



**Canada-U.S. Competent  
Authority MOU: First Steps to  
Mandatory Arbitration?**

**by Geoffrey S. Turner**

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# Canada-U.S. Competent Authority MOU: First Steps to Mandatory Arbitration?

by Geoffrey S. Turner

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The competent authorities of Canada and the United States announced on June 3, 2005, that they had entered into a memorandum of understanding (MOU)<sup>1</sup> regarding the mutual agreement procedure in Article XXVI of the Canada-United States Income Tax Convention (1980), as amended (Canada-U.S. treaty). That was followed up on July 28, 2005, with the release of a joint “Next Steps” statement appointing representatives of the Canadian and U.S. competent authorities to continue the discussions and establishing an agenda of priorities for those ongoing discussions.<sup>2</sup> As previously reported, the MOU signals an acknowledgement of difficulties in the relationship between the Canadian and U.S. competent authorities in recent years, difficulties that have stalled the resolution of a number of tax disputes under the

mutual agreement procedure.<sup>3</sup> The MOU attempts to improve the relationship between the Canadian and U.S. competent authorities by affirming the importance of resolving disputes in all cases and sets out guiding principles for the respective competent authorities to follow in their dealings with each other. Yet perhaps the most interesting aspect of the MOU, and at the same time its most disappointing feature, is the limited extent to which it embraces the concept of mandatory and binding arbitration when agreement is not otherwise reached—only on the facts of the case, and not on substantive issues.

This article is written from a Canadian perspective and considers the context in which the MOU has been agreed, in particular, the increasing recognition of mandatory arbitration as a suitable adjunct to tax treaties.<sup>4</sup> For the Canadian competent authority, the MOU caps off an active year, with the June 18, 2004, release of operational guidance on the mutual agreement procedure developed with other members of the Pacific Association of Tax Administrators,<sup>5</sup> the publication of the Canadian competent

<sup>1</sup>*Memorandum of Understanding Between the Competent Authorities of Canada and the United States Regarding the Mutual Agreement Procedure* (June 3, 2005), available at <http://www.cra-arc.gc.ca/tax/nonresidents/comp/mou-irs-e.html> (also available at 2005 WTD 107-13 or Doc 2005-12243); also see the Canada Revenue Agency (CRA) fact sheet on the MOU dated June 6, 2005, at <http://www.cra-arc.gc.ca/tax/nonresidents/comp/mou-fact-e.html>. See also U.S. IRS press release IR-2005-66 dated June 15, 2005, available at <http://www.irs.gov/newsroom/article/0,,id=139802,00.html> (also available at 2005 WTD 132-10 or Doc 2005-14611). The MOU was announced publicly on June 3, 2005, the date of its signing, at the International Tax Institute conference in New York presented by the American Bar Association Section of Taxation, Fordham University School of Law, and the U.S. branch of the International Fiscal Association.

<sup>2</sup>See *Next Steps — MOU Between the Competent Authorities of Canada and the United States on the Mutual Agreement Procedure* (July 28, 2005), available at <http://www.cra-arc.gc.ca/tax/nonresidents/comp/next-e/html>.

<sup>3</sup>See Lee Sheppard, “U.S. and Canadian Competent Authorities Sign Case Resolution Pact,” *Tax Notes Int’l*, June 13, 2005, p. 967, which describes the strained relationship with reference to “the two countries’ decades-long eye-poking contest.” See also James Fuller, “U.S. Tax Review,” *Tax Notes Int’l*, June 27, 2005, p. 1187, at 1190, which summarizes the MOU terms. The CRA fact sheet describing the MOU, *supra* note 1, acknowledges that the MOU was intended in part to “improve the relationship” with the U.S. IRS competent authority.

<sup>4</sup>Readers are also referred to J. Scott Wilkie, “Resolving International Tax Disputes: A Canadian Perspective on the Work of the OECD,” (July/August 2005) *International Transfer Pricing Journal*, vol. 12, no. 4, pp. 131-137, which comments principally on the July 27, 2004, OECD draft progress report (*infra* note 12) and other recent international developments, including the MOU, as examples of the trend toward increasing cooperation among tax authorities.

