MANDATORY ARBITRATION OF INTERNATIONAL TAX DISPUTES:

A SOLUTION IN SEARCH OF A PROBLEM

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Abstract

Many commentators have addressed the question of resolution of international tax disputes through various alternative mechanisms. The most debated question is whether or not to introduce mandatory arbitration into the bilateral tax treaty network and if yes, how can this be accomplished. From a first glance at the extensive literature that exists in this field, it appears as if an additional contribution is not an easy task to fulfill. Nevertheless, recent developments deserve further investigation, namely, the recent efforts by the Organization of Economic Development and Cooperation ("OECD") to include a provision addressing mandatory and binding arbitration in its Model Convention and the recently ratified protocols by the United States with Germany, Belgium and Canada which, *inter alia,* brought the inclusion of such a clause to the Double Tax Treaties (DTTs). I wish to examine these proposals and predict the probability of their success.

In **part one** of the article I will present a brief review of major literature contributions in this field. I will set forth an evaluation methodology that focuses on two questions: First, does (and how) a mandatory arbitration provision fit in the overall network of tax treaties? Second, does the mandatory arbitration provision actually resolve disputes? I will argue that when we are able to answer positively to both questions, a recommendation to adopt such a provision can be made.

In **part two** I will focus on the OECD proposal for mandatory arbitration aimed at improving the resolution of tax treaty disputes. Here, I reach the conclusion that under the current proposed structure, a negative answer to the above evaluation questions is more likely to be given than a positive one and therefore I conclude that this proposal should be reexamined. I will address the policy issues that are related to the proposal, structural deficiencies embodied in it as well as possible negative impacts it may have.

In **part three** I examine the U.S. provisions for mandatory and binding arbitration as adopted recently. I will address policy considerations surrounding the decision to include such a provision and whether these recent adoptions represent the U.S. policy on mandatory arbitration.

Part four is a summary of the work. I express the view that I do not oppose to the adoption of mandatory arbitration. Nevertheless, I offer some considerations regarding the circumstances accompanying the application of such a provision as well as its structure. I suggest that the proposals should be reconsidered because they lack features that are major and crucial for the mandatory and binding arbitration provision to function successfully.

I. Introduction

A. Arbitration of International Tax Disputes – General Background

The issue at stake is as follows: a DTT exists between two countries. A taxpayer having connections with both jurisdictions may be subject to tax in both jurisdictions. If both tax administrations exert their authority to tax, the taxpayer will potentially be subject to double taxation, a result which is arguably undesirable. The role of the tax treaties is, *inter alia*, to prevent such a result. "Income tax treaties have two primary operational goals - to reduce the risk of double taxation to taxpayers engaged in cross-border transactions and to mitigate the risks of undertaxation of taxpayers by promoting cooperation and exchange of information among responsible members of the international family of nations".[1]

Perhaps a clear example for the above scenario is the *Boulez* Case.[2] The issue in the case was whether certain payments received by Pierre Boulez constituted royalties or compensation for personal services. Had the payments been characterized as royalties, they would have been exempt from U.S. tax under the U.S. – Germany DTT. Had they been compensation for personal services performed in the U.S., they would have been subject to U.S. tax. Under the U.S.-German DTT valid at that time the only dispute resolution mechanism available was the Mutual Agreement Procedure (MAP). The MAP Article in the treaties is usually similar in its wording to Article 25 of the OECD Model Convention (MC).[3] Accordingly, when a taxpayer introduces its case to the relevant

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[1] BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, INTERNATIONAL TAX PRIMER, second edition, at 6. *See also* at 105: "The objective of tax treaties, broadly stated, is to facilitate cross-border trade and investment by eliminating tax impediments to these cross-border flows. This broad objective is supplemented by several more specific, operational objectives. The most important operational objective of bilateral tax treaties is the elimination of double taxation". *See also* Stef van Weeghel, *The Improper Use of Tax Treaties,* Series on International Taxation No. 19, (Kluwer Law), (1998) at 33 addressing the two above mentioned objectives as major objectives and adding to them, as a third and major objective, the non-discrimination clause.

[2] *Boulez v. Commissioner*, 83 T.C. 584 (1984).

[3] Because of its relevance to the discussion I will cite the wording of Article 25 of the OECD Model Conventions which reads as follows: " 1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention. 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. 3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention. 4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission

competent authority and if that competent authority cannot resolve the matter independently, the case will usually be discussed at the level of the competent authorities of both Member States in an attempt to settle the dispute. This is what happened in the *Boulez* Case. The dispute was referred to the competent authorities for resolution in an attempt to prevent double taxation of Mr. Boulez's income. The competent authorities of Germany and the US were unable to reach an agreement regarding the characterization of the payments. Germany took the position that the payments were royalties and therefore taxable exclusively by Germany. The U.S. took the position that the income generated from the performance of personal services in the U.S. and therefore taxable there. Mr. Boulez was taxed on his income in both jurisdictions.

In this example the taxpayer was subject to double taxation, even though one of the primary purposes of the treaty was to avoid double taxation. Despite its existence, the MAP Article lacks the power to compel the Contracting States to resolve the dispute and grant relief to the taxpayer. The Article entails a quasi duty[4] to endeavour to resolve the dispute in order to prevent the taxation that is not in accordance with the treaty. Nevertheless, there is no obligation to actually settle the dispute. Therefore, there is no guarantee that one of the primary goals of the DTTs (preventing double taxation) will be met. Because of disputes similar to this, which remained unresolved after the MAP, the search for a solution accelerated. Mandatory arbitration has been introduced in this context.

More common disputes, though, are transfer pricing disputes.[5] In these disputes, a taxpayer with cross-border tax producing activities will try to allocate income and deductions in a tax favorable manner. The concerned tax administrations may disagree with this allocation and exert their right to tax the profits according to an adjusted allocation, which they assert to be the proper one; this will cause potential double taxation. If the taxpayer regards the taxation not in accordance with the treaty, it can seek relief either at the domestic level or by utilizing the MAP Article.

B. Do we really need arbitration?

As a first reaction it seems plausible to argue that a dispute resolution mechanism that would ensure relief is in need. This, however, will be accompanied with certain tradeoffs the major of which is accepting the binding authority of an arbitral panel. This raises issues of surrendering tax sovereignty by those States, a dilemma that has long occupied proponents and opponents of mandatory and binding arbitration. This has been the major concern that has decelerated the adoption of such a provision.

One of the relevant and basic works in this field was that of Lindencrona and Mattsson in 1981.[6] The authors present a historical survey on the topic, scan the work of

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consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs".

[4] *See* part two of the paper for discussion regarding the scope of this duty and the controversies as to its existence.

[5] *See* REPORT TO THE CONGRESS ON EARNING STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES, available at http://www.ustreas.gov/offices/tax-policy/library/ajca2007.pdf noting that a substantial portion of the inventory of the U.S. Competent Authority consists of cases that involve transfer pricing agreements.

[6] GUSTAF LINDENCRONA & NILS MATTSSON, ARBITRATION IN TAXATION (1981).

international professional organizations up to that date and examine the manner in which international arbitration functions in other fields. If to be extremely brief, they acknowledge that avoiding double taxation is not guaranteed and therefore recommend adopting a mechanism which ensures a solution in all cases.[7] Despite the logic upon which this recommendation lies, it was not praised by the vast majority of countries who in fact have not adopted arbitration clauses in their treaty network to this day. The OECD Committee on Fiscal Affairs (1984) released a report noting:

> *"The Committee does not, for the time being, recommend the adoption of a compulsory arbitration procedure to supersede or supplement the mutual agreement procedure. In this view the need for such compulsory arbitration has not been demonstrated by evidence available and the adoption of such a procedure would represent an unacceptable surrender of fiscal sovereignty".* [8]

Despite this concern, many scholars and non-governmental organizations have suggested mandatory arbitration as a means to address income tax treaty disputes.[9] I agree that an effectively functioning mandatory and binding arbitration provision that meets the goals of the DTT network would constitute an appropriate solution. Whether the current proposals fall within this framework or not is discussed below.

The question presented in this sub-chapter could be approached in a different manner. Defenders of mandatory arbitration point to the prevention of double taxation as the primary justification for adopting this mechanism. They make the argument that improving taxpayer protection in international tax matters will facilitate cross-border transactions and flow of capital and investment. Potentially subjecting taxpayers to double taxation will affect their investment choices leading to a distortion that ultimately causes inefficiencies. The mandatory and binding arbitration is therefore offered to combat this defect.

This analysis is logical assuming the unresolved cases are double taxation cases. Yet this assumption is not free from doubts.[10] Lacking knowledge as to why unresolved cases remain as such, what the nature of the disputes were and the secrecy of the MAP in

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[7] *Id.* at 17. The authors state that: "If two states have decided to conclude an agreement on the avoidance of double taxation, they have thereby accepted to refrain from their right of taxation in certain situations. It is only logical that the states find solutions that ensure that disputes on the contents of the agreement can be solved in all situations."

[8] OECD, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues,* (1984). *See also* Karl Koch, *Mutual Agreement-Procedure and Practice,* LXVIa *Cahiers de droit fiscal international* 109, General Report to the IFA Congress (1981), at 125: "Although there has long been a call for the creation of arbitration procedure or an international court for tax matters, the opposition is probably too strong". For further discussion on fiscal sovereignty *see generally* Ramon J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation,* Series of International Taxation No. 23, (Kluwer Law), (1999). *See also* WILLIAM W. PARK & DAVID R. TILLINGHAST, INCOME TAX TREATY ARBITRATION (Sdu Fiscal), (2004). *See also* Tax Notes International's interview with Carol Danahoo, former U.S. IRS Competent Authority, available at LEXIS (2004 WTD 12-5) (January 19, 2004). *See also* Kevin Bell, *Germany-U.S. Tax Treaty Arbitration Process Addresses Sovereignty Issue*, 43 Tax Notes Int'l 214 (July 17, 2006).

[9] *See* William W Park, *Income Tax Treaty Arbitration*, Tax Mgmt. Int'l J, 31(5), 219 and the references thereafter. *See also* William W. Park & David R. Tillinghast, *supra* note 8.

[10] *See* Michael McIntyre, *Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes*, 7 Fla. Tax Rev. 622

general complicate the process of evaluating whether or not the mandatory arbitration provision is necessary.

To illustrate this point assume that all unresolved MAP cases are double non-taxation cases, *i.e.* had the taxpayer's position been accepted, the income would have escaped taxation in both jurisdictions. Further assume that one of the competent authorities was unwilling to settle the dispute through MAP in order to prevent the no-tax result. In this case, the above justification for mandatory arbitration is lost since the taxpayer never suffered from double taxation. This distinction will be relevant to the analysis hereinafter and will play a role in evaluating the proposals. In the same manner that preventing double taxation can benefit the public, preventing double non-taxation has a similar positive effect. Double non-taxation causes economic distortions as well. If the unresolved cases are double non-taxation cases, this sheds doubt as to the necessity of the mandatory arbitration.

C. Defining the goals of arbitration in the international tax arena:

In 1927 The League of Nations took the following position:[11]

> "*From the very outset, the Committee realized the necessity of dealing with questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that States should come to an agreement with a view to ensuring that a taxpayer shall not be taxed on the same income by a number of different countries, and it seems equally desirable that such international co-operation, should prevent certain incomes form escaping taxation altogether. The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once, and once only*".

This principal is referred to in the literature as the "Single Tax Principal" which seems to enjoy the support of many countries, academics and organizations.[12]This is the OECD's

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[11] *See* League of Nations, *Double Taxation and Tax Evasion – Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion,* League of Nations Doc. G. 216 M. 85. II (Geneva, April 1927). *See also* Cole, Venuti, Gordon and Croker, *Income: Income Tax Treaties – Administrative and Competent Authority Aspects,* 940 T.M., at A-1: "The most important functions (of tax treaties, e.f.) are (i) to avoid double or excessive taxation of income .....(ii) to assist in the prevention of tax avoidance and tax evasion".

[12] *See generally* Reuven Avi-Yonah, *International Tax as International Law,* Law & Economics Working Paper Series, 7-13 (2004). *See also* Reuven Avi-Yonah, *International Tax as International Law-An Analysis of the International Tax Regime,* Cambridge Tax Law Series, (2007) at 8: "Income from cross-border transactions should be subject to tax once (i.e., neither more nor less than once). The single tax principle thus incorporates the traditional goal of avoiding double taxation, which was the main motive for setting up the international tax regime in the 1920s and 1930s. Taxing cross-border income once also means, however, that it should not be under-taxed or (at the extreme) be subject to no tax at all". *See also* Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaty with Belgium and the Proposed Tax Protocols with Denmark, Finland, and Germany (JCX-51-07), (July 17, 2007), Thomas A. Barthold, Acting Chief of Staff of the Joint Committee on Taxation, stated that: "The principal purposes of the treaty and

position as well.[13]This principal is a manifestation of the two identified primary goals of the DTTs: preventing double taxation as well as double non-taxation. I believe that the mandatory and binding arbitration provisions, as an inherent part of the treaties, should participate in fulfilling these primary goals.[14] In order for this to be possible, the provision should meet a two-prong evaluation test. First, it should fit within the overall DTT network. This basically means that the provision should meet the goals of this network. Second, the provision should be able to function in a manner that will lead to the resolution of disputes. The first part of this test addresses a legal concern and the second part is a technical one. The success of the mandatory arbitration lies upon meeting both parts of this test.

II. The OECD Proposal for Mandatory and Binding Arbitration

A. The OECD Proposal: Overview

A few years ago the OECD launched a project aimed at improving the resolution of tax treaty disputes the outcome of which has been included in a final report that was released in 2/2007. The project was focused on enhancing the MAP under Article 25 of the OECD MC while simultaneously including a mechanism that will ensure a final, definite and binding resolution of disputes.[15] There was a previous version to this report and the basic change, according to the OECD, between the draft from February 2006[16] and the final report mainly reflects the decision not to require a waiver of domestic remedies as a condition for initiating the arbitration process.[17]

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protocols are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries".

