International Tax Arbitration and the Sovereignty Objection: The South American Perspective

by Natalia Quiñones Cruz

Natalia Quiñones Cruz completed an LL.M. in International Taxation at New York University School of Law in May 2008 and is a tax lawyer with Quiñones Cruz Ltda. in Bogotá.

This article was prepared as part of a research project for the International Taxation Program, New York University, School of Law. The author wishes to thank Profs. David Rosenbloom, Georg Kofler, and Noel Cunningham for their valuable comments and support.

International tax arbitration has become a reality. After several years of academic and political debate on whether arbitration was a viable mechanism for resolving tax disputes, many countries have decided to implement arbitration as a mandatory procedure for resolving disputes arising from tax treaties.

For income tax treaties, the most significant advance is the incorporation of the mandatory arbitration clause in the OECD model convention, which is the most widely followed model. This crucial step in the history of tax arbitration is the embodiment of efforts that multilateral organizations such as the World Bank, the Inter-American Development Bank, the International Chamber of Commerce, and the OECD had been undertaking since the early 2000s to incorporate arbitration as a binding alternative for the resolution of international taxation disputes.¹ The United States has chosen to endorse this initiative by negotiating three mandatory arbitration clauses in income tax treaties with Canada, Germany, and Belgium.

Given the new prominence that international tax arbitration has achieved, it is proper to examine some related issues. One aspect that requires further examination is the sovereignty implications that arbitration clauses have in tax treaties and bilateral investment treaties. There is a tension between domestic provisions that safeguard taxation matters from alternative dispute resolution mechanisms, and international tax arbitration (which many countries might find appealing for their tax treaties). This tension is especially evident in South America.

Certainly, for many South American countries (capital importers seeking foreign direct investment), strengthening dispute resolution procedures might be considered an incentive to enter into new tax treaties with capital-exporting countries. Indeed, the possibility of overcoming the inefficient (and often bureaucratic) domestic judicial system is likely to appeal to foreign investors; the certainty of an efficient mechanism for resolving tax disputes with the host country will counter the instability that investors perceive in South American tax systems. Therefore, mandatory arbitration represents an additional card that South American governments can play to attract more investment for development.

Most scholars agree that international tax arbitration is designed to improve the existing mutual agreement procedure, rather than to solve controversies between states directly.² However, even when we see international tax arbitration as merely an incentive for competent authorities to reach agreement, the possibility of

¹This can be seen in decisions made by International Centre for Settlement of Investment Disputes tribunals holding Ecuador and Argentina liable for investment contract breaches relating to taxes. See also Chetcuti, at section 2.3.

²See, e.g., Burnett, at 174-175.
having arbitration as an enforceable mechanism is essential for encouraging those authorities to provide a solution for the taxpayer in a reasonable amount of time. For that reason, it is important to verify that arbitration can function fully and not just as a paper provision that will never be applied in real life.

In this sense, fiscal sovereignty is still a threat to the actual functioning of mandatory arbitration clauses. In many countries, particularly in South America, fiscal sovereignty has been used as an argument against arbitration in tax matters, especially international tax matters. The purpose of this article is to describe the legal sovereignty constraints in South America, especially regarding the arbitrariness and enforcement of tax disputes, and to explore whether these objections can be overcome to ensure the viability of international arbitration in South America. In Section I, the content of the sovereignty objection will be examined, and then legal examples of three representative countries will be addressed. In Section II, the effects of entering into tax treaties with arbitration clauses will be examined to illustrate the conflict between the sovereignty objections and the commitment to submit tax disputes to international tax arbitration. Lastly in Section III, I will offer some short-term and long-term solutions to eliminate the tension between domestic legal provisions that forbid tax arbitration because of sovereignty and public order concerns, and the international commitments that South American countries have undertaken or are planning to undertake regarding international tax arbitration.

I. The Sovereignty Objection

Only a few South American countries (such as Chile and Argentina) have a broad tax treaty network; other countries (such as Colombia, Ecuador, Peru, and Bolivia) have preferred to alleviate double taxation unilaterally, rather than through a treaty that limits their sovereignty right to tax at source.3 Besides, a lack of resources from the export of capital and technology has made South American countries cling to fiscal sovereignty in the hope of maintaining sufficient revenue from taxes to provide for the welfare of their citizens.

