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Dispute Resolution: the Mutual Agreement Procedure

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Dispute Resolution: the Mutual Agreement Procedure

Hugh Ault

1. Introduction

1.1 Function of MAP

Article 25 of the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] ("UN Model Convention") is a very important procedural provision for the application and implementation of the bilateral treaties based on the Model. It provides for the establishment of a "mutual agreement procedure" ("MAP") which enables the parties to the convention to better carry out the substantive provisions of the convention which allocate taxing rights. The MAP is administered by the "Competent Authorities" (CAs"), who are generally named in Article 3(e) of treaties based on the UN Model Convention. Typically, CAs come from the Ministry or Tax Authority (the responsible branch of the governments of the contracting states). They are the persons who are normally responsible for administering the convention and the mutual agreement procedure in Article 25 sets forth the agreed rules and principles for ensuring that the convention carries out its proper functions. The role of the competent authorities in Article 25 is to "endeavor to resolve" by mutual agreement any difficulties or doubts arising as to the application of the convention. It applies in connection with all articles of the convention.

In order to ensure the proper functioning of the convention, Article 25 gives rights to taxpayers who believe that they are not being taxed in accordance with the substantive rules of the convention to request that the competent authorities bring their taxation into accordance with convention rules, either unilaterally or in consultation with their treaty partner. Taxpayer-initiated cases represent the bulk of cases under Article 25. Cases would typically involve transfer pricing disputes, allocation of profits to a permanent establishment under Article 7, the question of the existence of a permanent establishment or the appropriate residence of a person or company. Access to the MAP procedure should be broadly interpreted as it is essential to the proper functioning of the convention.

[1] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

Beyond taxpayer-initiated cases, the CAs may undertake themselves to resolve any "doubts and uncertainties" concerning the application of the convention, for example, by establishing an agreed meaning to an undefined term in the convention, thus insuring its uniform application. Finally, there is a broad provision which allows the competent authorities to consult together for the elimination of double taxation in cases not otherwise provided for in the convention.

The remainder of this paper will describe in some detail the various situations in which the MAP can be used to ensure the proper functioning of the convention. Two important sources of additional material on MAP are the UN "Guide to the Mutual Agreement Procedure under Tax Treaties" ("UN Guide")[2] and the Organization for Economic Co-operation and Development ("OECD") "Manual on Effective Mutual Agreement Procedures ("MEMAP")[3] and reference will be made to these materials in the descriptions below.

1.2 How MAP operates

Article 25 (4) of the UN Model Convention authorizes the CAs to deal with each other directly, either in writing or orally. This avoids the cumbersome formal rules which usually govern intergovernmental communications and allows efficient communication between the two tax authorities. Communications can take various forms including face-to-face meetings, exchanges of documents or positions papers and other forms of informal contacts. Article 25 (4) foresees that the two CAs may develop bilateral procedures deal with the various detailed questions which are necessary to implement the MAP. All information exchanged under the MAP procedures is subject to the confidentiality requirement of Article 26.

1.3 Outcomes of MAP

In the case of a taxpayer-initiated MAP, the normal result is an agreement between the CAs as to how the treaty should be applied in the taxpayer's case with both CAs thus applying the same interpretation of the treaty. The taxpayer typically has the right to accept the results of the MAP and give up his domestic remedies in the two jurisdictions or to reject the MAP and seek judicial relief under the domestic legal systems. As discussed below in Section 5, if the treaty provides for arbitration, the resulting MAP may have involved a supplementary arbitration process.

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[2] The latest draft is available at http://www.un.org/esa/ffd/tax/seventhsession/CRP_4_clean.pdf

[3] Available at http://www.oecd.org/ctp/dispute/manualoneffectivemutualagreementprocedures-index.htm.

In the case of a CA-initiated procedure, the result will typically be the publication of some other sort of advice indicating how the two States will apply the treaty. Cases involving the relief of double taxation not otherwise provided for in the treaty, which are rare, can either be taxpayer specific or result in some form of general guidance. An example would be the treatment of a third country resident who had a permanent establishment in both states but, lacking a residence connection, had no right to claim relief from double taxation in either state.

1.4 Relation between MAP and domestic legal remedies

As specifically provided in Article 25(1) of both the UN Model Convention and the Organization for Economic Co-operation and Development Model Tax Convention on Income and on Capital[4] ("OECD Model Convention")[5], MAP is in principle available to the taxpayer in addition to his normal legal remedies under domestic law. Thus it is important to clarify clearly the exact relation between the two systems of relief which is a matter of domestic law. If a domestic court has already reached a decision in the case at issue, the CA may be bound by the decision of the domestic court and may not be in a position to provide any unilateral relief. In addition, its ability to deal with the other State in the MAP may be limited to seeking to obtain double tax relief from the other State. Where the application of domestic relief and the MAP are both open to the taxpayer, there should be some rules establishing the relation between the two systems. Some States require the taxpayer to waive all of his rights under domestic law before the CAs will accept a case for MAP but this practice is not usual. States taking this position are concerned about devoting the resources and efforts to find a MAP solution which the taxpayer may ultimately reject. More commonly, however, the taxpayer will only be required to suspend the active pursuit of his domestic law remedies while the MAP case is being implemented. In such cases, it is important that the taxpayer take the necessary steps as required under domestic law (obtaining a waiver of time limits, submitting a protective claim, etc.) to keep his domestic law remedies available should, in the end, the MAP not produce a satisfactory result. Alternatively, it is possible for the period in which the MAP claim is timely (see Section 2.2.3) to be either suspended or extended while the domestic legal proceeding is

[4] Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (loose-leaf).

[5] Any references to the UN Model Convention and Commentary are to the 2011 version unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version unless otherwise noted.

going on. Whichever approach is taken, it is important to have clear rules for both the taxpayer and the tax administration as to the relation between the two procedures.[6]

2. Taxpayer-initiated MAP

2.1 General

By far, most MAP cases involve a complaint by the taxpayer that it is not being taxed in accordance with the substantive rules in the treaty allocating taxing jurisdiction between the two states, thus resulting in unrelieved double taxation which frustrates the purpose of the treaty. This can involve a dispute with the source country as to whether that country has the right to tax under the treaty or with the residence state as to when it is required to give double tax relief.

