other, and most participatory, end of the spectrum, the taxpayer directly

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<sup>1152</sup> Rooney and Suit (n 1104) 701.

<sup>1153</sup> Terr and others (n 25) 441.

<sup>1154</sup> Burnett (n 77) 179.

<sup>1155</sup> Terr and others (n 25) 477.

engages in the face-to-face meetings between the competent authorities.<sup>1156</sup> Most of the concerns about taxpayer participation are more or less associated with full taxpayer participation. In contrast, this author proposes an intermediate level of taxpayer participation on the basis of the structured MAP as discussed above (Section 2.1.4). Specifically, taxpayers can participate at each milestone of a MAP process, albeit in a limited manner.

(1) Acceptance (or rejection) of the MAP request. Decisions on the admissibility of MAP requests, once made by a competent authority, should be communicated to the taxpayer concerned without delay. If the MAP request is denied, the taxpayer should be entitled to appeal the decision before the same competent authority, and where the appeal fails, to seek remedies from the domestic judicial system. The appeal mechanism and judicial review would also apply if the decision on admissibility of MAP requests is unduly delayed.

(2) Presentation of a position paper (or a responding paper). Before a competent authority presents its position paper to the other authority, the position should be communicated to the taxpayer, which is entitled to present its opinion on the position. Again, undue delay to the communication of the position would be subject to internal appeal or judicial review. However, the taxpayer should not be permitted to appeal or litigate the content of the position paper, since the latter has no final legal effect. The same rule is applicable to the milestone of presenting a responding paper.

(3) Mutual negotiation. Usually taxpayers are excluded from this bilateral process. Nonetheless, if one or both competent authorities anticipate that the resolution of the case cannot be achieved within the predetermined

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<sup>1156</sup> See *ibid* 440.

timeframe, they should communicate their views and disagreements on the case to the taxpayer separately. The taxpayer is entitled to present its position on these views. By the end of the negotiation, the competent authorities should notify the outcome of negotiation to the taxpayer without delay. Where the authorities fail to reach an agreement, they should inform the taxpayer indicating the reasons for this failure.

In this intermediate participation mode, the competent authorities are under greater monitoring pressure than with the status quo (effect on agency costs), because there are more occasions for taxpayer intervention in the MAP process. The taxpayer also gains multiple opportunities to present its understandings on the case to the competent authorities, and even engage in discussions – albeit separately – with those authorities during the process. Such taxpayer inputs not only reduce the information costs for the competent authorities (effect on administrative costs), but also help those authorities to develop a more realistic view on the case (effect on bargaining costs). Greater taxpayer participation also enhances the legitimacy of the process, thereby reducing the likelihood of the taxpayers rejecting a MAP agreement (effect on overall transaction costs). Meanwhile, the model avoids direct confrontation between the taxpayer and the competent authorities. In this way, the concerns about taxpayer advocacy and the impediment to the overall balance of a package of cases can be mitigated (effect on bargaining costs). The logistical burden associated with the tripartite, face-to-face meetings can also be avoided (effect on administrative costs).

It should be kept in mind that the above model is proposed as a bottom line of taxpayer participation. Thus competent authorities can by all means agree on more-ambitious approaches, such as the following three measures recommended by the MEMAP:

(1) Taxpayer presentation to both competent authorities. For those fact-intensive, unusual, or complex cases, it could be helpful to have the taxpayer make a presentation to both competent authorities at the same time, usually prior to the commencement of discussions.<sup>1157</sup> The taxpayer could include in the presentation its proposals for resolution. However, the risk for such exercise is that one competent authority may unduly rely upon this position as “the taxpayer’s position” and therefore be unwilling to explore other options in good faith.<sup>1158</sup>

(2) Frequent communication with the taxpayer. It is recommended that tax administrations conduct timely and frequent communication with the taxpayer regarding the status or issues of a case in the course of the MAP.<sup>1159</sup> Those administrations are also encouraged to consider obtaining input from the taxpayer on factual and legal issues that may arise during the process.<sup>1160</sup>

(3) Debriefing the taxpayer. Competent authorities are encouraged to debrief the taxpayer after each substantial MAP discussion (usually via telephone).<sup>1161</sup>

This author further takes the view that if the competent authorities and the taxpayer concerned have maintained a mutual trust, and the authorities feel no need to link the dispute to other cases in a package manner, an exercise of full taxpayer participation upon the consent of the competent authorities could produce a net benefit.

### **3.2 Package deal**

As discussed previously, the orthodox literature perceives the practice of

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<sup>1157</sup> OECD, ‘MEMAP’ (n 1) 24 (Section 3.3.2).

<sup>1158</sup> *ibid.*

<sup>1159</sup> *ibid* section 3.3.3, 25.

<sup>1160</sup> *ibid.*

<sup>1161</sup> *ibid* section 3.7, 30.

package deal as a pitfall of the MAP.<sup>1162</sup> The major concern is that individual cases might not be judged on their own merits, but rather determined as part of a larger trade-off between jurisdictions.<sup>1163</sup> This author has argued elsewhere that while blunt “horse-trading” by all means constitutes gross misconduct, one should not throw the baby out with the bathwater.<sup>1164</sup> To say the least, there have been few, if any, reported cases or anecdotes about any taxpayer being “sacrificed” in such deals. On the contrary, relevant practices all point to the “sunny side” of package negotiation.

### 3.2.1 US Framework Agreement with India and other treaty partners

From January 2015 to January 2016, the Indian and the US competent authorities resolved more than 100 MAP cases.<sup>1165</sup> These cases related to assessment years 1999-2000 to 2011-2012, involving around US\$ 737 million.<sup>1166</sup> They primarily involved the IT industry.<sup>1167</sup> Compared with the two-year benchmark timeframe for the MAP process, and those stalemated MAPs reported by a number of OECD countries, resolving 100 MAPs over one year is a remarkable achievement.

This achievement could largely be attributed to the Framework Agreement concluded by the two competent authorities.<sup>1168</sup> This Framework Agreement,

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<sup>1162</sup> See above, Chapter 1, Section 2.2.1.

<sup>1163</sup> *ibid.*

<sup>1164</sup> Cai (n 794).

<sup>1165</sup> CBDT, ‘India–USA Bilateral Competent Authority MAP/APA Meeting – Resolution of More than 100 Cases under MAP and Agreement on Terms and Conditions of First Ever Bilateral APA Involving India and USA’ (2016)

<<https://www.incometaxindia.gov.in/Lists/Press%20Releases/Attachments/547/India-USA-Bilateral-Competent-Authority-Meeting-Resolution-than-100-cases-under-MAP-Bilateral-APA-involving-India-17-11-2016.pdf>> accessed 18 March 2018; B.S. Reporter, ‘India and US Settle 100 Tax Disputes’ *Business Standard India* (29 January 2016)

<[http://www.business-standard.com/article/economy-policy/india-and-us-settle-100-tax-disputes-116012800624\\_1.html](http://www.business-standard.com/article/economy-policy/india-and-us-settle-100-tax-disputes-116012800624_1.html)> accessed 31 January 2018; Deloitte, ‘India, United States Reach Agreement to Solve Backlog of Competent Authority Cases’ (2015)

<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tpalert-26-210115.pdf>> accessed 18 March 2018; KPMG, ‘India-USA Competent Authorities Resolve More than 100 Cases under MAP and Agree on Terms and Conditions of First Indo-US Bilateral APA’.

<sup>1166</sup> CBDT (n 1165).

<sup>1167</sup> KPMG (n 1165).

<sup>1168</sup> *ibid.*

which followed meetings between the competent authorities in India on January 15 and 16, 2015, set out general terms and conditions for the resolution of some 200 tax disputes between the two countries.<sup>1169</sup> Obviously, the Indian and the US competent authorities resolved the MAPs in a package manner, with the Framework Agreement functioning essentially as a kind of package deal.<sup>1170</sup> The deal marked a breakthrough in a long-pending conflict over the taxation of IT between the two countries.<sup>1171</sup> Indeed, the IRS had previously declared that until there was a framework to settle a significant number of the outstanding MAPs, the IRS would not allow for bilateral APA cases with India.<sup>1172</sup>

In addition to its agreement with India, the US has also concluded several general agreements or memoranda of understanding with other treaty partners to address recurring issues arising from MAP cases.<sup>1173</sup> For instance, the US-Belgium Competent Authority Agreement –Profit Attribution (June 17, 2013) involves the interpretation of Article 7 of the US-Belgium tax treaty.<sup>1174</sup> The US-Austria Tax Treatment of Certain Scholarships (March 1, 2005) concerns the interpretation of Articles 20, 21, and 23 of the US-Austria tax treaty.<sup>1175</sup>

### **3.2.2 Amicable agreements between Luxembourg and its neighbouring countries**

Most of the MAP cases in Luxembourg concern disputes over the taxation of

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<sup>1169</sup> Deloitte (n 1165); B.S. Reporter (n 1165).

<sup>1170</sup> Cai (n 794) 751.

<sup>1171</sup> EY, 'US and India Tax Authorities Agree on Framework for Resolving Certain Double Tax Cases' <[http://www.ey.com/Publication/vwLUAssets/US\\_and\\_India\\_Tax\\_Authorities\\_agree\\_on\\_framework\\_for\\_resolving\\_certain\\_double\\_tax\\_cases/\\$FILE/2015G\\_CM5155\\_TP\\_US%20and%20India%20TA%20agree%20on%20framework%20for%20resolving%20certain%20double%20tax%20cases.pdf](http://www.ey.com/Publication/vwLUAssets/US_and_India_Tax_Authorities_agree_on_framework_for_resolving_certain_double_tax_cases/$FILE/2015G_CM5155_TP_US%20and%20India%20TA%20agree%20on%20framework%20for%20resolving%20certain%20double%20tax%20cases.pdf)> accessed 18 March 2018.

<sup>1172</sup> *ibid.*

<sup>1173</sup> 'Competent Authority Arrangements | Internal Revenue Service' <<https://www.irs.gov/individuals/international-taxpayers/competent-authority-arrangements>> accessed 4 October 2019 see also peer review report on US, para. 112. .

<sup>1174</sup> US-Belgium Competent Authority Agreement - Profit Attribution - 7-16-13 *ibid.*

<sup>1175</sup> US - Austria: Tax Treatment of Certain Scholarships. March 1, 2005 *ibid.*

cross-border employees. As of August 2018, Luxembourg had more than 190,000 cross-border commuters, most of whom lived in Belgium, France, or Germany.<sup>1176</sup> Previously, foreigners employed by a Luxembourg company were taxable in Luxembourg for the days physically present in the country and taxable in their own residence countries for any other days being outside Luxembourg.<sup>1177</sup> However, it was common for those daily commuters to stay one or more days outside Luxembourg for business trips, trainings, holidays, or sick leaves. Consequently, the rule caused much uncertainty as to those commuters' tax status.<sup>1178</sup> Indeed, the number and harshness of tax audits over cross-border employees by their respective residence countries were making frequent headlines in local presses.<sup>1179</sup> In this connection, Luxembourg reached several mutual agreements regarding this issue with its neighbouring countries. In the first, which was concluded with Germany in May 2011, Germany agreed to a 19-day period of grace, during which it gave up tax rights over its resident commuters provided that their working days spent outside Luxembourg were below 19 days.<sup>1180</sup> On 16 March 2015, Luxembourg reached a mutual agreement with Belgium that a 24-day tolerance would be granted to Belgian workers employed in Luxembourg.<sup>1181</sup> While it remains unknown how many MAP cases were covered by these agreements, the OECD MAP statistics provide some clue about the efficacy of the Luxembourg-Belgium mutual agreement. Specifically, the MAP

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<sup>1176</sup> JE Nis 20 11 2018 at 2:53 pm, 'Tax and Social Security for Cross-Border Commuters/Home-Workers' (*KPMG Luxembourg*, 9 August 2018) <<https://blog.kpmg.lu/tax-and-social-security-for-cross-border-commuters-home-workers/>> accessed 10 March 2019.

<sup>1177</sup> *ibid.*

<sup>1178</sup> 'Luxembourg and Germany clarify the tax position of German cross-border workers' <<http://www.infinance.lu/actualites/luxembourg-and-germany-clarify-tax-position-german-cross-border-workers>> accessed 10 March 2019.

<sup>1179</sup> Écrit par Alain Ducat, 'Frontaliers Victimes de Harcèlement Fiscal Belge' <<https://paperjam.lu/article/news-frontaliers-victimes-de-harcement-fiscal-belge>> accessed 4 October 2019; 'Luxembourg: Le Fisc a Contrôlé Les Travailleurs Frontaliers - Le Soir' <<https://www.lesoir.be/art/928721/article/actualite/regions/namur-luxembourg/2015-07-06/luxembourg-fisc-controle-travailleurs-frontaliers>> accessed 4 October 2019.

<sup>1180</sup> 'Luxembourg and Germany clarify the tax position of German cross-border workers' (n 1178).

<sup>1181</sup> Deloitte, 'Amicable Agreement on the Double Tax Treaty Concluded Between Luxembourg and Belgium (24-Days Rule)'.

statistics reported by the two countries suggest that the 2015 amicable agreement between them had a dramatic impact on their MAP performance in the same year.<sup>1182</sup>

### **3.2.3 Comments on the above cases**

While these cases are still insufficient to draw the conclusion that package deals are good deals, they at least suggest the desirability of reassessing the pros and cons of the package deals.

#### **3.2.3.1 Administrative costs**

An obvious strength of a package deal is its generation of scale economies, and hence its economising of administrative costs of MAP processes. By bringing a number of cases simultaneously to a negotiation, competent authorities at least dilute the logistical expenses of the ITDR processes, such as travels and accommodations, over multitudes of MAP cases. In the Peer Review Report on Spain, one peer particularly proposed that the two jurisdictions should try to bring as many cases as possible to future meetings considering the significant burden that face-to-face meetings entail.<sup>1183</sup> Another jurisdiction reported that the usual budget limit for traveling imposed on its competent authority was a maximum of two people traveling abroad to attend the same event.<sup>1184</sup> In addition to the logistical expenses, for those MAPs with similar factual patterns or legal issues, package negotiation also helps to save the “cognitive” costs in relation to case analysis, because there are fewer needs for the competent authorities to mentally “reinvent the wheel” case by case. The US-Indian Framework Agreement mainly covers transfer-pricing disputes in sectors of IT or IT-related services. The cases under the amicable agreements between Luxembourg and its neighbouring

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<sup>1182</sup> See above, Chapter 3, Section 5.2.2.

<sup>1183</sup> Peer Review Report on Spain, 58 (para.148).

<sup>1184</sup> Report on Belgium, 43 (para.105).

countries are more concentrated in that they all concern the tax status of daily commuters working in Luxembourg. In the Peer Review Report on Japan, one peer revealed that most of the cases that it discussed with Japan's competent authority concerned transfer-pricing issues with common fact patterns.<sup>1185</sup>

The method of package negotiation and the attendant economies of scale are of particular value in light of the high frequency of tax disputes, as discussed previously.<sup>1186</sup> First, national governments and international communities have been struggling to find ways to cope with the proliferation of cross-border tax disputes. Package negotiation provides a cost-efficient option without involving extra governmental investment. Second, the more MAP cases a pair of competent authorities has, the greater the potential of scale economies, and the more attractive the method will become.

#### 3.2.3.2 Bargaining costs

Another advantage of the package deal is its effect on the bargaining costs of MAP processes. First, by creating a scenario of case linkage, which is similar to issue linkage, package deals have the effect of turning a MAP bargaining into a problem-solving discussion, thereby increasing the space for mutual compromise and innovative solutions by competent authorities. Questions may arise as to the legitimacy of horse trading. In this author's view, at least for transfer-pricing disputes, which constitute the vast majority of MAP cases, a pragmatic and flexible approach by competent authorities can be justified. This is because, as discussed previously, the arm's-length price is essentially a legal fiction and may span a wide range.<sup>1187</sup> Even the US domestic jurisprudence on this issue is replete with "approximations, compromises and

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<sup>1185</sup> Report on Japan, 67-68 (para.180).

<sup>1186</sup> For discussion of the frequency of tax disputes, see above, Chapter 4, Section 3.2.3.

<sup>1187</sup> See above, Chapter 3, Section 3.4.2.2.

rules of thumb”.<sup>1188</sup> Therefore, this author sees no problem for a pair of competent authorities to make some marginal adjustment on the transfer price of a particular MAP in light of the overall balance of all MAPs between the pair. A similar view has been expressed in a study on the WTO consultation process. The article establishes that trade disputes that have continuous and divisible features, such as tariff rate, are more amenable to case linkage and side payment, and thus more likely to be resolved at consultation stage, whereas lumpy issues – those that have an all-or-nothing quality such as the legitimacy of a restriction policy – are more likely to escalate to the panel phase.<sup>1189</sup>

The advantage of a pragmatic approach to MAP negotiation is also acknowledged in the MEMAP, albeit in a quite prudent manner. On the one hand, the MEMAP confirms that MAP discussion should be conducted in a principled, fair, and objective manner, “with each case being decided on its own merits and not by reference to any balance of results in other cases”.<sup>1190</sup> On the other hand, it also admits that:

*Although a principled approach is paramount, where an agreement is not otherwise achievable, both competent authorities should look for appropriate opportunities for compromise in order to eliminate double taxation.*<sup>1191</sup>

Elsewhere, the MEMAP further confirms that practical and pragmatic solutions to contentious MAP cases “are regularly the result of compromise and concessions made by parties involved”.<sup>1192</sup> It is reasonable to infer that the MEMAP has left a “back door” for the exercise of package deals, because compromise and concessions are mostly reciprocal, with one party compromising in some cases in exchange for the other party’s concession in

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<sup>1188</sup> *ibid.*

<sup>1189</sup> Guzman and Simmons (n 307) 227.

<sup>1190</sup> OECD ‘MEMAP’ (n 1) 11 (Section 1.3.1).

<sup>1191</sup> *ibid.*

<sup>1192</sup> *ibid* section 3.6, 29.

others.

Second, package negotiation is more conducive to the method of monetary side-payment, which directly reduces the distributive conflict between the negotiating parties. During the negotiation of the above-mentioned Luxembourg-Belgium amicable agreement, Luxembourg agreed to transfer €30 million to Belgium as a financial compensation – the compensation amount is to be updated every three years – because the regime of the 23-day period of grace for Belgium residents working in Luxembourg has the effect of shifting some tax revenue from Belgium to Luxembourg.<sup>1193</sup> It is worth noting that the Luxembourg-Belgium agreement involves cases other than transfer pricing disputes. This indicates that, through the use of an overall side payment, a package deal facilitates negotiation not only for continuous and divisible tax disputes, but also for more lumpy issues.

Third, compared with the case-by-case approach, package negotiation is more likely to engage higher echelons of competent-authority officers. This is beneficial for overcoming bargaining problems, since lower-echelon officers of competent authorities might lack sufficient authority to conclude a deal. According to news reports, the negotiation of the India-US deal engaged top-level representatives of the two competent authorities: Douglas O'Donnell, US competent authority and Deputy Commissioner (International) of the IRS Large Business & International Division, and Akhilesh Ranjan, the Indian competent authority and Bilateral Advance Pricing Agreement Commissioner.<sup>1194</sup> The package deal between Germany and Luxembourg also benefited from excellent relationship between the ministers of finance Mr. Luc Frieden and Mr. Wolfgang Schäuble.<sup>1195</sup>

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<sup>1193</sup> Deloitte (n 1181).

<sup>1194</sup> EY (n 1171).

<sup>1195</sup> 'Luxembourg and Germany clarify the tax position of German cross-border workers' (n 1178).

### 3.2.3.3 Agency costs

Unlike administrative and bargaining costs, which may be reduced by the use of package deals, agency costs of the MAP could be intensified.<sup>1196</sup> Specifically, while a package deal creates more scope for compromise between competent authorities, it also gives rise to more space for manipulation or even corruption, considering that the MAP process is mainly dominated by competent authorities. Indeed, the primary concern about this method – that certain taxpayers' interests may be sacrificed as part of a larger trade-off between jurisdictions – mainly points to the agency problem of the method. In this connection, some element of transparency may help to reduce the risk of opportunism on the part of competent authorities, thereby increasing taxpayer confidence in the procedure. Specifically, competent authorities may implement appropriate mechanisms to increase the level of taxpayer participation in the package negotiation. In the India-US deal, companies which may be directly affected by the deal were invited by the two competent authorities to present their positions and to discuss the proposed settlement.<sup>1197</sup> In addition to taxpayer participation, publishing the content of package deals also enhances the transparency of the deals. Most of the above-mentioned framework agreements and memoranda of understanding are published.<sup>1198</sup> It is true that taxpayer participation and other measures aiming at enhancing the transparency of package deals may consume extra resources and slow down the processes. Nevertheless, owing to economies of scale, these extra costs can be diluted among the cases included in a package.<sup>1199</sup>

A published package deal may also produce a positive spill-over effect: it not

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<sup>1196</sup> Cai (n 794) 750.

<sup>1197</sup> Deloitte (n 1165).

<sup>1198</sup> 'Competent Authority Arrangements | Internal Revenue Service' (n 1173); Deloitte (n 1181).