For that reason, South American countries have retained constitutional and legal clauses that situate taxation in the impenetrable realm of sovereignty. Fiscal sovereignty is thus embedded in the concepts of public order, sovereign economic policy, or the catchall notion of public policy, as in Argentina. The scope of these provisions is vague, but courts and scholars seem to agree that they are designed to protect the state’s fundamental economic interests by proscribing particular acts, contracts, or awards that threaten those interests. The question is whether international tax arbitration truly jeopardizes those interests, and if so, whether an international commitment to be bound by arbitration can trump the power of the domestic sovereignty concept.

South American countries have retained clauses that situate taxation in the impenetrable realm of sovereignty.

The determination and collection of taxes owed by nationals and foreigners conducting activities within the boundaries of national territory is one prominent example of the interests protected; consequently, tax issues are not subject to discussion outside the sovereign sphere. This classic concept of sovereignty in taxation, however, usually refers to a country’s ability to define its fiscal policy without the intervention of foreign states. Does this necessarily mean the resolution of tax controversies is a part of the protected sovereignty?

Some academics claim the resolution of tax disputes falls within the spectrum of administrative independence, which in turn is one of the interests that sovereignty clauses seek to protect. This concept has been defined as a country’s ability to administer its tax system without the intervention or assistance of the tax authorities of other countries.4 According to McLure, “Sovereignty in taxation is clearly greater the higher the level of administrative independence.”5 Initially it appears that international arbitration compromises the principle of administrative independence insofar as it requires the participation of a foreign authority, as well as foreign arbitrators, in the resolution of a particular tax dispute. However, alternative dispute resolution mechanisms can be designed to involve the proper national authorities, so that administrative independence is not compromised. In fact, the arbitration provisions that have been adopted by the United States and its treaty partners, or described in the commentary to the OECD model, reflect this concern to the extent that they contemplate a central role for national authorities in the arbitration process. With the involvement of national authorities and the exclusion of national tax authorities of other countries.4 According to McLure, “Sovereignty in taxation is clearly greater the higher the level of administrative independence.”5 Initially it appears that international arbitration compromises the principle of administrative independence insofar as it requires the participation of a foreign authority, as well as foreign arbitrators, in the resolution of a particular tax dispute. However, alternative dispute resolution mechanisms can be designed to involve the proper national authorities, so that administrative independence is not compromised. In fact, the arbitration provisions that have been adopted by the United States and its treaty partners, or described in the commentary to the OECD model, reflect this concern to the extent that they contemplate a central role for national authorities in the arbitration process. With the involvement of national authorities and the exclusion of national tax

---


4McLure, at 331.
policy from the process, administrative independence is fully preserved in the national domain and is only partially modified in the domain of international taxation disputes.

Thus, arbitration procedures can be designed to respect administrative independence, and no other arguments have been presented to suggest that alternative dispute resolution violates South American sovereignty provisions. Therefore, it would seem in principle that South American tax sovereignty provisions could be interpreted as confining policy decisions regarding taxation to the sovereign domain of the national lawmaker, while allowing the resolution of tax disputes in the international arena with the significant involvement of national tax authorities. Nonetheless, it is important to examine a few specific cases.

A. The Public Order Clause

In examining sovereignty concepts in Colombia, Ecuador, and Argentina, I will provide an overview of how fiscal sovereignty is generally understood in South America. Colombia has struggled for almost two decades to make the necessary reforms to attract foreign investment into the country, especially in the case of oil and gas and other sectors in which the country lacks the necessary technology to fully exploit its natural resources. However, the Colombian legislature, respecting the need to protect sovereignty, has not withdrawn the old rule that proscribed arbitration for issues relating to “public order,” an ethereal concept broadly defined so as to capture anything that has to do with sovereignty, chiefly economic sovereignty. The rule is included in several legal provisions, but in Colombia, as well as Venezuela and Bolivia, the idea has not been elevated to constitutional status. Thus, the provisions that protect fiscal sovereignty in the region may be revised by the legislature at any time, like other norms in ordinary law.

The Colombian concept of public order refers to precepts that cannot be ignored by particular agreements, inasmuch as they concern the state’s public, economic, and social interests. Neither the courts nor an arbitral award can overrule these principles; on the contrary, the procedure for annulment will apply to a decision that violates the precepts protected by the public order doctrine (Civil Procedural Code, section 140). This clearly follows the model in article 6 of the French Civil Code of 1804, which inspired most South American procedural rules. In fact, the Colombian Procedural Code contains a provision that requires an international arbitral award to respect the public order precepts to be deemed valid in Colombian territory (Civil Procedural Code, section 695-2).