[13] *See* OECD, *Commentary on the Articles of the 2005 OECD Model Income and Capital Tax Convention* (July 15 2005), Commentary on Article 1, para. 7 titled: "Improper use of the Convention" states that: "7. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion. 7.1 Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral double taxation conventions that would have the effect of allowing abusive transactions that would otherwise be prevented by the provisions and rules of this kind contained in its domestic law".

[14] Many other goals have been identified but I choose to focus on these two as they are the primary goals. For an exhaustive discussion *see* Zvi D. Altman, *Dispute Resolution under Tax Treaties*, Volume 11, Doctoral Series, (IBFD, 2005). *See generally* Michael Lang and Mario Züger, *Settlement of Disputes in Tax Treaty Law* (Eucotax, 2003), Mario Züger, *Arbitration under Tax Treaties,* Volume 5, Doctoral Series, (IBFD, 2001). *See also* Henry J. Brown and Arthur L. Marriot Q.C., *ADR Principles and Practice,* 2nd edition, (Sweet & Maxwell) (1999).

[15] *See* OECD official website at http://www.oecd.org/dataoecd/17/59/38055311.pdf for the full report "IMPROVING THE RESOLUTION OF TAX TREATY DISPUTES", Report adopted by the Committee on Fiscal Affairs on 30 January 2007, February 2007 (hereinafter "the OECD report").

[16] *See* OECD official website at http://www.oecd.org/dataoecd/5/20/36054823.pdf for the full version: "PROPOSALS FOR IMPROVING MECHANISMS FOR THE RESOLUTION OF TAX TREATY DISPUTES", Public Discussion Draft, (February 2006), (hereinafter "the 2006 OECD report").

[17] *See* the OECD report, *supra* note 15 para. 15.

This part of the paper attempts to evaluate the structure of the proposed provision. I argue that the proposed structure has a "built in" flaw which, in certain circumstances, can defeat the idea of having mandatory and binding arbitration as a final resort for the resolution of disputes. In addition I argue that the current structure of the proposal will have negative impacts on the MAP which the proposal was aimed at enhancing. A few recent commentaries address the OECD proposal and offer some suggestions for its improvement.[18] I agree, in general, with most of the recommendations in these articles. Yet I tackle the proposal from a structural point of view.

> The OECD proposal adds paragraph 5 to the existing Article 25 of the MC:
> "5. Where,
> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
>
> b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,
>
> any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.[19]

The proposal builds on the assumption that in order for a dispute to become "eligible" for resolution through mandatory arbitration, the competent authorities of both countries must first negotiate through MAP. If they are unsuccessful in arriving at an agreement pursuant to Article 25(2) within two years, the mandatory arbitration provision is triggered upon request by the taxpayer. In other words, the mandatory arbitration is an extension of the MAP procedure and not an independent procedure.[20]

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[18] *See* Michael McIntyre, *supra* note 10. *See also* Marcus Desax and Marc Veit, *Arbitration of Tax Treaty Disputes: The OECD Proposal*, Arb. Int'l 23:3 (2007), 405. *See also* James Morgan, New Developments in the Resolution of International Tax Disputes, 43 Tax Notes Int'l 77 (July 3, 2006).

[19] *See* the OECD report, *supra* note 15, at p. 5.

[20] *See* the OECD report, *supra* note 15, the proposed commentary on the new paragraph provides that: "The paragraph is, therefore, an extension of the mutual agreement procedure that serves to enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Thus, under the paragraph, the resolution of the *case* continues to be reached through the mutual agreement procedure, whilst the resolution of a particular *issue* which is

B. What is the Mutual Agreement Procedure (MAP)?

In order to better understand the proposal, especially seeing the manner in which it was structured, a few words addressing the scope and nature of the MAP are necessary. The MAP is a mechanism to be utilized in cases where a dispute regarding the application or interpretation of a DTT arises between two Contracting States usually upon taxpayer's request. The intention is to enable the Contracting States to reach a settlement which would help improve the fiscal relationship between the competent authorities and provide better taxpayer protection.

The MAP is part of a diplomatic process manifested in the bilateral negotiations between two governments. Both governments are the decision makers in this proceeding. They decide to what extent to release fiscal sovereignty, which cases are suitable to be negotiated and whether or not to settle. The basic feature of MAP, and the most widely criticized, is that the parties are under no obligation to resolve a dispute, as distinguished from the obligation to set the process in motion.

C. What is the case when no MAP was set in motion?

An inevitable question is whether the wording of the proposed paragraph 5(b) "the competent authority are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State" includes a situation where the competent authorities do not commence negotiations at all. I believe this situation is not addressed in the proposed paragraph. I take this position for the following reasons: First, the proposal is clearly structured as an extension of the MAP. The intention is for this mechanism to operate when and after both competent authorities are unable to settle through the MAP. Paragraph 12 of the OECD report[21] states that:

> "*Recourse to these techniques, however, must be an integral part of the mutual agreement procedure and should not constitute an alternative route to solving tax treaty disputes between States, which would risk undermining the effectiveness of the mutual agreement procedure*".[22]

Secondly, from the proposed paragraph 46 to the commentary[23] it is clear that there is a distinction between the "case" and the "issue". This paragraph addresses a hypothetical situation where the competent authorities are unable, during the negotiations, to resolve one or more issues and are therefore unable to resolve the case in whole. In this case the proposed paragraph would cause the unresolved issues to be

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preventing agreement in the case is handled through an arbitration process. This distinguishes the process established in paragraph 5 from other forms of commercial or government-private party arbitration where the jurisdiction of the arbitral panel extends to resolving the whole case". (Emphasis in source).

[21] *See* the OECD report, *supra* note 15.

[22] *Id.*, para. 46.

[23] *Id.*, para. 16.

resolved through the arbitration, leaving the resolution of the case to be achieved through MAP.[24] Here too the assumption is that the negotiations have already commenced.

Thirdly, according to paragraph 50 of the proposed commentary:[25]

> *"Where the mutual agreement procedure is not available, for example because of the existence of serious violations involving significant penalties, it is clear that paragraph 5 is not applicable".*

In other words, the paragraph clarifies that its application is conditioned upon the availability of MAP.

Fourth, according to the proposal the case is referred to mandatory arbitration when, *pursuant to paragraph 2*, the parties were unable to settle. Paragraph 2 of Article 25 deals with the MAP negotiations. The referral to paragraph 2, in this case, emphasizes that exhausting the MAP negotiations is a condition to triggering the arbitration.

D. Is there a duty to negotiate? Various Positions

Because of the manner in which the proposal was structured, the question whether or not a duty to initiate MAP exists has a direct impact on the future operation of the provision. Under the proposal, commencing the MAP is a condition to triggering the mandatory arbitration. Assuming that competent authorities are under no duty to participate in MAP negotiations, this could create a tool that could be utilized in order to prevent triggering the mandatory arbitration. The competent authority can deny a MAP request and this will ultimately prevent triggering the mandatory arbitration.[26]

The OECD view

The OECD takes the view that the competent authorities are under a duty to initiate MAP upon request from the taxpayer.[27] In my mind this position is problematic, not to say contrary to the language of Article 25. Article 25(2) implies that the so called "duty to negotiate" is not unconditioned. The Article poses two conditions once met, will presumably establish a duty, or better say a quasi duty, to "endeavour" to resolve the case by mutual agreement. The first condition is: "*if the objection appears to it to be justified*". The second condition is: "*if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority*". If a competent authority considers a taxpayer's objection *not* justified, the first condition is not met and therefore, the "duty" to negotiate is not established.

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[24] *Id.*, para. 46 of the commentary in para. 16.

[25] *Id.*, para. 16.

[26] *See* section G(1) below for a deeper discussion on this point.

[27] *See* OECD, *Commentary on the Articles of the 2005 OECD Model Income and Capital Tax Convention* (July 15, 2005), Commentary on Article 25, paragraph 26, stating that: "Paragraph 2 no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result".

The OECD commentary suffers from inconsistency. Paragraph 20 of the commentary[28] provides that:

> "*The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of the State of which he is a resident.....that competent authority is under an obligation to consider whether the objection is justified and,* ***if it appears to be justified****, take action on it in one of the two forms provided for in paragraph 2*".

Paragraph 23 of the commentary states:

> "*An application by a taxpayer to set the mutual agreement procedure in motion should not be rejected* ***without good reason***".[29]

The commentary is not clear on this issue. What constitutes "a good reason" to deny a MAP request? Paragraph 22 addresses a situation in which the taxpayer approaches the resident competent authority and "if it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty -- as clearly appears by the terms of paragraph 2 -- to set in motion the mutual agreement procedure proper".[30] To set in motion the MAP, at this stage, means that the "resident" competent authority approaches the "source" competent authority with the potential taxation not in accordance with the convention. The "resident" competent authority is under a duty-- established in paragraph 22 of the commentary-- to do so. The "source" competent authority, in return, is also obliged to set the MAP in motion. This is established by paragraph 26. Yet, the duty imposed upon the "resident" competent authority (initially approached by the taxpayer) is subject to the taxpayer's objection being justified. Paragraph 23 of the commentary makes this clear. The same could be argued regarding the "source" competent authority. It also has to consider taxpayer's objection justified. Nevertheless, paragraph 26 emphasizes that paragraph 2 no doubt entails a duty to negotiate. This confusion does not contribute to the discussion. It seems difficult, therefore, to reconcile between these different approaches.[31]

> One commentator, Richard Hammer, believes that:
> "*Paragraph 1 (of Article 25, e.f.) provides the taxpayer with the right to seek CA intervention, whether or not the taxpayer has yet exhausted all his legal remedies in his home country. Paragraph 2 then refers it* ***to the judgment of the relevant CA to decide whether or not the case is of***

[28] See OECD, Commentary on the Articles of the 2005 OECD Model Income and Capital Tax Convention (July 15, 2005), Commentary on Article 25, para. 20. Emphasis added.
[29] *Id.*, para. 23. Emphasis added.
[30] *Id.*, para. 22.
[31] An additional issue that should be pointed out is that the commentary is not as emphatic, regarding the interpretive and legislative MAP under paragraph 3, as under paragraph 1 and 2 of Article 25. *See* para. 32 of the commentary stating that the first sentence of the paragraph 3 of Article 25 invites and authorizes the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. In one case the OECD sees a "duty" and in the other only an "invitation".

> ***sufficient merit*** *for pursuance by the CA. If the complaint is justified, the CA to which the appeal was directed (generally the CA of the country of residence or citizenship of the complainant) is obliged to trigger off the mutual agreement procedure mechanism, which of course involves government to government negotiations*".[32]

According to this view, which strikes me as reasonable, it is up to the competent authority to judge whether or not the case is of sufficient merit.[33] Pierre Kerlan, former Director of International Tax Affairs in France, went beyond and questioned whether Article 25(2) could oblige the competent authority to initiate MAP, even assuming that taxpayer's objection is justified.[34]Jon Bischel notes that:

> "*Yet, to be truly effective, some alterations are essential to existing competent authority structures. For instance, the present procedure is voluntary since a competent authority to which a claim is presented may refuse to consider the request if it determines it meritless*".[35]

The U.S. view

The U.S. tax authorities are required to notify the taxpayer whether or not the case is suitable for consideration under MAP.[36] The flip side of this requirement is that some cases are not suitable for MAP. Previously, it was possible for a taxpayer to request review of the decision not to initiate MAP.[37] This review option was decreased by Rev. Proc. 79-32[38] and abolished completely by Rev. Proc. 91-23.[39] These modifications

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[32] Richard Hammer, *Introduction to Competent Authority*, *in* NEW YORK UNIVERSITY, INTERNATIONAL INSTITUTE ON TAX AND BUSINESS PLANNING, (1977), at 171. Emphasis added.

[33] *See also Id.*, at 177, he states: "From the U.S. taxpayer's point of view, there are several weaknesses in the CA procedure. First of all, the IRS has ***the sole right*** to decide if a case is meritorious and if it should go to CA. The taxpayer has no right to appeal an adverse determination on this question". Emphasis added.

[34] Pierre Kerlan, *International Disputes With Respect to Tax Conventions – The French View*, *in* NEW YORK UNIVERSITY, INTERNATIONAL INSTITUTE ON TAX AND BUSINESS PLANNING (1977), *supra* note 32, at 232.

[35] Jon E. Bischel, *Tax Allocations Concerning Inter-Company Pricing Transactions in Foreign Operations: A Reappraisal*, 13 Va. J. Int'l L. 490 at 514. *See also* Adrian A. Kragen, Avoidance *of International Double Taxation Arising From Section 482 Reallocations*, 60 Cal. L Rev. 1493 at 1514 arguing in favor of this claim.

[36] *See* Matthew T. Adams, *The Procedure for Invoking Competent Authority Assistance Under United States Income Tax Treaties*, *in* NEW YORK UNIVERSITY, INTERNATIONAL INSTITUTE ON TAX AND BUSINESS PLANNING, (1977), *supra* note 32 at 188.

[37] Rev. Proc. 77-16; 1977-1 C.B. 573, § 6.03. The Rev. Proc. provides that: "The decision of the review panel as to whether competent authority assistance should be provided is not further reviewable within the Service. (However, the taxpayer may pursue all rights to judicial review of the review panel's decision under the laws of the United States.)".

[38] Rev. Proc. 79-32; 1979-1 C.B. 599, § 3.02 amended §6.03 of Rev. Proc. 77-16 by making the decision of the review panel designated by the Internal Revenue Commissioner final and omitting the part granting right for judicial review of the reviewing panel's decision under U.S. laws. It could be argued though that the judicial review is still available despite the fact that the sentence granting this review was omitted.