2.2 Basic requirements for a taxpayer initiated MAP

To make a request for a MAP, Article 25 of the UN and OECD Model Conventions require that the taxpayer be a resident of one of the Contracting States and establish that an action by one or both of the States results or "will result" in taxation not in accordance with the convention. The request is made to the State of which the taxpayer is a resident, even if the claim relates to taxation imposed by the other state. It should be noted that the taxpayer has the right to make a MAP request if the actions "will result" in its being inappropriately taxed; it is not necessary that the taxpayer has in fact already been charged to tax. Thus, for example, if a law has been enacted that, when applied to the taxpayer would, in its view, result in inappropriate taxation, the taxpayer would be able to request MAP provided it had or expected to have income of the type covered by the newly enacted law.

2.2.1 Information requirements. For the MAP to be successful, the taxpayer requesting the MAP must provide the necessary information for the CAs to assess the case. Some countries have developed a formal procedure which must be followed by the taxpayer in its MAP requests. While the requirements vary somewhat, the following basic information should be required in order for the MAP request to be processed.[7]

1. The name, address, and any taxpayer identification number of the taxpayer;

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[6] UN Guide, paragraphs 72-77.

[7] UN Guide, paragraph 94.

2. The name, address, and any taxpayer identification number of the related foreign taxpayer(s) involved (for transfer pricing cases);

3. The foreign tax administration involved and, if relevant, the regional or local tax administration office that has made, or is proposing to make, the adjustment(s);

4. The tax treaty article that the taxpayer asserts is not being correctly applied, and the taxpayer's explanation of how it believes the article should be interpreted and/or applied;

5. The taxation years or periods involved;

6. A summary of the facts, including the structure, terms, and timing of all relevant transactions and the relationships between related parties (the taxpayer should advise the competent authority of how the facts may have changed during or after the relevant taxable period, and of any additional facts that come to light after the submission of the MAP request);

7. An analysis of the issues for which competent authority assistance is requested and the relevant legal rules, guidelines or other authorities (including any authorities that may be contrary to the conclusions of the taxpayer's analysis). The analysis should address all specific issues raised by either tax administration as well as the amounts related to the adjustment(s) (in both currencies and supported by calculations, if applicable);

8. For transfer pricing cases, any documentation required to be prepared under the domestic legislation of the taxpayer's State of residence (where the volume of a taxpayer's transfer pricing documentation is large, a competent authority may determine that a description or summary of the relevant documentation is acceptable);

9. A copy of any other relevant MAP request and the associated documents filed, or to be filed, with the competent authority of the other Contracting State, including copies of correspondence from the other tax administration, copies of briefs, objections, etc., submitted in response to the action or proposed action of the tax administration of the other Contracting State (translations of relevant documents may be helpful, and, where documentation is voluminous, a competent authority may determine that a description or summary of such documentation may be acceptable);

10. A statement indicating whether the taxpayer or a predecessor has made a prior request to the competent authority of either Contracting State with respect to the same or a related issue or issues;

11. A schedule of the relevant time limits and statutes of limitation in each jurisdiction (whether imposed by domestic law or the tax treaty) with respect to the taxable periods for which MAP relief is sought (in cases of multiple taxpayers, a schedule for each taxpayer);

12. A statement indicating whether the taxpayer has filed a notice of objection, notice of appeal, refund claim, or any other comparable document in either of the relevant jurisdictions;

13. A statement indicating whether the taxpayer's request for MAP assistance involves issues that are currently or were previously considered by the tax authorities of either Contracting State as part of an advance pricing arrangement, ruling, or similar proceedings.

Where the taxpayer does not supply sufficient evidence or does not cooperate in the production of the necessary information, the CA is justified in suspending consideration of the request, or if necessary, not accepting the case.

2.2.2 Requirement of Payment. Article 25 of the UN Model Convention and the OECD Model Convention does not by its terms require the taxpayer to have paid the tax before making the MAP request. Indeed, in some cases, the request may be timely even before the tax has been charged. While some states have required that the tax be collected prior to the beginning of the MAP, the better practice is to suspend or defer the obligation to pay the tax during the period of the MAP.[8] Where the CA has found the taxpayer's MAP request to be justified, it would not be consistent with the basic purposes of MAP resolution to further require the advance payment of the tax obligation in dispute. If the taxpayer ultimately prevails in its claim and the tax paid in advance is refunded, the taxpayer will have suffered the loss of the time value of money loss in connection with the payment. While these issues can in some cases be resolved by the application of interest payments and charges, it is simpler and more consistent with the underlying goals of MAP not to require payment.

[8] MEMAP Best Practice No. 21.

This may in some cases require changes in the country's domestic law to ensure that collection during the MAP can be suspended.

2.2.3 Time limits for Taxpayer Initiated MAP. Article 25(1) of the UN Model and the OECD Model Conventions provides that the taxpayer must present the case for MAP relief within three years of the first "notification" of the action taken by one of the States which will result in taxation not in accordance with the convention. This requirement is to protect tax administrations from late-filed objections to the application of the treaty rules. The three year period is only recommended and States are of course free in their bilateral negotiations to agree on a different period. The period may also be related to the domestic rules regarding statute of limitations and timeliness of claims. . In this connection, it should be noted that the taxpayer may be able to bring a MAP request as soon as it becomes clear that inappropriate taxation may result (see Section 2.2 above). This may occur substantially before the actual notification of the action which triggers the three-year period.

The determination of exactly what constitutes "notification" for purposes of establishing the period in which a taxpayer can present a claim is very important and is clarified in the UN Commentary[9]. The notification will generally be the act of taxation itself, for example, the payment of an amount which is subject to a withholding tax or the actual issuance of a notice of assessment or official demand for collection. In cases of self-assessment, in general the taxpayer's filing of a tax return does not in itself constitute a notification; there must be some action on the part of the tax authorities such as the denial of a claim for refund or the issuance of a notice of liability which makes the taxpayer aware that taxation not in accordance with the convention is going to be imposed.