The application of this concept in the area of dispute resolution for tax matters was clearly established by the Colombian Congress in the Alternative Dispute Resolution Mechanisms — Law Decree No. 1818 of 1998 (ADRMns law). When considering administrative conflicts (involving a public entity) susceptible of conciliation, the legislature explicitly excluded tax conflicts:

Art. 56. Issues susceptible of conciliation. Governmental entities will be able to conciliate, totally or partially, through their representatives or by power of attorney, particular conflicts with economic content that would be susceptible of review by the Administrative Jurisdiction in accordance with the Administrative Code.

Paragraph 2. There can be no conciliation of issues regarding taxation conflicts.

Following the same text included in the previous ADRM law (article 70, Law 446/1998), the statute denies the possibility of submitting tax disputes to alternative dispute resolution. The clause is also applicable in determining whether an issue can be resolved in international conciliation procedures (article 100, Law Decree No. 1818 of 1998). The rationale has to do with the fact that the ability to conciliate or settle a dispute is determined by the possibility of renouncing the right that gave rise to the obligation that the procedure will extinguish.

The same principle holds true for arbitration: Article 111 of Law 446 of 1998 established that arbitration can be accepted in Colombia only for conflicts involving renounceable rights. In other words, the submission of taxation disputes to conciliation and arbitration in Colombia is denied because it is understood that the state cannot renounce its right to tax a particular act of the taxpayer. Unsurprisingly, the courts have decided

---

8Conciliation is one of the alternative dispute resolution mechanisms contemplated in South American law. It is a settlement between the opposing parties, reached with the aid of the conciliator. The only difference between “transaction” (a plain vanilla settlement) and “conciliation” is that in the latter, a third party acts as an impartial person who ensures that an agreement is reached that does not violate any norm or fundamental right of the parties. This mechanism can be compared to mediation in the United States.

9Free translation. Original text in Spanish reads: “Par. 2: No puede haber conciliación en los asuntos que versen sobre conflictos de carácter tributario.”

10Art. 111, Law 446 of 1998: The mechanism of arbitration can only be invoked by parties in a conflict in which the right giving rise to the obligation that would be extinguished by the procedure is susceptible of renunciation. **
that the reason why the state cannot renounce its right to tax a particular taxpayer is that public order would be violated.\footnote{Decision No. C-146/2000 for the Constitutional Court, and Decision 16.973, June 8, 2000, Consejo de Estado.} In the case of international tax arbitration, the violation of public order would be exacerbated by the fact that it is not even a sovereign authority that is waiving the state’s economic interest of raising revenue by the equal application of domestic tax laws to every taxpayer.

The position taken by Colombian courts assumes prima facie that the state (represented by tax authorities) has a right to tax the taxpayer in a particular amount and for a particular act. This can be a wrong assumption, because the point of bringing the conflict to an alternative resolution authority is to question the right to tax, which must be suspended while a final decision is made. Of course, the protection of the country’s economic interests requires that the final decision be vested with legitimacy; arbitration, especially in the international context, necessarily gives national authorities a significant degree of control over the procedure. Consequently, to comply with the Colombian public order provision, the arbitrator will be able to choose only one of the interpretations of the treaty given by the national authorities, following the “base-ball approach” adopted by the United States.\footnote{See Burnett, at 183-184.}

In any case, the exclusion of taxation conflicts from the realm of arbitrable issues rests on the confusion between the sovereign right that a country has to decide how to tax its taxpayers, and the right to pursue the collection of tax that might not be owed under the applicable laws. Naturally, the first right is not susceptible of renunciation, and, therefore, of transaction, as it pertains to the still vigorous domain of national sovereignty. Any international arbitration procedures initiated against the state would have to exclude all decisions pertaining to tax policy to preserve this vital right of countries.\footnote{This feature is clearly protected in the OECD model, as well as in existing mandatory arbitration protocols, as the arbitration panel would not have the power to question the “fairness” or “validity” of the tax laws and treaties enacted by Congress. The arbitrators would merely apply those laws to the particular case, following the interpretation that they believe reflects the true spirit of the treaty.} In this way, the sovereign right of Congress to choose the appropriate tax policy for the country would be left untouched by arbitration.

The second right, however, should be susceptible of renunciation and transaction, as it will not even materialize as enforceable until a recognized authority decides the taxpayer has an obligation to pay the tax that the tax authority is claiming as due. This right does not relate to the prerogative that Congress has to enact independent and sovereign tax laws and to adopt treaties, but rather to the application that the administrative authorities give to such laws and treaties. If the courts or the legislature would distinguish between these two rights, the intuition mentioned above would be fully confirmed, and the arbitration of international taxation disputes would be permissible without violating sovereignty or public order in countries such as Colombia.

