Treaty Arbitration from a Japanese Perspective
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This article examines whether or not treaty arbitration is constitutional in Japan.

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1. IFA’S DISCUSSION DRAFT

The recent discussion draft of the International Fiscal Association on tax treaty arbitration is an intellectual achievement laying the foundation for future discussion on the subject. The draft has three remarkable features. First, it is based on the co-authors’ rich experience in both the tax field and non-tax fields. Second, it contains some specific proposals in the form of draft model treaty language. Particularly noteworthy is its detailed discussion of the procedural mechanics of mandatory arbitration. Third, it provides an effective mechanism that allows no leeway for governments to back off. In short, the draft has strong teeth.

2. A JAPANESE PERSPECTIVE

For Japan, the draft sheds light on some unexplored legal issues. Indeed, years before the IFA draft was circulated, one prominent commentator raised constitutional issues regarding treaty arbitration in general. If treaty arbitration violates Japan’s Constitution, the Japanese government could not adopt an arbitration mechanism in its income tax treaties. Currently, Japan’s income tax treaties do not contain an arbitration clause.

Therefore, it is worth asking whether treaty arbitration violates Japan’s Constitution. Specifically, does the Constitution permit the Japanese government to adopt some sort of mandatory arbitration mechanism in the income tax treaties that Japan concludes with other countries?

This short article is an attempt to answer this question. It argues that treaty arbitration may be constitutionally permissible if it satisfies certain conditions. The article focuses exclusively on the constitutional limitation on treaty arbitration. Whether or not arbitration is advisable for Japan as a matter of treaty policy is another question.

3. COMPATIBILITY WITH THE CONSTITUTION

3.1. What is at stake

There are at least two distinct lines of argument supporting mandatory arbitration. First, arbitration is necessary to improve the mutual agreement procedure (MAP). A treaty-based dispute resolution mechanism is necessary to avoid discrepancies in the interpretation and application of the treaty provisions. Yet, the present MAP has its own limitations. Therefore, the MAP should evolve into a more effective mechanism accompanied by the back-up of mandatory arbitration, which will automatically be initiated a few years after the case is presented to the competent authorities. This argument is discussed further in 3.5.

Second, arbitration is necessary in order to circumvent domestic judicial proceedings. Under this view, the arbitration court functionally replaces the local judicial court. Accordingly, arbitration awards should have the same legal effect as final judicial judgements under domestic law. In addition, arbitration awards must be recognized and enforced without exception.

The second line of argument has a realistic background. Multinational enterprises often do not have sufficient trust in the local tax authorities and the judicial system of the host country. They fear that taxation may eventually remain as “not in accordance with the provisions of the treaty” even if they appeal to the local court. From their point of view, arbitration is preferable to local litigation because arbitration is more timely, cost-effective and transparent.

The host country, however, is unlikely to be satisfied with this view. Domestic court procedures will be circumvented by treaty arbitration if arbitration awards play the same role as final judicial judgements under domestic law. An arbitration court rather than a domestic judicial court reviews the actions of the tax authorities. This tantamount to a partial transfer of judicial power. It is no wonder that arbitration has been opposed on the ground of state sovereignty.

The issue of the constitutional permissibility of tax treaty arbitration reflects this basic tension. This article focuses on inbound transactions whereby multinational enterprises enter the Japanese market. In other words, the discussion examines the application of Japan’s Constitution in the

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situation where Japan is the host country. The constitutional issues in this setting can be broken down into three sub-issues: access to the courts, transfer of judicial power and statute-based taxation.

3.2. Access to the courts

According to Art. 32 of Japan’s Constitution, no person may be denied the right of access to the courts. This provision guarantees the right of every taxpayer to be heard before a judicial court that is independent of political bodies. The term “courts” in this provision means the Supreme Court and the inferior courts that are established by law (Art. 76). As in many other jurisdictions, due process is constitutionally guaranteed (Art. 31).

Does Art. 32 prohibit the adoption of treaty arbitration that binds both the taxpayers and the tax authorities? There is no authoritative precedent on this issue in Japan. Art. 32, however, is a weak argument against arbitration. Japan already has arbitration procedures in non-tax fields, and it is undisputed that they are permissible under Art. 32. Therefore, Art. 32 should be read as permitting the legislature to design various types of dispute resolution mechanisms, including arbitration. Multinational enterprises are not likely to raise this issue because they would prefer treaty arbitration to domestic litigation, as explained in 3.1. Art. 32 guarantees taxpayers the right of access to the courts, but it should not be construed as forcing taxpayers to go to the courts.

3.3. Transfer of judicial power

Is it constitutionally possible for a state to transfer part of its judicial power to a transnational organization such as an arbitration court set up by a treaty? It has been reported that Austria’s Constitution was amended in 1981 to permit the transfer of federal competence to international organizations. Japan’s Constitution lacks such a provision; therefore, this issue is entirely up to interpretation.

According to Art. 76 of Japan’s Constitution, all judicial power is vested in the Supreme Court and in the inferior courts established by law. One way to read this provision is that it forbids the carving out of some judicial power and taking it away from the domestic courts mentioned in Art. 76. But this interpretation is too narrow. The judicial system exists to assist persons in resolving disputes and realizing their rights. Thus, it would be inappropriate to assume that the Constitution flatly prohibits the adoption of a suitable dispute resolution mechanism for cases that cannot be properly handled by the domestic courts. Treaty provisions require constant interpretation and application, and discrepancies are inevitable if there is no coordination among the tax authorities of different jurisdictions. The domestic courts in separate jurisdictions cannot produce authoritative precedent on this issue in Japan. Art. 32, however, is a weak argument against arbitration. Japan’s Constitution precludes arbitration on tax matters. The government may not conclude a treaty that contains such a provision. Therefore, the issue is whether or not the Constitution itself permits tax arbitration. Here again, it is necessary to go back to the basics of why the Constitution provides special rules on tax matters. Taxation must be based strictly on the statutes (Art. 84). As a corollary, it is generally accepted that there is no room for compromise between taxpayers and the tax authorities. These rules exist because taxpayers should be protected from arbitrary taxation that is not in accordance with the statutes. If this is the case, it cannot be invoked as a ground for the total denial of a well-designed arbitration procedure that aims to accomplish, rather than destroy, the rule of law. The Constitution should be interpreted so as to leave room for constructing appropriate mechanisms for alternative dispute resolution even in the tax field.