[39] Rev. Proc. 91-23; 1991-1 C.B. 534, § 1 pointed out that: "Rev. Proc. 82-29, 1982-1 CB. 481, and Rev. Proc. 77-16, 1977-1 C.B. 573, as amplified by Rev. Proc. 79-32, 1979-1 C.B. 599, are superseded by this revenue procedure". In § 11.04 the Rev. Proc. 91-23 read: "Review of Denial of Request for Assistance. The U.S. competent authority's denial of a taxpayer's request for assistance or dismissal of a matter

indicate the U.S. position as to taxpayer's rights (or competent authority's obligation) to initiate MAP.

The omission of the right to request review of the competent authority's decision was coupled with an increase in the number of circumstances in which the competent authority could deny MAP assistance. Rev. Proc. 77-16 enumerated three such circumstances while Rev. Proc. 2006-54 enumerates eight cases.[40]For example, the competent authority can classify a case as unsuitable for MAP consideration or assistance if the taxpayer is willing to accept a settlement under conditions that are unreasonable or prejudicial to the interests of the U.S. government.[41] Authority to deny MAP assistance is also granted where the competent authority believes that the transaction giving rise to the request for competent authority assistance is more properly within the jurisdiction of IRS appeals or is designated by the IRS for litigation.[42]

Other commentators acknowledge that Article 25 does not entail a duty upon the competent authorities to commence the negotiations yet take the position that this should be revised.[43] In presenting some of the technical and practical problems associated with MAP negotiations, Sanford Goldberg deals with the procedural aspects of the MAP and he also acknowledges these limitations.[44] John F. Avery Jones and others proposed procedural improvements to the MAP acknowledging that:

> *"At present the taxpayer's only right is to present his case to the competent authority of the State of which he is resident (or in some cases of which he is a national). After that, the matter is outside his control in a way which does not happen in litigation.* ***He cannot force his competent authority to take the matter up with the other competent authority****, and, even if it does so, the taxpayer does not know how strongly it will press his case".*[45]

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previously accepted for consideration pursuant to this revenue procedure is final and not subject to administrative or judicial review". Rev. Proc. 2006-54; 2006 I.R.B 1035, which is valid to date, states, in section 12.04 that: "The U.S. competent authority's denial of a taxpayer's request for assistance or dismissal of a matter previously accepted for consideration pursuant to this revenue procedure is final and not subject to administrative review".

[40] *See* § 12.02 0f Rev. Proc. 2006-54, *supra* note 39.

[41] § 12.02 (2) of Rev. Proc. 2006-54, *supra* note 39.

[42] § 12.02 (8) of Rev. Proc. 2006-54, *supra* note 39. *See also* Paul C. Rooney and Nelson Suit, *Competent Authority*, 49 Tax Law 675, at 681: "Moreover, the competent authority procedure, by stating that assistance may be denied if the case has been "designated for litigation" by the Service, shows the manner in which the Service would appear to retain discretion to litigate a case rather than allow it to proceed through the competent authority process".

[43] *See* John F. Avery Jones *et al., The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention-I*, [1979] Brit. Tax Rev. 333 at 337, citing Pierre Kerlen, *supra* note 34, arguing that the question whether competent authorities are under an obligation to refer the matter to the other competent authority, or merely under a recommendation to do so, is disputed by some states.

[44] Stanford H. Goldberg, *How and Does the Competent Authority Work?* 39 TAX EXECUTIVE, 1985-87, 3. He points out that a request for MAP may be denied for substantive or procedural reasons.

[45] *See* John F. Avery Jones *et al., The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention-II,* [1980] Brit. Tax Rev. 13, at 19. Emphasis added.

Arvid Skarr has expressed a similar opinion.[46] Referring to Article 25(2) of the OECD MC, he notes that:

> "*Thus, the taxpayer's rights depend upon the discretionary assessment of the competent authority of his state of residence*".[47]

The General Report presented to the International Fiscal Association (IFA) Congress in 1981[48] addressed this issue as well. In reviewing the several reasons for refusal to grant competent authority assistance, the report makes clear that:

> "*The taxpayer has no legal right to require implementation of mutual agreement procedure (except in Belgium), but solely a right to require that the competent authority should decide, within the scope of its due discretion, whether mutual agreement procedure should be started*".[49]

It is also noteworthy that the U.S. commentary does not contain a paragraph similar to paragraph 26 of Article 25 of the OECD MC, which states that a duty to negotiate exists, and this is in line with the U.S. position.

Considering the above commentary and the changes in the Revenue Procedures throughout the past thirty years it seems conceivable to claim that from a U.S. prospective, competent authority assistance is granted at the discretion of the tax authority and there is no duty to grant it. This position was upheld by the District Court in the *Yamaha* Case.[50] Yamaha sought a declaratory judgment that the Service wrongfully refused its request for MAP assistance under the DTT and to compel the Service to consider this request. The IRS filed a motion to dismiss and the court granted the motion holding that it lacked jurisdiction to review the determination. The court essentially held that the tax authority is under no duty to grant MAP assistance. In denying Yamaha's plea the court clarifies:

> "*First, it is* ***entirely possible*** *that the Government could prevail in its attempt to prevent Plaintiffs from immediate access to negotiations via the Treaty. For example, the* ***Government could decide that the Plaintiffs' double tax claim has no merit, and could deny the request***".[51]

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[46] Arvid Aage Skaar, *The Legal Nature of Mutual Agreements Under Tax Treaties,* 5 Tax Notes Int'l 1441 (1992). *See also* Zvi D. Altman, *supra* note 14 at 272. He enumerates the disadvantages of the MAP and notes that: "Another very important disadvantage of the MAP concerns the unlimited discretion given to the competent authority in deciding which cases to accept and which to reject".

[47] *Id.*, at 1447. In elaborating the question whether or not a taxpayer's claim is justified, he points out that: "Unfortunately, the authorities of different countries have different policies concerning what makes it "justified" to initiate mutual agreement procedure. From the taxpayer's point of view, the most frightening aspect of this procedure is that the competent authorities may refuse to institute the mutual agreement procedure simply because they disagree with the taxpayer".

[48] *See supra* note 8.

[49] *Id.*, at 109.

[50] *Yamaha Motor Corp. USA v. United States, 779 F. Supp 610(D.D.C. 1991).*

[51] *Id.*, at 613. Emphasis added.

In the *Filler* case, decided 10 years before the *Yamaha* case, a similar decision, denying the court's jurisdiction to initiate competent authority proceedings, was granted.[52] The court characterizes the MAP as an international administrative procedure that is pursued between the competent authorities of the Contracting States and therefore not judicial. These decisions have not escaped the criticism of some commentators.[53] Nevertheless, they are valid and support the policy of the U.S. tax authorities as reflected in Rev. Proc. 2006-54.

The Canadian View

The Canada Revenue Agency (CRA) has issued Information Circular 71-17R5 *Guidance on Competent Authority Assistance Under Canada's Tax Conventions* which is valid to date.[54] Paragraph 12 of the Information Circular provides:

> "*Where a request is made to the Canadian Competent Authority under the MAP article of a tax convention, the Canadian Competent Authority will first, if the request appears to be justified and can be accepted by the Canadian Competent Authority from a policy standpoint, attempt to resolve the matter unilaterally*".

Paragraph 24 of the Information Circular, dealing with the acceptability of requests, enumerates 4 circumstances in which the Canadian competent authority will accept a request for assistance, the last of which is that the issue is not one that the Canadian and/or the foreign competent authority have decided, *as a matter of policy*, not to consider. This indicates that CRA has discretion to deny certain MAP requests.

In a 1998 article, Claude Lemlin and Regina Deanehan acknowledge that such authority for denial of MAP assistance, on both the Canadian and U.S. sides exists. They

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[52] *See Filler v. Commissioner, 74 T.C. 406 (1980),* at 407-408: "We hold that article 25, which establishes a certain procedural device for dealing with rights agreed upon in the convention, does not afford petitioner a remedy which can be asserted in this Court". *See also* AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON UNITED STATES INCOME TAX TREATIES (1992) at 99 stating, based on *Filler* that: "In the United States, a claim for relief under Article 25, paragraph 1 may not be asserted in court, but may only be made to the competent authority".

[53] *See* Rooney & Suit, *supra* note 42 (arguing that the *Yamaha* decision was wrongful and that there should exist a judicial review mechanism that would ensure taxpayer's right to initiate the MAP proceedings and serve as a judicial review for the Service's decision whether or not to commence MAP negotiations). *See also* Sanford H. Goldberg and Seth B. Goldstein, *U.S. District Court Lacks Jurisdiction to Compel IRS to Consider Request for Competent Authority Assistance,* 40 Can. Tax J., 1008 (1992), (arguing that the U.S. position violates many treaties and that the *Yamaha* decision is very disturbing). *See also* Stanford H. Goldberg and Peter A. Glicklinch, *Treaty-Based Nondiscrimination: Now You See It Now You Don't*, 1 Fla. Tax. Rev. 51, at 57:"Nor is it clear that a U.S. taxpayer can compel the Internal Revenue Service to participate in negotiations under the competent authority procedure".

[54] Available at http://www.cra-arc.gc.ca/E/pub/tp/ic71-17r5/ic71-17r5-e.html. This circular replaced Information Circular 71-17R4 from May 12, 1995. Paragraph 25 of the Information Circular provides:
"The CRA will notify the taxpayer in writing whether the Canadian Competent Authority has accepted or declined the request for competent authority assistance normally within thirty days of receiving a complete request. The taxpayer will be provided with the reasons for the decision where a request is declined".

refer to Information Circular 71-17R4 and Rev. Proc. 96-13 which were valid at time.[55] This view was also presented by the National Reporter of Canada in 1981 IFA Congress on Mutual Agreement – Procedure and Practice.[56]

The German View

Klaus Vogel points out that the competent authority must first of all determine whether the taxpayer's assertion that he has been taxed contrary to the treaty is justified. The authority is duty bound by Article 25 to make that determination.[57]In other words, the obligation upon the competent authority is not to proceed to the negotiations but rather to determine whether the objection is justified. It is clear, however, that two conditions exist: *if* the competent authority considers the taxpayers objection to be justified and *if* it further considers the taxation complained of to be – wholly or partly-attributable to actions of the other contracting State, it will, by means of international understanding with the competent authority of the other contracting State, endeavour to set a mutual agreement in the narrower sense in motion.[58] The issue therefore is whether or not the taxpayer has the right to demand that the competent authority properly use its discretionary powers when deciding whether or not to set a mutual agreement procedure in motion.[59] Vogel indicates that:

"*According to BFH (abbreviation for Bundesfinanzhof, Federal Fiscal Court, e.f.) rulings, the competent authority has on the other hand the power of discretion to decide whether or not to allow the objection and consequently to set the mutual agreement procedure in motion* ***even when*** *the taxation complained of has been* ***proved*** *to be contrary to the Convention.*"[60]

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[55] *See* Claude Lemelin and Regina Deanhan, *The Competent Authority Process: A Canadian And US Comparative Analysis,* 46 Can. Tax J, 657 (1998) at 664-665. *See also* Catherine Brown, *The U.S.-Canada Tax Treaty: Its Impact On the Cross Border Transfer of Technology*, 9 Transnat'l Law. 79 at 117: "Relief from double taxation can be sought through the mutual agreement procedure. To access this procedure, taxpayers must request competent authority assistance from their government. Approval can be denied, and has been in the United States in at least one recent instance. The Canadian government will also refuse to act for a number of reasons, including whether the issue is one the competent authorities of each jurisdiction may not agree to accept, or where the foreign government refuses to deal with the case".

[56] *See* Karl Koch, *Mutual Agreement-Procedure and Practice,* LXVIa *Cahiers de droit fiscal international* 109, General Report to the IFA Congress (1981), *supra* note 8, at 122, presenting the various positions that were taken regarding the suggestion to improve the mutual agreement procedure by, *inter alia*, giving taxpayers a legal right to require initiation of mutual agreement procedure or in the event of refusal to appeal to the domestic courts: "The National Reporters for Austria, Canada, Japan and Norway do not regard improvements as necessary, expressing substantial doubts in this respect. In the view of the National Reporter for Canada, such measures would strike at the very root of the consensual nature of mutual agreement procedure, and could also result in appeals to the courts beyond those provided by the domestic legislation".

[57] *See* KLAUS VOGEL, DOUBLE TAXATION CONVENTIONS, 3RD Edition (1998), at 1366.

[58] *Id.*, at 1367

[59] *Id.*, at 1367.

[60] *Id.*, at 1367-1368. Emphasis in source.

Either way, it is clear that the German competent authority has no *duty* to initiate MAP negotiations and under the German Federal Fiscal Court rulings, this authority is fully at the discretion of the competent authority, even in cases where taxation not in accordance with the convention has been proven. Friedhelm Jacob and others agree with the view that taxpayers have no right to require the German tax authorities to pursue MAP.[61] In a recent article, Peter Dehnen and Silke Bacht also present a similar position.[62]

The Israeli view

The Unit for International Taxation in Israel issued MAP guidelines in Executive Instruction 23/2001 dealing with the mutual agreement procedures.[63] Section 5.1 states that the competent authority will consider the application for MAP assistance and whether or not it could be justified. If the competent authority finds the assistance request not to be justified, it will notify the taxpayer its explained decision in writing.