<sup>5</sup>“MAP Operational Guidance for Member Countries of the Pacific Association of Tax Administrators (PATA),” available at <http://www.cra-arc.gc.ca/tax/nonresidents/comp/map-e.html>.

authority's first progress report,<sup>6</sup> and the release of a final updated information circular on the competent authority process in Canada.<sup>7</sup> From an international perspective, the MOU comes at a time of growing consensus and momentum to develop mandatory arbitration provisions for inclusion in the mutual agreement procedure articles of tax treaties. For example, the Tax Executives Institute (TEI) recommended in July 2000 that the United States pursue a mandatory arbitration procedure (with the consent of the taxpayer) when the competent authorities are unable to reach agreement after two years.<sup>8</sup> In 2001, the Taxation Commission of the International Chamber of Commerce (ICC) released a proposed bilateral tax convention article on arbitration of tax matters that incorporates compulsory or mandatory arbitration.<sup>9</sup> In March 2004 the International Fiscal Association (IFA) released its study on income tax treaty arbitration, with a focus on possible mandatory arbitration procedures.<sup>10</sup> In April 2003 the OECD established a working group to recommend ways to improve the mutual agreement procedure in bilateral income tax treaties, including the feasibility of mandatory arbitration mechanisms.<sup>11</sup> On July 27, 2004, the OECD released its

draft progress report,<sup>12</sup> which was followed up with a two-day conference in Washington on January 13-14, 2005.<sup>13</sup> The OECD study on the mutual agreement procedure is ongoing, and the mandate of the OECD working group has been extended to December 2006. Moreover, numerous articles and papers have now been written on the subject of mandatory arbitration as a means of facilitating resolution of competent authority disputes under the mutual agreement articles of international tax conventions.<sup>14</sup>

Viewed in that light, the MOU takes a helpful first step toward incorporating a mandatory arbitration feature into the existing mutual agreement procedure under the Canada-U.S. treaty. But this article argues that the Canadian and U.S. competent authorities should use this opportunity to take a more ambitious leap. They should negotiate a workable framework for a full-fledged mandatory arbitration procedure for inclusion by their respective governments in Article XXVI of the Canada-U.S. treaty, applicable to substantive issues of treaty interpretation, not just to the facts of a particular case.<sup>15</sup> A possible framework for a mandatory arbitration procedure is proposed. For that reason, the

<sup>6</sup>Competent Authority Services Division, International Tax Directorate, Canada Revenue Agency, "CRA MAP Program Report, 2001-2004," available at [http://www.cra-arc.gc.ca/tax/nonresidents/comp/map\\_report-e.pdf](http://www.cra-arc.gc.ca/tax/nonresidents/comp/map_report-e.pdf).

<sup>7</sup>Information Circular 71-17R5, "Guidance on Competent Authority Assistance under Canada's Income Tax Conventions," dated Jan. 1, 2005, available at <http://www.cra-arc.gc.ca/E/pub/tp/ic/71-17r5/README.html>. Some commentary on this circular appears in "Canada Issues Competent Authority Circular to Expand, Update, Replace 1995 Provisions," (Feb. 2, 2005) *Tax Management Transfer Pricing Report*, vol. 13, p. 956.

<sup>8</sup>See Tax Executives Institute, "Improving the Competent Authority Process," (July 19, 2000) *Tax Executive*, vol. 52, no. 4, pp. 325-327, also available at [http://www.findarticles.com/p/articles/mi\\_m6552/is\\_4\\_52/ai\\_65543913](http://www.findarticles.com/p/articles/mi_m6552/is_4_52/ai_65543913).

<sup>9</sup>See Robert Couzin, "Arbitration in Tax Treaties," (Mar. 1, 2002) *Tax Planning International Review*, vol. 29, no. 3, pp. 12-20. Couzin was the ICC member primarily charged with responsibility for preparing the May 3, 2000, ICC position paper on arbitration in tax matters and the subsequently released draft bilateral convention article on arbitration matters, each of which is appended to the foregoing article.

<sup>10</sup>William W. Park and David R. Tillinghast, *Income Tax Treaty Arbitration*, a study prepared under the auspices of the International Fiscal Association (Amersfoort: Sdu Fiscal and Financial Publishers, 2004). An excerpt from that publication appears as annex 4 of the OECD draft progress report of July 27, 2004, *infra* note 12.

