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Revision of the Manual for the Negotiation of Bilateral Tax Treaties

Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties

Summary

This note comprises a part of the draft revision of the Manual for Negotiation of Bilateral Tax Treaties prepared by the Subcommittee on Revision of the Manual. It addresses dispute resolution issues.

Dispute Resolution Mutual Agreement Procedure

1. Given the scope and complexity of the issues that a tax treaty must address, Contracting States will inevitably have occasional differences of opinion on how the treaty should be applied in specific cases. In the absence of a mechanism to resolve such disagreements, the certainty of avoiding international double taxation may be compromised.
2. Article 25 of the UN Model sets out two broad areas in which the Contracting States endeavor to resolve their differences by mutual agreement:
 - (1) cases in which a taxpayer considers that the acts of one or both of the Contracting States result or will result for the taxpayer in taxation not in accordance with the provisions of the treaty (covered by paragraphs 1 and 2 of Article 25); and
 - (2) cases in which there are difficulties or doubts as to the interpretation or application of the treaty (covered by paragraph 3 of Article 25).
3. Paragraph 1 of Article 25 of the UN Model permits a taxpayer who considers that the actions of one or both of the Contracting States result or will result in taxation not in accordance with the provisions of the treaty to present its case to the Contracting State of which it is a resident.
4. A Contracting State's taxation of a person or transaction in a manner inconsistent with provisions of a treaty will in most cases result in international double taxation - that is, either (i) the imposition of tax in both Contracting States on the same taxpayer in respect of the same income ("juridical double taxation") or (ii) the imposition of tax in both Contracting States on the same income in the hands of different taxpayers ("economic double taxation").
5. Historically, a large number of type (1) cases have involved transfer pricing issues when a Contracting State makes adjustments to income from related party non-arm's length transactions among and between the members of a multinational group of enterprises. Taxpayers have also used the Mutual Agreement Procedure where they disagree with a Contracting State's conclusion about whether their presence or activities in that State give rise to a permanent establishment that the host State may tax under Article 5.
6. Requests for the Mutual Agreement Procedure in this context will also address the amount of profits attributable to a permanent establishment. Another example of where the Mutual Agreement Procedure has been requested involves cases where a source State seeks to impose withholding taxes on dividends, interest, and royalties paid to, and beneficially owned by, a resident of the other Contracting State in excess of the amount allowed under the applicable treaty.

7. The UN Model, like other Models, uses the term “competent authority” to refer to the person or body within a Contracting State with responsibility for resolving issues that arise in connection with the treaty. The role of the competent authority is to ensure that a tax treaty is properly applied and to endeavor in good faith to resolve any disputes that may arise in its application or interpretation. In performing its functions, the competent authority is to be guided first by the terms of the treaty itself. The competent authority must then refer to any guidance promulgated under the treaty. Such guidance may include, for example, an agreed-upon memorandum of understanding or technical explanation to the treaty, or an agreement of general application concluded by the competent authorities pursuant to the Mutual Agreement Procedure. Model tax treaties (such as the UN Model) upon which the treaty was based, and their commentaries, are an additional important source of guidance.
8. Competent authorities should make every effort to resolve cases in a principled, fair, and objective manner, deciding each case on its own merits and not with reference to revenue statistics or an overall balance of results. Moreover, and especially in light of the principle of reciprocity underlying any international agreement, competent authorities should be consistent in their approach to an issue, regardless of the Contracting State that is favored by that approach in a particular case. Where competent authorities are otherwise unable to reach an agreement, however, they should seek appropriate opportunities for compromise to provide relief from double taxation.
9. The mutual agreement procedure provided for by Article 25 of the UN Model is available to taxpayers irrespective of the remedies provided by the domestic law of the Contracting States. The Mutual Agreement Procedure is a special procedure that exists in addition to domestic law remedies. For example, a taxpayer has the right to request assistance under the Mutual Agreement Procedure even though the taxpayer may have the right to challenge the actions taken by a country’s tax administration in a domestic court or through a domestic administrative process.
10. A Contracting State should determine the procedure to be followed when a taxpayer has invoked both the Mutual Agreement Procedure and a domestic recourse procedure. As a general matter, most tax administrations will deal with a taxpayer’s case in the Mutual Agreement Procedure or in a domestic forum (usually a court), but not both at the same time: one process should be suspended or put on hold pending the outcome of the other. The competent authorities of the Contracting States should reach agreement on this procedural issue. Another issue they should consider is how to ensure that any applicable domestic statute of limitations does not operate to prevent the dispute being resolved in the domestic courts if the Mutual Agreement Procedure (which can take some years) is not able to resolve the dispute. Such a result can have unfair results in particular cases, unless the limitation period is “frozen” during the time of the Mutual Agreement Procedure. It will also discourage use of the Mutual Agreement Procedure as compared with domestic litigation.