Nevertheless, given the courts’ current position on this issue,\footnote{The Constitutional Court ratified its belief in the impossibility of renouncing “taxation rights” in 2004, when a temporary tax conciliation law’s constitutionality was questioned. In Decision 910/04, the Constitutional Court declared that the “right” of the tax administration was uncertain while litigation was still pending, and even more so when the taxpayer had prevailed in the first instance. Since conciliation was allowed only in those cases, the Constitutional Court concluded that the temporary tax conciliation law was constitutional.} it is likely that international tax arbitration will be considered a breach of Colombian law and the underlying public order doctrine. Consequently, awards against the state will be unenforceable, and mandatory arbitration clauses will be futile in view of the legal precepts that protect national fiscal sovereignty against international compromises. Although Colombia has already begun to negotiate bilateral investment treaties, free trade agreements, and income tax treaties, it has not been subject to an arbitral claim so far. Nonetheless, there could well be serious validity problems for any future award against the country, especially if it is related to a tax controversy.

\section*{International tax arbitration is likely to be considered a breach of Colombian law and the underlying public order doctrine.}

In general, this analysis applies for other countries that safeguard the public order and fiscal sovereignty tradition, such as Venezuela,\footnote{Law No. 36430, Apr. 7, 1998, Arbitration Act. Article 3(a) denies arbitrability for issues related to public order. Article 44 establishes that an award on a public order question is voidable by means of annulment before national Venezuelan tribunals. Article 49 denies enforceability of awards that are contrary to public order.} Bolivia,\footnote{Law No. 1770, Mar. 10, 1997, Arbitration and Conciliation Act. Article 3 denies arbitrability of public order matters. Article 6(l)(4) excludes from arbitration any disputes that relate to the...} and Chile.\footnote{See Burnett, at 183-184.} However, some progress has been made in countries such as Peru, in which the public order exception is
still part of the arbitration laws, but has been mitigated by a provision that allows state companies and agents to submit administrative disputes (with no exclusion for taxation conflicts) to international arbitration and thereby bind Peru to a subsequent award.19 Because of the “later in time” rule, the law that allows arbitration in administrative disputes prevails over the public order clause in the arbitration law in Peru. In contrast, Bolivia in June 2007 denounced the Washington convention for international arbitration in investment disputes in view of possible future expropriation claims that might challenge fiscal sovereignty.

Likewise, Ecuadorian arbitration law includes a clause that resembles the Colombian public order principle, in which sovereignty issues like taxation are excluded from the domain of arbitration. Like in Colombia, the public order clause in Ecuador is part of ordinary law. According to the Ecuadorian Arbitration and Mediation Law of 1997 (RO/145 of 1997), claims that affect national interests or the interests of society are not arbitrable. Article 1 limits arbitrability to “those issues susceptible of transaction.” Just as in Colombia, the controversy must deal with rights that can be renounced, and Ecuadorian courts have considered that this requirement is not fulfilled in matters of taxation. In Ernesto Salcedo’s opinion, regarding an arbitral award issued by the International Center for the Settlement of Investment Disputes (ICSID):

Ecuador cannot submit the issues that imply transaction or renunciation of public rights, such as the ones relating to its taxing power, to an arbitral decision. In effect, taxation issues, for being a part of the sovereign power of the State, of its power to tax, cannot be submitted to the decision of an arbitral tribunal, but only to the decision of the competent judges within the country.20

Further, under a reform enacted in 2005, article 41 of the Ecuadorian Arbitration and Mediation Law states that parties may agree to international arbitration only (1) if they are domiciled in different states, (2) if the place of compliance of a substantial part of the obligations or the site to which the matter of the dispute is more closely related is located outside the state where at least one of the parties is domiciled, or (3) if the matter in dispute refers to an international trade operation “that may be subject to compromise and which does not affect or hurt national interests or the interests of society.” Moreover, article 31(d) of the Arbitration and Mediation Law declares that any award referring to a nonarbitrable conflict will be subject to annulment by petition of any of the parties. Public order and the economic interests of the state are not used merely to challenge the validity of an arbitral award regarding taxation issues; those concepts are used to justify the nonarbitrability of tax conflicts in the first place. Following the pattern described for Colombia, tax conflicts are excluded from the range of arbitrable issues, and international awards deciding tax disputes are denied enforceability because of a failure to distinguish the sovereign rights of Congress from the uncertain realm of tax collection.