2.3 Evaluation by Competent Authority of the MAP request

When a MAP request fulfilling the above requirements has been submitted to the CA of the residence country, the CA must determine "if the objection appears to be justified."[10] While this language seems to give wide discretion to the CA of the residence country, the grounds on which such a request in practice have been denied are quite limited and the best practice is to be liberal in granting MAP requests.[11] In some cases, there may be a domestic law impediment to accepting the

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[9] Paragraph 21 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the UN Model Convention, quoting paragraph 21 of the Commentary on Article 25 of the OECD Model Convention;

[10] Article 25(2) of the UN and the OECD Model Conventions.

[11] MEMAP Best Practice No. 9

case but this should be a most unusual situation.[12] Some States deny access to MAP where the transaction in question has been found to be "abusive", for example, covered by a domestic anti-avoidance provision. However, the UN Commentary[13] indicates that this generally should not be a basis to deny access. On the other hand, where there are violations of domestic law which involve significant penalties, some States may wish to deny access to a MAP. If this is the case, it should be clearly indicated in the treaty. If granting taxpayer relief would be contrary to a final court decision that the tax authority is required to follow, a MAP request might be rejected (see Section 1.4).

2.4 Unilateral resolution

When a request for a MAP has been accepted, Article 25 of the UN and OECD Model Conventions provides that in the first instance, the residence country should attempt to resolve the case unilaterally, for example, by granting a tax credit or giving an exemption which would be justified in the particular circumstances of the case. If unilateral resolution is not successful, the CA of the Residence State then contacts the CA of the partner state to begin bilateral discussions.

2.5 Structure of bilateral MAP negotiations

If the requested residence State cannot solve the inappropriate taxation unilaterally, it then typically opens discussion with the other State regarding a solution to the inappropriate taxation asserted by the taxpayer in its request. While these steps can vary and may be established under the procedures foreseen in Article 25(4) of the UN Model Convention, the first step in this process is usually for the residence state to develop a position paper setting forth its views of the case. The initial position paper would typically cover the following points[14]:

1. The name, address, and taxpayer identification number (if any) of the taxpayer making the MAP request and of related persons in the other Contracting State (if relevant), and the basis for determining the association;

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[12] Paragraph 27 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the UN Model Convention, quoting paragraph 27 of the Commentary on Article 25 of the OECD Model Convention.

[13] Paragraph 26 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the UN Model Convention, quoting paragraph 26 of the Commentary on Article 25 of the OECD Model Convention.

[14] UN Guide, paragraph 170.

2. Contact information for the competent authority official in charge of the MAP case;

3. A summary of the issue(s) presented, the relevant facts, and the basis for the tax administration action that is the subject of the MAP request;

4. The taxation years or periods involved;

5. The amount of income and the relevant tax for each taxable year, if applicable;

6. A complete description of the issue(s) presented, the relevant tax administration actions and adjustments, and the relevant domestic laws and treaty articles;

7. To the extent relevant and appropriate, calculations and supporting data (which may include financial and economic data and reports relied upon by the tax administration, as well as relevant taxpayer documents and records.

After the receipt of the initial position paper from the CAs of the residence State, the other State may find it useful to provide a rebuttal or response statement. This paper would be focused on responding to the points raised in the initial position paper and would typically contain[15]:

1. An indication whether a view, resolution, or proposed relief presented in the initial position paper can be accepted;

2. An indication of the areas or issues where the competent authorities are in agreement or disagreement;

3. Requests for any required additional information or clarification;

4. Other or additional information considered relevant to the case but not presented in the initial position paper; and

5. Alternative reasoned proposals for resolution.

After this initial exchange of views, the CAs will continue their discussions which will typically end in a face-to-face meeting in which a final resolution of the case may be achieved. If no successful

[15] UN Guide, paragraph 173.

agreement is reached, the issues preventing the resolution of the case may be submitted to arbitration as discussed in Section 4.2 below, if Alternative B of the UN Model Convention is followed.

2.5.1 Participation of the taxpayer in the MAP process. While the taxpayer has a right under Article 25 of the UN and OECD Model Conventions to submit a request for a MAP, the process once undertaken is a government -to -government relationship. Nonetheless, successful MAP requires close cooperation between the taxpayer and the CAs. The taxpayer provides the necessary information to the CA in its state of residence which in turn communicates that information to the other State. It may be necessary to request further information or clarifications from the taxpayer. Depending on the situation, the CAs may permit the taxpayer to submit briefs or make presentations to either one or both of the CAs. These presentations may also contain taxpayer proposals for the resolution of the case. However, direct taxpayer participation in the competent authority negotiations would not be appropriate, given the differing interests of the parties, though timely indications to the taxpayer of the status of the negotiations would be useful in moving the case forward.[16]

2.6 Implementation of the MAP result

2.6.1 General Assuming that the MPA negotiations have successfully reached an agreement as to the appropriate interpretation and application of the convention in the case, several steps are still required before the MAP can be implemented. In the first place, the agreement must be accepted by the taxpayer. The taxpayer is not bound by the agreement reached by the CAs but must accept it before it can be implemented. In addition, if the taxpayer had initiated or still has the right to initiate domestic judicial procedures, it is appropriate at this time for the taxpayer to waive any rights to further judicial proceedings in order to take advantage of a solution which involves a uniform interpretation and application of the convention.[17] However, if the taxpayer choses to wait until the conclusion of the judicial procedures before accepting the agreement, the taxpayer cannot be assured that the proposed agreement will still be available. [18] In addition, it might be possible to condition the agreement on its acceptance by the taxpayer within a certain time period.

[16] UN Guide, paragraphs 149-54.

[17] Paragraph 45 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the UN Model Convention, quoting paragraph 45 of the Commentary on Article 25 of the OECD Model Convention.

[18] Footnote 49 in Paragraph 42 of the Commentary on Article 25 of the UN Model Convention.