This position was upheld in a District Court decision in Israel.[64] Jeteck Technologies Ltd., a company resident in Israel, carried on a business in software production and development and it had an agreement with a Japanese company whereby Jeteck would sell to the Japanese company the right to use its computer software in return for royalties. The Japanese company withheld tax from the payments it made to the Japanese company. Jeteck claimed a tax credit in Israel for the taxes withheld in Japan. The Israeli tax authorities denied the claim, arguing that Jeteck did not prove which part of the payments constituted royalties and which part constituted business income. Consequently, the tax authorities considered the whole amount of the payments as business profits subject to tax only in Israel under the DTT (since Jeteck did not have a permanent establishment in Japan). The payments that Jeteck received were therefore taxed twice, once in Japan and again in Israel. Jeteck contested the assessment of the

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[61] Jacob Friedhelm, *et. all,* HAND BOOK ON THE 1989 DOUBLE TAXATION CONVENTION BETWEEN THE FEDERAL REPUBLIC OF GERMANY AND THE UNITED STATES OF AMERICA, International Bureau of Fiscal Documentation, at 15, on Article 25, citing also section 3.3.1 of BStBl 1997 I (Administrative Principles published by the Federal Ministry of Finance in Germany).

[62] Peter H. Dehnen and Silke Bacht, *Compatibility of the Recent OECD Proposals with Germany's Tax Dispute Resolution Mechanism*, BULL. FOR INT'L FISCAL DOCUMENTATION 463 (November 2006), at 466, under the discussion about the DTT between Germany and Sweden stating that: "...none of the tax treaties obliges the contracting states to start MAP. And, while German national law gives taxpayers the right to appeal against the tax administration's refusal to start a MAP, the higher courts are only allowed to ascertain whether the tax administration's decision was within its discretionary authority". *See also: May a Taxpayer Force the Use of a Mutual Agreement Procedure,* 23 EUROPEAN TAXATION 195, dealing with the same case, at 198: "...the court may decide only if the tax authorities made a fair and competent use of their discretionary power, as provided in FGO, section102. If the tax authorities' discretionary power were construed narrowly, the German tax authorities would have been obliged to comply with P's (plaintiff, *e.f.*) request. However, the Supreme Tax Court rejected such a narrow interpretation because it would have conflicted with the purpose of the mutual agreement procedure, since the outcome of the procedure is dependent not only on the will of the tax authorities to whom the request is made but also on whether or not the other State is prepared to comply with the request by entering into negotiations. Therefore, the tax authorities to whom the request is made ***may also base their decisions on reasons of suitability or convenience***". (Emphasis added). *See also* Peter Dehnen, *Germany issues new Mutual Agreement Procedures Decree*, available at LEXIS (2006 WTD 188-8).

[63] Executive Instruction Income Tax No. 23/2001 dated December 16, 2001.

[64] *See* Income Tax Appeal 1255/02 *Jeteck Technologies Ltd. v. Assessing Officer Kfar Saba* (Tel-Aviv District Court, April 7, 2005).

Israeli tax authorities and requested them to initiate MAP negotiations. The Israeli tax authority denied the request claiming that MAP could be initiated only after the Israeli Court had determined the character of the payments. The District Court held in favor of Jeteck and obliged the tax authority to *consider the merits* of the taxpayer's request for MAP assistance and to determine whether or not it was justified, before hearing the appeal that Jeteck had filed to the Israeli Court.[65]

This case constitutes a good example for the question at stake. A careful reading of the court's reasoning makes clear that the court does not regard the initiation of MAP as an obligation. The Court expresses, though, its consent that the taxpayer has the right to demand that the competent authority properly use its discretionary powers when deciding whether or not to set a MAP in motion. Nevertheless, the Court acknowledges that when the tax authority deals with a matter within the international arena, it will sometimes be required to appraise, in view of the contracting State's practices, the MAP's chance of being successful, the involved expenditures and how the procedure could influence the relations between the two authorities involved.[66] In this case, the Israeli competent authority did not revoke the necessity of commencing the MAP; it only took the position that these should be postponed to a later stage. The court disagreed with this position. The court emphasized that it is granting an order to *consider the merits* of the taxpayers' request and not an order to initiate MAP. The court further clarified that the order is granted because the Israeli competent authority does not contest the need to commence the negotiations and seeks only to postpone them to a later stage.[67]

The Japanese view

The National Tax Authorities of Japan have also published guidelines for the MAP known as "Commissioner's Directive on Mutual Agreement Procedures".[68] Section 13 (1) of the Directive reads:

> "*Where the Office of Mutual Agreement Procedures has received an Application for Mutual Consultations and attachments as described in 6(2) and the request is considered to have merit for mutual consultations, the Office of Mutual Agreement Procedures shall, except in the cases given below, propose to commence mutual consultations to the competent authority of the treaty partner nation*".

The situation here is similar and the competent authority has to determine that the application has merit for consultations in order to agree to initiate the

[65] *Id.*, at 11.
[66] *Id.*, at 8.
[67] *Id.*, at 11. This decision was cited again, in a later decision rendered by the same Tel-Aviv District Court: Income Tax Appeal 1192/04 *Kloteen Yigaal & Sara v. Assessing Officer Kfar Saba* (Tel-Aviv District Court, opinion rendered on May 17, 2006). In this case, the Court upheld the tax authority's position not to initiate MAP, which was based on the fact that the taxpayer did not cooperate. The court rules that it will seldom interfere with the authority's decision, especially in a case such as this one, where the competent authority notified the taxpayer that lacking some information and documentation it had requested, it was unable to take a fundamental position as to whether or not to initiate MAP and therefore denied the request.
[68] "The Commissioner's Directive on Mutual Agreement Procedures" is available at http://www.nta.go.jp/foreign_language/00.pdf.

negotiations.[69] This has also been Japan's historical view, as expressed by the National Reporter of Japan in the International Fiscal Association Congress.[70]

The Australian View

The Australian tax authorities also condition the initiation of MAP upon a finding that taxpayer's request is justifiable. The taxpayer does not have a right to cause the MAP to be set in motion and in certain circumstances the competent authority will characterize a case as unsuitable for MAP. This was the position of the Australian National Reporter at the International Fiscal Congress.[71] This is also the official position in Taxation Ruling 2006/12 issued by the Australian Taxation Office and valid to date.[72]

The Spanish view

The competent authority in Spain is the General Directorate of Taxes.[73] The procedure begins, as in most cases, when the competent authority receives the claim. It then evaluates it and comes to a decision whether it is justified in order to proceed further with the other Contracting State.[74]

> "*Nonetheless, the tax administration is never compelled to start the mutual agreement procedure. Therefore, it may at its election* ***refuse*** *to ask the foreign administration to reach an agreement following the procedure and is no longer compelled to find a solution with respect to the double taxation matter, since it only has an obligation to use all the necessary means at its disposal to achieve a good result, and not an obligation to achieve a good result.* ***The taxpayer has no means to force the competent authority to start the mutual agreement procedure****...The taxpayer is allowed to challenge this refusal before courts or administrative bodies since there is a deed to challenge*".[75]

This position was upheld by the High Courts of Spain. The Spanish Tax Courts' approach was examined by Dr. Jose Calderón.[76] He addresses two different rulings, passed by the Supreme Court of Spain and another high court that in his view open the

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[69] According to section 13(2) of the Directive, The Office of Mutual Agreement Procedures shall notify the applicant when it does not propose mutual consultations to the competent authority of the treaty partner nation. This also indicates that such authority to deny competent authority assistance exists.

[70] *See supra* note 8.

[71] *See* LXVIa *Cahiers de droit fiscal international, supra* note 8, at 190. In the summary report, the National Reporter of Australia enumerates the circumstances under which the competent authority will usually refuse to initiate the MAP negotiations.

[72] See TR 2000/16, available at http://law.ato.gov.au. Section 4.4 states that stage one of the consideration process is divided to 3 elements, the second of which is "consideration by the competent authority whether the case presented is justified; and, if so...".

[73] *See* Fernando Serrano Antón, *Settlements of disputes in Spanish Tax Treaty Law, in* Michael Lang and Mario Züger, *supra* note 14 at 431.

[74] *Id.*

[75] *Id.* Emphasis added.

[76] See Dr. Jose M. Calderón, *The Taxpayer's Right to Set 'Mutual Agreement Procedure' in Motion: the Spanish Tax Court's Approach*, Intertax 2001/11, p. 362.

door to the judicial review of the decisions of the Spanish competent authority.[77] In his view, these decisions are positive decisions in the meaning that they acknowledge that the competent authority's administrative decision is subject to judicial review, something that was not that clear up to these decisions. Nevertheless, he acknowledges that the Spanish courts should in fact take into account not only the taxpayers' legitimate interests "but also the 'tax policy' reasons underlying in the decision of the Competent Authority denying the setting in motion of the mutual agreement procedure; it should be pointed out that such a decision generally depends on a series of factors such as 'tax policy reasons', 'strategy reasons', 'the international context', or 'the current status of the international or diplomatic relations between the Contracting States".[78]

In the above mentioned cases, both the Spanish Supreme Court and the other high court (Audiencia Nacional) upheld the competent authority's decision not to initiate MAP. The Audiencia Nacional ruled that the tax conflict was an internal issue that does not concern either the interpretation or the application of the Tax Treaty and the Supreme Court found that the tax conflict between the taxpayers and the tax Administration did not have international relevance; that is, the controversy did not involve either the interpretation or the application of the provisions of the Spain-Austria Tax Treaty.[79]

In Calderón's view, the real objective of the case was to determine if the ruling of the tax administration denying the computation of the tax loss resulting from the sale of the Austrian binds had 'international relevance'. In his opinion, the courts erred by dismissing the taxpayer's arguments.[80] Nevertheless, these are examples that clearly indicate that a taxpayer does not have a right to cause the initiation of competent authority negotiations and there will be cases where this request will be denied.

The French view

In summarizing the French tax authority's position on this issue, which follows the above mentioned trend, Hugues Perdriel-Vaissière states that:

> "*The practice is to invoke the competent authority procedure where all the required conditions are met. Nonetheless, the tax administration remains* ***entirely free to refuse*** *to ask the foreign administration to reach an*

[77] *Id.*, at 364: "It can be said that as a consequence of these rulings taxpayers' rights deriving from the tax treaties are strengthened; any taxpayer who considers that the actions of the Spanish tax Administration constitute taxation which is not in accordance with a tax treaty can file an application to set in motion the mutual agreement procedure. The Spanish Competent Authority cannot deny such claim without having a legitimate reason; the fact that the decision of the Competent Authority can be subjected to judicial review can exert an important influence in order to limit the discretion of the Competent Authority when deciding whether or not a 'legitimate reason' is met".

[78] *Id.*, at 364, also citing Rooney & Suit *supra* note 42.

[79] *Id.*, at 363 – 364. He points out, at 362, that the tax conflicts concerned the taxation applicable to a typical interest stripping transaction in which the taxpayers bought Austrian bonds and sold them just after collecting the interest derived from the securities; according to the Spain-Austria tax treaty the interest was exempt in both countries; the taxpayers also considered that the capital loss which resulted from the sales of the Austrian bonds had to be taken into account in computing their taxable income; however, the tax Administration denied the capital loss, considering it a sham. The author expressly disagrees with this interpretation and criticizes the courts on upholding the competent authority's argument that this is an internal issue (at 365).

[80] *Id.*, at 365.

agreement following the procedure...Aside from this example (referring to the DTT with Italy which imposes an obligation to settle, e.f.) the taxpayer has no means of forcing the competent authority to start a MAP".[81]

The Belgian view

In Belgium, the taxpayer's "right" to demand the initiation of MAP seems to be better secured and apparently Belgium follows the OECD interpretation of the duty to negotiate as presented in the OECD commentary. Here, the fiscal administration has no discretionary power to veto MAP when the taxpayer is entitled to claim it under a convention. The taxpayer's right is safeguarded since the request for MAP assistance is presented to the regional director of taxes against whose decision the taxpayer can appeal before the courts in accordance with domestic law.[82]

E. Summary of the Possibilities and Preferred Interpretation:

It is beyond the scope of this paper to check every State and its internal procedural rulings or customary laws as to whether or not it grants taxpayers legal or other rights regarding the initiation of the MAP.[83] From the above presented literature a conceivable conclusion could be drawn that the decision to initiate MAP is at the competent authority's discretion and there is no duty to act in this direction.

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[81] Hugues Perdriel-Vaissière, *Settlement of Disputes in French Tax Treaty Law,* in Michael Lang and Mario Züger, *supra* note 14 at 200. Emphasis added. He mentions that the Council of State (*Counseil d'Etat)* and the administrative courts of appeal have always had this point of view and the sources thereof.

[82] *See* LXVIa *Cahiers de droit fiscal international*, *supra* note 8 at 223. *See also* Klaus Vogel *supra* note 57, at 1367: "Belgian law, moreover, affords the taxpayer a **legal claim** to have a mutual agreement procedure set in motion". *See also* Luc Meeus, *Settlements of disputes in Belgian Tax Treaty Law, in* Michael Lang and Mario Züger, *supra* note 14 at 99: "If it appears to the competent authority of the State where the complaint was filed that the taxation complained if is due, wholly or in part, to a measure taken in the other State, it will be incumbent on it to set in motion the mutual agreement procedure proper". Belgium's position is based, apparently, on its more general principle of giving higher priority to a (tax) treaty with direct effect over domestic (tax) legislation. This principle is based on the Belgian Supreme Court decision from 1971 (*Cour de Cassation/Hof van Cassatie*), 27 May 1971, *Pas.*, 1971, I, 886 (Case of *Fromagerie Franco-Suisse* "Le Ski"), securing individual rights granted under treaties and ensuring that these rights are superior to domestic laws. *See also* Gerrit Groen, *Arbitration in Bilateral Treaties*, Intertax 2002/1, p. 3.