<sup>11</sup>See Organization for Economic Cooperation and Development, "OECD Launches Project on Improving the Resolution of Cross-Border Tax Disputes" (Apr. 29, 2003), available at [http://www.oecd.org/document/26/0,2340,en\\_21571361\\_34590630\\_2508762\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/26/0,2340,en_21571361_34590630_2508762_1_1_1_1,00.html).

<sup>12</sup>See Organization for Economic Cooperation and Development, "Improving the Process for Resolving International Tax Disputes" (July 27, 2004), available at <http://www.oecd.org/dataoecd/44/6/33629447.pdf>.

<sup>13</sup>See United States Council for International Business press release, "US Business Engages OECD on International Tax Issues" (Jan. 14, 2005), available at <http://www.uscib.org/index.asp?documentID=3200>.

<sup>14</sup>For a nonexhaustive example of some of the recent writing on that topic, see William W. Park, "Income Tax Treaty Arbitration," (May 10, 2002) *Tax Management International Journal*, vol. 31, no. 5, pp. 219-253; David R. Tillinghast, "Issues in the Implementation of the Arbitration of Disputes Arising Under Income Tax Treaties," (Mar. 1, 2002) *Bulletin for International Bureau of Fiscal Documentation*, vol. 56, no. 3, pp. 90-99; Maarten J. Ellis, "Issues in the Implementation of the Arbitration of Disputes Arising Under Income Tax Treaties — Response to David Tillinghast," (Mar. 1, 2002) *Bulletin for International Bureau of Fiscal Documentation*, vol. 56, no. 3, pp. 100-101; Gerrit Groen, "Arbitration in Bilateral Tax Treaties," (2002) *Intertax*, vol. 30, no. 1, pp. 3-27; Ron Haigh, "Arbitration of Tax Disputes: An Issue Whose Time Has Come," (Aug. 18, 2003) *Tax Planning International Transfer Pricing*, vol. 4, no. 8, pp. 7-9; and Aurora Ribes Ribes, "Compulsory Arbitration as a Last Resort in Resolving Tax Treaty Interpretation Problems," (Sept. 1, 2002) *European Taxation*, vol. 42, no. 9, pp. 400-404. Apologies to other authors who have made contributions on the topic of mandatory arbitration that are not cited here or elsewhere in this article.

<sup>15</sup>In Canada, treaty negotiations are the responsibility of the Department of Finance, Tax Legislation Division, and not the competent authority, which is a branch of the CRA. It is understood that the Department of Finance intends to wait  
(Footnote continued on next page.)

article may be of interest to readers beyond North America. It is submitted that a mandatory arbitration procedure is likely to be a more effective means of achieving the goals that the Canadian and U.S. competent authorities have set out for themselves in the MOU.

## The Mutual Agreement Procedure

### Voluntary Arbitration Is Not Enough

It is necessary to view the MOU in the context of the existing mutual agreement procedure in Article XXVI of the Canada-U.S. treaty. That provides a mechanism, similar to that envisioned by article 25 of both the OECD model tax convention<sup>16</sup> and the U.S. model tax convention,<sup>17</sup> by which a taxpayer may attempt to resolve a tax treaty dispute through negotiations between the Canadian and U.S. competent authorities.<sup>18</sup> The Canada-U.S. treaty expressly contemplates in a number of provisions that a taxpayer may bring a dispute to the competent authorities. For example, Article IV(2) dealing with the residence of individuals requires unresolved conflicts of residence (when both jurisdictions assert that the taxpayer is resident in their state, resulting in double taxation) to be settled by mutual agreement of the competent authorities; Article IX(3) provides for possible competent authority relief from double taxation resulting from transfer pricing adjustments made by one of the states; and Articles XIII (8) and (9) provide for the competent authorities

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until the OECD has completed its project on the mutual agreement procedure before committing to any arbitration procedure. See question 1 under “Mediation/Arbitration” at <http://www.cra-arc.gc.ca/tax/nonresidents/common/panel-e.html>. Nonetheless, the Canadian competent authority could begin work with its counterpart in the United States to develop a practical framework for a mandatory arbitration provision in the context of the MOU. That framework could then be made part of the Canada-U.S. treaty through an appropriate treaty protocol.