The legal status of the agreement and the actual steps necessary for its implementation will depend on the normally applicable procedural rules in the two States. However, Article 25(2) of the UN and the OECD Model Conventions specifically indicates that an agreement shall be implemented notwithstanding any time limits of domestic law. This obligation may require changes in the domestic limitation rules to provide a specific exception for adjustments arising under an agreement.

2.6.2 Interest In many cases, the agreement which has been reach in the MAP will involve possible interest charges on tax deficiencies and interest payments on tax refunds. States differ over how interest charges and refunds should be treated under Article 25.[19] The treatment of interest may differ in the domestic systems of the two countries. Despite these difficulties, it would be desirable from the point of view of the effective functioning of the MAP that a symmetrical treatment of interest charges and expense could be established in the implementation of the agreement.

2.7 Application of MAP to cases arising under Article 9 dealing with transfer pricing

The bulk of cases involving MAP arise in the context of Article 9 and transfer pricing. In these cases, there are some special considerations which must be taken into account. MAP cases dealing with, for example, the existence of a permanent establishment or the allocation of profits between a permanent establishment and the head office, typically involve so-called "juridical" double taxation; the same income is being taxed by both states to the same taxpayer. In the case of Article 9, however, where there is a disagreement as to the transfer price between related entities, the resulting double taxation is "economic", that is, the same item of economic income is being taxed to two different taxpayers. Thus when a transfer pricing adjustment is made to increase the income of one of the related parties, that same "economic" income will have also been taxed by the other state in the hands of its resident taxpayer. The application of Article 25 to this situation involves some special considerations.

2.7.1 "Corresponding" or "Correlative" Adjustments. The UN Model Convention and many existing treaties contain a special provision in Article 9(2) which deals with the situation of potential economic double taxation. That section provides that where one state makes an adjustment of the profits of its taxpayer (the "primary" adjustment) to reflect what in its judgment the appropriate transfer price should be, the other state "shall" make an appropriate adjustment (the "corresponding"

[19] Paragraph 9 of the Commentary on Article 25 of the UN Model quoting paragraph 46 of the Commentary on Article 9 in the OECD Model.

or "correlative" adjustment) to its taxation of the related party in its jurisdiction. Thus potential double taxation of the same economic income will be eliminated.

On its face, the primary adjustment by the first moving state would seem to require the other state to follow the determination of that state in establishing the appropriate transfer price. However, paragraph 6 of the UN Commentary on Article 9, quoting paragraph 6 of the OECD Commentary, indicates that the second state is only required to agree to the adjustment if it considers the adjustment justified "both in principle and as regards the amount." If this is not the case, that is, if the second state does not agree with the primary adjustment made by the first state, then paragraph 9 of the Commentary on Article 25 of the UN Model Convention, quoting para 10 of the OECD Commentary on Article 9, makes clear that in such a case the MAP can be used to determine if the adjustment is "well founded" and appropriate in amount. In this way, a MAP will be available to relieve economic double taxation. However, even when in general a State is willing to agree to a corresponding adjustment, Article 9(3) of the UN Model Convention provides that no such adjustment is required if one of the parties involved in the primary adjustment is liable for a penalty based on fraud, gross negligence or willful default.

Some treaties, especially those signed before 1977, do not contain Article 9(2). Nonetheless, paragraph 9 of the Commentary to Article 25 of the UN Convention, quoting paragraph 11 of the OECD Commentary takes the position that economic double taxation resulting from transfer pricing adjustments is not within the "spirit " of the treaty and thus should fall within the scope of MAP even in the absence of Article 9(2) in the convention. Not all states share this view and this is a point which is important to clarify in treaty practice.

2.7.2 "Secondary" adjustments. Once an adjustment to the income of the two parties has been agreed in the MAP, there remains the question of how to implement the adjustments agreed on. In effect, on the basis of the adjustment, the actual cash or assets of the taxpayer which are shown on the taxpayers' books does not correspond to the adjustment amount of the income. Paragraph 44 of the UN Commentary on Article 25 deals with some of these situations. Thus, for example, if income is allocated to a parent company for the payment of services provided to a related subsidiary and taxed to the parent company, it would be possible for the subsidiary company to make a repayment to the parent company of the "excess" cash it had as a result of the adjustment. This could be provided for by allowing the parent company to establish a receivable for the amount of the excess

which the subsidiary could pay to the parent company on a tax neutral basis in both the source and resident states. Other techniques are available to work out these adjustments.

2.7.3 Other procedural issues in Article 9 cases. Since a transfer pricing adjustment can be proposed by either state, and since Article 25 recognizes that economic double taxation should be covered by a MAP, the taxpayer in either state could be the one to request mutual procedural relief from its state of residence. Thus suppose that State S proposes increase the profits of S Co. because of a transfer pricing adjustment. Those profits have already been taxed by State P in the hands of P Co. on the basis of the originally determined transfer price. Thus P Co could request a MAP from its state of residence. If State P in fact agreed with the primary adjustment proposed by State S, it could deal with the resulting economic double taxation by making a corresponding adjustment unilaterally as is provided for in Article 25. If, as is more likely, it does not agree with the adjustment, State P would then be obligated to contact State S to begin bilateral consultations. Similarly, S Co, the taxpayer to whom the primary adjustment has been made could also make a request for a MAP to State S, again on the basis of the economic double taxation arising from the adjustment. Thus in transfer pricing cases, the administrative procedures must be adapted to the situations in which both taxpayers have the right to request a MAP.

3. General "Best Practices" in Structuring a MAP

Both the UN "Guide to the Mutual Agreement Procedure under Tax Treaties" and the "OECD Manual on Effective Mutual Agreement Procedures" provide very useful guidance in structuring and implementing MAP. This guidance is framed in terms of best practices and is distilled from the experience with MAP of both developed and developing countries. The recommendations of course must be evaluated in the light of each countries' background and context but they provide valuable insights into how to make the MAP work most effectively.