<sup>1199</sup> Cai (n 794) 750.

only settles the disputes at hand, but also provides guidance for competent authorities and taxpayers in dealing with similar issues to those covered by the deal.<sup>1200</sup> Indeed, the conclusion of MAP framework agreements is closely associated with the interpretative MAP provided in the first sentence of Article 25 (3) of the OECD Model. Such interpretative MAPs, explains the MEMAP, “frequently relate to topics of a general nature which concern, or may concern, a category of taxpayers rather than a specific taxpayer’s case”.<sup>1201</sup> Through the publication of package deals or interpretative MAP agreements, transaction costs related to future tax disputes and their resolution can be effectively saved. In Luxembourg, after the adoption of the above-mentioned deals, the number of tax audits generating double taxation declined markedly compared to the years before.<sup>1202</sup>

#### 3.2.3.4 Summary

It could be seen that the method of package negotiation contains two basic elements. The first is batch negotiation: two or more competent authorities resolve a number of disputes at the same time. The second is some mutual compromise made by those authorities in the negotiation. As demonstrated above, batch negotiation generates economies of scale, thereby reducing the average transaction costs of each MAP case. Things become more complicated when the issue of mutual compromise is concerned. This author has argued that while blunt horse-trading at the expense of individual taxpayers’ interests should be banned, some marginal concession, particularly with respect to transfer pricing disputes, is not only desirable, but even unavoidable, considering the difficulties in pinning down an arm’s-length price in such disputes. While it is true that in light of the agency problem,

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<sup>1200</sup> *ibid.*

<sup>1201</sup> OECD, ‘MEMAP’ (n 1) 10 (Section 1.2.2).

<sup>1202</sup> Mara BILO, ‘Les frontaliers belges s’adaptent au fisc’ (*Wort.lu*, 8 March 2018)

<<https://www.wort.lu/fr/economie/les-frontaliers-belges-s-adaptent-au-fisc-5aa14e28c1097cee25b83d14>> accessed 4 October 2019.

package deal is vulnerable to horse-trading, a more transparent and principled package negotiation can effectively mitigate such concern. In particular, the conclusion of framework agreements represents an ideal way to strike a balance between the benefit of scale economies and the need to protect taxpayers' interests.

## **4. Evaluation of BEPS Action 14**

### **4.1 Overview**

As discussed previously, the measures developed under BEPS Action 14 aim to strengthen the effectiveness and efficiency of the MAP process.<sup>1203</sup> In this connection, the Action 14 Final Report, which was delivered at the end of 2015, reflects countries' commitment to implement a minimum standard on dispute resolution, which consists of specific measures that aim to remove obstacles to an effective and efficient MAP mechanism.<sup>1204</sup> Some key measures of Action 14 were later incorporated into Part V of the MLI.

To ensure that those elements of the minimum standard are effectively satisfied, Action 14 contains a peer-review process.<sup>1205</sup> The peer-review reports (Stage 1) have already been examined previously.<sup>1206</sup> For the purpose of the peer-review process, countries further agree to provide timely and complete reporting of MAP statistics pursuant to an agreed statistical reporting framework.<sup>1207</sup>

Action 14 also identifies several best practices that complement the minimum standard in removing obstacles that may prevent the timely resolution of MAP

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<sup>1203</sup> See above, Chapter 1, Section 1.7.1.

<sup>1204</sup> OECD, 'Action 14 Final Report' (n 114) 11 (para.3).

<sup>1205</sup> *ibid* 11 (para.3); 38 (para. 60 (5)).

<sup>1206</sup> See above, Chapter 3, Section 5.3.

<sup>1207</sup> OECD, 'Action 14 Final Report' (n 114) 16 (para. 20).

cases.<sup>1208</sup> Nevertheless, these best practices will not be monitored or evaluated, either due to their subjective or qualitative character, or because not all OECD and G20 countries are willing to commit themselves to them at this stage.<sup>1209</sup>

Accordingly, this section will focus on four key aspects of BEPS Action 14: (a) the minimum standard of the MAP; (b) the best practices; (c) the peer-review process; and (d) the new statistical reporting framework.

## **4.2 Minimum standard**

The elements of the minimum standard are set out in relation to three general objectives regarding resolution of tax disputes.<sup>1210</sup> Each of these objectives and their supporting elements will be viewed through the lens of the TC framework developed in preceding chapters.

*Objective 1: Countries should ensure that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner.*<sup>1211</sup>

A number of recommendations have been proposed to ensure the achievement of this objective. Specifically, states should:

- (1) Include paragraphs 1 through 3 of Article 25 (i.e. the MAP article) in their tax treaties, and ensure access to the MAP and the implementation of MAP agreements regarding transfer-pricing cases;
- (2) Provide MAP access in cases involving anti-abuse provisions;
- (3) Commit to resolving MAPs within an average time frame of 24 months, and agree to be periodically reviewed in this regard;

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<sup>1208</sup> *ibid* 12 (para. 7).

<sup>1209</sup> *ibid*.

<sup>1210</sup> *ibid* 12 (para. 4).

<sup>1211</sup> *ibid*.

- (4) Become members of the FTA MAP Forum;
- (5) Provide reporting of MAP statistics pursuant to the above-mentioned reporting framework;
- (6) Commit to reviews of their compliance with the minimum standard through the above-mentioned peer-review process; and
- (7) Provide transparency regarding their position on MAP arbitration.<sup>1212</sup>

Elements under Objective 1 reflect states' general commitment to the key aspects of Action 14. In particular, elements (1), (2) requires states to remove legal obstacles to the accessibility of the MAP and the implementation of MAP agreements.

*Objective 2: Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes.*

Elements of the minimum standard in relation to this objective are that states should:

- (1) Publish MAP guidance and profiles and ensure that they are clear and easily accessible;
- (2) Ensure the authority and independence of competent-authority staff in resolving MAP cases;
- (3) Avoid using the amount of sustained audit adjustments or maintaining tax revenue as the performance indicators for their competent authority functions and for their staff members in charge of the MAP process;
- (4) Ensure that adequate resources are provided to the MAP function;
- (5) Clarify in their MAP guidance that audit settlements between tax authorities and taxpayers do not preclude access to MAP; and

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<sup>1212</sup> *ibid* 13–17.

(6) Provide for roll-back APAs.<sup>1213</sup>

Elements under Objective 2 concern the actual application of the MAP mechanism. Specifically, element (4) reflects a recognition that the MAP process implies transaction costs and therefore demands resources. Elements (2) and (3) aim to increase the independence of the competent authorities, thereby mitigating the agency problems in the MAP process, as was proposed above (section 2.1.1). Elements (1) and (5) are focused on the publication of MAP guidance and profiles, which are the key information of the procedure. In this way, the information asymmetry between tax authorities and taxpayers regarding the MAP process – which is a major source of agency problem – could be relieved.

*Objective 3: Countries should ensure that taxpayers that meet the requirements of paragraph 1 of Article 25 can access the MAP.*

Elements under this objective include:

(1) That either the Contracting States amend paragraph 1 of Article 25 to permit a MAP request to be made to the competent authority of either Contracting State, or, where a treaty does not permit a MAP request to be made to either Contracting State, the competent authorities from both states jointly evaluate whether a taxpayer's objection is justified in case of any controversy about access to the MAP;

(2) That countries' MAP guidance should identify the specific information and documentation that is demanded from a taxpayer in submitting the request for MAP assistance; and

(3) That any mutual agreement reached through the MAP should be implemented regardless of the time limits provided for by domestic law.

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<sup>1213</sup> *ibid* 17–21.

While elements (1) and (2) under Objective 1 concern the legal framework for the issues of accessing the MAP and implementing MAP agreements, the elements under this objective focus on the two issues at an operational level. Elements (1) and (2) particularly manifest the logic of TC theory. With respect to element (1), by establishing a consultation process that can be invoked if the first competent authority denies the access, or more straightforwardly, by allowing a MAP request to be made to the competent authority of either Contracting State rather than of the residence state, the discretion on the admissibility of MAP requests is vested in both competent authorities rather than the first authority. The checks-and-balance mechanism between the two competent authorities in MAP process has already been covered above (Section 2.1.2). Allowing MAP requests to be made to both Contracting States is also the major innovation in Part V of the MLI as opposed to the traditional MAP provision.<sup>1215</sup>

The function of element (2) is analogous to that of elements (1) and (5) under Objective 2: to promote the disclosure of information about the MAP process so that the information asymmetry between competent authorities on the one hand and taxpayers on the other can be remedied. The implementation of this element makes it more difficult for countries to limit MAP access on the ground of insufficient information if the taxpayer concerned has provided the required information.<sup>1216</sup>

### **4.3 Best practices**

Action 14 further identifies 11 best practices regarding the MAP process.<sup>1217</sup>

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<sup>1214</sup> *ibid* 21–26.

<sup>1215</sup> MLI, Part V, Art. 16 (1).

<sup>1216</sup> OECD, 'Action 14 Final Report' (n 114) 26.

<sup>1217</sup> *ibid* 28–37.

Most of these measures also correspond to the logic of TC theory.

Best practices 8 to 11 concern the specific contents of the published MAP guidance, with a view to further broadening access to the MAP.<sup>1218</sup> For example, best practice 9 recommends that countries' published MAP guidance should provide MAP access in the case of *bona fide* taxpayer-initiated foreign adjustment.<sup>1219</sup> Essentially, these best practices complement the element (1) under Objective 2 in providing sufficient information about the MAP process.

Second, best practice 6 recommends that countries provide for a suspension of collections during the period when a MAP case is pending.<sup>1220</sup> As explained above (Section 2.2.2), suspension of revenue collection during the MAP process helps to mitigate the bargaining problem arising from vested interests.

Third, best practice 5 recommends that countries introduce the joinder method into the MAP process. Specifically, in certain cases, a MAP request may present recurring issues that will also be relevant to either previous or subsequent filed tax years, where the relevant facts and circumstances are the same.<sup>1221</sup> In these cases, countries should implement appropriate procedures to permit taxpayers also to request MAP assistance with respect to such recurring issues for other filed tax years.<sup>1222</sup> As the Action 14 Final Report recognises, a MAP procedure that allows the joining of cases that arise from recurring issues “may help to avoid duplicative MAP requests and permit a more efficient use of competent authority resources”.<sup>1223</sup> In this sense, the joinder method is analogous to the package negotiation and the

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<sup>1218</sup> *ibid* 32–37.

<sup>1219</sup> *ibid* 33–34.

<sup>1220</sup> *ibid* 31.

<sup>1221</sup> *ibid* 30-31 (para. 49).

<sup>1222</sup> *ibid* 30–31.

<sup>1223</sup> *ibid* 30-31 (para. 49).

attendant economies of scale (Section 3.2.3.1) – a single procedural outlay on the MAP can be extended to multiple cases, and the average cost of each MAP is reduced.

#### **4.4 Monitoring mechanism**

The Assessment Methodology of Action 14 establishes detailed procedures and guidelines for a two-stage peer-review and monitoring process regarding the implementation of the minimum standard.<sup>1224</sup> The process is coordinated by the FTA MAP Forum.<sup>1225</sup> In short, the process contains the following stages: (a) obtaining inputs for the Stage 1 peer review; (b) drafting the Stage 1 peer-review report; (c) publishing the Stage1 peer-review report; and (d) monitoring measures taken by the assessed jurisdiction to improve the MAP regime (i.e. the Stage 2 peer monitoring).<sup>1226</sup>

The major function of the peer-review process is to impose peer pressure on the assessed members by disseminating information about the members' MAP performance. In this way, the members will incur reputational costs for their noncompliance. This is in line with the view of agency theory that it is in the interest of the principal to impose a monitoring mechanism upon the agent.<sup>1227</sup> The peer-based monitoring mechanism, sometimes known as the open method of coordination (OMC), has also been used in a variety of non-tax domains by the OECD and several other international organisations such as the International Monetary Fund (IMF) and the EU.<sup>1228</sup> OMC reflects a more structured and robust monitoring mechanism than fora based solely on conversation. At the same time, it is more flexible than those hard-law

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<sup>1224</sup> OECD, 'Action 14 Peer Review Documents' (n 856) 20.

<sup>1225</sup> OECD, 'Action 14 Final Report' (n 114) 16.

<sup>1226</sup> OECD, 'Action 14 Peer Review Documents' (n 856) 20–21.

<sup>1227</sup> See above, Chapter 2, Section 2.2.

<sup>1228</sup> Armin Schäfer, 'A New Form of Governance? Comparing the Open Method of Co-Ordination to Multilateral Surveillance by the IMF and the OECD' (2006) 13 *Journal of European Public Policy* 70; Susana Borrás and Kerstin Jacobsson, 'The Open Method of Co-Ordination and New Governance Patterns in the EU' (2004) 11 *Journal of European Public Policy* 185.

governance modes that are characterised by coercion or sanction mechanisms.<sup>1229</sup>

A distinctive feature of the peer-review process under Action 14 is the imposition of personal accountability on senior officers of competent authorities.<sup>1230</sup> As mentioned previously, the FTA consists of the most senior tax administrators of the member countries.<sup>1231</sup> Brown therefore notes that all the proposed measures under Action 14 “should be viewed in the light of not only the political commitments that are being made, but also the parallel work being undertaken within the FTA”.<sup>1232</sup> In this author’s view, the fact that the peer-review process penetrates the administrative level of the member countries is in line with the proposition that has repeatedly been made in this thesis: the obstacles to the ITDR process largely exist at the operational, rather than the political, level.

#### **4.5 Statistical report framework**

MAP statistics pursuant to an agreed report framework form the basis of the peer-review process. As discussed above (Section 2.1.3), compiling and disseminating MAP statistics *per se* mitigates information asymmetry, thereby reducing agency costs. Compared with the old statistical reporting framework,<sup>1233</sup> the major innovation of the new framework is the insertion into the MAP process of “Milestone 1”: the date when one of the competent authorities presents in written form its position on the case to the other competent authority.<sup>1234</sup> By introducing this milestone, the framework divides the MAP process into three stages: (a) assessments of the admissibility of a MAP request; (b) preparation of the position paper; and (c) mutual

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<sup>1229</sup> Borrás and Jacobsson (n 1228) 188.

<sup>1230</sup> Brown (n 11) 98–99; Markham (n 18) 86.

<sup>1231</sup> See above, Chapter 3, Section 3.4.1

<sup>1232</sup> Brown (n 11) 99.

<sup>1233</sup> See above, Chapter 3, Section 5.2.

<sup>1234</sup> OECD, ‘Action 14 Peer Review Documents’ (n 856) 37.

negotiation.<sup>1235</sup> In this way, the new statistics calculate the average time taken both for the entire MAP process and for its intermediate steps. As a result, the measurability of the MAP process is enhanced. According to the above discussion (Section 2.1.4), it seems the new statistical framework can be further improved with the addition of another milestone: the presentation of a response to the position paper. At least in one peer-review report, several peers mentioned that a timely response to position papers would be helpful.<sup>1236</sup>

The 2016 and 2017 MAP statistics based on the new report framework have already been released. However, since the new statistics started from January 2016, the period for assessing post-2015 MAP statistics only comprises at most 24 months. Thus it is difficult to assess whether the average time for MAPs has been shortened owing to the implementation of Action 14. That being said, the new statistics still provide some useful information on the transaction costs of the MAP process. For example, in 2016, jurisdictions resolved 63 transfer-pricing cases and 290 other cases, all of which were initiated during the year. Those 63 transfer-pricing cases took on average 2.5 months to close, and the 290 other cases took an average of only 1.5 months.<sup>1237</sup> In 2016 and 2017, 251 new transfer-pricing cases took 7.8 months on average to close, and the 730 other new cases took 4.7 months on average.<sup>1238</sup> Several jurisdictions seem extremely efficient in resolving MAP cases. For example, in 2016, Canada resolved 42 new cases, among which transfer pricing cases took 1.10 months and other cases 6.40 months on average.<sup>1239</sup> In the same year, Luxembourg resolved around

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<sup>1235</sup> *ibid* 33–37.

<sup>1236</sup> Peer Review Report on India, 65 (para.177).

<sup>1237</sup> OECD, 'Mutual Agreement Procedure Statistics for 2016'

<<http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm>> accessed 3 April 2018.

<sup>1238</sup> 'Mutual Agreement Procedure Statistics for 2017 - OECD'

<<https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2017.htm>> accessed 16 September 2019.

<sup>1239</sup> Peer Review Report on Canada, 40-42 (paras 86, 91).

180 cases – all were non-transfer pricing cases – with each case taking 0.83 months on average.<sup>1240</sup> These statistics are in line with the data analysis in Chapter 3, demonstrating that the MAP process is not intrinsically time-consuming.<sup>1241</sup>

#### **4.6 Comments**

Given the propensity toward legalistic approaches in the orthodox literature on ITDR, it is not surprising that Action 14 was mainly crafted by policymakers and practitioners, with very meagre inputs from scholars. In particular, the peer-based mechanisms and the new statistical framework had received very scant research attention before the launch of the BEPS Project. Indeed, numerous researchers expressed open dismay following the release of Action 14. The criticisms mainly concern the fact that the action has failed to promote a universal adoption of tax arbitration among countries.<sup>1242</sup> Coupled with this disappointment is the critique that a majority of the measures adopted in the action has already been recommended in the MEMAP as best practices since some 10 years ago.<sup>1243</sup> Would the recommendations listed as best practices in the MEMAP, contend some commentators, carry more persuasive weight when presented as elements of a minimum standard under Action 14?<sup>1244</sup>

Based on the benefit-cost analysis in Chapter 3, this author also agrees that a well-designed arbitration clause can strengthen the MAP-based ITDR system. The next chapter will explore means of optimising tax arbitration. However, as analysed in the preceding chapters, for the ITDR system, a legalistic solution should not be taken as a panacea. Consider the two major obstacles to the

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<sup>1240</sup> Report on Luxembourg, 35-37 (paras 78, 87).

<sup>1241</sup> See above, Chapter 3, Section 5.2.2.

<sup>1242</sup> Markham (n 18) 91–92.

<sup>1243</sup> Nias (n 232) 2.

<sup>1244</sup> Markham (n 18) 85.

resolution of MAP cases: the lack of resources and the undue practice of audit settlement. Reliance on arbitration may exacerbate these problems. First, the high transaction costs of arbitration as opposed to the MAP may further stretch the budget constraints facing national governments. Second, the prospect of arbitration may spur tax administrations to be more proactive in using audit settlements as a way to limit access to the MAP. One might argue that the issue of blocking MAP access can be solved by introducing a more independent arbitration mechanism, because even if the taxpayer were compelled to waive the access to the MAP in return for a more favourable audit settlement, it could still pursue arbitration.<sup>1245</sup> The drawbacks of independent tax arbitration will be elaborated later.<sup>1246</sup> Here it suffices to point out that even if taxpayers have the legal right to renege on the audit-settlement deal and pursue arbitration to eliminate remaining double taxation, they may be unwilling to test this right for fear that their good working relationships with the relevant tax authorities could be significantly disrupted.<sup>1247</sup> By contrast, a strengthened mechanism of policy coordination, as manifested in Action 14, seems a better solution to address the practice of using audit settlements to limit MAP access.

As to the “soft” character of many measures endorsed in Action 14, this author has already argued above (Section 4.4) that the peer-based monitoring mechanism, though not as hard as a legal instrument, produces a “law-like” sense of obligation. In particular, the imposition by the FTA MAP Forum of direct accountability on competent authorities further strengthens the member countries’ commitment to resolving tax disputes effectively, efficiently, and in good faith. Therefore, while Action 14 substantially falls back on the MEMAP in terms of content, the two initiatives carry different strengths.

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<sup>1245</sup> Farah (n 174) 39.

<sup>1246</sup> See below, Chapter 6, Section 2.1.

<sup>1247</sup> Markham (n 18) 88.

## **Chapter 6. Economising Third-Party Procedures of ITDR**

### **1. Overview**

This chapter seeks to explore ways to economise third-party procedures – mainly tax arbitration and mediation – of ITDR. Many general aspects of tax arbitration and mediation have already been extensively studied in the literature of international commercial dispute settlement, a subject more fully developed than ITDR. Accordingly, this chapter focuses only on the “tax facet” of these third-party procedures. In particular, the chapter centres on the supplementary role of tax arbitration (and mediation), in light of the MAP-based ITDR system proposed in Part I. As with the MAP, many issues in this chapter encompass more than one type of transaction cost.

Sections 2 to 5 examine four fundamental aspects of tax arbitration. Section 6 analyses one particular issue of tax mediation. Section 7 provides an assessment of the recent reform of tax arbitration embodied in Part VI of the MLI.

### **2. Relationship between tax arbitration and the MAP**

#### **2.1 Tax arbitration as an extension of the MAP**

Under the current ITDR system, tax arbitration is instituted as an integral part of the MAP, rather than as a self-standing alternative. This built-in feature distinguishes tax arbitration from its international commercial equivalent, where individuals have direct access to arbitration should a dispute arise. In line with the preference for legalistic approaches in the orthodox literature of

ITDR, some have argued for stand-alone tax arbitration, to which taxpayers can have direct access.<sup>1248</sup> However, as argued in Chapter 3, given the characteristics of the international tax regime and tax disputes, a MAP-based system that is supplemented by third-party procedures represents the optimal mode for the international economy. Chapter 5 further established that for those countries with a high inventory of tax disputes, the MAP in a package manner provides a powerful tool for countries to address their heavy caseloads of tax disputes.<sup>1249</sup>

## **2.2 Implications of “building” tax arbitration into the MAP**

### **2.2.1 The MAP as a prerequisite to arbitration**

The built-in characteristic of tax arbitration means that only if and when the competent authorities are unable to resolve the case within the predetermined time frame – usually two years – can the arbitration procedure be invoked. A particular problem is where the competent authorities even disagree on the admissibility of a MAP request in the first place. Under the DSU of WTO, the failure of the responding party to reply to the other party’s request for consultation within 10 days can directly trigger a panel procedure.<sup>1250</sup> Nonetheless, under tax arbitration, which is built into the MAP, the denial of MAP access by one competent authority does not trigger the arbitral procedure over the tax dispute. As discussed previously, in numerous countries, a taxpayer that is denied MAP access can seek a remedy before the domestic court.<sup>1251</sup> At the most, an arbitral panel can be envisaged to resolve the dispute over the admissibility of a MAP request, yet with no jurisdiction over the substantive issues of the tax dispute.