The Argentine case represents a final illustration of the sovereignty constraints that have been imposed by South American countries.

The Argentine case represents a final illustration of the sovereignty constraints that have been imposed by South American countries. Regarding the arbitrability of tax conflicts, the Civil Procedures Code (section 737) establishes that only issues susceptible of transaction will be arbitrable. The lack of arbitrability is again based on the impossibility of waiving taxation rights. Indeed, section 872 of the Argentine Civil Code states that “rights granted on behalf of public policy cannot be waived.” Argentine courts and doctrine agree on classifying every tax conflict as involving a right that is not renounceable. In fact, tax professors at the University of Buenos Aires released a public statement in opposition to the conclusions reached at the XXII Latin American Tax Law Congress in 2004, in which they defended the “jurisdictional immunity of the State from arbitrators and international tribunals regarding the decision of conflicts related to the exercise of the iure imperii powers, such as the power to tax, by such mechanisms.”21 Once again, the sovereign characteristics of Congress’s right to tax are extended to uncertain collection claims by the tax administration, even

---

21Salcedo, at 7.

Footnote continued on next page.)
when the same sovereign power (Congress and the executive) have willingly yielded jurisdiction on taxation claims by agreeing to arbitration clauses in the first place.

Like other countries, Argentina’s version of the public order clause plays a fundamental role in excluding taxation disputes from the ambit of arbitrable issues, as well as in providing a cause for annulment of awards that decide on such matters. Under Argentine law, when matters of public policy are involved, local courts may review the reasonability, fairness, and constitutionality of an award. The newly elected Federal Supreme Court of Argentina has tried to enforce this clause, even when there has been a voluntary waiver of appeal by the parties.22 Concurring with the professors, the Court understands that only sovereign appointed bodies can claim jurisdiction on matters of public policy, even when the arbitration clause in most conventions provides that contracting states will waive the review of the awards by national courts. For that reason, the Supreme Court has rejected the possibility of any parties’ agreement that may limit its review over matters of public policy, including arbitration clauses in tax treaties and bilateral investment treaties. In many cases, the practical effect of the Supreme Court’s position is to leave the taxpayer with the only remedy of submitting the conflict to national courts for a de novo review (as if there had never been an award).

In all the cases examined above, arbitrability and enforcement of international tax arbitration awards are denied either by an explicit legal provision or by the interpretation of general rules regarding which conflicts are susceptible of transaction. In all cases, the qualification of tax disputes as not susceptible of transaction is supported by an expansive view of public order and fiscal sovereignty: If tax disputes fall within the public order domain, then the rights involved in such claims cannot be waived. This reasoning is suspect insofar as it ignores the distinction between rights to determine a country’s tax policy (which, in effect, belong to the public order and sovereignty domain) and rights of the tax administration to collect tax from a taxpayer based on a debatable interpretation of an applicable law or treaty. The question now turns to the validity of the South American statements of fiscal sovereignty when mandatory arbitration clauses are included in income tax or investment treaties.

II. Arbitration Clauses in Tax Treaties

The limitations on international tax arbitration imposed by South American countries are all established in statutes and court decisions, but none has a constitutional legal status. However, all South American countries require that every treaty must be approved by Congress by adopting the treaty text in internal law. In some countries, treaties are even given primacy over internal law, following the principle of good faith and pacta sunt servanda in the Vienna Convention on the Law of Treaties (to which most South American countries are parties). This implies that arbitration clauses in treaties are part of a privileged expression of sovereignty by the legislature, which is in clear conflict with the domestic provisions examined above.

The waiver of sovereignty is an essential characteristic of international treaties, but the waiver becomes the core of the agreement. Indeed, each country’s right to apply domestic tax laws is limited by the provisions of the treaty regarding a group of taxpayers that would otherwise be subject to the unilateral sovereign will of Congress. The tax policy expressed in treaties is subject to the constraints imposed by the interests of another sovereign nation, but both contracting states voluntarily agree to cede their absolute freedom in regulating taxation in all relevant aspects, including dispute resolution, in the hope that their nationals will benefit from the agreement.

### The waiver of sovereignty is an essential characteristic of international treaties, but the waiver becomes the core of the agreement.