3.1 Developing guidelines and procedures for taxpayer access to a MAP (UN Guide, paragraph 92)

For the MAP to function most effectively, it should be as transparent and accessible to the taxpayer as possible. Article 25 itself does not set forth rules or other guidelines for the taxpayer who wishes to use MAP. However, countries have found that the MAP can be encouraged by having a process that is as transparent and free from formalities as possible. Ideally, a country should develop and

publicize appropriate forms, format and instructions as to how to begin the MAP request, the time deadlines which must be met and guidance as to the other formal requirements.

3.2 CAs should make every effort to resolve cases on a principled and fair basis (UN Guide, paragraph 49)

It is important that the CAs approach each case on the basis of a principled and consistent view of the facts and circumstances of the case and the applicable legal and economic principles. Each case should be decided on the basis of its own merits and thus the same principles may generate different results in different cases. The role of the CA is to achieve a solution to the case which resolves the issue of potential double taxation and not to merely attempt to find the most advantageous resolution from the revenue point of view. Flexibility may be needed to achieve an appropriate compromise in a given case.

3.3 Audit settlements should not require the taxpayer to relinquish subsequent recourse to a MAP. (UN Guide, paragraph 80)

In some jurisdictions, it is often a practice to include in an audit settlement an agreement by the taxpayer not to seek MAP relief after the settlement. In effect, two parties, the taxpayer and one tax administration, thus exclude the other tax administration from a consideration of the case. This may lead to double taxation and the development of inappropriate principles on the basis of which cases are settled, causing in the long run a system in which cooperation in the appropriate resolution of international double taxation is impeded.

3.4 Separation of the MAP and audit functions. (UN Guide, paragraph 62)

While there are many ways to organize a MAP function which fit within the overall structure of the tax administration, it has been found to be desirable to separate the MAP and audit and assessment functions. It is important that the MAP function be independent and objective, with a focus on applying the convention and relieving international double taxation. This requires a somewhat different “mind-set” from an auditor whose principal job focus and relation to the taxpayer tend to be somewhat different. The criteria for assessing a successful MAP function should be in terms of the time to resolve cases, and the achievement of principled and objective outcomes and not, for example, the amount of revenue collected.

3.5 Liberal use of the MAP under Article 25 (3) (MEMAP, Best Practice 1)

While in practice, most MAP activity involves taxpayer-initiated MAP seeking relief from taxation not in accordance with the treaty, it is also important the CAs take full advantage of the authority they have under Article 25(3) of the UN Model Convention, to issue guidance and interpretations of general application. This can help avoid unnecessary disputes later over such matters in the context of a concrete case and allows taxpayers to better organize their affairs.

4. Arbitration under Article 25(5)

4.1 Introduction

Article 25(2) of both the UN and OECD Model Conventions establish that, when presented with a taxpayer-initiated MAP request, the obligation of the CAs is that they "shall endeavor" to resolve the case under the MAP. While the CAs will make every effort to resolve the case on a principled basis, and while the majority of cases in practice will be resolved, there will inevitably be cases in which, after good faith efforts, no agreement will be reached. As a result, unless there can be a consistent resolution of the case in the domestics courts of the countries involved, there will be unrelieved double taxation and one of the principal purposes of the convention will not be fulfilled. In response to this problem, in 2010, the OECD Model Convention introduced paragraph 5 of Article 25 which provides that where the CAs, have not been able to resolve a MAP case within two years of its presentation to the CA, the issues which are preventing the CAs from reaching an agreement will be submitted to an independent arbitration board. The board will resolve the issues involved and then, under the OECD procedure, the CAs will proceed to arrive at a MAP which will insure that taxation is carried out in accordance with the convention. The details of the OECD procedure and its relation to the UN Model Convention are discussed below but it is important to observe at the outset that the arbitration procedure outlined in the OECD Model Convention in not in any sense an alternative to the MAP but provides a mechanism for supplementing it and allowing it to more effectively perform its functions.

4.2 Arbitration and the UN Model Convention

The pros and cons of arbitration were discussed at length in the Committee of Experts and the UN Model Convention contains two versions of Article 25, Alternative A, which does not contain an

arbitration provision and Alternative B which contains an arbitration provision which is modeled on but differs from the OECD Model Convention. Since this issue is of great important to developing countries considering whether or not to include some form of arbitration in their treaties, it is useful to examine at some length the considerations that the Committee articulated[20].

"*The decision whether to agree in a bilateral convention on a mutual agreement procedure without mandatory arbitration as in alternative A or with mandatory arbitration as in alternative B depends on policy and administrative considerations of each Contracting State and its actual experiences with mutual agreement procedures. Countries should in advance analyze the advantages and disadvantages of mandatory or voluntary arbitration (see paragraph below) and evaluate whether or not arbitration is appropriate for them. Countries having limited experience with mutual agreement procedures could have difficulties to determine the consequences of adding arbitration in a mutual agreement procedure. Those countries could simply decide to refuse arbitration at this stage. They could, however, also include arbitration but postpone its entry into force until each country has notified the other that the provision should become effective. Those countries could also decide that despite their lack of experience they are willing to add arbitration in a mutual agreement procedure in order to give certainty to taxpayers that a case presented under paragraph 1 of Article 25 will be solved through mutual agreement unless a taxpayer rejects the mutual agreement.*

Members of the Committee in favour of alternative A pointed mainly to the following considerations and arguments:

- *only a small number of cases are submitted to the mutual agreement procedure under paragraphs 1 and 2 of Article 25 and very few of them remain unresolved;*
- *domestic legal remedies can resolve the few cases that the competent authorities are not able to resolve through the mutual agreement procedure;*
- *due to the lack of expertise in many developing countries with mutual agreement procedures, arbitration would be unfair to those countries when the dispute occurs with more experienced countries;*
- *the interests of countries, which are so fundamental to their public policy, could hardly be safeguarded by private arbitrators in tax matters; arbitrators cannot be expected to make up for the lack of expertise in many developing countries;*

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[20] Paragraph 3-5 of the Commentary on Article 25 of the UN Model Convention.