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<sup>1248</sup> Falcao (n 195); Terr and others (n 25) 493.

<sup>1249</sup> See above, Chapter 5, Section 3.2.3.1.

<sup>1250</sup> See above, Chapter 4, Section 2.1.

<sup>1251</sup> See above, Chapter 5, Section 2.1.2.

Despite the built-in manner of tax arbitration, the triggering of the arbitration procedure does not necessarily need to wait until the entire two years elapse. The competent authorities can, upon the consent of the taxpayer concerned, agree to initiate tax arbitration before the deadline, if and when, for example, they anticipate at an early stage of a MAP that the prospect of achieving an agreement is gloomy.<sup>1252</sup>

### **2.2.2 Taxpayer participation in arbitral proceedings**

Given the built-in manner of tax arbitration, the inter-governmental nature of the MAP will remain during arbitral proceedings. Accordingly, taxpayers do not have any greater right to participate in arbitral proceedings than they have in the MAP.<sup>1253</sup> Indeed, the cases for increased taxpayer participation may even be weaker in tax arbitration than in the MAP. Specifically, while taxpayer participation in the MAP has the value of mitigating the agency and bargaining problems in the process, this value is discounted in tax arbitration, which *per se* implies a lower level of agency and bargaining costs.<sup>1254</sup> Furthermore, given that tax arbitration is more formalised than the MAP, taxpayers' full participation in arbitral proceedings may lead to a significant increase in administrative costs in terms of logistical expenses and the fees for legal counsel. Park instances a particular "hassle" that may arise from taxpayer participation in tax arbitration: if the two competent authorities and the taxpayer concerned each nominates an arbitrator and the three arbitrators so appointed further nominate a fourth arbitrator to chair the tribunal; this would produce an even-numbered tribunal that would risk an awkward 50/50 split, with no one to break a possible deadlock.<sup>1255</sup> Moreover, the risk that

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<sup>1252</sup> Owens, Gildemeister and Turcan (n 193) 1008.

<sup>1253</sup> H David Rosenbloom, 'Mandatory Arbitration of Disputes Pursuant to Tax Treaties: The Experience of the United States' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015) 163–164.

<sup>1254</sup> See above, Chapter 3, Section 4.5.

<sup>1255</sup> Park (n 154) 814–815.

greater taxpayer participation will bring extra advocacy into an international tax relationship is more prominent in tax arbitration than in the MAP. This is because while in a MAP, a taxpayer is permitted to take a more flexible approach in participating in the process so as to mediate the conflict between the competent authorities, the taxpayer's latitude would be more restricted by law under tax arbitration. Consequently, it becomes quite difficult, if not impossible, for that taxpayer to avoid an impression that it is siding with one of the competent authorities. This concern may explain, at least partially, the taxpayer's absence in the arbitral proceedings in the Electrolux case, even though the company had been invited by the arbitral panel to attend the procedure.<sup>1256</sup>

That being said, the information value of taxpayer participation matters for both the MAP and tax arbitration. Indeed, given that arbitration is more demanding than negotiation on the precision of case information (in terms of both facts and legal arguments), taxpayer participation can play a greater role in reducing information costs in tax arbitration as opposed to the MAP. For instance, the Chairman of the Advisory Commission in the Electrolux case had requested the position of the taxpayer on the disputed issues.<sup>1257</sup> In this connection, a minimum standard of taxpayer participation in arbitral proceedings is recommended at least for two stages of the process. The first stage is the initiation of an arbitral process, where the taxpayer, in requesting the triggering of the arbitral procedure, is entitled to submit its position accompanied by supporting documents. The second is the pre-hearing stage, where the taxpayer should be informed of the major arguments and evidence presented by both competent authorities and is entitled to present its arguments either in written form or orally before the panel. In addition, upon the consent of both competent authorities, the panel certainly can invite the

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<sup>1256</sup> See above, Chapter 3, Section 5.4.2.

<sup>1257</sup> *ibid.*

taxpayer to fully participate in the arbitral proceedings if the former thinks desirable and appropriate to do so.

### **2.2.3 Enforcement of arbitral decisions**

Enforcement of arbitral decisions constitutes one of the key pillars supporting the legalistic method of resolving international commercial and economic disputes.<sup>1258</sup> For example, both the New York Convention and the ICSID Convention set forth a legal framework for the worldwide execution of arbitral awards rendered under these conventions.<sup>1259</sup> Under the New York Convention, if an arbitral award prescribes that the respondent is liable to the claimant for monetary damages, should the respondent fail to honour the award in time, the claimant may seek recognition and enforcement of the award in a jurisdiction where the respondent's assets are located, provided that the jurisdiction is a party to the Convention.<sup>1260</sup> Indeed, it has been widely recognised that one of the prime reasons parties include an arbitration clause in an international contract is the relatively certain enforceability of arbitral awards.<sup>1261</sup> The DSU of the WTO also has detailed rules on the enforcement of panel decisions.<sup>1262</sup> In this connection, a number of tax scholars have also discussed this issue.<sup>1263</sup> For instance, Park recommends applying the New York Convention as a legal framework for the enforcement of tax-arbitral awards.<sup>1264</sup>

Nonetheless, in this author's view, given the built-in character of tax arbitration, the enforceability of tax-arbitral awards is intrinsically different from that of their commercial equivalents. Specifically, a tax-arbitral award

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<sup>1258</sup> Margaret L. Moses (n 769) 211.

<sup>1259</sup> *ibid* 211-212, 236-237.

<sup>1260</sup> *ibid* 212-213.

<sup>1261</sup> *ibid* 211.

<sup>1262</sup> See above, Chapter 4, Section 2.3.5.

<sup>1263</sup> See above, Chapter 1, section 2.3.1, see also Wilkie (n 192); Park (n 154) 838-850; Ault (n 154)

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<sup>1264</sup> Park (n 154) 838-839.

only forms an interim opinion that needs to be incorporated into the final MAP agreement. As Article 25 (5) of the OECD Model states, arbitral decisions rendered under this Article must be implemented through mutual agreement.<sup>1265</sup> In the context of the UN Model Convention and the EU Arbitration Convention, the competent authorities can even take a decision which deviates from the arbitral decision.<sup>1266</sup> The enforceability of MAP agreements has already been discussed previously.<sup>1267</sup> To recapitulate, tax administrations are obliged to implement MAP agreements, and failure to do so may trigger domestic procedures of judicial review upon the request of the taxpayers concerned.<sup>1268</sup> This enforcement framework is in line with the BOS character of the international tax regime, which indicates that although the resolution of MAP cases implies distributive conflict, once the case has been settled, countries will have no incentive to defect from their agreement.<sup>1269</sup> On the contrary, allowing taxpayers to seize the assets of award-debtor countries, as in the case of international commercial (and investment) arbitration, may risk damaging the ongoing tax relationships.

#### **2.2.4 Synergy between the MAP and tax arbitration**

The “built-in” approach of tax arbitration indicates that an arbitration procedure can take advantage of its preceding MAP phase. In this way, transaction costs of tax arbitration can be significantly reduced. The synergy between the MAP and tax arbitration will be elaborated below (Sections 4 and 5).

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<sup>1265</sup> OECD Model Convention (2014) Art. 25 (5).

<sup>1266</sup> UN Model Convention(2011) Art.25(5) (Alternative B)90/463/EEC, Art. 12 (1).

<sup>1267</sup> See above, Chapter 5, Section 2.1.4.

<sup>1268</sup> *ibid.*

<sup>1269</sup> See above, Chapter 2, Section 2.3.1.

### 3. Procedural rules of tax arbitration: flexibility vs. robustness

#### 3.1 Overview

The balance between procedural flexibility and procedural robustness has been extensively discussed in the literature of international commercial arbitration.<sup>1270</sup> On the one hand, procedural flexibility allows the parties to craft a procedure tailored to the particular kind of dispute. On the other hand, if either party engages in deliberate obstruction of the process, the advantage of procedural robustness becomes obvious.<sup>1271</sup> A party, usually the respondent, may feel it is in its interest to delay, obstruct, or otherwise to subvert the arbitral process.<sup>1272</sup> Occasionally, claimants may also have an interest to do so when, for example, they discover that their claims do not have the expected value, or the prospect of facing a counter-claim raised by the respondents becomes evident.<sup>1273</sup> Procedural obstruction may occur at almost all stages of an arbitral proceeding including the initiation of arbitration, the establishment of a panel, and the post-panel procedure. Accordingly, a consensus is that although procedural flexibility is an obvious advantage of arbitration vis-à-vis litigation, unlimited flexibility does not always lead to maximum procedural efficiency.<sup>1274</sup>

The arbitration clause of the OECD Model leaves the arbitration process to be applied by competent authorities through mutual agreement.<sup>1275</sup> Intuitively, procedural flexibility seems desirable for tax arbitration, which is still in its embryonic stage compared to commercial arbitration. According to Pit's study,

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<sup>1270</sup> For representative comments, see Margaret L. Moses (n 769) 9–10; Ian Ming Choo, 'Procedural Soft Law in International Arbitration: Resolving the Tension Between Flexibility and Predictability' 7 *European International Arbitration Review* 37; Gordon Blanke, 'Institutional versus Ad Hoc Arbitration: A European Perspective' (2008) 9 *ERA Forum* 275, 276; Ault and Majdanska (n 193) 269–270.

<sup>1271</sup> Margaret L. Moses (n 769) 10.

<sup>1272</sup> Harris (n 781) 87.

<sup>1273</sup> *ibid.*

<sup>1274</sup> Blanke (n 1270) 276.

<sup>1275</sup> OECD Model Convention (2014) Art. 25 (5); Commentary on Art.25, 394 (para.85).

in most of the 158 tax treaties with an arbitration clause, there are no operational rules on how to act during an arbitration procedure.<sup>1276</sup> However, as discussed previously, the advantage of tax arbitration in constraining agency and bargaining costs hinges upon the robustness of the arbitral procedure.<sup>1277</sup> In particular, given the built-in manner of tax arbitration, the initiation of an arbitration phase indicates that leaving the parties to resolve the dispute on their own has been unsuccessful. Should the arbitral proceedings be governed by procedural flexibility, the same problems associated with party autonomy may creep into tax arbitration and increase the risk of procedural impasses. It is worth noting that the motivation for procedural obstruction is not always clear-cut. Obstructive behaviours may result from either the determination of one party to block the procedure, a desire to maximise the party's procedural gain, or a sincere belief that the procedure should be conducted in a certain manner.<sup>1278</sup> Accordingly, obstructive behaviours in tax arbitration may reflect either agency costs, or bargaining costs, or both. Procedural robustness has slightly different implications for different stages of tax arbitration.

### **3.2 Initiation of the arbitral procedure**

A particular issue at this stage is the choice between voluntary and mandatory arbitration. Mandatory arbitration means that an irrevocable agreement to arbitrate was concluded between the Contracting States before, rather than after, a dispute arose.<sup>1279</sup> The OECD Model Convention contains a mandatory arbitration provision, which a taxpayer can invoke upon the expiration of the MAP timeframe, without being subject to the approval of

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<sup>1276</sup> Pit (n 94) 469.

<sup>1277</sup> See above, Chapter 3, Section 4.2.2.

<sup>1278</sup> See Scott (n 802) 94.

<sup>1279</sup> Park (n 154) 811.

either competent authority.<sup>1280</sup> In contrast, under voluntary arbitration, the initiation of the procedure is subject to the consent of both parties.<sup>1281</sup> For instance, the 1989 US-Germany Income Tax Treaty provided that tax arbitration will only be triggered if both competent authorities agree so.<sup>1282</sup> In between pure mandatory and voluntary approaches, there lies a third type which is patterned after Article 25 B (5) of the UN Model Convention, whereby arbitration may be requested by the competent authority of one of the Contracting States.<sup>1283</sup>

Obviously, voluntary arbitration is more vulnerable to procedural obstruction. As Park notes, when a real tax dispute arises, one side usually has second thoughts about its commitment to a binding resolution. “Consequently, no [tax] arbitration has yet taken place pursuant to such treaty provisions.”<sup>1284</sup> Arguably, the defending competent authority in an ITDR process would usually have more vested interests in sabotaging the arbitral procedure. Therefore, as many agree, a mandatory procedure reflects a preferential choice for tax arbitration.<sup>1285</sup>

### **3.3 Establishment of the panel**

International commercial arbitration usually provides for either a sole arbitrator or a three-member tribunal. A typical arbitral panel under the OECD Model Convention has three members, with two co-arbitrators being appointed respectively by the two competent authorities, and the third being appointed as the chair of the panel by the two co-arbitrators.<sup>1286</sup> The process of establishing an arbitral panel is vulnerable to agency and bargaining

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<sup>1280</sup> OECD Model Convention (2014) Art. 25(5).

<sup>1281</sup> Kollmann and Turcan (n 58) 32.

<sup>1282</sup> US-Germany tax treaty Art. 25(5).

<sup>1283</sup> UN Model Convention(2011) Art.25(5) (Alternative B).

<sup>1284</sup> Park (n 154) 811.

<sup>1285</sup> Ault (n 154) 145; Park (n 154) 811–812.

<sup>1286</sup> OECD Model Convention (2014) Sample Procedure, 407 (para.14).

problems given that before the panel is created, the procedure is still largely governed by party autonomy.<sup>1287</sup> Specifically, either competent authority may deliberately delay the appointment of arbitrators (agency problem), or challenge the impartiality of the arbitrator proposed by the other side (agency or bargaining problem). In the Electrolux case, while the delay in the establishment of the Advisory Commission largely reflected the high administrative cost of finding the right person to be the Chair of the panel, some suggest that certain opportunistic “shirking” may also play a role.<sup>1288</sup>

The process of establishing an arbitral panel in ad hoc tax arbitration can be strengthened mainly by introducing a specified time frame plus a backstop mechanism should that time frame be exceeded. The OECD Sample Procedure recommends a time frame for the appointment of panel members.<sup>1289</sup> If any of the appointments are not made within the required time period, the arbitrator(s) not yet appointed shall be appointed by the Head of the CTPA.<sup>1290</sup> That being said, the Sample Procedure has no binding effect.

### **3.4 Post-panel proceedings**

After the establishment of the arbitral panel, the full arbitral process typically involves the following steps: some kind of organisation meeting to discuss how the arbitration will proceed; further written submissions to clarify the positions of each party; a pre-hearing disclosure involving exchange of documentary evidence and/or witness statements; the hearing procedure including oral testimony, submission of documentary evidence, the cross-examination of witnesses and legal arguments; post-hearing submissions; and a deliberation period for arbitrator(s) before the final award

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<sup>1287</sup> See above, Chapter 3, Section 4.2.2.

<sup>1288</sup> See above, Chapter 3, Section 5.4.3.

<sup>1289</sup> OECD Model Convention (2014) Sample Procedure, 399-400.

<sup>1290</sup> *ibid.*

is made.<sup>1291</sup>

In general, under the supervision of the panel, the post-panel proceedings could be more controllable and predictable than the pre-panel stages. Nevertheless, the devil is in the detail. According to TCE theory, legal rules are incomplete and thus susceptible to opportunistic exploitation.<sup>1292</sup> Commentators have enumerated the most common types of obstructive behaviours during the post-panel process in international commercial arbitration:

- (1) Challenging the member(s) of the arbitral tribunal for insignificant reasons;
- (2) Changing lawyers before the expiry of a particular deadline so as to ask for an extension;
- (3) Asking for extensions on a regular basis;
- (4) Making file submissions late or presenting documents/witnesses at the very last moment;
- (5) Refusing to produce documents;<sup>1293</sup>

...

Given its embryonic stage of development, tax arbitration may be more vulnerable to procedural obstruction, although empirical information on this point is scant.

For ad hoc tax arbitration, the post-panel proceedings can be strengthened in two ways. The first is to develop more-detailed arbitral rules that can accommodate procedural contingencies as much as possible. Nevertheless,

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<sup>1291</sup> Margaret L. Moses (n 769) 157; Park (n 154) 821.

<sup>1292</sup> See above, Chapter 3, Section 3.2.1.

<sup>1293</sup> Tobias Zuberbühler, 'How to Overcome "Obstructive" Behaviour in International Arbitration'; Harris (n 781); Scott (n 802); Margaret L. Moses (n 769) 148.

given the presence of bounded rationality, absolute perfection of procedural rules is merely wishful thinking. Therefore, the second solution is also critical: to grant the arbitral panel broad discretion in determining procedural issues. For example, in any circumstances that are not anticipated by the existing rules of tax arbitration, the simplest way to address procedural contingencies is “to leave it to the arbitrators to develop these rules on an ad hoc basis”.<sup>1294</sup> In doing so, arbitrators may resort to their own experience or reasoning in managing the procedures; they may also refer to commercial arbitration rules, such as the United Nations Commission on International Trade Law (UNCITRAL) rules, which provide a full-fledged procedural framework for ad hoc commercial arbitration.<sup>1295</sup>

### **3.5 Potential concerns**

One might argue that maintaining party autonomy in tax arbitration preserves states’ sovereignty as much as possible. The flaw of the sovereignty argument has already been examined;<sup>1296</sup> it suffices here to point out that there is little merit for countries to embrace tax arbitration on the one hand, while on the other hand rejecting specified and predetermined arbitral rules. Another potential challenge is that the notion of robust tax arbitration seems to contradict the antilegalistic position characterising this thesis. However, strengthening arbitral procedure does not alter the supplementary role of tax arbitration and the central status of the MAP in the ITDR system. And obviously, an arbitration of a supplementary nature should not be equated as a procedure fraught with loopholes. Furthermore, party autonomy is still preserved to a substantial extent in tax arbitration with robust procedural rules. For example, in the case of panel establishment, the appointment of

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<sup>1294</sup> OECD Model Convention (2014) Sample Procedure, 408 (para.18).

<sup>1295</sup> *ibid*; see also Blanke (n 1270) 278.

<sup>1296</sup> See above, Chapter 1, Section 2.7.

co-arbitrators is still in the hands of the competent authorities in the first place. Those authorities can also agree on different rules on the panel establishment.<sup>1297</sup> Only when they encounter deadlock in the process would the default arbitral rules apply.

## **4. Decision modes of tax arbitration: conventional vs. final-offer approach**

### **4.1 Overview**

According to the way an arbitral panel reaches its decision, tax arbitration could be divided into two types: conventional and final-offer.<sup>1298</sup> Conventional arbitration, or independent-opinion arbitration, refers to an approach under which arbitrators make their own independent decisions based on the facts and arguments presented before them by the parties.<sup>1299</sup> The arbitrators normally need to specify the reasoning behind their decisions. Under the final-offer approach, also known as baseball arbitration, each competent authority presents the arbitral panel with a proposal for the resolution of the dispute and the panel is allowed to choose only between the two proposals.<sup>1300</sup> Usually, an arbitral decision under the baseball approach merely states a number, such as monetary amount or tax rate, without any additional information or comments from the panel.<sup>1301</sup> Obviously, the final-offer arbitration is far less legalistic than the conventional approach. The final-offer approach is the default mode in the Sample Procedure of the UN Model.<sup>1302</sup> The US treaty practice generally employs the final-offer approach

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<sup>1297</sup> OECD Model Convention (2014) Sample Procedure, 407 (para.14).

<sup>1298</sup> Kollmann and Turcan (n 58) 33.

<sup>1299</sup> *ibid.*

<sup>1300</sup> *ibid.*

<sup>1301</sup> Petruzzi, Koch and Turcan (n 190) 155.

<sup>1302</sup> UN Model Convention(2011) Sample Procedure, 426 (para.12).

as the exclusive means of arbitration.<sup>1303</sup> By contrast, the conventional approach is the exclusive mode of arbitration in the EU Arbitration Convention, and the preferred mode in the OECD Model Convention (pre-2017 version).<sup>1304</sup>

As its name indicates, conventional arbitration represents the most common form of arbitration. The following analysis will be focused on the final-offer approach.

## **4.2 Advantages and theoretical implications of the final-offer approach**

As its name suggests, baseball arbitration was originally developed as a means of resolving salary disputes between US Major League Baseball (MLB) players and their clubs.<sup>1305</sup> Like many other sport leagues in the country, the US baseball leagues use a long-established reserve system as part of their employment practice.<sup>1306</sup> Under the system, a player who signs a contract with a baseball team is bound to play for that team for a certain number of years (usually six).<sup>1307</sup> However, after three years of service to the current employer, the player is eligible to invoke salary renegotiation with the employer.<sup>1308</sup> The use of final-offer arbitration in salary negotiation has an important function: to promote good-faith negotiation and pre-hearing settlement.<sup>1309</sup> Specifically, when an arbitrator is limited to a choice between two final offers, each party may realise that if their final offer is too extreme, an arbitrator will choose the final offer of the opposing party.<sup>1310</sup>

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<sup>1303</sup> US Model Convention (2016) Art. 25 (9); see also Brown (n 11) 107–108.

<sup>1304</sup> See above, Chapter 1, Sections 1.4, 1.5.

<sup>1305</sup> Petruzzi, Koch and Turcan (n 190) 140.

<sup>1306</sup> Benjamin A Tulis, 'Final-Offer Baseball Arbitration: Contexts, Mechanics & Applications' (2010) 20 *Seton Hall J. Sports & Ent. L.* 85, 90–91; Jonathan B Goldberg, 'Player Mobility in Professional Sports: From the Reserve System to Free Agency' (2008) 15 *Sports Law. J.* 21, 22–24.

<sup>1307</sup> Tulis (n 1306) 90–91; Goldberg (n 1306) 22–24.

<sup>1308</sup> Tulis (n 1306) 90–91.

<sup>1309</sup> *ibid* 89.