Regarding dispute resolution, the treaty wording has usually carried soft connotations; for example, in the word “endeavor” used in the mutual agreement procedure articles in most model treaties. However, scholars have recognized that despite the softness of the wording, states that include an arbitration clause in their treaties actually cede their sovereignty in this respect. Commenting on an ICSID award against Ecuador for a VAT dispute, Susan Franck warns states about possible concessions of sovereignty that a treaty may entail:

Cases such as Occidental are useful, however, in the sense that they enable states to obtain more

---


23. Chile and Argentina grant a priority legal status to international treaties over internal law; see *Cafes la Virgina*, Argentine Supreme Court, 1994.
information about the scope and potential interpretation of rights that they may be granting investors. Armed with this extra information as to how they might inadvertently cede their sovereignty, states can make more informed decisions about the rights that they grant to investors in the future. By scrutinizing treaty rights in this manner during treaty negotiations, a state can form more realistic expectations, thereby preventing post hoc dissatisfaction with awards and also, more generally, giving states enhanced confidence about the areas in which they can legislate and regulate, and with what consequences.24

International arbitral tribunals have used the 

\textit{effet utile} doctrine (under which laws and treaties must be interpreted to achieve an effect in reality, beyond mere paper) to give force to the arbitration clause in a tax dispute.25 The use of the \textit{effet utile} doctrine in this context has been criticized, given that the soft wording used in the dispute resolution provisions in treaties is usually intentional; however, it would appear that the avoidance of strong verbs only demonstrates the intention of countries to limit their commitment to means and not ends.

When confronted with the needs of globalization, small economies (like those of many South American countries) tend to seek coordination with larger economies. That is because, as Jeffrey Owens points out, if they did not seek such coordination, they would be forced to shape their unilateral tax policies to accommodate the international tax policy decisions of the investors' countries of residence.26 For example, Bolivia was forced to abandon a cash flow tax that replaced the regular income tax because it would not be creditable in countries that adopt the foreign tax credit as a means of according unilateral relief from double taxation.

Some South American countries have opted for coordination by voluntarily waiving fiscal sovereignty as source countries. This waiver on core topics of tax treaties is accepted and welcomed because it brings certainty and, with that certainty, an increase in foreign direct investment. Nonetheless, the voluntary waiver of national judicial jurisdiction over tax disputes in treaties is criticized as curtailing sovereignty and violating public order provisions. In South America, the reaction to international tax arbitration clauses in treaties has elicited strong reactions by judges and scholars, such as the one from Argentine professors after an International Tax Congress in Quito concluded that international tax arbitration was an acceptable alternative for making tax treaty compromises efficient.

Some South American governments have decided to limit voluntary waivers to the distributive rules in tax treaties and to avoid signing arbitration clauses so that national courts can retain jurisdiction over tax disputes.27 However, that approach could frustrate the coordination drive needed in a globalized world. For Owens, one necessary manifestation of coordination is compulsory international tax arbitration, as it would prove the only efficient mechanism to guarantee coordination between contracting parties.28 Further, investors are usually interested in having a neutral mechanism to resolve tax disputes that arise from the interpretation of treaties. In this sense, the voluntary waiver of jurisdiction is as justified as the voluntary waiver of the sovereign right of Congress to tax at source.

As McLure points out, not all voluntary limitations on national sovereignty in taxation matters are market-induced; nations sometimes agree voluntarily to negotiated limits on their exercise of sovereignty.29 Those nations may agree to a limitation on the rational assumption that curtailing fiscal sovereignty will not harm the country, as long as it maintains a sound, equitable tax policy. However, countries must be aware of the benefits that this voluntary waiver provides: an investor that can eliminate or significantly reduce the risk of delayed, biased decisions of a host country’s judicial system will be more inclined to allocate capital to that country. The possibility of an international tribunal deciding a tax question should not be seen as threatening if the country is confident of the soundness of its tax policy, which should be the case in all countries, as the tribunal will have enough rules and guarantees to ensure a fair award taking into account the taxpayer’s and the host country tax administration’s points of view.

In the end, it seems paradoxical that the waiver of fiscal sovereignty is widely welcomed when it comes to the core sovereignty aspect of taxation — tax policy decisions made unilaterally and independently by Congress — but the waiver on the dispute resolution aspect is seen as a threat to fiscal sovereignty.30 The real imposition on the contracting state's sovereignty arises