- *the neutrality and independence of possible arbitrators appears difficult to guarantee;*
- *it is very difficult to find experienced arbitrators;*
- *mandatory arbitration is costly and therefore not suitable for developing countries and countries in transition;*
- *it is not in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.*

Members of the Committee in favour of alternative B pointed mainly to the following considerations and arguments:

- *despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be significant double taxation;*
- *arbitration provides more certainty to taxpayers that their cases can be resolved under the mutual agreement procedure and contributes to cross-border investment;*
- *domestic remedies may not resolve adequately and rapidly disputes concerning the application of bilateral conventions (risks of inconsistent court decisions in both countries and of unilateral interpretation of the Convention based on domestic law);*
- *the obligation to submit unresolved cases to arbitration after a given period of time may facilitate the endeavours of the competent authorities to reach an agreement within that period of time;*
- *on the basis of the experience under the EU Arbitration Convention, the effective recourse to mandatory arbitration should be rather unusual and the costs relating to that mechanism should be low; moreover, as arbitration provides more certainty to the taxpayers, it reduces the number of costly "protective" appeals and uncertain domestic proceedings;*
- *arbitrators have to reach a well-founded and impartial decision; consequently, they can adjust for the levels of expertise of countries and overcome the possible lack of experience of some countries;*

- *skilled and impartial arbitrators do exist from various backgrounds (government officials, judges, academics and practitioners) and from various regions (including from developing countries);*
- *it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.*"

Thus each country must consider the factors outlined above in developing its own approach to arbitration. In some cases, national law, policy or constitutional provisions may raise questions as to the ability of the state to enter into treaties which contain an arbitration provision, and these factors must be considered as well.

Since the introduction of the OECD provision in 2010, a growing number of countries, including developing countries, have been including some form of arbitration clause in their treaties and this increased experience should also be taken into consideration. Some treaties which have no arbitration clause require that if the treaty partner enters into a treaty with another partner which does have an arbitration clause, then that issue must be reopened in the existing treaty without further formalities being required.

4.3 Differences between the OECD and UN versions of Article 25(5)

Before considering in detail the provisions of Article 25(5) (Alternative B) in the UN Model Convention, it is useful to point out some important differences between the OECD and UN approaches. While they both aim at obtaining a final resolution of the MAP, they differ in important ways. In general, the UN approach leaves more power in the hands of the CAs but this is at the expense of insuring that a MAP will ultimately be achieved.

4.3.1 Period in which CAs must resolve a MAP case. In the OECD Model Convention, if the CAs have not reached an agreement within two years of the initial presentation of the case by the taxpayer, the issues which are preventing resolution must be presented to the arbitration process. The UN Model Convention provides for a three year period.

4.3.2 Who submits the case to arbitration? Under the OECD approach, it is the taxpayer who has the right to require that the unresolved issues in the case must be submitted to arbitration. In the UN version, the case is submitted to arbitration if one competent authority wishes to have the case arbitrated. Thus if both CAs do not want to have the case go forward to arbitration, they can prevent

a final resolution of the case and the case will go undecided and result in double taxation. In this regard, the UN procedure is, from the point of view of the taxpayer, not truly mandatory.

4.3.3 Finality of decision. Under the OECD Model Convention, once the arbitration decision has been reached and communicated to the CAs, the CAs are required to follow the decision and reach a MAP. Under the UN provision, modeled on a similar provision in the European Union Arbitration Convention, the CAs can deviate from the decision of the arbitrators if they can reach an agreement within 6 months of the arbitration agreement. Thus they are still required to reach an agreement but it can differ in result from the agreement which would have been based on the arbitration decision.

4.3.4. Form of decision. Both the UN and the OECD Model Conventions have published a Sample Mutual Agreement on Arbitration which sets out many of the technical and procedural aspects of the arbitration procedure. Under the OECD approach, the "default" or generally applicable rule is that the arbitrators must give a reasoned opinion for their decision. There is an alternative "streamlined" form of decision which is based on the so-called "last best offer" or "baseball" approach, under which each CA submits its desired result and the arbitrator simply picks one or the other of the two options without any reasoned opinion justifying the result. In the UN Sample Agreement, the "last best offer" approach is the base rule, although the CAs can elect to use the "independent" format.

4.4 Basic features of the UN Arbitration Provision

4.4.1 Supplementary Dispute Resolution. As mentioned above, the basic function of Article 25(2) is to insure that the MAP comes to a satisfactory conclusion and eliminates taxation which is not in accordance with the views of the two CAs as to the proper interpretation and application of the convention. It does not represent a "free standing" alternative dispute resolution procedure. The end result of the proceeding under Article 25(5) of the UN Model Convention is an agreement to which the normally applicable MAP principles apply. It is no different than an agreement which was arrived at without the introduction of arbitration. In a sense, the whole MAP itself is already an alternative to the uncoordinated resolution of the dispute in the domestic courts. The procedural requirements which are developed in the Article and the accompanying Annex must be understood in this light.

4.4.2 Time limits for requesting submission to arbitration. Article 25(5) of the UN Model Convention provides that a request that any unresolved issues be submitted to arbitration cannot be made until three years after the presentation of the case by the taxpayer requesting MAP relief. The request can be made at any time after the three year period has past, that is, the CA who may want to initiate the arbitration procedure may wait beyond the three year period to see if a MAP can be achieved through the usual means. It should be remembered (see section 2.2 above) that the taxpayer can request a MAP as soon as he believes that an action of one of the states "will result" in taxation not in accordance with the convention. When a request has been made in these circumstances, there is no right at this point to request arbitration. The three year period which must run before arbitration can be requested only commences after the taxpayer has presented a case that the actions of one of the states have in fact resulted in inappropriate taxation.

4.4.3 Relation between arbitration and domestic legal proceedings. Article 25(5) of the OECD and UN Model Conventions expressly excludes from arbitration any issue on which a court or administrative tribunal in either State has already given a decision. This restriction is necessary since in most countries, the CAs are not in a position to effectively overrule a court decision. In such a situation, the CAs would not be in a position to implement a MAP based on an arbitration decision which deviated from the court decision. In countries where the CAs can deviate from a court decision in a MAP, this restriction may not be included in the text of Article 25.