<sup>1310</sup> *ibid*.

Consequently, it is to the strategic advantage of each party to maintain a position that is closer to the middle.<sup>1311</sup> This middle-ground approach enhances the likelihood of settlement prior to an arbitration hearing.<sup>1312</sup> In contrast, arbitrators in conventional arbitration are often perceived to have an inclination to “split the difference” between each party’s position.<sup>1313</sup> It follows that the parties may have a greater incentive to take extreme positions so that the arbitral “compromise” will be skewed in their favour.<sup>1314</sup> Pre-hearing settlement avoids arbitral proceedings, which are usually lengthy and adversarial.<sup>1315</sup> In particular, parties avoid the embarrassing moment when, in an arbitration proceeding, a team management questions a player’s value to the club.<sup>1316</sup> To summarise, final-offer arbitration is instrumental for parties to maintain a congenial relationship. This is quite important because under the reserve system in baseball, a player would still remain with the team after the salary arbitration.<sup>1317</sup> Therefore, the adoption of the final-offer approach in the MLB salary arbitration constitutes a good example of how relational contracts can benefit from a flexible and collaborative governance structure.

Going further, this relational employment contract between baseball players and the MLB is related to the notion of asset specificity.<sup>1318</sup> On the surface, the reserve system seems to unduly restrict the freedom of baseball athletes, and occasionally the reserve practice did result in players bringing lawsuits against the system.<sup>1319</sup> Nonetheless, the system survived judicial scrutiny, and the major argument relied on by the court is related to transaction-specific investment. The players, argued the court, must be so unique and extraordinary that the breach of contract would result in

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<sup>1311</sup> *ibid.*

<sup>1312</sup> *ibid.*

<sup>1313</sup> *ibid* 88.

<sup>1314</sup> *ibid.*

<sup>1315</sup> *ibid* 89.

<sup>1316</sup> *ibid* 92.

<sup>1317</sup> *ibid* 90–91.

<sup>1318</sup> *ibid*; Goldberg (n 1306) 22–24.

<sup>1319</sup> Goldberg (n 1306) 26–30.

irreparable harm to the team.<sup>1320</sup> Indeed, not only does a team deploy specialised investment in their players, the players also invest team-specific human assets through special training and adaptive learning. Therefore, there is a mutual dependency developed between a team and its players.

Commentators observe that the use of final-offer arbitration is largely confined to sport leagues salary arbitration and public employment interest arbitration, both of which involve employment contracts.<sup>1321</sup> Literature on international dispute settlement, particularly international commercial and investment arbitration and the WTO panel procedure, indicates very scant use of this approach. In this sense, the use of final-offer approach constitutes a distinctive feature of tax arbitration. This indicates some similarity between international tax relationships and the MLB employment relationships, both of which assume an ongoing and relational character. As established previously, the ongoing nature of international tax relationships also arise from the high degree of asset specificity embodied in the relationships.<sup>1322</sup>

While studies on employment salary arbitration emphasise the merit of the final-offer approach in promoting good-faith negotiation and pre-hearing settlement, it should be noted that even if the pre-trial negotiation breaks down and the prospect of arbitration becomes unavoidable, the parties would still benefit from the final-offer approach over the conventional approach. Specifically, given that the authority of a panel in final-offer arbitration is limited to one of the two resolutions submitted by the parties, the final-offer approach not only saves arbitrators the burden of drafting a well-reasoned decision, but also entails less-extensive fact finding and legal reasoning than conventional arbitration.<sup>1323</sup> For example, a face-to-face hearing will typically

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<sup>1320</sup> *ibid* 26.

<sup>1321</sup> Tulis (n 1306) 95–100.

<sup>1322</sup> See above, Chapter 3, Section 3.

<sup>1323</sup> Petruzzi, Koch and Turcan (n 190) 156; Brown (n 11) 108.

be unnecessary and the arbitrators will be able to liaise between themselves and with the parties by telephone or video conference.<sup>1324</sup> The result is increased expediency and cost-efficiency for the final-offer approach relative to the conventional mode

Some commentators argue that the final-offer approach entertains sovereignty concerns.<sup>1325</sup> Since the panel under the final-offer approach has to adhere to the view of one of the Contracting States instead of developing its own opinion, this approach gives Contracting states more control over the dispute resolution process.<sup>1326</sup> To some extent, the UN Model's emphasis on the final-offer approach as the generally applicable process reflects the sovereignty concerns, as the UN Model is more favourable for developing countries, and developing countries are presumably more sensitive to their sovereignty interests.<sup>1327</sup> Without prejudice to the previous critique of the sovereignty notion, this author argues that even if the sovereignty concerns are justified, the effect of the final-offer approach on sovereignty interests is not straightforward. If a panel in final-offer arbitration selects the proposal of one state, it seems as if the sovereignty interest of the other state is dismissed entirely. In contrast, given that arbitrators in conventional arbitration tend to split the difference between the parties, the perception would be that the sovereignty interests of both countries have been accommodated. More importantly, as will be argued below (Section 4.3.2), the final-offer approach requires parties to possess a certain degree of sophistication. Since tax administrations of developing countries are more likely to suffer from shortages of expertise and resources, the final-offer approach may in fact pose a greater challenge to their sovereignty interests.

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<sup>1324</sup> OECD Model Convention(2017) Sample Procedure, 480 (para.23).

<sup>1325</sup> Zeyen (n 192) 725; Petruzzi, Koch and Turcan (n 190) 144.

<sup>1326</sup> *ibid.*

<sup>1327</sup> For developing countries' concern about sovereignty interest, see above, Chapter 1, Section 2.7.

### 4.3 Potential concerns about the final-offer approach

Several concerns about the final-offer approach have been raised in the literature on tax arbitration. They are centred upon two major issues: unreasoned decisions made by the panels and unreasonable offers submitted by the competent authorities.

#### 4.3.1 Unreasoned decisions

As discussed above (Section 4.1), a panel of final-offer arbitration usually does not state the reasoning for the decision. As a result, such decisions are perceived to have little value in guiding the resolution of future cases as well as in preventing similar disputes in future.<sup>1328</sup> In contrast, reasoned decisions under the conventional approach seem more instrumental in the development of a coherent body of jurisprudence on international tax law, although such case laws may not have any precedential value. A related concern is about the legitimacy of final-offer arbitration. It is argued that the explanation of the reasons behind a decision may increase acceptance of the result, and an opaque decision without reasoning may lead to doubts about the panel's competence and impartiality.<sup>1329</sup>

Accordingly, a compromise solution has been proposed in the orthodox literature of tax arbitration: recognising the utility of both final-offer and conventional arbitration, and using whichever better suits the type of tax dispute.<sup>1330</sup> This is also the approach adopted by the Sample Procedure in the OECD Model (pre-2014 version), which recommends the conventional approach as the default mode and the final-offer approach for those disputes in which the unresolved issues will be primarily factual and/or numerical.<sup>1331</sup>

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<sup>1328</sup> Sven-Olof Lodin, 'The Arbitration Convention in Practice: Experiences of Participation as an Independent Member of Arbitration (Advisory) Commissions' (2014) 42 *Intertax* 173, 175.

<sup>1329</sup> Petruzzi, Koch and Turcan (n 190) 156; Falcao (n 195) 478.

<sup>1330</sup> Petruzzi, Koch and Turcan (n 190) 155.

<sup>1331</sup> OECD Model Convention (2014) Sample procedure, 406 (para.13).

Such issues “will often arise in transfer pricing cases, where the unresolved issue may be simply the determination of an arm’s length transfer price or range of prices”.<sup>1332</sup>

Nonetheless, based on the theoretical reflections in Part I , this author contends the validity of the above concerns. Specifically, as explained previously, the non-substantive nature of tax treaties and the separate-entity approach to the taxation of MNEs significantly compromise the value of the legalistic method characterising conventional arbitration.<sup>1333</sup> Adjudicators may frequently be situated in a difficult situation: if they split the difference of the parties’ positions, the arbitral decisions will be perceived to lack any elements of the rule of law; if they strictly adhere to legal principles, the decisions are quite likely to encounter political backlash from the losing party. By the same token, the strength of conventional arbitration in guiding the resolution of future disputes and thus fostering greater legal certainty is questionable.<sup>1334</sup> In contrast, the final-offer approach avoids the cumbersome and troublesome task of judging domestic tax laws and/or establishing arm’s-length prices. It is true that an opaque decision without reasoning does not represent a perfect solution. Nevertheless, since the final-offer approach exerts “a centripetal force on the parties to move toward a middle ground”,<sup>1335</sup> the potential harm of this approach is somewhat constrained as opposed to the conventional approach, in which parties tend to polarise their position.

Therefore, final-offer arbitration provides a conducive mechanism for both transfer pricing and non-transfer pricing cases. A possible challenge would be that this approach was originally developed to solve monetary disputes, while non-transfer pricing cases usually involve legal interpretation or

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<sup>1332</sup> *ibid.*

<sup>1333</sup> See above, Chapter 3, Section 3.4.

<sup>1334</sup> see Brown (n 11) 106.

<sup>1335</sup> Tulis (n 1306) 100.

classification.<sup>1336</sup> For example, the core issue of the Boulez case is about the correct categorisation of the activity undertaken by Boulez – whether it is provision of service or a license of royalties.<sup>1337</sup> The reply to this challenge is simple: all such legal issues in tax cases can be ultimately translated into monetary disputes. In the end, the taxpayer in the Boulez case cares about the exact amount of revenue he should pay, for whatever reason and to whichever jurisdiction.

#### **4.3.2 Unreasonable offers by the competent authorities**

Another concern about final-offer arbitration is that parties may misunderstand this “non-mainstream” mechanism.<sup>1338</sup> For example, if the parties in a final-offer arbitral proceeding are unable to understand that the panel is to choose the more reasonable offer, they may see the opponent’s more reasonable offer as a concession, and may therefore polarise their positions much as they might in the conventional approach.<sup>1339</sup> This author rather doubts the weight of this concern. Non-mainstream as it may be, final-offer arbitration is not so complicated to understand. Some explanation and training for competent authorities can easily dispel the mysteries about the approach.

However, the final-offer approach does require sophisticated parties to handle the procedure. Specifically, since a panel may only choose one of the final offers, the parties’ preparation of such final offers and the supporting arguments plays a critical role in determining the outcome of the dispute resolution. Basically, parties must walk a tightrope between their interests of revenue maximisation, on the one hand, and the reasonableness of their offers, on the other. They also need to craft their position paper and the

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<sup>1336</sup> Petruzzi, Koch and Turcan (n 190) 155.

<sup>1337</sup> *Boulez*, 83 TC (1984) (n 688) 584.

<sup>1338</sup> Tulis (n 1306) 106; Petruzzi, Koch and Turcan (n 190) 156.

<sup>1339</sup> Tulis (n 1306) 106.

supporting documents such that the panel can be convinced as strongly as possible. In contrast, under conventional arbitration, arbitrators must lay out their own reasoning in the decision.<sup>1340</sup> In this way, at least part of the burden of legal arguments has been shifted from competent authorities to arbitrators.<sup>1341</sup> Arguably, one of the reasons that parties in conventional arbitration are more inclined to polarise their position is because they are aware that under this approach the panel is less dependent on the arguments they put forth.<sup>1342</sup> Therefore, it is reasonable to infer that many competent authorities, particularly those from developing countries, may need quite a while to get used to and become more confident about final-offer arbitration.<sup>1343</sup>

#### **4.4 Summary**

From the benefit perspective, final-offer arbitration is congruent with the MAP-based ITDR system, which, in turn, facilitates the ongoing international tax relationships. On the cost-side of the equation, this approach implies lower procedural costs than the conventional model. There are several concerns about final-offer arbitration, yet many of them are overstated. This author particularly argues that the type of tax dispute does not significantly affect the applicability of this approach, which can cover both transfer pricing and non-transfer pricing cases. That being said, this author realises that for tax administrations with low capacity, final-offer arbitration does imply some risks. Therefore, this author generally favours a wider application of this approach, but also submits that competent authorities should be allowed to choose a different approach. In particular, if the two competent authorities are unable to agree on an arbitration mode for a particular case, the conventional

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<sup>1340</sup> Petruzzi, Koch and Turcan (n 190) 155.

<sup>1341</sup> *ibid.*

<sup>1342</sup> *ibid.*

<sup>1343</sup> Jérôme Monsenego, 'Designing Arbitration Provisions in Tax Treaties: Reflections Based on the US Experience' (2014) 42 *Intertax* 163, 165.

approach should apply.

It should be noted that despite the merits of final-offer arbitration, this approach does have a technical limitation that has been overlooked by most commentators: it is only suitable for bilateral disputes, because it necessitates a pair of binary offers, so that the panel's selection of one party's offer also delineates the disputed tax base for both parties. By contrast, in a multilateral case, each of the competent authorities can only propose its own share of the tax base, and the choice of any single offer cannot settle the share of the remaining parties.

## **5. Trial method: oral hearings vs. documentary trials**

### **5.1 Oral hearings as the default mode of arbitral trial**

Typically, a full arbitral proceeding features an oral hearing that includes, *inter alia*, opening statements, oral testimony, and legal arguments.<sup>1344</sup> The process certainly incurs substantial transaction costs. As the International Chamber of Commerce (ICC) confirms in a Guide, oral hearings are typically one of the most expensive and time-consuming phases of the arbitral process.<sup>1345</sup> The following are the most common costs of oral hearings that has been identified by the ICC:<sup>1346</sup>

- (1) The cost of the extensive preparation that a hearing usually necessitates.
- (2) The expenses of physically bringing numerous people (parties, legal counsel, witnesses) together and hiring the facilities for the hearing.
- (3) The difficulty of scheduling a commonly convenient time for all relevant

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<sup>1344</sup> Margaret L. Moses (n 769) 157.

<sup>1345</sup> ICC, 'Effective Management of Arbitration – A Guide for In-House Counsel and Other Party Representatives' (n 813) 52.

<sup>1346</sup> *ibid* 52, 57.

participants.

(4) The fees for interpreters in cases where participants use different languages.

The ICC's list is not conclusive. For example, the issue of multiple languages also raises equity problems for oral hearings in international commercial arbitration, in which English is the most common language. Specifically, the arbitration system will favour those counsellors and arbitrators who are from English-speaking jurisdictions.<sup>1347</sup> Moreover, oral hearings may increase party confrontation and advocacy so that parties become more dependent on the expertise of sophisticated legal counsel. In this way, an arbitral procedure can become prohibitively expensive.

Accordingly, international arbitrations are increasingly relying on standardised procedures such as one or more rounds of pre- and post-hearing memorials.<sup>1348</sup> Even for those arbitrations centred in common law systems, which have a stronger tradition of oral advocacy, oral hearings play a more limited role than common-law court proceedings. Certain constraints apply to arbitral hearings, such as shorter evidentiary examination (and cross-examination) and greater reliance on written materials.<sup>1349</sup> One practitioner observes that, even for those arbitral proceedings that feature oral hearings, "the limited time available for opening submission was best spent giving the tribunal a road map as to where important documents can be found in the exhibit binders submitted by each side".<sup>1350</sup>

That being said, oral hearings have advantages. Among others, they are often considered an effective means to assess evidence.<sup>1351</sup> In particular,

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<sup>1347</sup> Willim G Horton, 'Oral Advocacy in International Arbitration' [2012] Lawyers Weekly, 1 <<http://wgharb.com/wp-content/uploads/oral-advocacy-in-international-arbitration.pdf>>.

<sup>1348</sup> *ibid* 2.

<sup>1349</sup> *ibid*.

<sup>1350</sup> *ibid* 1.

<sup>1351</sup> ICC, 'Effective Management of Arbitration – A Guide for In-House Counsel and Other Party

while legal argument may take both oral and written forms, the questioning of witnesses is mostly an oral skill.<sup>1352</sup> Indeed, in the context of international commercial arbitration, which is under a mounting pressure to reduce the length of hearings as much as possible, the primary function of an arbitral hearing has become the cross-examination of witnesses.<sup>1353</sup>

## 5.2 Documentary methods in tax arbitration

Given the cost-benefit analysis of oral hearings, the pros and cons of the documentary method in arbitral trials become clear as well: it significantly saves transaction costs for parties, albeit at the expense of thorough fact finding. However, in the context of tax arbitration, the cost-advantage of the documentary method outweighs its evidentiary disadvantage, primarily because the built-in manner of tax arbitration reduces the need for a thorough fact-finding in the arbitral proceedings. First, pursuant to Article 25 (5) of the OECD Model Convention, only disputed issues that are unresolved in the preceding MAP phase will be referred to arbitration.<sup>1354</sup> This narrows the scope of tax disputes that need to be dealt with in an arbitral proceeding.<sup>1355</sup> Second, since the major function of tax arbitration is to facilitate MAP negotiations, the deliberation of an arbitral panel should be principally based on the facts and evidence that have already been presented by the parties in the MAP phase.<sup>1356</sup> Indeed, the evidentiary rules of tax arbitration should be designed in such a way that competent authorities are generally precluded from strategically hiding key evidence in the MAP process and using them to their own advantage during arbitration.<sup>1357</sup> Third, even in a MAP process, it

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Representatives' (n 813) 51.

<sup>1352</sup> David JA Cairns, 'Oral Advocacy and Time Control in International Arbitration' (2005) 801 *International and Comparative Law Quarterly* 1, 3.

<sup>1353</sup> Michael Kerr, 'Concord and Conflict in International Arbitration' (1997) 13 *Arbitration International* 121, 125–6; see also Cairns (n 1352) 3.

<sup>1354</sup> OECD Model Convention (2014) Article 25 (5).

<sup>1355</sup> Cai (n 327) 452.

<sup>1356</sup> OECD Model Convention (2014) Sample Procedure, 408-409 (para.18); Cai (n 327) 452.

<sup>1357</sup> Cai (n 327) 452; see also Brown (n 11) 108.

would be very unusual for competent authorities to deal with evidentiary disputes, since the MAP negotiation is usually based on a set of facts that are commonly agreed upon by the parties.<sup>1358</sup> Consider a case in which a taxpayer challenges the procedural legitimacy, and thus the evidentiary value, of a tax audit conducted by a tax administration. The appropriate forum for the resolution of such dispute should be domestic procedures such as litigation or administrative appeal mechanisms in the state of that tax administration. It would be quite unrealistic and somewhat odd for the competent authority of another Contracting State to judge whether or not the aforementioned tax administration has satisfied a due-process requirement in carrying out its tax audit.<sup>1359</sup>

### **5.3 US tax treaty practice**

Almost all US tax treaties that contain arbitration provisions adopt the documentary method for arbitral proceedings.<sup>1360</sup> For instance, the US-Canada Competent Authority Memorandum of Understanding (MoU) provides that all communications, except for logistical matters, between the competent authorities and the board of arbitrators must be in writing.<sup>1361</sup> Generally, the board is not allowed to require new evidence from the competent authorities beyond the documents produced on the basis of the MAP phase that precedes the arbitral procedure.<sup>1362</sup>

It is true that most of the US tax treaties adopt final-offer arbitration, which is less demanding on fact finding and legal reasoning. Nevertheless, the documentary method is not intrinsic to the final-offer approach. Indeed, the MLB baseball arbitration, which is the origin of final-offer arbitration, contains

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<sup>1358</sup> Cai (n 327) 452.

<sup>1359</sup> *ibid.*

<sup>1360</sup> Rosenbloom (n 1253) 165.

<sup>1361</sup> Canada - US Competent Authority MoU 2010 Art.14.

<sup>1362</sup> *ibid* Art.10; see also Brown (n 11) 108.

a simplified oral hearing procedure, where the parties can make an oral presentation to the panel.<sup>1363</sup> Rather, in this author's view, the documentary method in the US-Canada MoU, particularly with respect to the limitation on the source of evidence, is more connected with the built-in character of tax arbitration.

## **6. Tax mediation: from ivory tower to the real world**

### **6.1 Overview**

As discussed previously, despite the benefits of mediation in ITDR, the mechanism has never been used.<sup>1364</sup> The reason for this underuse has already been discussed: while mediation implies higher administrative costs than the MAP, it cannot guarantee a final result of dispute settlement.<sup>1365</sup> In particular, considering that competent authorities under the traditional MAP process have no obligation to achieve a final settlement, they have insufficient incentives to invest extra resources on mediation with no assurance of finality. Based on the TC framework developed in Part I of this thesis, two ways to increase the use of tax mediation can be envisaged.

### **6.2 Mediation in the shadow of arbitration**

As mentioned previously, the incorporation of an arbitration clause into MAP provisions has the effect of spurring a higher level of diligence and goodwill from the competent authorities in conducting MAP cases.<sup>1366</sup> If the competent authorities encounter a bargaining impasse and the prospect of arbitration looms large, they would have a greater incentive to seek assistance from an impartial and sophisticated mediator.

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<sup>1363</sup> Petruzzi, Koch and Turcan (n 190) 140.

<sup>1364</sup> See above, Chapter 1, Section 1.8.

<sup>1365</sup> See above, Chapter 3, Section 4.5.

<sup>1366</sup> See above, Chapter 3, Section 4.2.2.