[83] Note that Denmark, the Netherlands and Finland maintain a similar position. *See generally* in Michael Lang and Mario Züger, *supra* note 14, the following: Karin Skov Nilaysen, *Settlement of Disputes in Danish Tax Treaty Law,* at p. 143 arguing that it is not possible to force the competent authority of Denmark to initiate MAPs, yet if it decides to refuse a request, it will have to give reasons for the refusal. Eric Velthuizen, *Settlement of Disputes in Dutch Tax Treaty Law*, at p. 158 arguing that: "The specific case mutual agreement procedure provisions do not grant many rights to the taxpayer. It is clear that a taxpayer has the right to present his case to the authorities. But, it is not clear whether the taxpayer can go to a Dutch court and request that a mutual agreement procedure is initiated. The most likely view is that in the Netherlands, the taxpayer is not entitled to call for proceedings; the initiation of the mutual agreement procedure is at the discretion of the authorities". Marjaana Helminen, *Settlement of Disputes in Finnish Tax Treaty Law*, at p. 188 clarifying that the taxpayer may not force the authority to invoke the mutual agreement procedure or to grant a tax exemption. Entering into negotiations and granting an exemption is totally up to the case-by-case consideration of the authorities. An appeal is not possible against the decision.

F. Justifications: MAP functions positively

As clarified above, MAP is voluntary. When taking this into consideration, in addition to the informality accompanied with the negotiations, the fact that it is a government to government negotiation process, the confidentiality of the process and the fact that it is not binding on the taxpayer, all these strengthen the view that this procedure should be commenced when competent authorities believe it to be justified. The spirit of MAP is that it is fully consensual and voluntary and in my opinion, imposing an initial duty to negotiate contradicts with this spirit. This seems to be the general trend.[84]

It is noteworthy that MAP has obtained positive results despite the "no duty" to negotiate or settle. This is because States favor MAP, where control over fiscal sovereignty is much greater than in mandatory and binding arbitration. This is why competent authorities tend to positively respond to taxpayer's requests to grant MAP assistance. One commentator noted that in the U.S. refusal to grant MAP assistance is very rare, as few as five times since 1970.[85]

During a joint conference of the Canadian and U.S. branches of the International Fiscal Association in Toronto on May 18, 2007 discussing a fifth protocol to the Canada-U.S. income tax treaty, Frank Ng said that:

> *"In general the success rate of competent authority cases handled by the IRS is good, with only about 5 percent of cases failing to produce tax relief. That tends to suggest the process is working in terms of results".*[86]

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[84] See *Yamaha* and *Filler* cases above, *supra* notes 50 and 52, the two Spanish cases, *supra* note 76 and the two Israeli cases, *supra* notes 64 and 67. *See also* Rooney & Suit *supra* note 42 at p.700: "Courts, however, may be especially hesitant to interfere in competent authority negotiations because of the perceived executive nature of the government-to-government negotiation process and perhaps out of deference to the Service's administration of the tax treaties. Judicial review may also be more difficult when only one party to the negotiation is subject to U.S. jurisdiction, but should not be impossible for that reason alone. It is a more serious objection that foreign governments may decline to negotiate if their positions and approaches would become public in U.S. court proceedings. It may be, therefore, that aspects of the U.S. competent authority process leading up to sovereign-to-sovereign negotiations are the more promising candidates for invoking the courts".

[85] Elaine Platt, *The Mutual Agreement Procedure in the U.S. Income Tax Treaties- a Primer,* 32 Tax Mgmt. Int'l J. 593 (Nov. 14, 2003) citing Cole, Venuti, Gordon and Croker, *supra* note 11, at A-25: "In practice over the years, the US Competent Authority has rejected very few taxpayer initiated cases for any reason, and these have been cases in which the US Competent Authority could not find an applicable treaty issue or where the US Competent Authority was certain, on the basis of past experience with the foreign treaty country involved, that a procedural bar or foreign treaty country interpretation, would prevent relief". *See also* James R. Mogle, *Competent Authority Procedure*, 23 Geo. Wash. J. Int'l L. & Econ. 725 (arguing that while treaties generally do not require competent authority assistance requests to be granted, they are typically granted absent unusual circumstances). *See also* Hugues Perdriel-Vaissière *supra* note 81 indicating that in France the practice is to invoke MAP. *See also* Karin Skov Nilaysen, *supra* note 83, at 144 (claiming that the competent authority of Denmark seems quite open in relationship to initiating a MAP and presenting a few cases where despite the fact that the tax authority was unwilling to give up its taxing rights, it tried to convince the other tax authority to give up its taxing right to tax or to provide relief on the basis of equity).

[86] *See Canadian Officials Discuss Upcoming Protocol, Joint Initiatives* (May 21, 2007) available at LEXIS (2007 TNT 99-7). *See also* Susan Lyons, *Competent Authority Process Discussed at FBA Meeting* (March 11, 1996) available at LEXIS (96 TNT 49-5) reporting the view of a former IRS assistant commissioner

The Canadian side reports success of the MAP as well. Over 80 percent of Canadian MAP cases involve the United States, and more than 50 percent of U.S. cases involve Canada.[87] CRA reported that:

> "*Of the 266 cases resolved in fiscal year 2006-2007, 65 cases were categorized as negotiable, which means that discussions with another tax administration were required to resolve an issue. Of the 65 cases negotiated with other tax administrations, 6% resulted in no relief being provided (4 cases), and 2% resulted in partial relief being realized (1 case), for the reason on see next page. In summary, 92% of taxpayers who sought assistance obtained full relief from double taxation*".[88]

In a 2006 public discussion draft dealing with proposals for improving mechanisms for the resolution of tax treaty disputes, the OECD characterized the cases where the competent authority were unable to reach an agreement as ***rare***.[89] This is compatible with the data cited above.[90]

(international tax matters) on MAP success. *See also* Robert T. Cole, *Keeping the Competent Authority Process Effective: Moral Obligation and Arbitration,* 32 Tax Mgmt. Int'l J. 83, (Feb. 13, 2003) at 83: "...at least where the US Competent Authority is involved, since 1970 there have been very few cases in which the Competent Authorities have failed to agree and failed to avoid double taxation". *See also* LXVIa *Cahiers de droit fiscal international*, *supra* note 8, at p. 103: "Most National Reporters stated that in the great majority of cases a settlement has been reached on the avoidance of double taxation(e.g. in Austria, Canada, Federal Republic of Germany, Italy Swede, Switzerland and USA). Only in a small number of cases was it not possible to eliminate the double taxation through the mutual agreement procedure". *See also* Kathleen Matthews, *IFA Panel Discusses Competent Authority,* 14 Tax Notes Int'l 1734, (May 26, 1997) claiming that ninety percent of the competent authority cases are successfully resolved. In the other 10 percent of the cases, the failure to reach mutual agreement is often a result of the untimely filing of the request for competent authority relief". *See also* Matthews Kathleen, *Transfer Pricing: Competent Authorities Will Use Comparable Profits -- If They Have To*, 8 Tax Notes Int'l 1300, report on a seminar sponsored by U.S. Federal Bar Association's Tax Section held in Washington on May 4, 1994: "The competent authority process functions well in the Netherlands, Babberich said. He reported there are no unresolved competent authority cases and that cases are generally concluded within one year. He added that the Dutch have had considerable experience in successfully resolving competent authority cases with Germany, a major trading partner of the Netherlands". *See also* Matthews Kathleen, *U.S., Canadian and Mexican Competent Authorities Discuss Dispute Resolution*, (May 19, 1997) available at LEXIS (97 TNT 96-4), citing Deborah Nolan, then IRS deputy assistant commissioner (international), who said that ninety-five percent of the competent authority cases in the United States are resolved with either 100 percent or partial relief.

[87] Greg Noble and Robert Turner, *Competent Authority Update, Report of the Proceedings of the Fifty-Seventh Tax Conference,* Canadian Tax Foundation, p. 29:13.

[88] *See* Canada Revenue Agency, MUTUAL AGREEMENT PROCEDURE PROGRAM REPORT available at http://www.cra-arc.gc.ca/tax/nonresidents/comp/map_report_2006-2007-e.pdf.

[89] *See* the 2006 OECD report, *supra* note 15. The proposed commentary in this report stated that: "This paragraph provides that, in the ***rare*** cases where the competent authorities are unable to reach an agreement under paragraph 2, the unresolved issues will, at the request of the person who presented the case, be solved through an arbitration process" (Emphasis added). Note that this characterization has been omitted from the OECD report", the final report adopted by the Committee on Fiscal Affairs on 30 January 2007, February 2007, *supra* note 15. Nevertheless, it is very reasonable to argue that this omitting does not indicate a change in the OECD characterization which occurred within the one year period between February 2006 and February 2007. If in fact rare cases remained unresolved through MAP according to the 2006 report, one could presumably rely on this data as being accurate in 2007 as well, especially when this position is

G. Structural Deficiencies of the Proposal

1. The Two-Step Approach and the Blocking Method

The link between MAP and the mandatory arbitration and the fact that mandatory arbitration operates only as an extension to the MAP weakens the proposal. Assume that a taxpayer requests competent authority assistance claiming taxation not in accordance with the treaty. Assume further that the competent authority does not intend (say for policy reasons) that the issue at stake be resolved through mandatory arbitration. The competent authority, therefore, declines to initiate MAP. As shown above, this is possible. In this scenario the mandatory and binding arbitration provision will malfunction. This is because under the current proposal, the mandatory arbitration will be triggered only after the competent authorities exhaust the MAP negotiations. Since in this case they did not, the arbitration is not triggered. This mechanism will be referred to hereinafter as the Blocking Method. The competent authority in this example utilized this mechanism to block the mandatory arbitration, hence the name. [91]

It is noteworthy that the issue of the obligatory feature of the MAP was addressed in the work of William W. Park and David R. Tillinghast in 2004, sponsored by the International Fiscal Association.[92] The IFA-sponsored draft treaty avoids the problem by taking, as a trigger mechanism, presentation of the claim to only one of the competent authorities.[93]The OECD proposal was influenced by this work in many respects but not in how to trigger the mandatory arbitration.

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evident in the literature. It could well be that this characterization was omitted from the final report due to comments of Michael McIntyre *supra* note 19 arguing that if in fact only rare cases remain unresolved then it is worth double checking whether adopting the arbitration provision is a necessity seeing the other costs accompanied with such a step.

[90] Other commentators disagree with the general notion in the literature regarding the rate of success for MAP cases. For a thorough discussion see Zvi D. Altman, *supra* note 14 . *See also* Cole, Venuti, Gordon and Croker, *supra* note 11 at A-39: "Statistics show that while currently a high percentage of double taxation cases brought before the U.S. competent authority are resolved with full relief from double taxation, in the mid 1980's, a relatively large number of cases (approximately 40%) were disposed of with no relief or only partial relief".

[91] *See* Gerrit Groen, *supra* note 82 at p. 13-14: "As a consequence, if a contracting state is unwilling to enter into a mutual agreement procedure, the mutual agreement procedures have not been fully exhausted, and the dispute can therefore not be submitted to arbitration. Furthermore, the standard arbitration clause does not give a general consent to submit an unsettled dispute to arbitration before the two-year period has elapsed even if it is evident that within this period the dispute will not be resolved through negotiations".

[92] William W. Park & David R. Tillinghast, *supra* note 8 at 74: "The tax treaty arbitration has a close connection with the mutual agreement procedure. Arbitration would be initiated only after a mutual agreement procedure. Therefore, binding and mandatory arbitration would actually require also that the initiation of a mutual agreement procedure would be obligatory. For example, the Dutch representative (Mr. Gerrit Groen) has pointed out that mandatory tax treaty arbitration should require that the competent authorities would be obliged to initiate a mutual agreement procedure at the request of the taxpayer. It could be considered whether the mutual agreement procedure should be rewritten to this effect. Alternatively, as the representative from Singapore (Mrs. Christina Ng) has suggested, the arbitration article could expressly state that arbitration would be initiated also in a situation where the taxpayer was unable to avail itself or was denied the mutual agreement procedure notwithstanding the presentation of its case to the mutual agreement procedure".

[93] William W. Park & David R. Tillinghast, *supra* note 8 at 94. Note that there is no referral here to paragraph 2 of Article 25 dealing with the negotiations themselves as in the OECD proposal. William Park

Structuring the mandatory arbitration as an extension of the MAP Article has been referred to in the literature as the two-step-approach, meaning the arbitration shall only be initiated if the competent authorities cannot find a mutual solution in relation to an international tax conflict.[94] It is not at all clear that this is the preferred method. Introducing mandatory and binding arbitration as an extension of the MAP will entail a risk of function failure and will accordingly miss the target of ascertaining the resolution of disputes. The major problem, as shown above, is the availability of the Blocking Method. Even if the Contracting States may tend to accept requests for competent authority assistance, this should not, and can not, justify the existence of the Blocking Method. In addition, as I argue below, this tend is likely to decrease if the proposals are not restructured.

The OECD has emphasized in its reports that the major goal is to enhance and increase the effectiveness of the MAP.[95]A risk exists that the proposal will have an opposite effect. The fact that the vast majority of Contracting States have not yet embraced the idea of mandatory and binding arbitration (despite its long existence in the international tax arena) is not a secret. Nor is the fact that the States are, at the least, reluctant in giving up their taxing powers. This is especially true when dealing with cross border transactions of multinational corporations where millions of dollars of potential revenue is at stake. It is obvious therefore that the States will demonstrate hesitancy toward adopting a provision that could in effect expel them from their taxing rights.