With respect to ongoing domestic legal proceedings involving the issues in dispute, many States allow the proceedings to be suspended if a MAP is requested and then require the taxpayer to terminate the domestic procedures as a condition of accepting the MAP resolution of the case (see section 2.6.1). The same approach should be taken with respect to an agreement which has been reached by means of an arbitration of unresolved issues. After arbitration, the taxpayer would be required to waive any existing claims under domestic legal proceedings and the accepted agreement would then be binding on both CAs and the taxpayer. Of course, for countries which require the waiver of domestic legal remedies as a condition for accepting a MAP request, the issue will not arise.

4.5 Procedural aspects of arbitration under Article 25 (Alternative B)

4.5.1 General. There are no procedural requirements in Article 25(5) other than the requirement that the unresolved issues be submitted for arbitration after the three year period following the

presentation of the case. Instead, Article 25 provides that the CAs shall settle the "mode of application" of Article 25(5) by mutual agreement. A Sample Agreement setting out a number of procedural rules is attached as Annex to the Commentary on Article 25. In general, it is similar to the Sample Agreement used in the OECD Model Convention but as mentioned above in section 4.3.4, the UN Agreement uses the "last best offer" approach as the basic format for the proceedings, though the CAs can agree to use an "independent opinion" approach. In addition, the UN Agreement provides for a *de minimis* amount below which arbitration would not be available and also requires appointed arbitrators to certify their independence and impartiality.

4.5.1. The request for arbitration. Where the competent authorities have not been able to reach an agreement to resolve a case within three years from the time the case was presented by the taxpayer, one CA has the right to request that the unresolved issues be submitted to arbitration. This referral of unresolved issues to arbitration is mandatory and does not depend on prior agreement of the other CA. As indicated in the discussion above, the function of arbitration in the model used in Article 25 is not to decide the case itself, but only the issues that are preventing the competent authorities from coming to a mutual agreement. The introduction of arbitration enables the mutual agreement procedure to reach a satisfactory resolution of the case, which is being blocked by the failure to agree on certain issues.

4.5.2 Terms of Reference The Terms of Reference establish the jurisdictional base for the arbitration process and set out the issues to be decided in the arbitral process. The competent authorities are required to establish the Terms of Reference within three months of the request for arbitration.[21] The Terms of Reference may also establish additional procedural rules to govern the arbitration process. The Terms of Reference are to be communicated to the person who has presented the case who would presumably be consulted on the formulation of the terms.

4.5.3 Appointment of arbitrators. After the Terms of Reference have been established and communicated to the person who has presented the case, the competent authorities have three months

[21] Paragraph 3 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 1 of the Annex to the Commentary on Article 25 of the UN Model Convention, quoting paragraph 3 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

to each appoint an arbitrator.[22] The Sample Agreement does not set out any special qualifications for the arbitrators on the assumption that all of the parties will be interested in appointing qualified persons. Government officials may be appointed as long as the official was not directly involved in prior stages of the case. As a default rule to deal with the situation where one of the competent authorities has not made a timely appointment, the Sample Agreement gives authority to the Chair of the UN Committee of Experts to make the appointment.[23] After their appointment, the two designated arbitrators have two months to appoint a third arbitrator, who will function as the chair of the arbitral panel. Again as a default mechanism, if the arbitrators are unable to appoint a chair, the UN Chair can fill that position. The arbitrators may develop whatever procedural or evidentiary rules they deem necessary beyond those established in the Terms of Reference. Information provided to the arbitrators will be subject to the same confidentiality requirements as are normally applicable to the competent authorities. The bilateral agreement will set the compensation of the arbitrators and the arbitrators to be appointed will be required to certify that there are no circumstances which might give rise to any doubts as to their independence or impartiality. [24]

4.5.4 Participation of the taxpayer. The arbitration foreseen in Article 25(5) is structured as an extension of the mutual agreement procedure. Since this is basically a government-to-government procedure aimed at a consistent application of the convention, the taxpayer's right to participate in the process is correspondingly limited. Thus, the Sample Agreement provides that the taxpayer shall have the same rights to present its case in writing to the arbitrators as it would have in a MAP.[25] The Sample Agreement does foresee, however, that, with the permission of the arbitrators, an oral presentation may be made. This limited degree of participation is consistent with the fact that the taxpayer, at the conclusion of the proceeding, has the right to reject the final agreement which is based on the arbitral decision. The process of reaching a decision is basically up to the CAs.

4.5.5 The arbitral decision. As indicated above, the UN version of the Sample Agreement takes as its default position for the arbitral procedure the so-called "last best offer" approach. Under this

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[22] Paragraph 5 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 1 of the Annex to the Commentary on Article 25 of the UN Model Convention, quoting paragraph 5 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

[23] Paragraph 5 of the Annex to the Commentary on Article 25 of the OECD Model Convention and paragraph 1 of the Annex to the Commentary on Article 25 of the UN Model Convention, quoting paragraph 5 of the Annex to the Commentary on Article 25 of the OECD Model Convention.

[24] Paragraph 1 of the Annex to the Commentary on Article 25 of the UN Model Convention.

[25] Paragraph 11 of the Annex to the Commentary on Article 25 of the UN Model Convention.

approach, each CA makes a proposal for the resolution of the issue in dispute to the arbitral board and the board chooses one or the other of those proposals. The arbitrators are given only a limited time to make the decision and do not give a full written explanation of the decision but only "short reasons" explaining the choice.[26] The Committee of Experts selected this approach as it is quicker and less costly. However, the Terms of Reference allow the CAs to select an "independent opinion" if they wish. This approach has the advantage of providing a fuller explanation of the decision and gives the possibility for the decision being a guide to the settlement of future cases involving the same issue. If an independent opinion approach is taken, it would also be possible, with the approval of both CAs and the taxpayer to publish a redacted version of the decision. This too would help resolve cases in the future.