\footnote{24Franck, at 681.}
\footnote{26Owens, at 41.}
\footnote{27The presidents of Argentina and Ecuador have criticized the results of arbitration concerning tax disputes in bilateral investment treaties.}
\footnote{28Owens, at 43.}
\footnote{29McLure, at 330.}
\footnote{30This was the evident position of the OECD member countries before the newly proposed article 25 for the model convention. In fact, in the 1984 report, delegates concluded that “the need for compulsory arbitration has not been demonstrated by (Footnote continued on next page.)}
from the treaty provisions that deal with the distribution of revenue between the countries, not from allowing states and taxpayers to use arbitration as a mechanism to resolve disputes arising from interpretation of the treaty. As Mario Züger suggests, the instrument that restricts a nation’s sovereignty is the tax convention or the investment treaty itself, rather than the arbitral decision, as the decision may be presumed to be executing an obligation contracted by the state in good faith. Indeed, arbitration boards have the task of interpreting and applying the treaty, knowing that a tax administration’s interpretation is not final. Therefore, the issue that the arbitration tribunal will examine is not final, as tax laws always leave enough room to guarantee ambiguity in the application of each provision to a set of facts. Of course, deciding on issues that are uncertain cannot be compared to interfering with final, sovereign rights.

III. What Are the Options?

South America faces a conflict between the domestic prohibition on submitting tax disputes to arbitration and international commitments to be bound by arbitration when there is an arbitration clause in a treaty. Of course, the tension would be resolved if South American countries have not yet entered into tax treaties and bilateral investment treaties would refrain from including an arbitration clause, but this does not appear to be a plausible option for countries that need international trade and investment. Some authors recognized years ago the impossibility of absolute tax sovereignty in the current context of globalization: “Of course, complete sovereignty is impossible, except perhaps for a country that is totally isolated from external influences, such as Burma.” South America’s dependence on trade cannot be denied, and most governments in the region are seeking to increase the volume of trading and foreign direct investment.

Besides, most South American countries that have not already signed arbitration clauses in tax and investment treaties are seeking to enter into those agreements with their major trading partners, and many of those trade partners may want an arbitration clause in the treaty. Even if a South American country had the bargaining power to avoid such arbitration clauses, that would still be a harmful policy decision to the extent that many risk-averse investors will be deterred from placing their capital in the country. Indirectly, the decision may cause the country to be more isolated within the region if the trading partner’s companies find a similarly profitable investment in another country that will be willing to waive jurisdiction to provide a neutral and efficient alternative to resolving international tax disputes.

The real and permanent solution to the dilemma of sovereignty and international alternative dispute resolution mechanisms includes the abandonment of the idea of a sovereign right in every tax dispute and accepting that tax disputes will always carry uncertainty that leaves room for arbitration. But this abandonment requires a change of laws that will shape the attitude of tax administration officials and taxpayers, which is often difficult given the organic structure of the state in South American countries. In the meantime, short-term solutions are needed to allow countries that have adopted arbitration clauses to fulfill their international commitments, providing security to foreign investors but preserving as much sovereignty as the rules will permit.

It is more realistic to examine the possibilities of making arbitration a procedure that will not invade countries’ sovereign right to tax and still remain compatible with the voluntary waiver of jurisdiction implicit in arbitration clauses. The concern is how to make public order and economic policy compatible with a waiver by the state of a portion of its fiscal rights — namely, the right to decide all tax disputes in local courts. Taking advantage of the flexibility of arbitration, and the novelty of the procedure in the tax area, it is suggested that South American states try to shape arbitration protocols to include the following features.

A. Composition of Arbitration Board

Some South American rules of civil procedure require that all tax disputes be settled by national judicial authorities. To vest the arbitration board with the legitimacy requirement of state participation in the decision, the board can be composed of judges of both contracting states and an independent arbitrator from a third country, which is one option contemplated in the Germany-Sweden income tax treaty. By having a national judge participate in the decision, South American countries cannot be considered as waiving jurisdiction over taxation rights. At the same time, the presence of a neutral arbitrator who presides over the board will give investors the sense of an unbiased decision, consistent with the state’s international commitments as expressed in the treaty.

Naturally, the selection of the neutral third party must be made by both contracting states from an approved list of recognized experts in the subject to be arbitrated.

evidence available and the adoption of such procedure would represent an unacceptable surrender of fiscal sovereignty.”
31Züger, at 32.
33McLure, at 329.
34Züger, at 34.
B. The Baseball Approach