11. A request for assistance under the UN Model Treaty's Mutual Agreement Procedure is the main way by which a taxpayer makes a competent authority aware that one or both of the Contracting States is not (in the view of the taxpayer) correctly applying the treaty. A request for assistance under the Mutual Agreement Procedure generally must be made to the competent authority of a taxpayer's State of residence (see paragraph 1 of Article 25 of the UN Model).
12. A taxpayer may also make a Mutual Agreement Procedure request to the Contracting State of which it is a national in a case that falls under paragraph 1 of Article 24 (Non-Discrimination) of the UN Model. Under Article 24(1), nationals of a Contracting State may not be subjected in the other Contracting State to taxation or any tax-related requirement which is other or more burdensome than the taxation and tax-related requirements to which nationals of that other State in the same circumstances (including as to their residency) are subjected.
13. Article 26 (Exchange of Information) of the UN Model authorizes the competent authorities of the Contracting States to exchange such information as is necessary for carrying out the provisions of the treaty. Article 26 thus expressly authorizes the exchange of taxpayer information between competent authorities to carry out the Mutual Agreement Procedure provided for by Article 25. Paragraph 1 of Article 26 provides that any information exchanged between the competent authorities is required to be treated as secret in the same manner as if such information were obtained under the domestic laws of the respective Contracting States. Competent Authorities should continually keep in mind their obligations under Article 26, which is intended to supplement the generally applicable confidentiality provisions of Contracting States' domestic tax laws.
14. Where the competent authority of the other Contracting State agrees to discuss the case in the Mutual Agreement Procedure, both competent authorities will proceed to an in-depth analysis of the merits of the case and the issues presented, in preparation for the bilateral discussion of the case. The framework for this analysis and discussion is generally provided by a position paper prepared by one of the competent authorities. In practice, the position paper is typically prepared by the competent authority of the Contracting State that took the action(s) that led to the taxation that is alleged to be contrary to the treaty. In a more complex Mutual Agreement Procedure case, it is often helpful if the other competent authority prepares and presents a reasoned rebuttal to the initial position paper.
15. When the competent authorities are ready to discuss a Mutual Agreement Procedure case, their discussions may take place using a great variety of methods - for example, by correspondence, by telephone or video conference, or in face-to-face meetings. Usually it is helpful to have a face-to-face meeting early, to ensure that any misunderstandings can be quickly resolved, and the real areas of dispute can be focused on.
16. Depending on the complexity of the issues involved, the competent authority discussions may require several meetings or other consultations. The Mutual Agreement Procedure

discussions may also lead to requests for additional information or other clarification from the taxpayer.

17. As with other aspects of the Mutual Agreement Procedure, Article 25 of the UN Model is silent with respect to how Contracting States will conduct their negotiations. Under Article 25(4), the Contracting States are directed to develop appropriate bilateral procedures to implement the Mutual Agreement Procedure.
18. If the competent authorities of the Contracting States reach an agreement on how to resolve a case that was submitted to the Mutual Agreement Procedure, the agreement will be evidenced by a formal exchange of letters. In most cases these letters would only be signed after the taxpayer ceased any alternative domestic proceedings. In this formal settlement, the competent authorities should take steps to provide correlative relief to prevent double taxation (or unintended under-taxation) in the country of residence. In other words if the profits booked to one related party for tax purposes are increased or reduced in one State, those booked by the related part in the other transaction should be correspondingly decreased or increased in the other State.
19. Importantly, Article 25 does not oblige the Contracting States to reach agreement in the Mutual Agreement Procedure but instead only requires the Contracting States to use their best efforts to reach an agreement. As a result, there will be circumstances in which the competent authorities are unable to agree on a resolution. In such situations, there may be unrelieved double taxation or taxation not in accordance with the treaty.
20. This inability of the Mutual Agreement Procedure of Article 25 to ensure a final (or timely) resolution of a case is one of the primary obstacles to giving foreign investors assurance that their economic activities will not be subject to international double taxation. When a taxpayer or a tax administration is unsure that a matter will be resolved through the Mutual Agreement Procedure, it may be hesitant to commit time and resources to seeking a resolution under Article 25. In addition, a competent authority may not take all possible steps to find a resolution through the Mutual Agreement Procedure where there is no obligation to do so and no mechanism in place to break a stalemate in Mutual Agreement Procedure negotiations.
21. As mentioned in paragraph 36 of the Commentary on Article 25, in light of these shortcomings of the Mutual Agreement Procedure, some tax administrations consider that the Mutual Agreement Procedure could be improved through the addition of an arbitration provision as a tool to ensure that the competent authorities are able to reach an agreed solution to a taxpayer's case.