It should be noted that the Constitution prohibits the establishment of extraordinary tribunals (Art. 76). This rule supplements the constitutional guarantee of access to the courts by ensuring that the courts are equipped with independent judges. The term “extraordinary tribunals” in this provision should be construed so as to exclude arbitration courts that are properly set up by tax treaties.

3.4. Statute-based taxation

As indicated above, there are reasons to think that Japan’s Constitution leaves room for treaty arbitration in tax matters. On the other hand, it would be too hasty to argue that there are no constitutional constraints on tax arbitration.

According to Art. 84 of the Constitution, no new taxes may be imposed or existing taxes modified except by law. These rules exist because taxpayers should be protected from arbitrary taxation that is not in accordance with the statutes. If this is the case, it cannot be invoked as a ground for the total denial of a well-designed arbitration procedure that aims to accomplish, rather than destroy, the rule of law. The Constitution should be interpreted so as to leave room for constructing appropriate mechanisms for alternative dispute resolution even in the tax field.

First, an arbitration court must apply substantive rules that are clear and precise. For instance, when applying the “associated enterprises” provision of a treaty, the arbitration court determines the arm’s length price. The treaty language itself, however, is not sufficiently clear for such

A related argument against arbitration is that the field of taxation is inappropriate for arbitration. According to this argument, the legal relationship between the taxpayer and the state (Steuerrechtsverhältnis) is, by its nature, non-arbitrable. A possible counterargument to this is that the defence of “subject matter arbitrability” can be excluded by inserting explicit language into the treaty provision. If, however, Japan’s Constitution precludes arbitration on tax matters, the government may not conclude a treaty that contains such a provision. Therefore, the issue is whether or not the Constitution itself permits tax arbitration. Here again, it is necessary to go back to the basics of why the Constitution provides special rules on tax matters. Taxation must be based strictly on the statutes (Art. 84). As a corollary, it is generally accepted that there is no room for compromise between taxpayers and the tax authorities. These rules exist because taxpayers should be protected from arbitrary taxation that is not in accordance with the statutes. If this is the case, it cannot be invoked as a ground for the total denial of a well-designed arbitration procedure that aims to accomplish, rather than destroy, the rule of law. The Constitution should be interpreted so as to leave room for constructing appropriate mechanisms for alternative dispute resolution even in the tax field.

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a determination. It is necessary to add normative content to the provision so that taxpayers will be assured of legal certainty. For this purpose, it could be considered that the OECD Transfer Pricing Guidelines be given an elevated legal status and that they be further clarified.

Second, an arbitration court must operate in a manner similar to formal judicial proceedings. Otherwise, arbitration would be no different from an ad hoc compromise. At the very least, the arbitrators must concentrate on the points to which the parties refer, the findings of fact must be based on evidence, and the awards must be accompanied with a reasoned opinion on the particular issues.

Treaty arbitration that does not meet these requirements should be held unconstitutional. The government will not be allowed to conclude a treaty that contains an arbitration clause that is unconstitutional. Even if the Cabinet and the Diet both agree that a particular arbitration clause seems constitutionally permissible, the domestic courts should retain their power of constitutional review over the issue and determine whether the arbitration clause meets the above standards.

3.5. Effect of arbitration awards under domestic law

A difficult question is how to view the legal status of treaty-based arbitration awards under domestic law. Suppose that the treaty contains an explicit provision to the effect that an arbitration award has the same res judicata effect as a final judicial judgement under domestic law. At the treaty level, the effect of arbitration awards seems to be clear. It is still, however, a matter for the constitutional structure of each jurisdiction whether such a provision is legally sustainable.

One conceivable view is that Japan’s Constitution fully recognizes treaty arbitration as an authentic dispute resolution mechanism and that therefore arbitration awards are permitted to replace judicial judgements. Needless to say, this view is valid only if the arbitration procedure in question satisfies the conditions discussed in 3.4.

Another possible view is that an arbitration award binds only the tax authorities as if the award were an administrative circular within the tax administration. According to this position, the domestic courts retain jurisdiction over the controversy. If arbitration awards ever bind the taxpayers, it is due to the collateral effect arising from the fact that they have voluntarily relinquished their right to access to the courts.

Both positions have merits and demerits. On balance, the former view seems more consistent with the arguments advanced in 3.3. On the other hand, two difficulties with this view must be noted. One is that reciprocity is not achieved with respect to those treaty partners whose constitutional framework permits domestic law to override treaties. Another difficulty is how to reconcile the domestic administrative procedure with the civil procedure, such as the New York Convention on Recognition and Enforcement.

Even if these difficulties are considered to be grave, the idea of treaty arbitration should not be abandoned altogether. Alternatively, arbitration could be designed as an extension of the MAP, and an arbitration award could have the same effect as agreements reached in the MAP process. True, this alternative lacks the vital feature of the IFA discussion draft, but it should be remembered that even the use of mediation⁵ is a step forward compared with the status quo.