The question remains why should the Contracting States take a different position now? What change in circumstance occurred as to cause the States to welcome the mandatory arbitration? My concern is that the tax authorities are still reluctant to do so and if this is true, the proposal will have a boomerang effect. The availability of the Blocking Method will accelerate due to the reluctance to participate in the mandatory arbitration. Denying requests for competent authority assistance (as an inherent part of utilizing the Blocking Method) will become more attractive. The direct result is blocking the mandatory arbitration. The indirect result is that lesser cases will be referred to MAP (in order to prevent them from ultimately being subject to mandatory arbitration if they remain unresolved). As a consequence, instead of enhancing the MAP and ensuring a

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expressed a similar view in a Tax Council Policy Institute symposium in Washington in February 2002, *See* Kevin Bell, *Danahoo Favors Exploring Arbitration to Resolve Competent Authority Disputes,* available at LEXIS (2002 TNT 31-10).

[94] See Luc Hinnekens, The Search for an Effective Structure of International Tax Arbitration Within and Without the European Community, in Michael Lang, *Multilateral Tax Treaties*, Series on International Taxation 18 (1998) 539.

[95] *See* the OECD report" *supra* note 15, para. 13: "These additional techniques (referring to the mandatory arbitration, *e.f.*) can make the MAP itself more effective even in cases where resort to the techniques is not necessary. The very existence of these techniques can encourage greater use of the MAP since both governments and taxpayers will know at the outset that the time and effort put into the MAP will be likely to produce a satisfactory result. Further, governments will have an incentive to ensure that the MAP is conducted efficiently in order to avoid the necessity of subsequent supplemental procedures. In addition, the introduction of supplementary dispute resolution techniques will reduce the likelihood of costly, time-consuming and possibly conflicting domestic judicial proceedings".

"fully effective MAP process that has the confidence of taxpayers"[96] the outcome could well possibly be weakening it.

2. Mapping the Arbitration

The proposed structure suffers from an additional structural flaw. The differences in the nature of a MAP and a mandatory and binding arbitration procedure are sufficient to make the marriage between the two problematic. The current proposal, as mentioned above, is to add paragraph 5 to Article 25 of the Model Convention. By "mapping the arbitration", if I may use this phrase, the proposal mixes two separate proceedings that have significantly different features. MAP is consensual and voluntary whereas mandatory arbitration is compulsory. MAP is a government to government diplomatic procedure while mandatory arbitration is referring a dispute to a third, unrelated party, for binding resolution. Contracting States should be allowed to control whether or not to grant competent authority assistance while they should not be granted this privilege in mandatory arbitration.[97] In a MAP the parties can reach the settlement that suits both sides, even if there could be a deviation from principals utilized in previous settlements. This is the advantage of the MAP. And the fact that the taxpayer is not bound by the agreement supports this feature. In mandatory arbitration, on the other hand, it is presumed that general and internationally accepted principals should guide the arbitration panel in reaching its decision and should be the source of law in the arbitration.[98]

International arbitration plays a significant role in producing international trans-border rule of law that will constitute a source of law to be referred to in future disputes.[99] Some kind of transparency and publicity is therefore necessary in mandatory arbitration. In MAP confidentiality is an accepted feature.[100] MAP has limitations and restrictions that emerge from domestic and internal legal systems of the Contracting States. The MAP is different in each jurisdiction while mandatory and binding arbitration should have a more unified feature to ensure its success. More importantly, the parties to the arbitration relinquish control over the proceedings,[101] unlike the case in the MAP where the parties

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[96] *See* the OECD report "Improving the Process for Resolving International Tax Disputes - Version released for public comment on 27 July 2004" p. 2, available at http://www.oecd.org/dataoecd/44/6/33629447.pdf.

[97] *See* part H of this chapter suggesting a different view when the dispute involves tax arbitrage.

[98] *See generally* IFA Congress seminar series, *Resolution of Tax Treaty Conflicts by Arbitration,* (Kluwer 1994).

[99] *See* Thomas E. Carbonneau, THE LAW AND PRACTICE OF ARBITRATION, 2nd ed. (Juris Publishing, 2004) at 429 arguing for this point in the International Commercial Arbitration context.

[100] *See* Michael McIntyre, *supra* note 10 at 636: "Defenders of secrecy are likely to argue that secrecy is a normal feature of an arbitration procedure. It is certainly true that most domestic arbitration proceedings are secret. The analogy to domestic arbitrations, however, is inappropriate. Domestic arbitrations are typically between private parties, the costs of the arbitration are privately financed, and the issues being resolved are private disputes. In sharp contrast, the OECD is proposing an international body that would be charged with the responsibility of deciding the amount of tax due to sovereign states. That dispute is a public dispute, the costs of resolving it are charged to the public, and the parties to that dispute (the governments) are public bodies accountable to their citizens".

[101] *See* Thomas E. Carbonneau., *supra* note 99, at 1 defining arbitration: "Arbitration is a private and informal procedure for the adjudication of disputes. It is an extrajudicial process. It functions as an alternative to conventional litigation. It yields binding determinations through less expensive, more efficient, expert and fair proceedings. Although it can engender settlements, arbitration is not intended to

are constantly in control of how the proceedings develop, when and if to settle or when to abandon the negotiations. In other words, there is an inherent distinction between the two proceedings and by "mapping the arbitration" we defeat the purpose of the mandatory arbitration. The mechanism under this proposal is neither mandatory nor is it arbitration. It lacks the compulsory feature because of the existence of the Blocking Method and the classification as arbitration is inaccurate because the proposed provision lacks basic features present in arbitration.

A final remark on this issue is noteworthy. Paragraph 46 of the OECD Commentary on Article 25 prior to the recent change resulting from the adoption of the proposal addresses a situation where MAP was unsuccessful stating:[102]

> *"It is difficult to avoid this situation without going* ***outside the framework of the mutual agreement****".*

In the current proposal this approach was not adopted. In the revised commentary, paragraph 46 is replaced with the new paragraph 46 stating that:

> *"The arbitration process provided for by the paragraph is not an alternative or additional recourse.....The paragraph is, therefore, an extension of the mutual agreement procedure..."*[103]

The language of the pre-revised commentary seems to suggest a similar logic that MAP and arbitration are two separate frameworks and the mixture of the two is bound to result in confusion, complexity in developing the arbitration and could undermine the arbitration as a mechanism for resolution of disputes.

I think the following comparison could serve as a good example to further illustrate this argument. Assume that a taxpayer files a tax return to the tax authorities who in turn disagree with certain issues, for example allocation of deductions or income. The taxpayer has the option of litigation but, in most cases, it also has available an "internal" appeal process, where the taxpayer attempts to settle the issue with the tax authority before turning to judicial remedies.[104]

This internal appeal process enjoys characteristics similar to the MAP: it is voluntary, the parties can decide whether to utilize it or to skip directly to litigation; it is a bilateral negotiation process between the two parties and binding only taxpayer and the IRS with no precedential value attached. The discussions and agreement remain confidential. The parties do not relinquish control over the process, its outcome and the determination whether or not to settle. This is the case in MAP as well.

Nevertheless, if the taxpayer is unable to settle the case with the tax authority through the appeal process (or if it decides not to utilize this opportunity), the case will

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operate as a means for achieving dispute resolution directly through party agreement. Arbitration is neither negotiation nor mediation. The parties confer upon the arbitrators full legal authority

[102] *See supra* note 27, para. 46 of the commentary on Article 25. Emphasis added.

[103] *See* the OECD report, *supra* note 15, para. 46.

[104] In the U.S. the tax decision reached by the examiner may be appealed to a local appeals office, which is separate and independent of the IRS Office that conducted the examination. If the parties agree, a closing agreement will be signed and the resolution is final. *See* Internal Revenue Service website for further information at: http://www.irs.gov/govt/fslg/article/0,,id=158488,00.html and IRC § 7121.

proceed to litigation, at which stage the parties are no longer decision makers. This is now an external proceeding rather than an internal one. The mandatory arbitration resembles the external proceeding while MAP resembles the internal one. These are two separate proceedings.

H. Arbitrage and Arbitration in Taxation

International tax arbitrage has been defined as a lofty term that refers to taking advantage of differences among country tax systems, usually differences in addressing a common tax question.[105] I will approach the discussion in this part of the article in the following manner: first, I will briefly raise the question whether international tax arbitrage is a concern; then, concluding that such a concern exists and under the assumption that oppressing tax avoidance is a goal of the DTT network, I will check how the mandatory arbitration provision addresses this issue and how it fits this framework.

1. Is Tax Arbitrage a concern?

Some commentators argue that the arbitrage is not (and should not) be a concern and as long as a transaction does not rise to the level of being a tax shelter or tax evasion, the taxpayers should be allowed to benefit from the tax results as permitted by each tax jurisdiction's laws.[106] Nevertheless, major players in the international tax arena take the opposing view including The League of Nations.[107] The U.S. has embraced this view as well.[108]

2. The relevance to the mandatory arbitration provision

One might wonder what relevance the above issue has to the discussion of mandatory and binding arbitration. Michael McIntyre has pointed out this relevance.[109] In discussing the arbitration as an optional dispute resolution mechanism the literature has focused on the distinction between allocation and non-allocation cases. This distinction has logic of its own. Transfer Pricing disputes probably consist the majority of the international tax disputes.[110] Nevertheless, this distinction ignores the debated topic of tax arbitrage. Why is this relevant? McIntyre argues that a mandatory arbitration could facilitate double non-taxation because taxpayers could utilize this mechanism to achieve no-tax results. This argument also has logic of its own. The assumption is that the arbitration panel will resolve the disputes based, first and foremost, on the wording of the

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[105] *See* H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the International Tax System,* 53 Tax L. Rev. 137 at 142. *See also* Daniel N. Shaviro, *More Revenues, Less Distortion? Responding to Cross-Border Tax Arbitrage,* 1 N.Y.U. J. L & Bus. 113, at 116: "taking advantage of inconsistencies between different countries' tax rules to achieve a more favorable result than that which would have resulted from investing in a single jurisdiction".

[106] *See* David H. Rosenbloom, *supra* note 105.

[107] *See generally supra* notes 11-13.

[108] *See* lecture by Treasury acting assistant secretary for tax policy Jonathan Talisman given at http://www.ustreas.gov/press/releases/ls1068.htm arguing that tax arbitrage is problematic and distorts economic behavior.

[109] *See* Michael McIntyre, *supra* note 10.

[110] *See supra* note 5.

DTTs.[111] Therefore, in the same manner that taxpayers utilize the DTTs to achieve double non-taxation they will be able to utilize the mandatory arbitration to enforce the double non-taxation.

Surprisingly (or not) the OECD does not address this issue. The proposal addresses only double taxation cases. The OECD did not condition triggering the mandatory arbitration upon actual double taxation. If the unresolved cases are only double taxation cases, why then not clarify that double taxation is required in order to trigger the arbitration. This could serve as a tool to confront tax arbitrage. This is the case in the EU convention for the arbitration of transfer pricing disputes.[112]

I will borrow an example from Lee Burns[113] to illustrate this issue. Lee Burns addresses an arbitrage known as the "double dipping" transaction, where the transactions are structured in a way that a single expenditure is deducted twice. The key to the tax benefit under such transactions is that the expenditure is deducted against two separate amounts of income in two countries with neither country taxing both amounts.[114] The example presented by Burns is that of a cross-border finance lease that involves the lessor (financier) in one country and the lessee in another country. The aim of a cross-border leasing transaction is to structure the transaction so that the tax treatment of the lease is different in the two countries - it is treated as a lease for tax purposes in the financier's country of residence and as a purchase on credit in the lessee's country of residence. This means that both the financier and the lessee can claim deductions in relation to the ownership of the asset (particularly, depreciation deductions). These deductions are applied against the income of the lessor (financier) and against the income of the lessee. While both countries are allowing a deduction for the same costs, each country is taxing only one amount of income. So a single outlay is being deducted against two separate amounts of income by two different taxpayers in two different countries.[115] If one of the countries disallows the deduction under the tax avoidance principles and the dispute is eventually referred to an arbitration panel for resolution, to me it seems that the arbitration panel will be compelled to accept the structure of the transaction as legal and

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[111] *See* section 14 of the sample mutual agreement on arbitration ("Applicable Legal Principles"), attached annex to the OECD report, *supra* note 15: "The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the treaty and, subject to these provisions, of those of the domestic laws of the Contracting States. Issues of treaty interpretation will be decided by the arbitrators in light of the principles of interpretation incorporated in Articles 31 to 34 of the ***Vienna Convention on the Law of Treaties***, having regard to the Commentaries of the OECD Model Tax Convention as periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction to the OECD Model Tax Convention. Issues related to the application of the arm's length principle should similarly be decided having regard to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The arbitrators will also consider any other sources which the competent authorities may expressly identify in the Terms of Reference".

[112] *See* Article 4 of the *Convention on the Elimination of Double Taxation in Connection with the Adjustments of Profits of Associated Enterprises* addressing the scope of the convention and clarifying that its application is in double taxation cases. *See also* Articles 6 and 7 making clear that the MAP and arbitration procedures are triggered where double taxation has not been removed.

[113] Lee Burns, *Cross-Border Tax Arbitrage,* Presentation Paper at the 2001 Tax Conference, ADB Institute (5-11 Sep., 2001), available at:
http://www.adb.org/Documents/Events/2001/Tax_Conference/tax_arbitrage.pdf

[114] *Id.*, at 2.

[115] *Id.* at 6.

compatible with the language of the treaty, which ultimately results in double non-taxation.[116]

The OECD proposal does not contribute in achieving the two primary goals of the DTT network. In fact, it can be utilized to defeat them. The result is that a negative answer will be given to the two evaluation questions presented in part one of the article leading to the conclusion that the proposal, in this structure, should be reexamined.

