



# **Tools for Applying Tax Treaties: Mutual Agreement Procedure**

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## **Article 25: Introduction**

- **Article 25 establishes a “mutual agreement procedure” (MAP) which enables the parties to a bilateral treaty to better carry out the interpretation and application of the substantive treaty provisions**
- **The MAP is administered by the “competent authorities”, the persons (Ministry or Tax Authority) designated in Article 3 (e) to administer the treaty**

## **Article 25: Introduction**

- **The principal function of the Mutual Agreement provision in Article 25 is to resolve situations caused by differences in interpretation and application of the treaty**
- **Double taxation issues may arise from disagreements concerning the facts of a particular case or the interpretation of particular Article of the treaty or from the way the treaty is applied**

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## **Article 25: Introduction**

- **Article 25 covers 3 different situations:**
  1. **Cases where a taxpayer resident in one of the States contends that he is not being or may not be taxed in accordance with the rules of the treaty**
  2. **Cases where the competent authorities on their own initiative resolve questions of interpretation or application of the treaty**
  3. **Cases involving double taxation which are not provided for in the substantive articles of the treaty, where legal basis are available (rarely used)**

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## Article 25: Introduction

### ➤ Outcomes of Article 25 procedures:

- Taxpayer-initiated MAP results in an agreement between the CAs as to how the treaty applies in the taxpayer's ("TxP") case
- CA-initiated procedures typically result in a publication or other form of advice indicating how the States will interpret or apply the treaty
- Other double tax cases (rarely occurring) can either be for a specific TxP or general guidance

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## Typical MAP cases

### ➤ Taxpayer-initiated cases:

- Transfer pricing disputes
- Article 7 allocation of profit disputes
- Existence of PE
- Dual residence (Article 4(2))
- Characterization issues

### ➤ CA initiated cases:

- Common interpretation of treaty term

### ➤ Other double tax cases:

- Third country resident with PE in both States

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## How MAP operates

- Article 25 (4) authorizes the CAs to deal with each other directly, either in writing or orally, without the usual restrictions on intergovernmental communications
  - Article 26 rules on confidentiality apply
- The CAs may also develop procedures to implement the MAP, e.g., the Mutual Agreement on how treaty arbitration under Article 25 (5) is to be carried out.

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## Requirements for taxpayer initiated MAP

- “Resident” of a State believes that he is not being taxed “in accordance with” the treaty
  - Residence determined under Article 4 rules
  - Tax need not be already assessed (“will result”)
- Must present case establishing inappropriate taxation to the CA of state of residence within three years of “notification” (see slide 11)

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## **Requirements for taxpayer initiated MAP**

- **Residence CA must establish that objection to taxation is “justified”**
  - CA has broad discretion to accept or reject case BUT best practice is to be liberal in accepting cases
  - Might exclude cases where there is finding of abusive transaction or where substantial domestic law penalties are involved

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## **Requirements for taxpayer initiated MAP**

- **TP must cooperate in providing necessary information for the CA to assess the case**
- **Commentary, Paragraph 23 sets out details of information necessary**
  - General description of background of case
  - Amount of tax involved
  - References to appropriate treaty provisions
- **CA are justified in not accepting case if information is insufficient**

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## **Time limits for TP-initiated MAP**

- **TP must present case within 3 years of “notification” of inappropriate taxation**
  - Notification is usually notice of assessment or charge
    - Note that TP may be able to bring case prior to notification if he believes there will be taxation not in accordance with treaty
  - In case of withholding tax, notification is when the income is paid
  - 3 year period is the recommended standard and States can agree to different period

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## **TP participation in MAP**

- **While the TP has the right to initiate a MAP, the proceeding for resolving the MAP issue is a government-to-government process**
- **The TP’s role in MAP is determined by domestic procedural law and is typically limited to providing the information necessary for the CAs to reach a resolution of the case.**
- **In some situations, the TPs may present briefs or presentations but are not directly involved in the MAP negotiations.**

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## **Collection of tax as condition of TP-initiated MAP**

- **Article 25 does not require the payment of the tax as a condition which the TP must fulfill in order to initiate MAP**
- **While many States in fact require payment, best practice is not to make payment a requirement (UN Guide to MAP; OECD MEMAP, BP 21)**
- **If payment is a requirement, the TP may receive an appropriate amount of interest if the case is ultimately resolved in his favor.**

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## **Government obligations under TP-initiated MAP**

- **Under Article 25, paragraph 2 in the case of a TP-initiated MAP, the CAs “shall endeavor” to reach a satisfactory solution to the case presented. There is no obligation to reach a solution**
- **Nonetheless, the CAs are under the general international law obligation to carry out the treaty in good faith (“pacta sunt servanda”) and to use every effort to arrive at a solution**
- **As discussed below, the inclusion of a mandatory arbitration clause in the treaty will help to ensure a resolution of the case, where otherwise appropriate**

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## **Example: Art 5/Art 7 MAP case**

- **Company R, a resident of State R, carries on business in State R and State S.**
- **For the year in question, it made a total profit of 100 and reported all of that profit in State R and none in State S**
- **State S assesses tax on 25 of the profits of Company R, finding that they were attributable to business activities in State S.**
- **Company S is thus subject to “juridical” double taxation, that is, the same legal person is subject to double taxation on the same amount of profit, 25 in the Example**

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## **Example 1: Art 5/Art 7 MAP case**