The expression *pro bono et aequo* refers to decisions based on equitable considerations perceived by the arbitrators, without an express request from either of the parties in the dispute. The role of the arbitrators here is to provide an independent solution that will satisfy their standards of equity, even if that implies the rejection of an important portion of each party's argument. Excluding this type of award grants a safeguard from the common fear of arbitrators' power to use considerations of equity in their decisions. This fear has developed as a reaction to the OECD 1992 commentary on article 25 of the model convention, which stated that the competent authorities, “as in the case of international arbitration, can, alternatively, have regard to considerations of equity in order to give the taxpayer satisfaction.” When fixing the procedures for international tax arbitration by an exchange of notes, South American countries can exclude the possibility of equitable considerations in the final award. Alternatively, by placing national judges on the arbitration board, the states can either limit equitable considerations to what is permissible for judges in the domestic realm, or completely bar the application of such principles, as in the Germany-Sweden treaty.35

As mentioned earlier, the baseball arbitration method seems to be the one that preserves the most sovereignty for the state, as the award will either accept or deny the competent authority’s interpretation of the treaty without substituting the arbitrators’ judgments for those of the tax authorities.

C. Limiting the Scope of Arbitration

This point is central to preserving sovereignty in South American terms. As described above in the representative cases of Colombia, Ecuador, and Argentina, the central core that the law excludes from the arbitrable domain is the sovereign right to adopt a certain tax policy at the domestic level. For that reason, the competence and jurisdiction of the international tax arbitration tribunal must be restricted to issues that arise from the interpretation and application of the treaty containing the arbitration clause.

The United States has adopted this solution in the arbitration procedure established for the Dutch, Mexican, and German treaties.36 This exclusion is far from clear, as Tillinghast points out,37 but it does not leave the arbitrable pool without disputes. Arbitral awards cannot decide on the fairness, constitutionality, or convenience of a domestic tax, nor can they examine the viability of a domestic tax benefit unrelated to the treaty. However, an arbitral tribunal could rule on transfer pricing matters, the withholding rate applicable to a cross-border transaction, or the treatment of partnership income when one of the countries perceives a corporation. Whether an issue is arbitrable is to be decided by the arbitration panel in an independent statement of jurisdiction.

D. Long-Term Solutions

The features mentioned above constitute short-term solutions to the tension between domestic sovereignty objections to arbitration and international commitments to be bound by such procedures in tax disputes. However, South America must realize that globalization is eroding fiscal sovereignty and that investors might obtain their wish of having arbitration as the ultimate dispute resolution mechanism in tax matters. It is desirable to gradually proceed beyond short-term solutions in favor of more solid alternatives to keep up with globalization and its demands.

There are two realistic possibilities for achieving this purpose in South America, and some countries, such as Peru, have already began to implement these strategies. The most immediate solution would require the efforts of the supreme and constitutional courts, which usually have the power to issue independent rulings that validate international awards and recognize international commitments. When courts take this position, some immediate revenue might be lost, but the trust of the international community in the stability of the country, and in its international commitments, will cause an increase in foreign investment.38 Further, a measure that will guarantee the sound functioning of international tax arbitration is likely to encourage the competent authorities to reach efficient agreements and to concentrate their efforts so as to avoid international disputes. As long as international arbitration remains in tension with domestic sovereignty provisions, the competent authorities will have no real incentive to reach an agreement in the mutual agreement procedure, or to avoid extreme interpretations of the treaty that would conflict with the other state’s and the taxpayer’s interests.

Another long-term solution that reflects the changing status of national-state frontiers would be to eliminate fiscal sovereignty provisions from South American legal systems. This would require a compromise by

---

35Tillinghast, at 351.
36For example, the first paragraph of the German letter of understanding provides that the competent authorities will not accede to arbitration regarding matters concerning the tax policy and domestic law of the contracting state.
37Tillinghast, at 353.
38It is safe to assume that in South American countries, where corruption and inequality in the redistribution of wealth are important factors to be considered, the benefits of long-term investments might be much more solid and durable for citizens than the immediate revenue of a tax that breaches international commitments.
different constituencies so that Congress would withdraw public order and public policy provisions. With this change, it would be possible to resolve the tension between international tax arbitration and local fiscal sovereignty, sparing countries from suffering the consequences of conflicts such as those of Argentina and Ecuador in ICSID tax arbitration procedures against them, and helping to make the region a safe and desirable investment environment.

Bibliography


---

39 Since the early 2000s, Argentina and Ecuador have been sued in arbitration for the violation of the tax clause in bilateral investment treaties signed with the United States. In those cases, the arbitration tribunal ruled in favor of the investor, requesting the state to suspend the collection of a tax (VAT in the Ecuadorian case and an oil export withholding tax in the Argentine cases). When the countries tried to deny enforcement of the awards because the arbitrators ruled on taxation matters, both countries received a political complaint from the United States; in one of the cases, a significant decrease was seen in the international aid package.