III. The United States and Mandatory and Binding Arbitration

A. Introduction

The situation in the U.S. regarding mandatory and binding arbitration of international tax disputes does not differ from that in other countries. The U.S. has agreed to include, in some treaties, ad hoc arbitration provisions, where the Contracting States were able to refer a dispute for resolution to an arbitration panel if both countries agreed. This is what is usually referred to as "voluntary" arbitration.[117] In this case, the Contracting States are under no obligation to refer the dispute to arbitration and it's at their full discretion. This is the situation for example in the DTT between the U.S. and Mexico and the previous DTT between the U.S. and Germany before the recent change, as will be addressed below.[118]

However, despite its existence in some treaties, this mechanism has not been utilized. I have personally contacted the Competent Authorities of both Germany and Mexico inquiring how many (if any) disputes between each of these countries and the U.S. have been referred to arbitration under the "voluntary" arbitration provisions, from their outset till today. Both respectful representatives answered that not any disputes have been referred to arbitration under these provisions.

When the then new provision calling for the resolution of unresolved disputes between Germany and the U.S. was first introduced, this was regarded a major and even unusual step because this was the first time an arbitration provision was presented.[119]

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[116] For further illustration see Michael McIntyre, *supra* note 10 at 627: "Double non-taxation cases are themselves common and are often the goal of sophisticated tax planning. As an example, assume that Country A exempts capital gains and Country B does not. Country B, however, has a tax treaty with Country A that exempts some but not all capital gains earned in Country B by a resident of Country A. The taxpayer, a resident of Country A, earns a capital gain of $ 100 million in Country B, which it claims is exempt from tax in Country B under the tax treaty. The tax officials of Country B disagree and have a reasonable basis for that disagreement. The taxpayer asks the competent authorities of Country A to intervene on its behalf, claiming that taxation by Country B is "not in accordance with" the treaty. If the matter were to go to arbitration and the taxpayer were to win, the result would be international double non-taxation".

[117] For an exhaustive discussion regarding the distinction between pre-dispute and post-dispute provisions *see* William W. Park & David R. Tillinghast, *supra* note 8.

[118] *See infra* note 137.

[119] *See* Fogarasi, Gordan, Venuti & Anderson, *Use of International Arbitration to Resolve Double Taxation Cases,* 18 Tax Mgmt. Int'l J. 319 (Aug. 11, 1989).

This was the notion despite the fact that this was an ad hoc voluntary provision.[120] Nonetheless, as mentioned above, this provision was never tested. The provision was intentionally broad granting both Contracting States wide discretion as to how, when and if to submit a dispute to arbitration.

The question I wish to address below is whether or not there has been a change in the U.S. tax treaty policy regarding the inclusion of mandatory and binding arbitration provisions in its DTT network. Do the recent ratifications of the protocols to the DTTs with Germany, Belgium and Canada, in which mandatory and binding arbitration provisions have been introduced, indicate a policy change? And if yes, to what extent is the U.S. willing to implement this policy, what method of arbitration will be favored, is the referral to arbitration in fact guaranteed and how will the proposed provisions operate.

B. Historical Background

It is not a secret that the Unites States, as other countries, has opposed the inclusion of mandatory arbitration in its treaty network. This was the position of the National Reporters of the United States presented in the 1981 conference of the International Fiscal Association.[121]

The earlier version of the arbitration provision in the DTT with Germany was advanced by the German government and therefore some scholars have expressed doubts as whether or not this indicates a policy decision from the U.S. point of view.[122] During the discussions for the inclusion of a similar provision calling for voluntary arbitration of unresolved disputes into the DTT with Canada, it was clarified in the explanation of the proposed protocol to the income tax treaty between the United States and Canada, prepared by the Joint Committee on Taxation, that the application of this provision was limited.[123] This approach was the United States' position with other treaty partners where voluntary arbitration provisions were adopted.[124]

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[120] *Id.* at 320, citing Joseph H. Guttentag and Ann E. Misback, *Resolving Tax Treaty Issues: A novel Solution,* Bull. For Int'l Fiscal Documentation (1986).

[121] *See* Robert Cole, John Huston & Stanley Weiss, in LXVIa *Cahiers de droit fiscal international, supra* note 8 at 279: "It is understood that the IRS does not favor arbitration, as it believes that the Mutual Agreement Article will work better if it continues to represent the US. Since there are many factors involved in the resolution of Mutual Agreement cases, arbitration would prevent the consideration of all these factors and the development of the bilateral rapport that has been so important in the resolution of cases until now". *See also* OECD position at that time *supra* note 8. *See also* Forgarasi *et all supra* note 119 at 321: "We understand that the IRS and Treasury representatives to the OECD were reluctant to accept the principles of arbitration to resolve double taxation cases, feeling that such a procedure would, in effect, be ceding the U.S. government's right to determine and assess its taxes".

[122] *See* Mark K. Beams, *Obtaining Relief Through Competent Authority Procedures and Treaty Exchange of Tax Information – The US Approach,* 46 Bull. For Int'l Fiscal Documentation, 119 (1992) at 121, addressing the then recently ratified treaty with Germany with the earlier version of the voluntary arbitration provision, states that: "Because the German government advanced this concept, it is not clear the extent to which it represents the current treaty policy of the United States, and it is therefore unclear whether this provision will appear in future U.S. treaties; indeed some more recent treaties have appeared that contain no arbitration provision". For a different opinion, *see* Forgarasi *et all supra* note 119 at 321: "The acceptance of the arbitration provision in the proposed U.S.-German income tax treaty indicates a change in view, at least by the Treasury Department negotiators".

[123] See Sen. Comm. Print (May 25, 1995), Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada at 44: "Even within the bounds of the competent authorities'

Hesitancy toward mandatory arbitration continued to lead and in an annual meeting of the Federal Bar Association Tax Section on March 1996, which was devoted to the competent authority process, IRS assistant commissioner for international tax matters Mr. John Lyons noted that arbitration procedures are interesting concepts, but he cautioned against putting too much hope in the arbitration process. He concludes, based on U.S. experience, that even agreeing to the architecture for arbitration takes an exceedingly long and difficult period of time.[125] This was also the notion at the ABA Tax Section meeting that took place on May 10, 1997.[126] The U.S. maintained this consistency in its position during the Uruguay Round of negotiations over expanding the General Agreement on Tariffs and Trade (GATT). Against the position of all the other members, the U.S. maintained its resistance for the national treatment obligation of the GATS to apply to income tax measures until very limited language was adopted.[127]

C. Has a change in the U.S. tax treaty policy occurred?

In the last 10 years or so, it seems as if the positions of IRS officials have deviated from the consistent reluctance to "willing to consider" mandatory arbitration. This, at least, is the impression from some of the interviews with IRS officials throughout this period.[128] In his testimony before the Senate Committee on Foreign Relations on Pending Income Tax Agreements, John Harrington, Treasury International Tax Counsel stated:

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decision making power, there likely would be issues that one or the other competent authority would not agree to put in the hands of arbitrators. Consistent with these principles, the Technical Explanation expects that the arbitration procedures will ensure that the competent authorities generally would not accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country".

[124] See Robert Green, *Antilegalistic Approaches to Resolving Disputes Between Governments: A Comparison of the International Tax and Trade Regimes*, 23 Yale J. Int'l L. 79, 101 and references thereafter. He states that: "Arbitration under these U.S. treaties will be voluntary, occurring only when both governments and the affected taxpayer agree to submit the case and to be bound by the award. The United States, Germany, Mexico, and the Netherlands have further stipulated that they generally will not agree to arbitrate matters concerning "tax policy" or "domestic tax law." The U.S. legislative history of the treaties with Canada, France, and Kazakhstan also suggests that arbitration under these tax treaties likely will be confined to fact-specific disputes".

[125] *See* Susan Lyons, *Competent Authority Process Discussed at FBA Meeting,* Tax Notes Today (March 11, 1996), available at LEXIS (96 TNT 49-5).

[126] *See* Kathleen Matthews, *U.S., Canadian, and Mexican Competent Authorities Discuss Dispute Resolution,* Tax Notes Today (May 19, 1997), available at LEXIS (97 TNT 96-4): "The competent authorities of Canada, Mexico, and the United States said May 10 that they do not see increasing the availability of arbitration as an important incentive to resolve disagreements". Representing the U.S. was IRS deputy assistant commissioner (international) Deborah Nolan, who made clear that the United States does not intend or desire to invoke arbitration as long as the competent authority process continues to enjoy its 90 percent success rate. She denied any knowledge of the United States engaging in discussions on its possible inclusion in the EC arbitration directive. *See also* Jacqueline Manasterli, *Multinational Government Officials Address Secret Comparables at IRS- GW International Tax Institute,* Worldwide Tax Daily (December 11, 1998), available at LEXIS (98 TNI 238-1).

[127] For an exhaustive discussion regarding the development of the negotiations and the U.S. position *see* Robert Green, *supra* note 124.

[128] *See* Tax Notes International's interview with Carol Danahoo, former U.S. IRS Competent Authority, available at LEXIS (2004 WTD 12-5), (January 19, 2004). Danahoo argues for the inclusion of mandatory and binding arbitration to the U.S. treaty policy and believes that such a provision is in need. She argues for mandatory and binding "Baseball" arbitration where the taxpayer is heard and the outcome of the

> "*Over the past few years, we have carefully considered and studied mandatory arbitration procedures. In particular, we examined the experience of countries that adopted mandatory binding arbitration provisions with respect to tax matters. Many of them report that the prospect of impending mandatory arbitration creates a significant incentive to compromise before commencement of the process. Based on our review of the U.S. experience with arbitration in other areas of the law, the success of other countries with arbitration in the tax area, and the overwhelming support of the business community, we concluded that mandatory binding arbitration as the final step in the competent authority process can be an effective and appropriate tool to facilitate mutual agreement under U.S. tax treaties*".[129]

He also mentioned that:

> "*Moreover, a country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions*".[130]

Nevertheless, the claim that a change in the United States' tax treaty policy has occurred is dubious. First of all, why wasn't such a provision included in the revised U.S. MC released November 2006? One explanation for this was offered by Benedetta Kissel Treasury deputy international tax counsel for treaty affairs stating: "We don't want to go ahead of Senate".[131]I am skeptical as to how convincing this argument is. It seems more reasonable that the U.S. is still hesitant when it comes to adopting mandatory arbitration.

Second, when comparing the scope of the MAP Article in the U.S. MC and the proposed arbitration clause, an attempt to narrow the application of the mandatory arbitration is evident. The MAP Article is wide in coverage and is intended to apply to a wide variety of disputes. The U.S. has taken steps towards expanding the application and utilization of MAP.[132] The MAP Article in the U.S. MC is even broader in its language than Article 25 of the OECD MC. For example, a taxpayer can present its case to any of the competent authorities and is not limited to the resident competent authority, as is the case in the OECD MC. The structure of the mandatory arbitration provisions in the U.S. follows the two-step-approach as well, meaning that the competent authority will first have to endeavor to resolve the dispute through the MAP negotiations, and if they were

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arbitration is not published. *See also* Kevin Bell, *Germany-U.S. Tax Treaty Arbitration Process Addresses Sovereignty Issue*, 43 Tax Notes Int'l 215 (July 17, 2006).

[129] *See* John Harrington, *Treasury International Tax Counsel Recommends Committee Approval of Four Pending Income Tax Agreements*, Tax Notes Today (July 18, 2007), available at LEXIS (2007 TNT 138-60).

[130] *Id.*

[131] *See* Robert Goulder, *U.S. Tax Officials Talk up Treaty Arbitration*, Worldwide Tax Daily (December 15, 2006), available at LEXIS (2006 WYD 241-1).

[132] *See generally* Christine Halphen and Ronald Bordeaux, *International issue Resolution Through the Competent Authority Process*, 9 Tax Notes Int'l 433 (August 8, 1994). *See also supra* note 14 and accompanying text. The fact that very few requests for MAP assistance have been denied can indicate the trend to utilize this mechanism at maximum.

unable to reach a complete agreement in a case, it is referred to arbitration.[133] Not all disputes eligible for discussion and resolution under MAP fall within the scope of the mandatory arbitration. For example the U.S.-Belgium DTT grants the competent authorities discretion to agree that certain cases are not suitable for determination by mandatory arbitration.[134] This is also found in the treaties with Germany and Canada in which cases additional limitations were added. In the DTT with Germany, disputes regarding the Dividends and Interest Articles were excluded from the scope of the mandatory arbitration.[135] In the DTT with Canada, in addition to the Dividend and Articles, certain disputes under the Royalties Article were also carved out of the scope of mandatory arbitration.[136]

Last, a common feature to the U.S. arbitration provisions is the use of the so called "Baseball Arbitration" where the arbitral panel can chose only one of the two proposed resolutions submitted by the Contracting States.[137] Officially referred to as "Final-Offer" arbitration, this is an arbitration in which each party submits a "final offer" to the arbitrator, who may choose only one.[138] This type of arbitration does not suit

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[133] Note that here the provision refers the *case* to arbitration unlike the OECD proposal that refers only the unresolved issues to the arbitration.

[134] *See Convention between the Government of the United States of America and the Government of the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, (November 27, 2006), available at LEXIS (2006 WTD 229-7).

[135] *See Protocol Amending the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to certain other Taxes*, (June 1, 2006), available at LEXIS (2006 WTD 107-9). The protocol amends paragraph 22. The new paragraph 22 states: "In respect of any case where the competent authorities have endeavored but are unable to reach an agreement under Article 25 regarding the application of one or more of the following Articles of the Convention: 4 (Residence) (but only insofar as it relates to the residence of a natural person), 5 (Permanent Establishment), 7 (Business Profits), 9 (Associated Enterprises), 12 (Royalties), binding arbitration shall be used to determine such application, unless the competent authorities agree that the particular case is not suitable for determination by arbitration. In addition, the competent authorities may, on an ad hoc basis, agree that binding arbitration shall be used in respect of any other matter to which Article 25 applies".