A typical mode of tax mediation in the shadow of arbitration can be seen in the institutional ITDR framework proposed by Owens et al.<sup>1367</sup> Under the framework, if the competent authorities are unable to achieve an agreement within 20 months from the initiation of the MAP, they shall, unless they otherwise agree, submit the unresolved issues to a third party for mediation. If the mediation is still unable to resolve the case, the remaining issues would be submitted to an arbitration procedure.<sup>1368</sup>

### 6.3 Package mediation

The method of package mediation is associated with the package deal of the MAP, as discussed previously.<sup>1369</sup> On various occasions, competent authorities undertaking a package negotiation may find it difficult to achieve a deal on their own, perhaps because the package covers too many cases or issues, thereby complicating the negotiation. In this case, the involvement of a mediator can facilitate the negotiation significantly. Competent authorities can also submit a batch of cases to mediation in the first place. Similar to package negotiation, mediation in a package manner produces economies of scale, and thus becomes more affordable than the case-by-case method of dispute resolution.<sup>1370</sup> In particular, the extra costs associated with the involvement of a third-party mediator can be diluted across multiple cases.<sup>1371</sup> Furthermore, a mediator in package mediation is equipped with more tools to create a problem-solving climate or a win-win prospect for the competent authorities.<sup>1372</sup> As the MEMAP notes, the mediator's ability to disengage parties from the classic zero-sum game and shift the focus to a more collegial and collaborative approach to dispute resolution will help the competent

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<sup>1367</sup> See above, Chapter 1, Section 2.5.3.

<sup>1368</sup> Owens, Gildemeister and Turcan (n 193) 1003–1004.

<sup>1369</sup> See above, Chapter 5, Sections 2.2.1, 3.2.

<sup>1370</sup> Cai (n 794) 750.

<sup>1371</sup> *ibid.*

<sup>1372</sup> *ibid.*

authorities reach a satisfactory result.<sup>1373</sup> Arguably, this ability could be significantly compromised if the mediator's authority were to be strictly confined to a particular dispute at hand. The notion of package mediation echoes Dalton's interview, which suggested that tax mediation is underused partly because case-by-case mediation cannot satisfy the broader perspective taken by competent authorities in handling MAP cases.<sup>1374</sup>

## **7. Evaluation of Part VI of the MLI**

### **7.1 Overview**

Part VI of the MLI contains the mechanism of tax arbitration. Each state has the option to apply this part with respect to their tax treaties, and the new rules would act to modify a tax treaty only if both parties so opt.<sup>1375</sup> As of October 2019, 30 jurisdictions have chosen to implement Part VI in their tax treaties.<sup>1376</sup>

### **7.2 Key aspects of Part VI**

#### **7.2.1 Initiation of arbitral procedure**

Pursuant to Article 19 of the MLI, while the usual two-year time limit regarding the initiation of arbitration still applies in principle, it is subject to several exceptions. First, prior to the expiration of that period, the competent authorities may agree to a different time period for the case, subject to

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<sup>1373</sup> OECD, 'MEMAP' (n 1) 29 (Section 3.5.2).

<sup>1374</sup> See above, Chapter 1, Section 2.4.

<sup>1375</sup> Art. 18 of the Part VI of MLI, , see also Sriram Govind and Laura Turcan, 'The Changing Contours of Dispute Resolution in the International Tax World: Comparing the OECD Multilateral Instrument and the Proposed EU Arbitration Directive' (2017) 71 Bulletin for International Taxation 2–3.

<sup>1376</sup> Andora, Australia, Austria, Barbados, Belgium, Canada, Curacao, Denmark, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, The Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK; 'MLI Matching Database (Beta) - OECD' <<https://www.oecd.org/tax/treaties/mli-matching-database.htm>> accessed 17 October 2019; see also Govind (n 132) 315.

notifying the taxpayer concerned (henceforth referred to as discretionary extension).<sup>1377</sup> Second, the period can be extended either on the grounds that the same issue is pending before a court or administrative tribunal (extension for procedural conflict), or that the taxpayer concerned has failed to provide in a timely manner any additional information requested by the competent authorities (extension for insufficient information).<sup>1378</sup> Third, the Contracting States may replace the two-year time limit with a three-year period, which is in line with Article 25 (5) of the UN Model (legislative extension).<sup>1379</sup>

### **7.2.2 Appointment of arbitrators**

The procedure of appointing arbitrators generally follows the pattern in the OECD Sample Procedure of the pre-2017 OECD Model, yet with substantial improvements. An arbitral panel consists of three individual members with expertise and experience in international tax matters.<sup>1380</sup> Each competent authority should appoint one panel member within 60 days of the date of the arbitration request, and the co-arbitrators so appointed should then appoint a Chair within 60 days of their appointments.<sup>1381</sup> Under the OECD Sample Procedure (2014), the time period for the appointment of co-arbitrators is three months after the Terms of Reference have been received by the taxpayer concerned, or, if the competent authorities fail to communicate the Terms of Reference to the taxpayer, four months after the request for arbitration.<sup>1382</sup> Therefore, the timetable for the appointment of arbitrators under the MLI is tighter than that of the OECD Sample Procedure.

Similar to the rule of the Sample Procedure, if any of the above appointments

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<sup>1377</sup> MLI, Art. 19 (1).

<sup>1378</sup> *ibid.*, Art. 19 (2) (3).

<sup>1379</sup> *ibid.*, Art. 19 (11).

<sup>1380</sup> *ibid.*, Art. 20 (2).

<sup>1381</sup> *ibid.*

<sup>1382</sup> OECD Model Convention (2014) Sample Procedure, 399-400.

has not been made within the given period, the outstanding appointment will be made by the highest-ranking official of the CTPA under the OECD.<sup>1383</sup> Part VI of the MLI further provides rules on the impartiality and independence of arbitrators.<sup>1384</sup>

### 7.2.3 Arbitration modes

As is the case in the UN Sample Procedure, Article 23 of the MLI provides the final-offer arbitration as the generally applicable arbitration process, although the competent authorities can also opt for the conventional approach. This is the most significant deviation from the OECD Sample Procedure that has been made in Part VI of the MLI. Article 23 further provides some basic procedural rules for each of the two arbitration modes.<sup>1385</sup> Under the final-offer approach, each competent authority submits to the arbitration panel a proposed resolution and a supporting position paper.<sup>1386</sup> The proposed resolution is typically a disposition of specific monetary amounts (e.g. of income or expense), or the maximum rate of tax charged.<sup>1387</sup> Nevertheless, in a case involving threshold questions such as residency status of a taxpayer at issue, or the existence of a PE, the proposed solutions can also be the determination of such questions.<sup>1388</sup> Each competent authority may also submit to the panel a reply submission as a rebuttal to the other side's position.<sup>1389</sup> The arbitration panel is to select as its decision one of the above proposed resolutions.<sup>1390</sup>

If the parties opt for the conventional approach, all the information previously available to the competent authorities should be provided to the panel without

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<sup>1383</sup> MLI, Art. 20 (3).

<sup>1384</sup> *ibid*, Art. 20 (2).

<sup>1385</sup> *ibid*, Art. 23.

<sup>1386</sup> *ibid*, Art. 23 (1)

<sup>1387</sup> *ibid*

<sup>1388</sup> *ibid*

<sup>1389</sup> *ibid*

<sup>1390</sup> *ibid*

delay.<sup>1391</sup> New information is principally not allowed unless otherwise agreed by the competent authorities.<sup>1392</sup> The panel would decide the case based on the tax treaty, domestic law and other sources identified by the competent authorities via agreement.<sup>1393</sup> The decision is to be supported by reasoning, yet does not have any precedential value.<sup>1394</sup>

#### **7.2.4 Implementation of arbitration decisions**

An arbitration decision is to be implemented through mutual agreement by the competent authorities.<sup>1395</sup> Such decisions are generally binding, except where (a) the taxpayer concerned does not accept the decision; (b) the court of either Contracting State rules that the decision is invalid; or (c) the taxpayer litigates the issue in question before any court or administrative tribunal.<sup>1396</sup> Article 24 (2) further stipulates that the arbitration decision will not be binding if the competent authorities agree on a different resolution of all unresolved issues within three months after the issuance of the decision.

#### **7.2.5 Costs**

The allocation of arbitration costs is to be settled through mutual agreement.<sup>1397</sup> If no such agreement is achieved, each party should bear its own expenses and those of its appointed panel members. Other expenses, including the cost of the Chair, will be borne by the parties in equal shares.<sup>1398</sup>

### **7.3 Comments**

For many commentators, the tax arbitration rules under the MLI represent a

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<sup>1391</sup> *ibid* Art. 23 (2)

<sup>1392</sup> *ibid*, see also Govind (n 132) 318.

<sup>1393</sup> MLI, Art. 23 (2)

<sup>1394</sup> *ibid*

<sup>1395</sup> *ibid* Art. 19 (4).

<sup>1396</sup> *ibid*.

<sup>1397</sup> *ibid* Art. 25.

<sup>1398</sup> *ibid*.

“half-way house” approach, having left much room for further improvement.<sup>1399</sup> In particular, the adoption of final-offer arbitration as the default mode is regarded as a compromise under the pressure of sovereignty concerns.<sup>1400</sup> However, this author takes the view that in principle, the new rules are in line with the MAP-based ITDR system. Specifically, the extended time limits regarding the initiation of an arbitral procedure reflects the policymakers’ intention to encourage the resolution of tax disputes within the MAP phase before such cases are eligible for arbitration. The use of final-offer arbitration as the default mode and competent authorities’ ability to agree on a resolution that differs from an arbitral decision highlight the role of tax arbitration in supplementing and facilitating MAP negotiation. With respect to conventional arbitration, the rules restricting the panels’ authority in requesting new information from the competent authorities are in line with the above notion of synergizing the MAP and the arbitration phase (Sections 2.2.4, 5.2).

Meanwhile, the MLI provides more-detailed rules on the arbitration procedure, thereby increasing the procedural robustness of the mechanism.<sup>1401</sup> It is true that the OECD Sample Procedure (pre-2017 version) also contained relatively detailed arbitration rules. However, the Sample Procedure is, after all, merely a sample lack of any binding effect. Therefore, through the adoption of Part VI of the MLI, operational rules of tax arbitration have been imported into the text of affected tax treaties, most of which were originally stipulated in a very general manner without further guidelines on how to operate the procedure.<sup>1402</sup>

Nonetheless, the new rules under the MLI are far from perfect. First, the rules

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<sup>1399</sup> Zeyen (n 192) 727–728; Govind (n 132) 321–322; Govind and Turcan (n 1375) 4.

<sup>1400</sup> Zeyen (n 192) 727–728.

<sup>1401</sup> Govind (n 132) 321; Govind and Turcan (n 1375) 3.

<sup>1402</sup> Govind (n 132) 321.

for post-panel procedures, particularly with respect to conventional arbitration, are still very preliminary.<sup>1403</sup> This raises a concern that parties may engage in procedural obstruction during arbitral proceedings. One solution is, as discussed above (Section 3.4), to accord more discretion to the arbitral panel in applying a wider range of procedural rules.

Second, procedural obstruction may also occur at the initiation of tax arbitration. In particular, the rule of discretionary extension may de facto nullify an arbitration clause in its entirety.<sup>1404</sup> Therefore, it seems advisable to subject this type of extension to the consent of the taxpayer concerned. For example, in a MAP case where there is every prospect of achieving an agreement yet the expiration of the two-year period is imminent, it is quite likely that the taxpayer may agree to an extension of the negotiation. As to the extension for insufficient information, Article 19 (10) states that the minimum information required is to be settled by the competent authorities through mutual agreement. Since this rule will also cause uncertainty for taxpayers, it is desirable for the OECD (or other relevant international organisations) to promulgate general rules for the information requirement during the MAP process. In principle, the required information should have substantial relevance to the resolution of a dispute. Moreover, the timing for requesting additional information should also be regulated. For example, any such requests should be made within a certain period of time from the admission of a MAP request to ensure that the taxpayer concerned will have sufficient time to reply, and that the competent authorities will not use such a request as a tactic to postpone the triggering of tax arbitration.<sup>1405</sup>

Third, the fact that an arbitration decision is subject to almost unlimited review

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<sup>1403</sup> *ibid* 320.

<sup>1404</sup> Govind and Turcan (n 1375) 3.

<sup>1405</sup> Art. 19(6) of the MLI provides that within three months after a competent authority receives a MAP request, the authority may request additional information from the taxpayer concerned. Nevertheless, this information request is associated with the admission of MAP access, rather than the post-admission stage of the MAP process.

by courts may open the door to unlimited disputes over the validity of arbitration decisions.<sup>1406</sup> First, the use of a final-offer approach and the attendant lack of reasoning in arbitral decisions may in itself constitute grounds for the domestic court to annul the decisions. Even under the conventional approach, it is easy for a domestic court of the jurisdiction that has lost in the arbitration to discredit the decision. This is because, as explained previously, the domestic court is justified to interpret the tax treaty at issue differently from the approach adopted by an international tribunal.<sup>1407</sup> On the other hand, considering the party-arbitrator relationship in the tax arbitration process, judicial review does constitute an effective means to address opportunism on the part of the arbitrators.<sup>1408</sup> Therefore, a balanced approach is to allow the judicial review of arbitration decisions, but on a very limited basis. Drawing on the New York Convention and the ICSID Convention, four possible grounds for nullifying a tax-arbitration decision can be envisaged:<sup>1409</sup>

(1) The tribunal was not properly constituted.

(2) The tribunal manifestly exceeded its powers. For example, an arbitrator conducted the procedure under the conventional arbitration mode although the parties had chosen the final-offer approach.

(3) There was corruption on the part of a member of the tribunal.

(4) There was a serious departure from a fundamental rule of procedure. For example, a party did not receive proper notice or the arbitrators prevented a party from being able to present its case.

In this way, the judicial review of a tax-arbitration decision is limited to the

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<sup>1406</sup> Govind and Turcan (n 1375) 3–4.

<sup>1407</sup> See above, Chapter 3, Section 3.4.2.1.

<sup>1408</sup> See above, Chapter 3, Section 4.2.2..

<sup>1409</sup> The New York Convention, Art. V (1); ICSID Convention Art.52 (1); Margaret L. Moses (n 769) 217, 236.

procedural and most fundamental aspects of the process, thereby ensuring the finality of an arbitration decision while at the same time reducing the agency problem of the arbitration process.

## **8. Some reflections on the cost analysis in Chapter 3**

In comparing the transaction costs of the MAP and that of tax arbitration in Chapter 3, this author mainly kept in mind a conventional mode of tax arbitration with full-fledged procedure.<sup>1410</sup> Accordingly, the analysis of this chapter may raise a potential concern that the final-offer approach, and the documentary method, of tax arbitration proposed above may weaken the analysis in Chapter 3. Specifically, one may argue that had these more efficient modes of arbitration been taken into account in Chapter 3, the cost analysis there may have led to different conclusions that could contradict the legalistic position characterising this thesis. The reply to this concern is twofold.

First and foremost, this chapter has demonstrated that the effectiveness of both the final-offer approach and the documentary method is conditioned upon the synergy between the MAP and arbitration. Therefore, these simplified versions of tax arbitration are indeed an integral part, rather than the antithesis, of an antilegalistic style of the ITDR system. In contrast, what becomes the target of this thesis are those proposals of stand-alone arbitration or more legalistic approaches. This explains why the cost analysis in Chapter 3 mainly concerns the conventional, full-fledged arbitration vis-à-vis the simplified versions.

Second, even assuming that the final-offer approach, and the documentary method, of tax arbitration can be operated on a stand-alone basis, the cost analysis in Chapter 3 still largely holds true. This is because compared with

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<sup>1410</sup> See above, Chapter 3, Section 3.4.

the MAP, even arbitration in its simpler version is still more formalised, let alone the extra costs associated with the establishment of an arbitral panel. Moreover, for countries with large inventories of tax disputes, the MAP may benefit from the method of package negotiation, particularly the conclusion of framework agreements, whereas arbitration, simplified though as it may be, is typically conducted on a case-by-case manner.

## Chapter 7. Institutional ITDR

### 1. Introduction

While Chapters 5 and 6 focus, respectively, on the improvement of the ITDR system within the paradigm of traditional MAP and third party procedures, this chapter will explore measures that can strengthen the entire ITDR system. To be sure, an apparent way to improve the system would be for national governments to augment their budgets for ITDR. As Terr et al. comment:

*Most would agree that more resources are needed now – in the form of increased numbers and quality of personnel and funding for training, operations, management, and the like – just to maintain existing levels of tax dispute resolution activity in the international tax area, let alone to undertake significant new ones such as...formulating and implementing procedures for expanded taxpayer participation in MAP and arbitration cases.*<sup>1411</sup>

However, for researchers adopting a law-and-economic approach, a budget increase should principally be the last option. This is because economics rest upon the assumption that resources are scarce and hence access to them is competitive, and the role of economists is to study how individuals optimise their choices in the face of resource constraints.<sup>1412</sup> Moreover, for researchers on tax systems, saving money for taxpayers (in a general sense) is always an overarching good. Lastly, for developing countries, particularly those of the least developed, budget constraints on national ITDR systems reflect the countries' overall incapacity.

Instead, this chapter focuses on a key elements that may affect the

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<sup>1411</sup> Terr and others (n 25) 441.

<sup>1412</sup> Robert. Cooter (n 306) 11–12.

cost-efficiency of the ITDR system: institutionalisation.

## 2. Transaction costs, firm theory, and institutionalisation

As demonstrated previously, TC theories are closely related to firm theory. First, classic TC theory started from Coase's seminal enquiry: why does a firm emerge at all in a specialised exchange economy? Coase argues that the firm economises transaction costs by reducing the number of voluntary exchanges that are otherwise necessary for collaborative production in the market.<sup>1413</sup> Second, in agency theory, the firm provides a mechanism whereby a central agent can monitor collaborative production to prevent the participants from shirking.<sup>1414</sup> Third, from the TCE perspective, the firm's role is to provide a governance structure for contracts with specialised investment and recurrent transactions so that opportunistic exploitation and competitive bargaining by parties on every occasion of contractual adaptation can be managed more effectively and efficiently.<sup>1415</sup> While different theories approach the phenomenon of the firm from slightly different perspectives, they share a commonality: the nature of the firm is to substitute a hierarchical structure for voluntary exchanges. By applying this hierarchical structure, which is characterised by the method of management order and entrepreneurial decision in allocating economic resources, the transaction costs associated with voluntary exchanges, including, *inter alia*, the costs of searching for the right parties, negotiating contracts, and monitoring contractual enforcement, can largely be saved.

In addition to the transaction-cost approach to firm theory, numerous theorists emphasise the knowledge aspect, or "core competence", of the firm.<sup>1416</sup> This

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<sup>1413</sup> See above, Chapter 2, Section 2.1.

<sup>1414</sup> See above, Chapter 2, Section 2.2.3.

<sup>1415</sup> See above, Chapter 2, Section 3.2.4.

<sup>1416</sup> Peter G Klein, 'New Institutional Economics' (Social Science Research Network 1998) SSRN Scholarly Paper ID 115811 17 <<https://papers.ssrn.com/abstract=115811>> accessed 30 January 2018;

latter approach regards the firm not as a nexus of contracts, but as a stock of knowledge or an accumulation of core competence.<sup>1417</sup> A well-known dictum under this approach is that “organizations know more than what their contracts can say”.<sup>1418</sup> It is this knowledge-based advantage that explains why some firms trump others in a competitive market.<sup>1419</sup> How, then, is this advantage generated within a firm? A common explanation is that the firm can supply some “higher-order organization principles” such as corporate culture or shared values.<sup>1420</sup> That being said, as some point out, the knowledge-based approach actually complements, rather than discredits, the hierarchy-based theory. The argument is that higher-order organisational principles, which help foster the firm’s knowledge stock and core competence, emerge exactly because the use of a hierarchical structure controls strategic behaviours of, or hostile bargaining among, parties in an organisation.<sup>1421</sup> Once such disruptive inclinations are tamed, a healthy and productive set of shared values or corporate culture would naturally grow within the organisation.<sup>1422</sup>

The firm theory, which emphasises the pivotal role of a hierarchy, can be further generalised as an organisational or institutional theory.<sup>1423</sup> This is because among various institutions, public or private, what matter are hierarchies.<sup>1424</sup> “Viewed against this background, state and private bureaucracies have a similar nature. They both serve as allocation

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See also Nicolai J Foss and Peter G Klein, *Organizing Entrepreneurial Judgment: A New Approach to the Firm* (Cambridge University Press 2012); Richard R Nelson, *An Evolutionary Theory of Economic Change* (Harvard University Press 2009); Edith Tilton Penrose, *The Theory of the Growth of the Firm* (Second edition., Basil Blackwell 1980).

<sup>1417</sup> Klein (n 1416) 17.

<sup>1418</sup> Nicolai J Foss, ‘Knowledge-Based Approaches to the Theory of the Firm: Some Critical Comments’ (1996) 7 *Organization science* 470, 471.

<sup>1419</sup> *ibid* 470.

<sup>1420</sup> Bruce Kogut and Udo Zander, ‘Knowledge of the Firm, Combinative Capabilities, and the Replication of Technology’ (1992) 3 *Organization science* 383; see also Foss (n 1418) 472.

<sup>1421</sup> Foss (n 1418) 473.

<sup>1422</sup> *ibid*.

<sup>1423</sup> Musole (n 383) 65.

<sup>1424</sup> *ibid*.

mechanisms that save on transaction costs.”<sup>1425</sup> Indeed, this institutional theory has exerted a far-reaching influence on IR theory, particularly the school of Liberal Institutionalism, which is frequently drawn upon in theoretical reflection on the topic of ITDR.<sup>1426</sup> Keohane, one of the founders of the school, compares international anarchy with the situation of market failure, whereby “economic activities uncoordinated by *hierarchical authority* lead to inefficient results”.<sup>1427</sup> To correct these defects, conscious institutional innovation is warranted, since international institutions, which are manifested in various international organisations, facilitate coordination among states by reducing transaction costs, i.e. costs associated with negotiation, monitoring, and enforcement of international agreements.<sup>1428</sup>

### **3. Institutional third-party procedures of ITDR**

In the context of dispute settlement, investigation and discussion of institutionalisation is mostly related to the dichotomy between ad hoc and institutional arbitration. Institutional arbitration mainly refers to arbitral proceedings that are administered by an established body or forum. This body or forum, also known as an arbitral institution, ordinarily provides disputing parties with secretarial support and other facilities such as a central place for hosting arbitral proceedings.<sup>1429</sup> In contrast, ad hoc arbitrations are those where the major aspects of arbitral procedures are determined by parties rather than by an arbitral institution.<sup>1430</sup> The choice between ad hoc and institutional approaches has been extensively discussed in the literature

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<sup>1425</sup> *ibid.*

<sup>1426</sup> Hasenclever (n 444) 4 (“Neoliberals have drawn heavily on economic theories of institutions focusing on information and transaction costs.”).