- **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 treaty”, since its business activities in State S are “preparatory or auxiliary” thus not a PE under Article 5(4)(e)**
- **The CA of State R accepts the claim under Article 25, para. 1, finding it justified. It cannot resolve the case unilaterally and contacts the CA of State S to open a MAP case**
- **After negotiations, the CAs of State S and State R agree that Company R does not have a PE in State S and agree in a MAP setting forth that conclusion**

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## **Example 2: Profit allocation**

- Suppose in Example 1 that after the negotiations, the CAs find that Company R does have a PE under Article 5 but that only 15 of the total profit is attributable to the PE. Thus under the MAP, State S is entitled to tax 15 of the profits and under Article 23, State R is required to provide double taxation relief on that 15 of profit and has the right to tax the remaining 85. Juridical double taxation has thus been avoided.
- Under the MAP, Company R is entitled to a refund of the taxes on the original 15 of profit it reported to Country R and owes tax on the 15 of profit it should have reported to Country S.

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## **Effect of the MAP agreement**

- State R and State S are obligated to implement the MAP decision even if the claim would have been barred under domestic statute of limitation rules.
- Depending on domestic law, R may be entitled to a refund of taxes with interest from State R and may owe interest to State S on the unpaid taxes. In some cases the MAP can cover interest as well.

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## **Relation between MAP and domestic legal remedies**

- **MAP is available to the TP in addition to his normal legal rights under domestic law. The relation between MAP and domestic remedies is a question of domestic law**
- **Thus Company R in the Example 1 could typically have resisted the payment of the State S tax in the State S courts.**
- **Some countries require that the TP waive his rights in domestic courts before he can begin a MAP proceeding but this practice is not usual**
- **If a domestic court has already reached a binding decision in the case, that may limit the extent of MAP relief**

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## **Relation between MAP and domestic legal remedies (cont.)**

- **Most countries simply require the TP to suspend any domestic litigation while the MAP case is proceeding. The TP should not be allowed to undertake two parallel proceedings at the same time**
- **If a MAP reaches a successful conclusion, the taxpayer typically then has the right to accept or reject the conclusions of the MAP.**
- **However, to accept the MAP the TP typically must at that point waive all domestic law remedies.**
- **The legal status of the MAP depends on domestic law**

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## MAP and transfer pricing under Article 9

- Under Article 9, adjustments to a resident company's profits are allowed if it has dealings with a related party in the other contracting state which are not at arm's length.
- As a result, there will be potential economic double taxation as a portion of the profits will be taxed in both countries
- Where a country has made an adjustment to the profits of a resident taxpayer (a "primary" adjustment), Article 9(2) obliges the country of the related party to make a "corresponding" adjustment to reduce its taxing claims and thus eliminate the potential double taxation

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## Application of MAP in transfer pricing cases

- However, under Article 9(2) a country is only required to make a unilateral corresponding adjustment to the profit if it finds that the primary adjustment is "justified both in principle and as regards the amount". UN Commentary, Article 9, paragraph 6.
- If the country does not agree with the primary adjustment, Article 25(1) does not literally apply as there is no juridical double taxation, that is, taxation of the same profits in the hands of the same taxpayer
- Thus there would be no access to the MAP to relieve the economic double taxation

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## **Application of MAP in transfer pricing cases**

- However, the UN Commentary to Article 25, para 2 provides that “most countries” consider that economic double taxation of the type described above constitutes taxation not in accordance with the treaty and is covered by Article 25 MAP
- Thus under this interpretation Article 25, para. 1 it would be possible to open a MAP resolve the economic double taxation arising from disagreement as to the application of Article 9

## **Application of MAP in transfer pricing cases**

- Even where the treaty does not contain the explicit obligation to make a corresponding adjustment under Article 9(2), the UN Commentary Article 25, para. 2 takes the position that MAP is available, though noting that “some countries” do not follow this view
- Given the purpose of the treaty to avoid double taxation, it seems hard to justify refusal to consider such cases under MAP, especially since, in the absence of an arbitration provision, the only obligation under MAP is to “endeavor” to resolve the case

## **“Secondary” adjustments**

- Once the countries have agreed on the “primary” and “corresponding” adjustments to income to avoid economic double taxation, there is still an issue of implementing the adjustments as the proceeds from the original transaction are in the “wrong place”
- UN Commentary, Article 25, para. 44 considers various techniques such as allowing a payment which would otherwise be taxable to be tax neutral or providing for the establishment of an account payable which can be discharged without tax consequences.

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## **“Best practices” for MAPs**

- Both the OECD and the UN give guidance as to “best practices” in structuring the mutual agreement procedure
  - UN Guide to Mutual Agreement Under Tax Treaties (“UN”), [http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide\\_MAP.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide_MAP.pdf)
  - OECD Manual on Effective Mutual Agreement Procedures (“MEMAP”), <http://www.oecd.org/ctp/dispute/36249394.pdf>
- CAs should make every effort to resolve cases on a principled basis, UN para. 49
- Audit settlements which involve the waiver of MAP access should be avoided, UN para. 80

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## **“Best Practices”**

- **Competent Authority function should be independent of audit function, UN para. 62**
- **Guidelines and procedures should be developed and publicized for taxpayer presentation of MAP cases, UN para. 92 and UN Commentary, paragraph 42**
- **Use of position papers and response papers to clarify area of disagreement, UN para. 169**
- **Resolving and publishing issues of interpretation under Article 25(3), MEMAP BP 1**
- **Liberal interpretation of time limits and advising of treaty rights, MEMAP BP 9**

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# **Thank you**

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