4.5.6 Implementation of the decision. After the arbitration procedure has resolved the issues which were preventing the issuance of an agreement, the case is returned to the CAs. Under the UN Model Convention, after the decision has been communicated to the CAs, they still have a 6 month period in which they can agree to a different solution than that arrived at by the arbitration panel, as long as that solution comes to a common understanding of the application and interpretation of the convention.

4.5.7 Costs. The Model Agreement stipulates that in general each CA will bear its own costs in relation to the arbitration. Thus each CA will bear the costs of the arbitrator which it has appointed. The costs of the third arbitrator and other general costs can be shared equally. The Sample Agreement also recognizes that when there is a significant disparity in the level of development of the two States it may be possible to agree on other methods of allocation of costs.[27]

4.5.8 "Voluntary" arbitration. In some cases, countries may not be ready to commit themselves to the mandatory type of arbitration described above which permits one CA to force the resolution of a case by arbitration. In such situations, a country may wish nonetheless to include a provision for so-called "voluntary" arbitration under which, if a case have not been resolved after a certain period, both CAs and the taxpayer may agree that the case be submitted for arbitration. This procedure gives more control to the CAs over the types of issues which will be submitted for arbitration. However, this procedure fails to insure that a case will ultimately be resolved which is the basic function of the

[26] Paragraph 6 of the Annex to the Commentary on Article 25 of the UN Model Convention.

[27] Paragraph 32 of the Annex to the Commentary on Article 25 of the UN Model Convention.

arbitration provision. In addition, experience with this type of arbitration clause in the past has indicated that it has not been effective to move cases to resolution.

Annex: examples and analysis of MAP cases

Example 1: Article 5/Article 7 MAP case

Example 1A. Company R, a resident of State R, carries on a business in State R and State S. In the year in question, it made a total profit of 100 and reported all of the profit to State R and none to State S. State S subsequently assessed a tax on 25 of the profits of Company R, asserting that the profits were attributable to business activities of Company R in State S. As a result of the assessment, Company R is potentially subject to "juridical" double taxation on the 25 of profit by State R and State S. Within 3 years of the assessment of the State S tax, Company R files a claim for MAP relief with State R, its State of residence, claiming that it is being taxed "not in accordance with the convention" as provided in Article 25, since its business activities in State S were "preparatory or auxiliary" and thus did not constitute a permanent establishment under Article 5, paragraph 4(e). The CA of State R accepts the claim under Article 25, paragraph 1, finding it justified; it has been filed within 3 years of the notification of the charge, Company R has provided all of the relevant information as to its activities in State S and there are no other indications as to why the case should not be accepted.

On examination of the facts of the case, State R finds that it cannot resolve the case unilaterally and contacts the CA of State S. It presents its position to State S outlining its view of the facts and the law and its reason for coming to the conclusions. After negotiations, and exchanges of position papers, State S and State R agree that Company R does not have a permanent establishment in State S and agree in a MAP setting forth that conclusion.

Example 1B. The facts are the same as in Example 1 but after negotiations the Competent Authorities find that Company R does have a permanent establishment in State S but disagree as to the amount of income to be attributed to the State S permanent establishment. They request additional information from the taxpayer as to the functions carried out in State S, the assets involved there and the risks assumed. After additional negotiations, they enter into a MAP that State S is entitled to tax 15 of profits. The taxpayer has the choice of either accepting the MAP and the allocation of profits agreed by the CAs or, if it has appropriately secured its rights to judicial remedies in State S, to attempt to obtain a judicial determination in State S that there was no permanent establishment or that less profit should be been allocated to State S. Assuming that

Company R prefers to accept the MAP, it must waive any rights to further legal remedies in State R and State S. Company R would then be entitled to a refund of tax from State R on the 15 of profit already taxed there and would have a tax liability on the 15 of profits not reported in State S. Depending on the domestic rules of State R and State S, Company R would owe interest on the liability in State S and be entitled to interest on the refund from State R. The MAP may have been able to deal with the interest issues as well.

Example 1C The facts are the same as in Example 1B, except three years have passed since Company R has presented its case and the CAs of State R and State S have still not been able to resolve the case. If the Country R-Country S treaty followed Alternative B of Article 25 of the UN Model, one of the CAs could request that the unresolved issues in the case could be submitted to arbitration, assuming that there is no prior decision by the courts or administrative authorities of either state in the case.

Example 2: Article 9 MAP case

Company R in State R produces cars at a cost of 100 and sells them to Company S, a wholly owned State S subsidiary organized in State S, at a price of 150, declaring and paying tax on a profit of 50 in Country R. Company S buys the cars for 150 and sells them for 175, declaring a profit and paying tax on 25 to State S. Country S audits Company S and proposes to adjust the price that S paid for the cars to 125 on the basis of Article 9, claiming that the transfer price of 150 was not at arm's length. The treaty between Country S and Country R follows the UN Model Convention and contains Article 9(2). As a result, there is economic double taxation, as 25 of profit is being taxed both in State R and State S, though to different taxpayers.

1. Company R could make a claim under Article 25 (1) of the UN Convention and make a request to State R to make a "corresponding" or "correlative" adjust reducing its profits by 25, corresponding to the "primary" adjustment made by State S in the profits of Company S. If Country R agreed with the Country S determination of the transfer price, it could make a unilateral resolution of the case.

2. However, State R is only required to make a unilateral corresponding adjustment if it finds that the Country S primary adjustment was "justified both in principle and as regards amount." Assuming that Country R does not agree with the determination of the transfer price by Country S. it would then begin the process of bilateral negotiations described in Section 2.5 above.

3. Assuming that Country S and Country R agree after negotiations that the appropriate transfer price was 135 and the Company R and Company S agreed with that result, an agreement to that effect could be implemented by reducing the tax of Company R and correspondingly increasing the tax on Company S. The agreement may also treat the question of interest in both States. However, after this adjustment, Company R still has received 15 too much cash from Company S. It may be possible to structure a "secondary" adjustment which would allow the return of the excess funds to Company S on a tax neutral basis.