<sup>1427</sup> Robert O Keohane, ‘The Demand for International Regimes’ in Stephen D Krasner (ed), *International Regimes* (Cornell University Press 1983) 151. Emphasis added by this author.

<sup>1428</sup> Hasenclever (n 444) 37; Keohane (n 1427) 155–157.

<sup>1429</sup> Harry L Arkin, ‘International Ad Hoc Arbitration: A Practical Alternative’ (1987) 15 *Int’l Bus. Law.* 5, 5.

<sup>1430</sup> *ibid.*

on international commercial (and investment) arbitration and those debates provide useful insights to the discussion here.<sup>1431</sup> The following investigation will centre upon several major aspects of an arbitral procedure.

### 3.1 Selection of arbitrators

Institutional arbitration usually benefits from access to a database of arbitrators.<sup>1432</sup> Numerous arbitral institutes maintain rosters of highly qualified experts from various regions and backgrounds. This allows parties to select arbitrators with the necessary skill, experience, and expertise for the disputed cases.<sup>1433</sup> Several arbitral institutes provide extra mechanisms to ensure arbitrators' impartiality. For example, under the rule of the Arbitration Institute of the Stockholm and Chamber of Commerce (SCC), chosen arbitrators must submit a written statement confirming their impartiality and independence.<sup>1434</sup>

By contrast, parties in an ad hoc arbitration usually have to rely on their own resources and experience in appointing arbitrators.<sup>1435</sup> Given the underdevelopment of tax-arbitrator communities, parties in ad hoc tax arbitration may encounter more difficulties in searching for competent arbitrators. In the Electrolux case, such difficulty resulted in a significant delay in the establishment of the Advisory Commission.<sup>1436</sup>

### 3.2 Secretarial support

Tribunal secretaries handle administrative tasks such as communicating

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<sup>1431</sup> For representative studies, see Margaret L. Moses (n 769) 9–10; Edlira Aliaj, 'Dispute Resolution through Ad Hoc and Institutional Arbitration' (2016) 2 *Academic Journal of Business* 241; Arkin (n 1429); Sundra Rajoo, 'Institutional and Ad Hoc Arbitrations: Advantages and Disadvantages' [2010] *The Law Review* 12; Blanke (n 1270); 'Institutional vs. "ad Hoc" Arbitration' <<https://www.out-law.com/en/topics/projects--construction/international-arbitration/institutional-vs-ad-hoc-arbitration/>> accessed 19 April 2018.

<sup>1432</sup> Blanke (n 1270) 279.

<sup>1433</sup> 'Institutional vs. "ad Hoc" Arbitration' (n 1431); Ault and Majdanska (n 193) 270.

<sup>1434</sup> Ault and Majdanska (n 193) 236.

<sup>1435</sup> Blanke (n 1270) 279.

<sup>1436</sup> See above, Chapter 3, Section 5.4.2.

procedural issues or coordinating logistical matters. Occasionally, they also undertake more-advanced, albeit more-contentious, duties including, *inter alia*, conducting legal research, attending panel deliberations, and drafting procedural orders.<sup>1437</sup> The involvement of a secretary enhances the efficiency of an arbitration proceeding, allows the panel to focus on deliberating the merits of the case, and enables the tribunal to render an award more quickly.<sup>1438</sup> Most arbitral institutes host a team of sophisticated staff that can routinely provide secretarial support for various arbitral proceedings. A number of arbitral institutes further codify their practice of appointing tribunal secretaries into rules, guidelines, or notes, such as the *ICC Note on the Appointment, Duties and Remuneration of Administrative Secretaries*.<sup>1439</sup>

The Advisory Commission and the competent authorities in the Electrolux case also found it helpful to have secretarial support. However, the fact that the secretary was a member of the respondent competent authority raises concerns about its impartiality.<sup>1440</sup>

### 3.3 Procedural rules

In most cases, by submitting their disputes for institutional arbitration, parties tacitly agree to accept that institution's procedural framework.<sup>1441</sup> These procedural rules are time-tested, and thus quite effective in dealing with most situations that may arise in an arbitral proceeding. They ensure that arbitrators (and tribunal secretaries) are appointed in a timely way, and that arbitral procedures proceed in a reasonable and efficient manner.<sup>1442</sup> In

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<sup>1437</sup> 'IBA - The Role of the Tribunal Secretary in International Arbitration: A Call for a Uniform Standard' <<https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=987d1cfc-3bc2-48d3-959e-e18d7935f542>> accessed 20 November 2018.

<sup>1438</sup> *ibid.*

<sup>1439</sup> ICC, 'Note on the Appointment, Duties and Remuneration of Administrative Secretaries' (2012).

<sup>1440</sup> See above, Chapter 3, Section 5.4.2.

<sup>1441</sup> Blanke (n 1270) 277.

<sup>1442</sup> Margaret L. Moses (n 769) 9.

particular, these procedural rules normally prescribe tight timelines for key stages of an arbitral proceeding – such as the appointment of arbitrators, the exchange of the parties’ pleadings, the main hearing and the publication of the final award – so as to expedite the process.<sup>1443</sup> Numerous arbitral institutes also provide mechanisms that could guarantee continuation of an arbitration proceeding in the event that either party defaults in the course of arbitration.<sup>1444</sup> For example, Article 26(2) of the ICC Rules of Arbitration provides that if any of the parties, although duly summoned, fails to appear without a valid excuse, the arbitral tribunal shall have the power to proceed with the hearing.<sup>1445</sup>

For tax arbitration, specified and time-tested procedural rules provided and executed by an arbitral institution are of particular benefit. As discussed previously, the advantage of tax arbitration over the MAP in terms of procedural finality and efficiency hinges upon the robustness of arbitral rules.<sup>1446</sup> Specifically, given the built-in manner of tax arbitration, the triggering of an arbitral procedure signifies a relatively low level of good faith between the parties.<sup>1447</sup> Moreover, the underdevelopment of tax arbitration further intensifies the risk of procedural impasses and abuses in the ad hoc approach.<sup>1448</sup>

### **3.4 Publication of arbitral awards**

While the last chapter recommended a wider use of the final-offer approach to tax arbitration and hence placed a lesser emphasis on the publication of arbitral awards,<sup>1449</sup> this author does acknowledge that where the

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<sup>1443</sup> Blanke (n 1270) 281.

<sup>1444</sup> *ibid.*

<sup>1445</sup> ICC, ‘ICC Rules of Arbitration’ (ICC 2017) Art. 26 (2).

<sup>1446</sup> See above, Chapter 6, Section 3.1.

<sup>1447</sup> *ibid.*

<sup>1448</sup> See above, Chapter 6, Section 3.1, 3.4.

<sup>1449</sup> See above, Chapter 6, Section 4.

conventional approach applies, such publication could be beneficial. The OECD states in its 2007 report that although the final decision of tax arbitration would not become a formal precedent, “having the material [of arbitral decisions on tax disputes] in the public domain could influence the course of other cases so as to avoid subsequent disputes and lead to a more uniform approach to the same issue.”<sup>1450</sup> In this author’s view, while the prospect of a uniform approach to legal application in international tax regime is doubtful, published decisions can at least foster a more educated approach. In addition, publication of arbitral awards can lend additional transparency to the process, and thus mitigate the risk of opportunism on the part of arbitrators.<sup>1451</sup> Some scholars voice their concerns about the possible damages to business confidentiality with the publication of arbitral awards.<sup>1452</sup> The solution is to take an incremental approach: at the early stage, decisions can be published in a redacted form, and full publication will be subject to party consent.<sup>1453</sup>

Despite the advantages of publishing tax-arbitration decisions, the task is more difficult to fulfil in the ad hoc approach than in an institutional setting. First, the task of writing and then publishing a well-reasoned and polished arbitral award may overload an ad hoc tribunal, which may have already been under stress due to the lack of administrative support. Second, based on the egoism assumption established in economics, neither parties nor an ad hoc tribunal will have sufficient incentives to assume the extra burden to produce a social good. In contrast, an arbitral institution not only possesses more capacity than an ad hoc tribunal, but also has a greater incentive to publish arbitral awards, because in so doing it can enhance its own credibility and

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<sup>1450</sup> OECD, ‘Improving the Resolution of Tax Treaty Disputes’ (2007) 24 (para. 39) <<http://www.oecd.org/ctp/dispute/38055311.pdf>>.

<sup>1451</sup> *ibid.*

<sup>1452</sup> Terr and others (n 25) 438, 491–492.

<sup>1453</sup> Ault and Majdanska (n 193) 272.

reputation. In fact, numerous well-known arbitral institutes, such as the ICC, the London Court of International Arbitration (LCIA), and the ICSID, routinely publish their arbitral awards.<sup>1454</sup>

### 3.5 Research and development

In addition to providing administrative services for the arbitral proceedings registered with an institution, staff of arbitral institutions may also engage in research and development activities with respect to substantive and procedural aspects of dispute resolution. They can draw lessons from its recurrent arbitration practices and seek to optimise the institution's procedural rules. They can conduct research on their case decisions to achieve more consistency and coherence in their approach to case decision.<sup>1455</sup> Numerous arbitral (or adjudicatory) institutes, such as the WTO, ICSID, and ICC, also play an active role in academic research on the relevant issue areas. For example, the Secretariat of the ICSID has long compiled and published national legislation and international agreements relating to foreign investments, and has regularly invited academic contributions on the topic of international investment to be published in its own journal.<sup>1456</sup> These activities have significantly contributed to the development of international investment law.<sup>1457</sup>

Given the immaturity of tax arbitration and the proliferation of tax disputes, an efficient research and development mechanism, whereby the stock of knowledge on ITDR can be rapidly built up, is of significant value.

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<sup>1454</sup> *ibid.*

<sup>1455</sup> Cai (n 327) 461.

<sup>1456</sup> The journal is entitled 'ICSID Review – Foreign Investment Law Journal' Antonio R Parra, *The History of ICSID* (OUP Oxford 2012) 153–156.

<sup>1457</sup> *ibid* 153–156.

### 3.6 Procedural costs

On the surface, opting for institutional arbitration may impose on the parties extra expenses related to the use of an arbitral institution that administers the case, such as registration and hearing fees.<sup>1458</sup> In the context of ITDR, institutional arbitration may further necessitate an outlay of setup fees to build an arbitral institution that is specialised in tax dispute settlement.

Nevertheless, the expenses of using an arbitral institution should not be exaggerated. First, compared with the party costs such as expenses for arbitrators, lawyers, or representatives – which will occur in both ad hoc and institutional settings – the expenses associated with the use of an arbitral institution are insignificant. For instance, according to a report from the ICC Commission on Arbitration, for ICC arbitrations finalised in 2003 and 2004, 82% of the costs were borne by parties to present their cases, 16% were attributed to arbitrators' fees, and only 2% were administrative expenses of the ICC.<sup>1459</sup> In 2012, Allen & Overy, a British law firm, studied the expense structure of international investment arbitration, finding that the average party costs for claimants and respondents respectively averaged US\$ 6,019,000 and US\$ 4,855,000, while tribunal costs averaged US\$ 933,000.<sup>1460</sup> Note that the tribunal costs in this study include both arbitrators' fees and institutional charges. The Allen & Overy study further shows that the average tribunal costs under the ICSID (US\$ 920,000) are even less than those of ad hoc arbitration under the UNCITRAL (US\$ 1,089,000).<sup>1461</sup> This discovery is somewhat surprising given that proceedings under the ICSID involve an extra

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<sup>1458</sup> Blanke (n 1270) 279.

<sup>1459</sup> ICC, 'Techniques for Controlling Time and Costs in Arbitration' (2007) Introduction <<https://uk.practicallaw.thomsonreuters.com/3-521-5857?transitionType=Default&contextData=%28sc.Default%29>>.

<sup>1460</sup> 'Investment Treaty Arbitration: Cost, Duration and Size of Claims All Show Steady Increase - Allen & Overy'

<<http://www.allenoverly.com/publications/en-gb/Pages/Investment-Treaty-Arbitration-cost-duration-and-size-of-claims-all-show-steady-increase.aspx>> accessed 16 February 2019.

<sup>1461</sup> *ibid.*

outlay of institutional charge. The most sensible explanation for this paradox is that the ICSID rules impose some regulations on arbitrators' remuneration. This could be another advantage of institutional arbitration in terms of procedural costs.

With regard to the setup fee of establishing an arbitral institution for tax dispute resolution, the rule of scale economies indicates that this setup outlay can be easily spread among those tax disputes that recur frequently. More importantly, based on the discussion in this section, it should be noted that the extra costs associated with the setup and use of an arbitral institution should be balanced against the benefits provided by the institution. This corresponds to the proposition that the transaction costs of ITDR include not only monetary, but also non-monetary expenses.

### **3.7 A firm-theory explanation**

The above lessons drawn from international commercial (investment) arbitration can also be viewed through the lens of firm theory. An arbitral institution, through its people functions such as secretarial support and administrative management, performs the role of a central agent in dispute-settlement activities and coordinates the conduct of the multiple participants – including, *inter alia*, competent authorities, arbitrators, taxpayers, lawyers and experts, translators, and witnesses – in arbitral proceedings. Instead of negotiating with each other on every procedural aspect, those participants only need to follow the directions of the institution, thereby saving a large amount of administrative costs. This central agent also helps monitor the participants' potential opportunism and resolve disagreements among them. In this way, arbitral proceedings can be managed in a more robust manner. Furthermore, through its focus on procedural management, the institution reaps the benefit of scale economies.

For example, its costs associated with the maintenance of secretarial services, arbitrator databases, courtrooms, and other facilities can be significantly diluted among a large number of cases it administers. Lastly, by engaging in research and development functions, an arbitral institution acquires more expertise on ITDR practice; it can even contribute to the development of the discipline of ITDRP as well as international tax law.

The benefits of institutional arbitration also apply to tax mediation. As discussed previously, the dormancy of tax mediation partly results from its higher administrative costs as opposed to the MAP.<sup>1462</sup> Specifically, the involvement of a third-party neutral and the organisation of face-to-face meetings may incur substantial expenses, both monetary and non-monetary. These costs can be economised effectively in an institutional setting.<sup>1463</sup>

#### **4. Institutional MAP: some preliminary thoughts**

Generally speaking, among various ITDR mechanisms, the MAP should be the last to be institutionalised, in light of the flexibility of the procedure. That being said, certain types of MAP particularly lend themselves to institutional facilitation. The first type involves cases with a high level of complexity and large funds at stake. Such cases imply a higher risk of impasses, and thus a greater possibility of triggering arbitral proceedings. As covered previously, the built-in manner of tax arbitration entails a synergy between the MAP and tax arbitration that requires a more structured MAP process.<sup>1464</sup> In the Electrolux case, the participants realised that the quantity and quality of documents available in the arbitral procedure depended critically on how well the MAP process was conducted.<sup>1465</sup> In this connection, an institutional

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<sup>1462</sup> See above, Chapter 3, Section 4.4.3.

<sup>1463</sup> *ibid.*

<sup>1464</sup> See above, Chapter 6, Sections 2.2.4, 5.

<sup>1465</sup> See above, Chapter 3, Section 5.4.2.

setting would be of substantial value in assisting competent authorities to conduct their MAPs in a more structured manner. For example, the institution's administrative function may help record and classify the documents generated in a MAP process. In particular, authoritative documents can be distinguished from informal correspondence; factual statements can be isolated from interim concessions. In this way, it becomes easier for the panel of the ensuing arbitral procedure to distinguish settled issues from those unsettled, and to identify which documents can be accepted as evidence and which cannot.

The second type of MAP that is amenable to institutionalisation concerns multilateral disputes. As the number of party increases, all three types of transaction costs will increase.<sup>1466</sup> Accordingly, the role of institutionalisation in economising these costs is highlighted. For example, a technical issue for multilateral MAPs is the free-riding situation, where no individual competent authority has the incentive to take an initiative in organising face-to-face meetings or serving key documents to all the procedural participants. The institutional approach provides an effective means to overcome such problems. Moreover, the high transaction costs of a multilateral MAP also indicate a greater likelihood for the process to escalate to an arbitral procedure. As discussed above, the high synergy between a case's MAP and arbitration phases, which is a critical means to enhance the cost-efficiency of the dispute-settlement process, requires a more structured MAP.

The third type of case involves package negotiation, particularly with respect to framework agreements. This type of MAP is more structured and usually involves multiple participants, and is thus more amenable to institutional facilitation. Indeed, competent authorities have already envisioned the prospect of institutional package MAPs. In at least five peer-review reports,

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<sup>1466</sup> See above, Chapter 2, Section 2.1.4; Chapter 3, Section 4.6.

peers suggested arranging regular MAP meetings in a centralised place (Paris).<sup>1467</sup>

Institutional MAPs also provide a setting conducive for promoting tax mediation. If a MAP negotiation were to go awry within an institutional setting, it would be quite natural for that institution to intervene as a mediator, or at least as a provider of good office.

To some extent, the idea of institutional negotiation has already been, at least partially, realised in the trade regime. Under the DSU of the WTO, all the requests of consultations must be notified to the DSB in writing.<sup>1468</sup> Any third country that desires to join the consultation should also notify the DSB of such intentions.<sup>1469</sup> Although the DSB does not substantially manage the consultation process, and thus fall short of a full institutional consultation, at least “a formal request to the DSB for consultations demonstrates that a Member is serious about resolving the dispute”.<sup>1470</sup> Furthermore, the DSU provides that the Director-General of the WTO may offer good offices, conciliation, or mediation to assist the Members’ consultation.<sup>1471</sup>

## 5. Institutional coordination on ITDR policies

The role of international institutions in coordination of national tax policies has been extensively investigated both by tax and IR scholars.<sup>1472</sup> In particular, it is widely recognised that the OECD has played a pivotal role in shaping the

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<sup>1467</sup> Peer Review Reports on Canada, 46–47 (para.109); Greece, 58 (para.150); Japan, 68 (para.181); Portugal, 53 (para.153); the US, 51 (para.127).

<sup>1468</sup> WTO DSU Art.4 (4).

<sup>1469</sup> *ibid* Art. 4 (11).

<sup>1470</sup> Robert Alilovic, ‘Consultations under the WTO’s Dispute Settlement System’ (2000) 9 *Dalhousie J. Legal Stud.* 279, 289.

<sup>1471</sup> WTO DSU Art.5 (6).

<sup>1472</sup> For representative studies, see Robert T Kudrle, ‘The OECD and the International Tax Regime: Persistence Pays Off’ (2014) 16 *Journal of Comparative Policy Analysis: Research and Practice* 201; Diane Ring, ‘Who Is Making International Tax Policy: International Organizations as Power Players in a High Stakes World’ (2009) 33 *Fordham Int’l LJ* 649; Sawyer (n 197); Frances M Horner, ‘Do We Need an International Tax Organization’ (2001) 24 *Tax Notes International* 1.

international tax regime.<sup>1473</sup> Its work on avoiding double taxation through the OECD Model Convention has become a fundamental part of the international tax architecture for more than 50 years.<sup>1474</sup> Its efforts to address double non-taxation, mostly reflected in the Harmful Tax Practices Project, ultimately resulted in the Global Forum on Transparency and Exchange of Tax Information, with more than 150 members around the world.<sup>1475</sup> More recently, in partnership with the G20, the OECD took the lead in launching the most fundamental rewrite of international tax rules in the past century: the BEPS Project.<sup>1476</sup> This thesis has already demonstrated the OECD's role in coordinating ITDR policies, in conjunction with the discussion of the dispute-settlement provision under the OECD Model Convention, the MEMAP,<sup>1477</sup> and particularly the peer-review process under BEPS Action 14.<sup>1478</sup>

To a lesser extent, the UN also plays an important part in shaping international tax policies. Specifically, the UN has in place a Tax Committee with an aim of enhancing and promoting international tax cooperation among national tax authorities.<sup>1479</sup> The UN Model Convention, though it reproduces the basic provisions of the OECD Model, reflects a greater accommodation of developing countries' interests.<sup>1480</sup> With respect to ITDR policies, the Committee recently formed a subcommittee with a mandate to draft a handbook on tax-dispute avoidance and resolution.<sup>1481</sup>

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<sup>1473</sup> Kudrle (n 1472) 201.

<sup>1474</sup> OECD, 'OECD Work on Taxation (2018-2019)' 4 <<https://www.oecd.org/tax/>>; Rixen, 'From Double Tax Avoidance to Tax Competition' (n 223) 208.

<sup>1475</sup> Kudrle (n 1472) 201; OECD, 'OECD Work on Taxation (2018-2019)' (n 1474) 5.

<sup>1476</sup> See above, Chapter 1, Section 1.7.1.

<sup>1477</sup> See above, Chapter 1, Section 1.3

<sup>1478</sup> See above, Chapter 5, Section 4.

<sup>1479</sup> The full name of the Committee is the 'Committee of Experts on International Cooperation in Tax Matters' <<https://www.un.org/esa/ffd/tax-committee/about-committee-tax-experts.html>> accessed 10 August 2019.

<sup>1480</sup> See above, Chapter 1, Section 1.3.1.