[136] The full version of the protocol is available at LEXIS (2007 TNT 185-82). In the letters exchanged between the two governments, it is clarified that the mandatory arbitration will deal only with specified issues: "In respect of any case where the competent authorities have endeavored but are unable to reach a complete agreement under Article XXVI (Mutual Agreement Procedure) of the Convention regarding the application of one or more of the following Articles of the Convention: IV (Residence) (but only insofar as it relates to the residence of a natural person), V (Permanent Establishment), VII (Business Profits), IX (Related Persons), and XII (Royalties) (but only (i) insofar as Article XII might apply in transactions involving related persons to whom Article IX might apply, or (ii) to an allocation of amounts between royalties that are taxable under paragraph 2 thereof and royalties that are exempt under paragraph 3 thereof), binding arbitration shall be used to determine such application, unless the competent authorities agree that the particular case is not suitable for determination by arbitration. In addition, the competent authorities may, on an ad hoc basis, agree that binding arbitration shall be used in respect of any other matter to which Article XXVI applies. If an arbitration proceeding (the "Proceeding") under paragraph 6 of Article XXVI commences, the following rules and procedures shall apply…".

[137] The relevant provisions in both the German and Belgian cases state that: "The arbitration board will deliver a determination in writing to the Contracting States within six months of the appointment of its Chair. The board will adopt as its determination one of the Proposed Resolutions submitted by the Contracting States".

[138] Black's Law Dictionary, 8th Ed. (2004).

disputes regarding the existence of a permanent establishment, for example, or the definition of terms such as "investment bank", "royalties" or "services".[139]

Recently, the U.S. and Germany signed a Memorandum of Understanding addressing the mandatory and binding arbitration provision that was added to the DTT.[140] Paragraph 2(c) of the Memorandum of Understanding provides that once a case is accepted into the mutual agreement procedure, neither competent authority will cease unilaterally to consider a case, except for the circumstances described in paragraph 3. Paragraph 3 addresses cases ineligible for arbitration.[141] From a U.S. perspective, these are cases enumerated in Rev. Proc. 2006-54 which include, as the reader may recall, cases designated for litigation or if the taxpayer is willing to accept a settlement under conditions prejudicial to the interests of the U.S. government.[142]

This is a clear example of how the introduction of the mandatory and binding arbitration in its current structure will malfunction. This is a manifestation of how the two-step-approach and the Blocking Method will impact the new provisions. What meaning is there to the mandatory arbitration provision if both competent authorities are free to opt out of it?

For the reasons mentioned above, I believe the U.S. expresses a policy position aimed at limiting the application of mandatory and binding arbitration.

IV. Conclusion:

A. Addressing the Concerns

I have attempted to present the structural problems that exist in the current proposals for mandatory and binding arbitration. These problems are not the only amendment that could be made to the proposals. Scholars have raised additional concerns regarding issues such as the selection of the arbitration panel, implementation of the arbitration decision and conflicts with domestic laws, time limitations, precedential value of the decisions, taxpayer participation in the proceedings, the binding aspect of the decision to the States and to the taxpayer, appointing the arbitrators, review of the arbitration decision, the costs and expenses of the proceeding, legal status of the treaty and commentary, the language of the arbitration and so on.[143]

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[139] *See* William W. Park, *supra* note 9 noting that: "However, for other issues the more traditional process might be appropriate. For example, arbitrators might be asked to determine what is a royalty (as opposed to personal services), interest (as opposed to rent in a finance lease), or to decide where the taxpayer has a "center of vital interest" or a permanent establishment. In international tax arbitration in which taxpayers are given a role it is uncertain how the baseball format would work".

[140] *See* Memorandum of Understanding Between the Competent Authorities of The Federal Republic of Germany and The United States of America, available at:
http://www.irs.gov/businesses/corporations/article/0,,id=201207,00.html

[141] Paragraph 3(c) of the Memorandum of Understanding

[142] *See supra* note 39 and accompanying text.

[143] *See generally* William Park & David Tillinghast, *supra* note 8. *See also* William Park *supra* note 9. *See also* Michael McIntyre, *supra* note 10. *See also* Zvi Altman *supra* note 14. *See also* Mario Züger *supra* note 14. *See also* Marcus Desax and Marc Veit, *supra* note 18. *See also* James Morgan *supra* note 18. *See*

I have chosen to focus on the structural problem which in my mind is the first step in the adoption of such a provision. The mechanics of the mandatory arbitration are not less important than the structure of the provision itself, yet the structure is the foundation. Adopting a provision which lacks structural consistency with the anticipation of future fixings is similar to building on weak foundations. This is why I believe that no arbitration is better than bad arbitration. If it were up to me I would adopt the mandatory arbitration provision only when a greater extent of certainty of its positive functioning exists and not in a situation, as is currently, where reasonable risks of wrongful application (or non application) are present.

A major flaw is the availability of the Blocking Method which defeats the basic concept of mandatory arbitration causing the provision to lose its efficiency and effectiveness. The provision will not function in a manner compatible with the goals of the DTT network. On one hand, it does not secure the prevention of double taxation and on the other hand, it could be abusively utilized to achieve a no-tax result. The latter argument is based on a different approach in defining the nature of the unresolved cases presented by Michael McIntyre.[144]

The concern of the DTTs historically was to prevent double taxation. This concern played a leading role in the evolution of the DTT network. Yet nowadays the focus seems to be more toward preventing double non-taxation and confronting sophisticated and aggressive tax planning strategies. This change sheds doubt on the relevance of the mandatory arbitration as a crucial and necessary mechanism. One possible conclusion could be that the mandatory arbitration idea should be revisited or at least postponed to a later stage.[145] The characterization of the OECD that the unrelieved cases of double taxation are "rare"[146] buttresses this conclusion. The overall result does not seem that dramatic. The DTTs have been developing for years and changes in one various tax jurisdiction have affected others. The consensus regarding taxpayer's protection against double taxation is strong and this can explain why only a small portion of double taxation cases remain unresolved.

The question is whether it is plausible to anticipate that the same course of development will occur with the campaign against double non-taxation. Is it reasonable to predict that contracting states will acknowledge the necessity of accepting harmonized and uniformed principles such as the single tax and the matching principles? Will countries accept the argument that aligning the tax systems as much as possible will have

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also See Hugh Ault, *Improving the Resolution of International Tax Disputes*, 7 Fla. Tax Rev. 137 and *infra* note 145, *See also* Gerrit Groen, *supra* note 82.

[144] *See* Michael McIntyre, *supra* note 10.

[145] *See* Gerrit Groen, *supra* note 82 at 27 expressing a skeptical view as to the adoption of mandatory arbitration claiming: "Mandatory arbitration at the request of the taxpayer should not be introduced, due to the obscurity of tax treaties on many issues such as e-commerce and hybrid entities. In cases like these it may be difficult for a board to decide a case on the basis of the treaty and principles of international law, thereby increasing the likelihood of decisions based primarily on considerations of equity which should be avoided. Only with respect to specific factual disputes, such as transfer pricing disputes, could mandatory arbitration at this point in time be considered. Moreover, further research should be done on the implementation of arbitration awards in the national legal order of the states involved and guidelines should be drafted concerning the annulment of the award by municipal courts in order to avoid incongruent implementation of the award.

[146] *See supra* note 89.

an overall benefit? Trends in this direction are evolving constantly and the OECD's focus on this issue is the best evidence.

The ultimate goal should be to arrive to a mandatory arbitration provision uniformed in terms of the triggering event, with taxpayer participation and binding to all parties and with clear guidelines as to how to the initiation of the mandatory arbitration, how it should be conducted and what are the controlling principles. Acknowledging that this is just too much to ask for, the question remains whether to adopt the current proposals or to reexamine them before doing so. I have advocated against introducing mandatory arbitration as proposed. The current proposals do not meet the basic goals of the DTT network, fail the two evaluation tests set forth in part one of this article and are neither efficient nor effective. They could be abused both by the Contracting States and by taxpayers.[147]

B. A more effective structure?

As an alternative, the mandatory and binding arbitration should be introduced as an independent stand-alone provision. The nature and core of MAP are its consensual and voluntary features. These do not exist in arbitration, when it is *mandatory* and *binding*. This resembles the dispute resolution mechanisms under Bilateral Investment Treaties and Free Trade Agreements. This is the case in the EU transfer pricing convention as well.[148] The mandatory arbitration should be triggered in the case of a dispute, as the default mechanism for the resolution of the dispute, at the request of the taxpayer, unless both Contracting States declare their willingness to enter into MAP negotiations, in which case the mandatory arbitration will be postponed. If the parties are able to settle the case, we can applause the result. If within the two year period they do not settle, the dispute will be transferred to the mandatory and binding arbitration for final resolution. When one or both competent authorities deny MAP assistance, the mandatory arbitration will be triggered with no need to wait the two year period.

In addition, actual double taxation should be a condition to triggering the arbitration. I realize that not only double taxation could be a violation of the treaty.[149] Nevertheless, this condition will mitigate the concern of the taxpayer achieving no-tax results. Taxpayer participation seems necessary, as a party potentially affected by the

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[147] In addition, note that the difference in the provisions adopted by the U.S. (with baseball arbitration) and mandatory arbitration under the OECD proposal (which will presumably be followed by the majority of the OECD member States) will cause additional confusion.

[148] *See* Marcus Desax and Marc Veit, *supra* note 18, at 413: "A person familiar with international commercial or investment arbitration may regret that OECD has shied away from setting up an independent system of arbitration. However, it must be recognized that the process leading to the proposal to supplement the mutual agreement procedure by arbitration had been a tedious one whereby lots of obstacles had to be removed. Several national tax authorities were afraid that by setting up an independent system of arbitration, they would give up a substantial part of their legal prerogatives to tax, which could raise delicate constitutional issues". *See also* Hugh Ault, *Arbitration in International Tax Matters: Some Structural Issues*, Series of International Taxation No. 27, (Kluwer Law), (2001) at 63: "More useful, perhaps, would be to provide a separate article in the Model Convention which would actually set forth a coherent arbitration scheme".

[149] *See* Mario Züger, *ICC Proposes Arbitration in International Tax Matters,* 2004 EUROPEAN TAXATION 221 at 224.

arbitration decision. This would require the taxpayer to waive its domestic remedies and accept the outcome, as was the situation in the original draft of the OECD. In addition, some kind of transparency would contribute to strengthening the application of the arbitration.

By making these modifications it will be possible to achieve the following: First, this will eliminate the concern that a Contracting State could utilize the Blocking Method. Denying MAP assistance in order to prevent mandatory arbitration is not available under this structure. Second, the effectiveness and efficiency of MAP will be enhanced. This structure will motivate the Contracting States to go to length in their efforts to settle. The probability of the Contracting States choosing to utilize MAP when mandatory arbitration is a definite alternative will increase. The Contracting States will find it more "attractive" to negotiate with the perception of settling rather than being subject to mandatory arbitration. The inevitable result is that more cases will be referred to MAP than under the current proposals. This is bound to enhance the effectiveness of the MAP and to motivate the competent authorities to efficiently take advantage of this alternative. Third, this structure will presumably goad tax administrations to augment the authority delegated to their competent authorities. The goal would be to enable the competent authorities to freely negotiate with broader authority to settle. Fourth, by conditioning the mandatory arbitration on the existence of double taxation we mitigate the concern of the abusing this provision by taxpayers seeking double non-taxation results.[150]

This structure presents the mandatory and binding arbitration as the default dispute resolution mechanism yet it is more than likely that disputes will be referred to MAP for resolution. The OECD and many commentators have argued that the mere existence of the mandatory arbitration will make the MAP more effective.[151] This argument has been presented by proponents of mandatory arbitration in only so many occasions yet it is not applicable to the current proposals. By utilizing the Blocking Method the competent authorities can block triggering the mandatory arbitration. The mandatory arbitration is not an incentive to utilize MAP, under the current proposals, but rather a disincentive. On the other hand, when the mandatory arbitration clause is an

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[150] At this point the reader wonder how to reconcile between the voluntary nature of MAP and this alternative that in effect turns MAP into an inevitable alternative. Two comments are offered: first, this is only an alternative. Maintaining the status quo for the time being doesn't carry harsh results and is as good a solution. Second, only double taxation cases are at stake. In this case, if the competent authorities do not want to negotiate, they are free to do so, but taxpayer is provided with full protection from being taxed twice. If they decide not to negotiate and no double taxation is at stake, this is a bearable result as well.

[151] *See* the OECD report *supra* note 15. *See also* William W. Park & David R. Tillinghast, *supra* note 8 at 20: "Perhaps the most significant effect of treaty arbitration provisions will lie in the incentive to the competent authorities to arrive at prompt and satisfactory agreements. Certainly, the number of cases which would actually go to arbitration would be a small fraction of those which entered the competent authority process". *See also* Marcus Desax and Marc Veit, *supra* note 18, at 429: "Possibly, the mere existence of the supplemental arbitration procedure will cause the competent authorities to reach agreement, and to reach agreement before the two-year waiting period to institute arbitration proceedings expires". *See also* Yitzhak Hadari, *Resolution of International Transfer-Pricing Disputes*, 46 Can. Tax J., 29 (1998) at p. 57: "It is contended that the mere fact that rules of compulsory arbitration are added to tax treaties would strongly encourage the competent authorities of the countries involved to resolve the dispute before the invocation of this avenue of this last resort. Thus, an arbitration mechanism would serve a useful purpose even if it were not invoked in practice". *See also* Thomas Rixen, *A Politico-Economic Perspective on International Double Taxation Avoidance"*, 49 Tax Notes Int'l 599.

independent stand-alone provision, the only way to "block" the mandatory arbitration is by settling the dispute. In this latter case, the mandatory arbitration functions as an incentive to utilize MAP.

I recommend reexamining the proposals before their adoption augments.

The Holy Bible, Proverbs (chapter XV, v. 17):

"*Better is a dinner of herbs where love is, than a stalled ox and hatred therewith*"