<sup>1481</sup> 'UN Tax Committee Releases Draft Tax Dispute Resolution Handbook, Treaty Negotiation Manual—MNE Tax' <<https://mnetax.com/un-committee-releases-draft-chapters-of-tax-dispute-resolution-handbook-update>

## 6. Boundary of institutionalisation

Given the advantages of institutionalisation in international tax coordination, it seems quite desirable to promote more-aggressive schemes such as the ITO or, at least, the ITC for the purpose of ITDR. While many commentators have championed such centralized plans, this author argues that institutional ITDR has its limits.<sup>1482</sup>

### 6.1 Theory on the firm's limits

After Coase addressed the question of why the firm emerges, he continues to inquire: if the firm is advantageous in economising transaction costs associated with market exchanges, why is not all production carried out by one big firm?<sup>1483</sup> The clue to this question still lies in TC theory. As a firm grows its size, wrote Coase, there may be decreasing returns to the entrepreneur function.<sup>1484</sup> Specifically, the costs of organising additional transactions within the firm may rise. It may also be that the entrepreneur fails to make the best use of production resources as the number of transactions increases.<sup>1485</sup> To a certain point, the costs of using the firm as a method of organising transactions will be equal to the costs involved in carrying out the transactions in the open market, and the expansion of the firm ceases.<sup>1486</sup>

Other theorists approach the same question from slightly different perspectives. One argument is that as the firm substitutes market exchanges,

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s-to-tax-treaty-negotiation-manual-27630> accessed 11 April 2019 See also below, this chapter, section 3.7.

<sup>1482</sup> For proponents of such a centralised plan, see Sawyer (n 197); Adrian John Sawyer, 'Developing an International (World) Tax Organisation for Administering Binding Rulings and APAS: The Way Forward' (PhD Thesis, University of Virginia 2007); Horner (n 1472); Altman (n 29); For opponents of ITO, see Kudrle (n 1472).

<sup>1483</sup> Coase (n 377) 394.

<sup>1484</sup> *ibid.*

<sup>1485</sup> *ibid* 394–395.

<sup>1486</sup> *ibid* 395.

there will be an impairment of incentives.<sup>1487</sup> For example, once an individual seller of an asset in the market is absorbed by a corporation, and hence becomes a division manager of the organisation, he can no longer be expected to use the assets with the same due care as before the merger.<sup>1488</sup> Another branch of literature has connected the issue of firm size to the notion of control loss. Specifically, expansion of an organisation removes the senior executive further from the basic data of the operating conditions.<sup>1489</sup> Information about those conditions must now be transmitted across successive hierarchical levels, with attendant information loss at each level.<sup>1490</sup> In a similar way, the superior's instructions to subordinates will also be increasingly distorted level by level within the hierarchy.<sup>1491</sup> As a result, there is a control loss within the organisation, and "the larger and more authoritarian the organization, the better the chance that its top decision-makers will be operating in purely imaginary worlds".<sup>1492</sup>

## 6.2 Limits on institutional ITDR

A centralised ITDR institution is analogous to a giant firm, and thus vulnerable to the maladaptation problem. First, Coase's "diminishing returns to the entrepreneur function" are quite pertinent to the ITDR context. As discussed previously, tax disputes are highly recurrent, and high caseloads may decrease the efficiency of a centralised ITDR institution to the point of malfunctioning.<sup>1493</sup> Indeed, the ADR movement resulted in part from the recognition that it is hardly possible for the court system alone to cope with massive caseloads, and that a decentralised system that includes courts and

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<sup>1487</sup> Williamson, *The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting* (n 498) 131–162.

<sup>1488</sup> *ibid* 137–138.

<sup>1489</sup> Oliver E Williamson, 'Hierarchical Control and Optimum Firm Size' (1967) 75 *Journal of political economy* 123, 126.

<sup>1490</sup> *ibid*.

<sup>1491</sup> *ibid* 127.

<sup>1492</sup> *ibid* 123.

<sup>1493</sup> See above, Chapter 4, Section 3.2.3.

various ADR providers may enhance the efficiency of the justice.<sup>1494</sup> Second, a centralised institution may have difficulty adapting itself to conditions of the front line. In the context of ITDR, most tax treaties are entered into bilaterally and are superimposed on domestic tax laws. It follows that countries may have diversified preferences over the manner of conducting the ITDR process. As the MEMAP acknowledges, some competent authorities have developed bilateral or multilateral arrangements on both the MAP process and substantive treaty issues.<sup>1495</sup> Some treaty partners with significant caseloads even have in place bilateral training initiatives, where their competent authorities have taken precisely the same training courses on ITDR.<sup>1496</sup> Third, processing ITDR in a centralised place increases logistical costs for parties located in a region far from the institution's location. For illustration, in the Peer Review Report on Canada, one peer, probably a European country, suggested that all MAP meetings between the two countries be arranged in Paris. The proposal was declined by Canada on the grounds that regular meetings in Paris would involve high travel costs.<sup>1497</sup> This example shows that while on the one hand, there is a need for more institutionalised MAP negotiations, on the other hand, a centralised ITDR scheme may increase the party costs to a prohibitive extent. It is true that both the WTO and the ICSID have centralised places for hosting dispute-resolution processes. Nevertheless, as discussed previously, tax disputes are far more recurrent than its trade/investment equivalents.<sup>1498</sup> According to TCE, *ceteris paribus*, high frequency of transactions warrants a more-specialised dispute-resolution mode.<sup>1499</sup>

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<sup>1494</sup> Edwards (n 810) 433–437.

<sup>1495</sup> OECD, 'MEMAP' (n 1) 29 (Section 3.5.2).

<sup>1496</sup> *ibid.*

<sup>1497</sup> Peer Review Report on Canada, para. 109.

<sup>1498</sup> See above, Chapter4, Section 3.2.3.

<sup>1499</sup> See above, Chapter2, Section 3.3.2.

### 6.3 Proposal on a multi-layer scheme of institutional ITDR

Given the concerns about centralised institutional ITDR, this author envisages a multi-layer scheme of institutionalisation, as illustrated in Figure 5.

(1) Tier I : inter-governmental organisations for ITDR policy coordination. At the top layer, various inter-governmental organisations, including the UN, OECD, EU, and others, will participate in international or regional coordination of ITDR policies. In the international context, this author takes the view that since the OECD and the UN have already become the central fora for the coordination of global tax policies, the case for the establishment of a brand-new ITO is quite “thin”.

(2) Tier II : ITDR institutions for dispute resolution. At the intermediate level, various international and regional ITDR institutions can facilitate the specific resolution of tax disputes. These institutions can be part of inter-governmental organisations. For example, the institutional ITDR body proposed by Owens, et al. is affiliated to the UN.<sup>1500</sup> They could also be non-governmental or even private organisations. In particular, various existing arbitral institutions can participate in the ITDR processes. For instance, the ICC has a long-established interest in engaging in tax arbitration. Regardless of their governance structure, these different types of ITDR institutions will have equal legal status, and therefore, national governments will be free to choose among them. For illustration, two Scandinavia countries may agree to refer their tax disputes to the SCC for arbitration so as to save travel costs. In contrast, another pair of countries may have more confidence in an ITDR institute under the auspice of the UN.

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<sup>1500</sup> Owens, Gildemeister and Turcan (n 193) 1007.

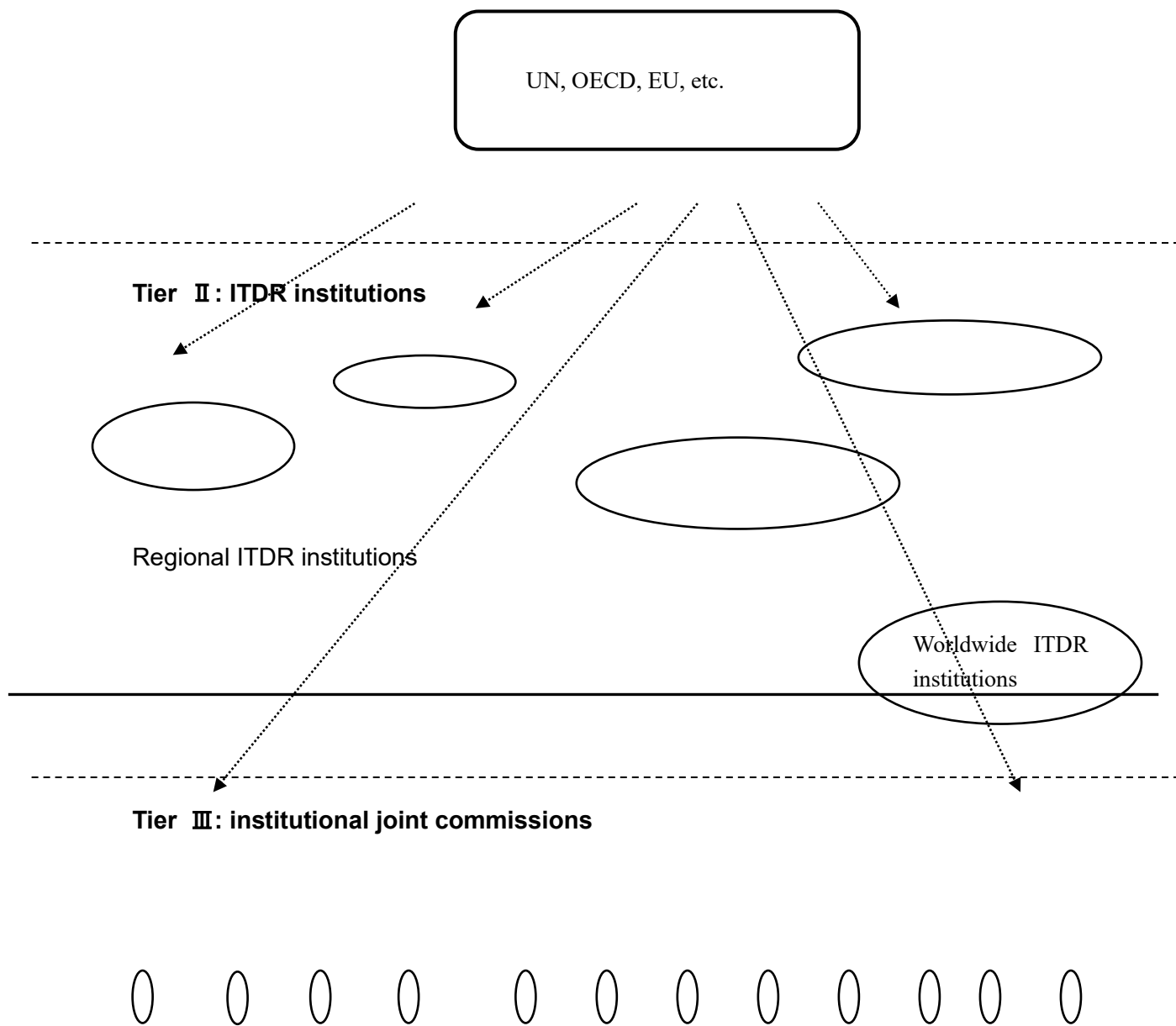
(3) Tier III: institutional joint commissions. At the bottom level, countries may bilaterally work out a customised way of institutionalising their ITDR processes. To some extent, this bilateral approach to institutionalisation can find its legal mandate in Article 25(4) of the OECD Model:

*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 paragraph.*

Compared with traditional MAPs, the joint commission reflects a more structured mechanism of conducting the procedure. Consider a pair of countries with high inventory of pending tax disputes; it would be desirable for the two competent authorities to establish a permanent joint commission. For example, they may appoint – in mutual agreement – some secretarial staff to facilitate the joint commission on a daily basis. This joint commission would be responsible for the management of not only MAPs, but also proceedings of tax arbitration and mediation. It may establish partnership with existing arbitration institutions. Take the aforementioned two Scandinavia countries for example, the joint commission between the two competent authorities may either manage tax arbitration procedures by itself, or refer certain cases to the SCC for arbitration.

**Figure 5: Proposal on a multi-layer scheme of institutional ITDR**

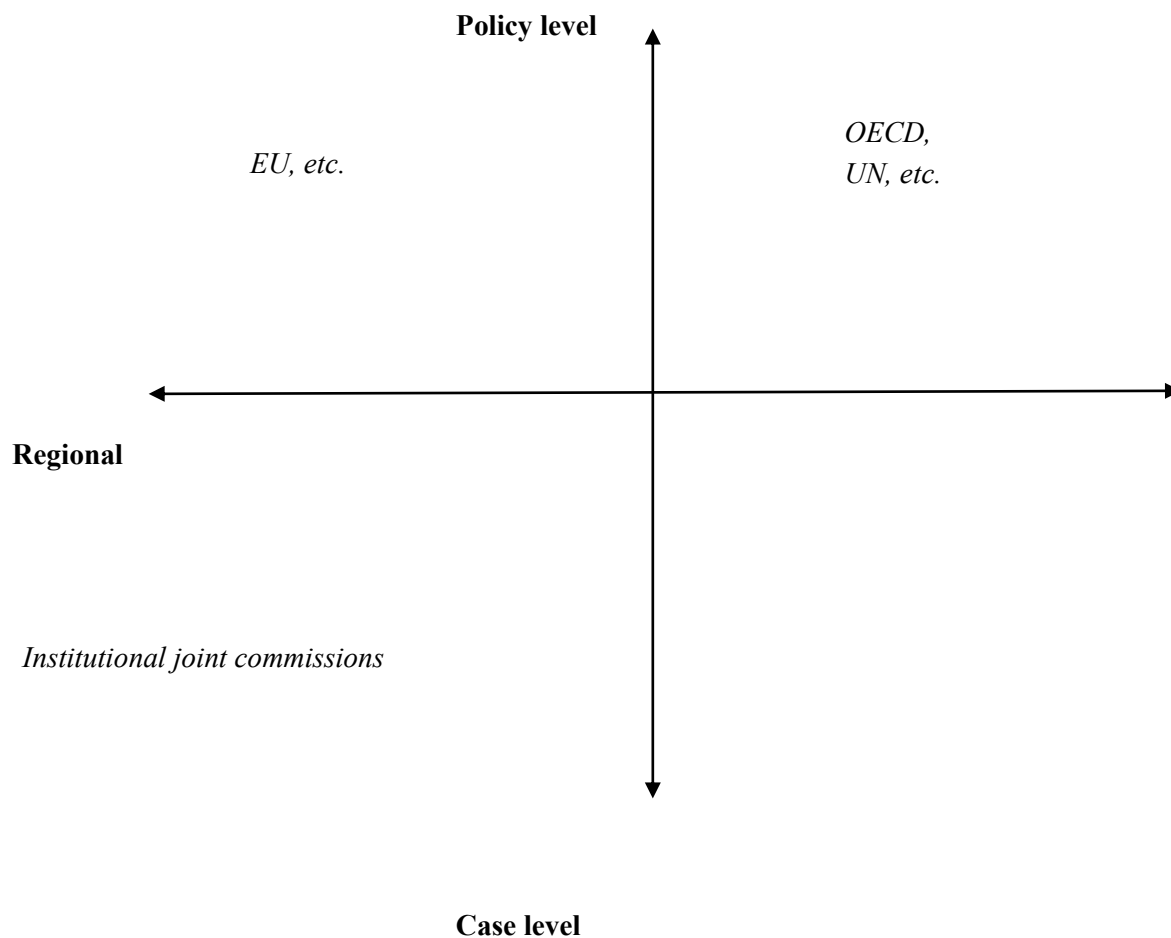
**Tier I : Inter-governmental organisations**



The multi-layer scheme can be summarised in a two-dimensional matrix. The first dimension is the order of the issue: whether it is an issue of policy coordination or specific resolution of ITDR cases. Policy coordination usually warrants the involvement of inter-governmental organisations whereas case-level dispute settlement allows for a more-decentralised institutional scheme. In this way, heavy caseloads of tax disputes can be dealt with in a more efficient manner while at the same time, the minimum standard of the ITDR process and a relatively consistent approach to treaty application can be better guaranteed. Furthermore, through policy coordination, inter-governmental organisations may help to create a political environment conducive to the development of case-level institutional ITDR.

The second dimension is the geographic scope: whether the issue is regional or global. For regional ITDR issues, a localised and customised approach is more desirable so as to entertain the different conditions of various countries. In particular, an institutional joint commission reflects the most specialised and customised model of institutional ITDR. That being said, the above matrix should not be taken as a limitation on institutional innovations. For illustration, while the ICC reflects a non-governmental institution, it has also played an active role in shaping ITDR policies.

**Figure 6: Two dimensions of the proposed multi-layer institutional ITDR**



## **7. Reply to potential concerns**

A major concern about the institutional approach is that this approach may reinforce the legalistic character of the ITDR system and thus contradict the antilegalistic position throughout the preceding chapters. In this author's view, however, there is a fundamental difference between institutionalisation and legalisation. Whereas legalistic approach emphasises the role of a third-party neutral in conducting an objective assessment of the facts and arguments of a dispute based on predetermined rules, institutional approach merely focuses on the aspect of procedural management. Obviously, a robust and

streamlined procedure benefits not only arbitration and adjudication, but also mediation and consultation.

One might further contend that institutional approach may indeed increase the transaction costs of the ITDR system, both in terms of setup costs and running costs of such institutions. However, as already discussed above, such increased costs, if any, should be weighed against the benefits of institutionalization (Section 2.2.6). For instance, tax arbitration can be considerably streamlined through institutional facilitation. Indeed, a combination of the final-offer arbitration and some institutional facilitation can be a very cost-efficient option for parties having large inventories of stalemated MAPs. Moreover, considering the high frequency of tax disputes, transaction costs associated with institutionalization can be substantially spread among the cases managed by those institutions. Last but not least, the decentralised scheme of institutional ITDR proposed above allows the existing dispute resolution institutions to participate in ITDR activities, thereby minimising the need to build new ITDR institutions from scratch.

## Chapter 8. Conclusion

### 1. Overview

This thesis has developed an interdisciplinary approach to the topic of ITDR, drawing on TC theory. Based on this law-and-economic framework, the thesis provided a benefit-cost analysis of the major ITDR mechanisms: the MAP, tax arbitration, and tax mediation. It then explored various measures to economise those mechanisms and the entire ITDR system. To recapitulate, the optimal ITDR system that can be derived from the TC framework features three fundamental elements.

(1) Comprehensiveness. The MAP, tax arbitration, and tax mediation all have their respective pros and cons. Therefore, a holistic approach that can synthesise their strengths is desirable. Chapters 5 and 6 respectively explore ways to economise the MAP and the third-party procedures of ITDR. Chapter 7 focuses on the improvement of the entire ITDR system.

(2) MAP-orientation. Despite the comprehensive approach discussed above, different ITDR mechanisms should not be given the same weight. Based on the benefit-cost analysis in Part I of this thesis, the ITDR system should be centred on the MAP, with tax arbitration and mediation built into the MAP to supplement or facilitate it.

(3) Institutionalisation. Various institutions can play an overarching role in facilitating ITDR processes as well as the international coordination of ITDR policies.

At the first glance, the above three elements do not add much new to the existing literature on ITDR. After all, despite the legalistic preference in the orthodox literature, many can also settle for the idea of building tax arbitration

into the MAP. The dichotomy between ad hoc and institutional approaches to tax arbitration has also received increasing attention in the scholarship of this area. In the article by Owens et al., the three elements – comprehensiveness, MAP-orientation, and institutionalisation – are all present.<sup>1501</sup>

However, this thesis differs from the existing literature of ITDR in several fundamental ways. First, in the orthodox literature, the built-in manner of tax arbitration is accepted mainly as a compromise in the face of sovereignty concerns, or as a “half-way house” approach. For the majority of students in this area, stand-alone arbitration still represents the ideal mode of ITDR. Many take investment arbitration and the panel procedure under the WTO as role models for the ITDR system. Accordingly, only scant attention has been paid to the traditional MAP. In contrast, this thesis established in its theoretical discussion that the MAP-based system is economically sound and thus can be justified for its own sake.

The emphasis on the MAP and the MAP-based ITDR system is also reflected in the policy discussions of this thesis. Specifically, Chapter 5 explored ways to economise the MAP from within, whereas in the orthodox literature, a legalistic approach seems to be the only promising solution to cure the flaws of the MAP. Several ideas that were proposed in the chapter, such as the structuring of the MAP and the reassessment of package deals, have not been touched in the existing literature.<sup>1502</sup> In seeking to economise tax arbitration, Chapter 6 mainly focuses on its supplementary role. In particular, the synergy between tax arbitration and the MAP and the implications of this synergy for the arbitration procedure, such as the selection of trial method (oral or documentary) and evidentiary rules, has been overlooked by past studies, although the issue has already been recognised in legal practice, as

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<sup>1501</sup> See above, Chapter 1, Section 2.5.3.

<sup>1502</sup> See above, Chapter 5, Section 2.1.4, 3.2.

exemplified in a number of the US tax treaties.<sup>1503</sup> The proposal on the wider use of final-offer arbitration, which is also distinctive relative to the existing literature, is again in line with the MAP-based ITDR system.<sup>1504</sup>

As to the institutional element, while the existing literature largely confines the discussion to the topic of institutional tax arbitration, this thesis further envisioned the prospect of institutional mediation, institutional MAPs and institutional coordination of ITDR policies. On the other hand, this thesis proposed a decentralised scheme of institutional ITDR, which also differs from the orthodox literature on the topic.

Finally, all the three elements were derived from a uniform and well-established conceptual framework: TC theory.

## **2. Managerial approach: insights from international-law theories**

This thesis prominently features a managerial approach. The evaluation of various ITDR mechanisms and the proposed measures to strengthen those mechanisms are mostly based on benefit-cost considerations rather than on pure legal analysis. In particular, the thesis favours a comprehensive *dispute management* system, in which arbitration forms only a small part. This managerial approach has its counterpart in public international law: the managerial mode of treaty compliance.<sup>1505</sup> Traditionally, theories on treaty compliance have been dominated by the enforcement mode, in which noncompliance has been conceptualised as wilful violation of treaty obligations that should be responded to with strict enforcement or coercive

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<sup>1503</sup> See above, Chapter 6, Section 5.

<sup>1504</sup> See above, Chapter 6, Section 4.

<sup>1505</sup> For representative researches on this topic, see Abram Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Harvard University Press 1995); Markus Burgstaller, *Theories of Compliance with International Law* (MNijhoff 2005) 141–152; Chayes, Chayes and Mitchell (n 444).

sanctions.<sup>1506</sup> Accordingly, politicians, academics, journalists, and ordinary citizens frequently seek to equip treaties with “teeth” in the form of coercive enforcement measures.<sup>1507</sup> In contrast, the managerial mode begins with the recognition that countries generally enter international agreements with goodwill.<sup>1508</sup> This is in line with the crux of IR theory that countries enter and observe certain regimes because they benefit from doing so.<sup>1509</sup> In this connection, the principle source of noncompliance is not wilful disobedience, but the ambiguity and indeterminacy of treaty language, the complexity of the regime, and the capacity limitations of the noncompliance countries in carrying out their treaty undertakings.<sup>1510</sup> Accordingly, the emphasis of the managerial mode is on addressing the sources of noncompliance and managing compliance rather than punishing misconduct.<sup>1511</sup> The key measures of promoting compliance under the managerial mode, including, *inter alia*, data collection, peer assessment, and capacity building, can all find their counterparts in this thesis.<sup>1512</sup> In particular, while dispute-settlement systems still play a part in the managerial mode, less emphasis is placed on legalistic dispute-resolution methods.<sup>1513</sup> As some leading writers on the managerial mode observe:

*Despite the fixation of international lawyers on the virtues of binding adjudication (preferably in the International Court of Justice, but if not, then by a specialized tribunal or arbitral panel), most treaty regimes turn to a variety of relatively informal meditative processes if the disputants are unable to resolve the issues among themselves.*<sup>1514</sup>

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<sup>1506</sup> Chayes, Chayes and Mitchell (n 444) 39,62.

<sup>1507</sup> Chayes (n 1505) 2.

<sup>1508</sup> *ibid* 3; Chayes, Chayes and Mitchell (n 444) 39.

<sup>1509</sup> See also above, Chapter 1, Section 2.5.4. Chayes (n 1505) 3–4.

<sup>1510</sup> *ibid* 22.

<sup>1511</sup> Chayes, Chayes and Mitchell (n 444) 39.

<sup>1512</sup> Chayes, Chayes and Mitchell (n 444).

<sup>1513</sup> *ibid* 54.

<sup>1514</sup> Chayes (n 1505) 24.

Antilegalist though it may be, the managerial approach highlights the role of international institutions in promoting treaty compliance. “It is no coincidence that the regimes with the most impressive compliance experience – ILO, IMF, OECD, GATT – depend upon substantial, well-staffed, and well-functioning international organizations.”<sup>1515</sup> It has further been recognised that various NGOs have also played an increasing part in the management of treaty compliance.<sup>1516</sup>

The managerial mode is not free from criticism. Above all, it is contended that on many occasions, noncompliance does result from wilful violation of treaty obligations by unscrupulous countries.<sup>1517</sup> Critics particularly refer to the PD situation, also known as the collaboration situation, where states have an incentive to renege on their commitments, “since they gain more from an agreement if they reap all the benefits without putting in their own share”.<sup>1518</sup> In such situations, enforcement mechanisms such as sanctions seem quite necessary to ensure compliance. Those critics particularly invoke the WTO as an example of the enforcement mode.<sup>1519</sup>

That being said, even those critics of the managerial mode acknowledge that this mode does work well in coordination games. In such games, as one writer reasons,

*once the parties have agreed on a certain set of behaviors, neither party has an incentive to deviate from the agreement, and compliance is the expected outcome even in the absence of enforcement. Because there is no incentive to cheat, there is no need to focus on enforcement. Resources are better*

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<sup>1515</sup> Chayes, Chayes and Mitchell (n 444) 58

<sup>1516</sup> *ibid*

<sup>1517</sup> Burgstaller (n 1505) 145–146.

<sup>1518</sup> Jonas Tallberg, ‘Paths to Compliance: Enforcement, Management, and the European Union’ (2002) 56 *International organization* 609, 612; further cited by Burgstaller (n 1505) 146.

<sup>1519</sup> Tallberg (n 1518) 612; see also Burgstaller (n 1505) 146.

*directed at managerial issues.*<sup>1520</sup>

As has been repeatedly mentioned, the international tax regime presents a typical coordination game, thereby providing an excellent case for the management mode of treaty compliance.

### **3. Reply to potential criticisms**

Given the antilegalistic position and the managerial approach in this thesis, it is not difficult to think of potential criticisms of the thesis and where they would come from. Specifically, proponents of a legalistic approach to ITDR typically highlight two advantages of this approach: preservation of taxpayer rights and promotion of legal certainty. These two aspects may also become the major grounds on which the legalistic camp can challenge this thesis.

#### **3.1 Taxpayer rights**

Criticism from the direction of taxpayer rights may argue that a taxpayer involved in a tax dispute will be directly affected by the resolution of that dispute. Therefore, the taxpayer's interests and rights should be vindicated in the process of dispute resolution. In a broader sense, the taxpayers' status in the ITDR process may involve the right to a fair trial, which is a fundamental human right. Such rights may be compromised in an antilegalistic approach.<sup>1521</sup> This criticism actually applies to the entire law-and-economic approach, which is often said to be so overwhelmed by the benefit-cost calculation that fundamental values such as justice, right, and fairness, are overlooked.

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<sup>1520</sup> At Guzman, 'A Compliance-Based Theory of International Law' (2002) 90 *California Law Review* 1823, 1831; Burgstaller (n 1505) 146.

<sup>1521</sup> Katerina Perrou, 'Participation of the Taxpayer in MAP and Arbitration: Handicaps and Prospects' in Michael Lang and Jeffrey Owens (eds), *International Arbitration in Tax Matters* (IBFD 2015) 293–296; Baker (n 196) 467–471.

Nonetheless, to yield refutable conclusions in social science research, one should be careful in resorting to those fundamental values. As Lucas claims, “the formal idea of equality or justice as a lodestar of social policy is devoid of all meaning; it is possible to advance every kind of postulate in the name of justice”.<sup>1522</sup> The same caveat also applies to the concept of sovereignty.

Without prejudice to the above argument, this author further contends that the antilegalistic position in this thesis is not necessarily incompatible with the rights-based approach. First, the thesis challenges the validity of the sovereignty argument, arguing that the notion of sovereignty should be subject to the more fundamental value: the welfare of individuals. In the ITDR literature, sovereignty constitutes a major impediment to the promotion of taxpayer rights. Second, while each of the ITDR players has its own benefit-cost payoff structure, with one party’s benefit being the other’s cost, this thesis adopts a global perspective, in which the prevention of double taxation, the efficient resolution of tax disputes, and the liberalisation of trade and investment, are all regarded as enhancing the global welfare. Obviously, these social goods are also in line with taxpayers’ interests. Third, compared with the status quo, the taxpayer-participation model proposed in this thesis significantly improves taxpayers’ standing in the ITDR process. It is true that this research did not recommend a full-participation model. This is because in general, the law-and-economic approach does not recognise absolute taxpayer rights, but emphasises the need to balance various different interests in institutional design.

### **3.2 Legal certainty**

Criticism based on legal certainty seems more compelling, as this value is not purely moral, but can also be incorporated into the law-and-economic

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<sup>1522</sup> JR Lucas, *On Justice* (Clarendon Press 1980) 31; Veljanovski (n 329) 60–61.

approach. Specifically, a stable tax environment reduces the risk of future tax disputes and encourages cross-border investments. For illustration, in an economic analysis of property rights, Barzel notes that in countries operating under a common-law tradition, such as the US and England, court rulings serve as precedents for new rulings.<sup>1523</sup> “Since court rulings become precedents for similar cases, litigants are resolving others’ disputes”.<sup>1524</sup> The role of precedents in solving distributive conflict has also been confirmed in the theory of the BOS game.<sup>1525</sup> In this connection, a potential challenge is that had the benefit-cost analysis of this thesis taken legal certainty into account, the conclusion would have been different.

While this author does acknowledge the value of legal certainty, he doubts the validity of the proposition that it can only be achieved through legalistic dispute settlement. First, as argued previously, considering the difficulties of treaty application, a tax arbitrator/adjudicator may even feel struggled to justify a decision to the concerned parties, let alone provide guidance for the general public through the decision.<sup>1526</sup> Second, legal certainty can also be achieved, at least partially, through antilegalistic methods. This author has demonstrated that MAP package deals, particularly with respect to framework agreements, also provide some legal certainty for wide groups of taxpayers.<sup>1527</sup> Third, through the development of model conventions (and the commentaries thereof), relevant international organisations also engage in providing tax certainty at the policy level, and in a conversational manner. As Brown notes:

*While the legalistic approach to resolving tax disputes – arbitration – has had almost no impact on the development of international tax rules, government –*

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<sup>1523</sup> Barzel (n 564) 98.

<sup>1524</sup> *ibid.*

<sup>1525</sup> See above, Chapter 2, Section 2.3.1.3.

<sup>1526</sup> See above, Chapter 6, Section 4.3.1.

<sup>1527</sup> See above, Chapter 5, Section 3.2.3.3.

*through international bodies such as the OECD and the United Nations – have been able to agree on substantive rules that address a multitude of increasingly sophisticated problems and situations.*<sup>1528</sup>

Finally, the wide use of the APA, which is unique to international tax practice, indicates that in this domain, certainty is more often attained in a flexible, consensual, firm- or business-specific manner. In contrast, the idea of general legal certainty, or certainty that can be acquired once and for all, might only be wishful thinking.

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<sup>1528</sup> Brown (n 11) 85.



## Appendices: Summary of Peer-Review Reports

**Table 9: Summary of Stage 1 peer-review reports (Part I )**

Country	Denial of access to MAP	Timely resolution of MAP (general comments)	Implementation of MAP agreement	
			Issue of actual implementation	Monitoring mechanism
Argentina	1 UO <sup>1529</sup> , not notified <sup>1530</sup> (para 42) <sup>1531</sup>	Limited experience (paras 133, 134)	No agreements <sup>1532</sup> (paras 161, 162)	N (para 161)
Australia	3 UO, notified; limitation based on AS <sup>1533</sup> , (paras 42-78)	Very good (para.140)	N <sup>1534</sup> (paras 189-199)	Y <sup>1535</sup> (para. 188)
Austria	1 UO, notified (paras 26-53)	Good (para.100)	N (paras 137-138)	N (para. 137)
Belgium	3 II, OG <sup>1536</sup> (paras 28-49)	Good (para.101)	N (paras 136-137)	Y (para. 134)
Canada	N (paras	Very good (para.140)	N (paras 143-144)	Y (para. 142)
Chile	N (paras	Good (para.112)	N (para.157)	N (para.156)

<sup>1529</sup> “UO” stands for “unjustifiable objection”; “2 UO” means “in two MAP cases, the assessed competent authority considered the objection not justified”.

<sup>1530</sup> “Notified” means for the MAP request considered as not being justified, the assessed competent authority has notified its treaty partner of such consideration.

<sup>1531</sup> The paragraph number denoted the exact place of the peer inputs in the Stage 1 reports on respective countries.

<sup>1532</sup> “No agreement” means that during the assessed period, the assessed competent authority had not achieved any agreement, and thus the actual implementation of MAP agreements cannot be assessed.

<sup>1533</sup> “AS” stands for “audit settlement”; “limitation based on AS” means taxpayers were asked by the audit department to forego MAP access as part of an audit settlement.

<sup>1534</sup> “N” stands for “No”. Specifically, “N” in the second column means no actual denial of access to MAP by the assessed competent authority during the assessed period. “N” in the fourth column means no issue of actual implementation of MAP agreement. “N” in the fifth column means the assessed competent authority has no monitoring mechanism in place for the implementation process.

<sup>1535</sup> “Y” stands for “Yes”.

<sup>1536</sup> “II” stands for “insufficient information”, “OG” means “opportunity granted”, and “3 II, OG” means the assessed competent authority denied access to the MAP in three cases, yet it had granted the taxpayers concerned opportunities to supplement the information required.

Colombia	N (paras 42-70)	Limited experience (para.72)	No Agreement (paras 109, 110)	N (para.108)
Croatia	1 UO, not notified (paras 38-65)	Good (paras 117, 128, 129)	No Agreement (para.153)	Y (para.152)
Czech Republic	N (paras 42-70)	Good (paras 115,126-129)	No Agreement (paras 149-155)	N (para.153)
Denmark	4 II (3 overruled by court ) (paras 42-75)	Good (para.128)	N (paras 169-170)	N (paras 169-170)
Estonia	N (para.28)	Good (para.112)	No Agreement (para.140)	N (para.139)
Finland	1 UO, notified (paras 38-65)	Good (para.118)	1 case delay (para.163)	Y (para.162)
France	18UO, 1 notified;16 II, OG (paras 25-48)	Mixed (paras 99, 100)	1case delay (para.145)	N (para.143)
Germany	10 UO, 1 notified; limitation based on AS; 1 II, OG (paras 42-72)	Good (paras 120, 137)	N (paras 177, 178)	N (para.176)
Greece	N (paras 46-75)	Negative (para.132)	N (paras 177-184)	Y (paras 177-184)
Hungary	N (paras 46-76)	Mixed (para.135)	N (paras 176-179)	Y (178)
Iceland	N (paras 35-60)	Good (para.112)	N (paras 141-148)	N (paras 141-148)
India	N (paras 62-95)	Mixed (para. 159)	N (paras 208, 209)	Y (para.207)
Ireland	N (paras 41-72)	Very good (para.128)	N (paras 188-196)	Y (para.188)
Israel	7UO, notified; 1 II (paras 42-72)	Good (para.131)	N (paras 165-172)	Y (para. 170)

Italy	1UO, notified; limitation based on AS (paras 33-64)	negative (para.116)	A few cases delay (paras 160-164)	Y (para. 160)
Japan	N (paras 44-75)	Very good (paras 172-176)	N (paras 215-217)	N (para.215)
Korea	N (paras 44-71)	Mixed (para.125)	N (paras 181-187)	Y (para.181)
Latvia	N (paras 35-64)	Good (paras 119, 120, 130)	N (paras 154-156)	Y (para.153)
Liechtenstein	1 II, OG (paras 17-37 )	Limited experience (paras 79, 85)	N (para.108)	Y (para.107)
Lithuania	N (paras 40-77)	Very good (paras 146-148)	N (para.175)	N (para.175)
Luxembourg	1UO, not notified; 1II, OG (paras 21-44)	Good (para.89)	N (paras 121-127)	N (para. 125)
Malta	N (paras 41-70)	Limited experience (para.129)	No Agreement (para.152)	Y (para.152)
Mexico	N (paras 42-73)	Mixed (para.139-141)	N (paras 181-189)	N (para.179)
The Netherlands	1UO, not notified; 8 II, OG (paras 22-52)	Very good (paras 93, 94)	N (paras 130-136)	N (para.130)
New Zealand	N (paras 43-72)	Very good (para.127)	N (paras 163-172)	Y (para.162)
Norway	2UO, notified (paras 37-64)	Good (para.116)	N (paras 153-159)	N (para.155)
Poland	4UO, 1 notified; 5 II, OG (paras 35-62)	Mixed (para.115)	N (para.147-153)	N (para.151)
Portugal	1UO, notified; 1 II, OG (paras 42-79)	Good (para.137)	N (para.179-186)	Y (para.184)
Romania	N (paras 40-67)	Good (paras 130-132)	No agreement (para.159)	N (para.153)
Singapore	N (paras 38-67)	Good (para.117)	N (paras 154-160)	Y (para.153)
Slovak Republic	N (paras 44-72)	Very good (paras 129, 137-139)	No agreement (para.169)	N (para.168)
Slovenia	2UO, notified; 1 II, OG (paras 48-81)	Very good (paras 150-153)	N (paras 177-187)	Y (para.176)
South Africa	N (paras 38-69)	Good (paras 124-126)	N (paras 164, 165)	Y (para.163)
Spain	3UO, 2 notified (paras 39-70)	Good (para.122)	N (paras 177-184)	Y (para.176)
Sweden	1UO, notified; (paras 30-56)	Good (para.101)	N (paras 141-146)	N (para.140)
Switzerland	N (paras 21-45)	Very good (para.80)	N (paras 108-114)	N (para.113)

Turkey	N (paras 42-74)	Good (para.130)	No agreement (para.167)	N (para.168)
UK	N (paras 26-50)	Very good (para.95)	N (paras 136-141)	Y (para.134)
USA	2UO, not notified (paras 31-59)	Very good (para.95)	N (paras152, 153)	N (para.152)

Derived from Stage 1 peer-review reports,  
<https://www.oecd.org/tax/beps/beps-actions/action14/> (accessed 9 Jul. 2019)

**Table 10: Summary of Stage 1 peer-review reports (Part II)**

Country	Late or lack of response	Rigid negotiation stance			Delay due to complexity of the case	Resource constraint
		General rigidity	Rigidity due to domestic procedure	Rigidity due to deference to audit department		
Argentina	Para.134					
Australia			Para.141			
Austria						
Belgium	Para.114					
Canada	Para.93	Para.93				
Chile						
Colombia	Para.83					
Croatia						
Czech Republic	Paras 115, 128	Para.128				
Denmark	Para.146					
Estonia						
Finland	Paras 135, 137				Para.135	Paras 135 (resource constraint and staff change), 138, 139
France	*Paras 100, 101 <sup>1537</sup>					Para.115(resource constraint and

<sup>1537</sup> “\*” denotes that the peers observed significant lack of responsiveness on the part of the assessed competent authority.

						staff change)
Germany	Paras 139, 140			Paras 147, 150	Para.146	Paras 139 (staff change), 150
Greece	*Paras 132-134					
Hungary	*Paras 135,136		Para.137			
Iceland						
India	*Paras 170-176	Para.182				Paras 179, 181
Ireland						
Israel						
Italy	*Paras 118-120, 143		Para.117			Para.134
Japan					Para.172	
Korea	*Para.143		Para.149		Para.149	Paras 125(staff change), 147
Latvia						
Liechtenstein						
Lithuania						
Luxembourg	Para.89					
Malta						
Mexico	*Paras 139, 141, 153					
The Netherlands					Para. 94	

New Zealand						
Norway	Paras 116, 129					Para.129
Poland	*Paras 115, 126	Para.127				Para.127
Portugal	Para. 137					
Romania						
Singapore						
Slovak Republic						
Slovenia						
South Africa						
Spain	Paras 141, 143,145	Para.147	Paras 142, 147			
Sweden			Para.117			
Switzerland						
Turkey						
UK						
USA						

Derived from Stage 1 peer-review reports, <https://www.oecd.org/tax/beps/beps-actions/action14/> (accessed 9 Jul. 2019)

**Table 11: Summary of Stage 1 peer-review reports (Part III)**

Country	Peer inputs on the use of ICT in the MAP process
Argentina	
Australia	The use of email increases efficiency (para.152); Suggested more use of teleconferencing (para.155).
Austria	Digital means of communication increases efficiency (para.112); Suggested finding new and secure electronic means to exchange information (para.114)
Belgium	Suggested periodic use of conference call; suggested the use of secured email to improve turnaround time (para.114);
Canada	Suggested more use of conference call (para.109)
Chile	Chile attributed the delay a peer had experienced in a MAP case to the use of mail via regular post. It therefore suggested more use of email (para.125).
Colombia	
Croatia	Suggested the use of safe electronic means (para.129)
Czech Republic	
Denmark	Suggested more use of email and conference call (para.143)
Estonia	
Finland	
France	Suggested more use of email (para.100); propose to use video conference (para.116) <sup>1538</sup>
Germany	Suggested more use of conference call (para.148); suggest more use of email; Germany raised the issue of information security in digital communication(para.149)
Greece	Suggested modern means of communication more frequently (para.148)
Hungary	
Iceland	
India	Recommended more use of regular email and teleconference, which has expedited the process (paras 171, 179)
Ireland	Suggested frequent use of email and conference call (para.151)
Israel	
Italy	Suggested more use of (video) conference call (para.132); suggest more use of electronic means of communication to exchange confidential data (para.134)

<sup>1538</sup> As to this point, France replied that it preferred to use audio-conference instead of video conference for technical reason (para.116).

Japan	Suggested more use of videoconferencing and email. (para.179)
Korea	
Latvia	
Liechtenstein	
Lithuania	Regular contact via post or electronic means
Luxembourg	
Malta	
Mexico	
The Netherlands	
New Zealand	Suggested more use of email (para.139)
Norway	
Poland	Suggested more use of email (para.127)
Portugal	Suggested more use of email (para.153)
Romania	Suggested more use of email (para.132); do not regard telephone conferences as efficient, due to the language difference (para.130)
Singapore	
Slovak Republic	
Slovenia	Email and conference calls increased efficiency (para.151)
South Africa	South Africa noted that its peers' use of mail by post rather than electronic channels caused delays (para.126)
Spain	Suggested more use of email (para.149)
Sweden	Suggested more use of video conference (para.118)
Switzerland	
Turkey	
UK	
USA	US raised the issue of information security in digital communication (para.123); suggest more use of conference calls or videoconferencing (para.127)

Derived from Stage 1 peer-review reports,  
<https://www.oecd.org/tax/beps/beps-actions/action14/> (accessed 9 Jul. 2019)

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