<sup>16</sup>OECD, *Model Tax Convention on Income and on Capital* (France: OECD, looseleaf service).

<sup>17</sup>U.S. Model Income Tax Convention of Sept. 20, 1996.

<sup>18</sup>The Canadian competent authority is defined in Article III of the Canada-U.S. treaty to mean the Minister of National Revenue or his authorized representative. Administratively, resolving specific taxpayer disputes is delegated to the director, Competent Authority Services Division of the International Tax Directorate of the CRA (see paragraph 5 of Information Circular IC 71-17R5, *supra* note 7). The U.S. competent authority is defined in Article III of the Canada-U.S. treaty to mean the Secretary of the Treasury or his delegate. That authority has been delegated to the commissioner of the IRS (see Treasury Order 150-17, Dec. 11, 1984), who in turn has delegated that authority to the director, international, acting with the concurrence of the associate chief counsel (international) (see Rev. Proc. 2002-52, 2002-31 IRB 242, released July 12, 2002, section 2.03).

to relieve taxpayers from double taxation on some capital gains. More generally, a taxpayer may invoke the mutual agreement procedure whenever it believes that it has been subject to tax in a manner not permitted by the treaty. In particular, paragraph 1 of Article XXVI provides that a taxpayer may present its case to the competent authority of its state if the taxpayer believes that the actions of one or both of the contracting states will result in taxation not in accordance with the treaty.

When a taxpayer has referred a tax matter to its competent authority, paragraph 2 of Article XXVI of the Canada-U.S. treaty provides that the relevant competent authority “shall endeavour . . . 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.” Further, paragraph 3 provides that “[t]he 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.”

**The MOU takes a helpful first step toward incorporating a mandatory arbitration feature into the existing mutual agreement procedure.**

What is clearly missing from Article XXVI is any requirement that the competent authorities of the two contracting states must reach agreement on the relevant matter. All the states are required to do is “endeavour” to resolve the case by mutual agreement. In the OECD model treaty, that is the end of the story — there is no further procedure by which the competent authorities may resolve a deadlock, and the double taxation or taxation contrary to the treaty may remain unaddressed. Paragraph 45 of the commentary to article 25 of the OECD model treaty<sup>19</sup> acknowledges that unsatisfactory possibility, and paragraph 48 of the commentary puts forward arbitration as a possible solution.<sup>20</sup> The

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<sup>19</sup>Minor amendments to the commentary to article 25 were approved by the Committee on Fiscal Affairs on June 1, 2004, and were released in the “2005 Update to the Model Tax Convention” on Mar. 15, 2005. However, those amendments only affect paragraph 4 of the commentary to article 25. See [http://www.oecd.org/document/7/0,2340,en\\_2649\\_33747\\_34576839\\_1\\_1\\_1\\_1\\_00.html](http://www.oecd.org/document/7/0,2340,en_2649_33747_34576839_1_1_1_1_00.html).

<sup>20</sup>In this article, voluntary arbitration is an arbitration process to which a competent authority agrees to submit itself only after the dispute arises with the counterpart competent authority. Mandatory arbitration, in contrast, refers to an arbitration process that the competent authority agrees to (Footnote continued on next page.)

Canada-U.S. treaty is one of the tax conventions that has gone further than the OECD model treaty in that respect. Paragraph 6 of Article XXVI sets out a voluntary arbitration process as follows:

If any difficulty or doubt arising as to the interpretation or application of the Convention cannot be resolved by the competent authorities pursuant to the preceding paragraphs of this Article, the case may, *if both competent authorities and the taxpayer agree*, be submitted for arbitration, provided that the taxpayer agrees in writing to be bound by the decision of the arbitration board. The decision of the arbitration board in a particular case shall be binding on both States with respect to that case. The procedures shall be established in an exchange of notes between the Contracting States. *The provisions of this paragraph shall have effect after the Contracting States have so agreed through the exchange of notes.* [Emphasis added.]

A similar voluntary arbitration procedure appears in a number of other Canadian and U.S. tax treaties. Canada's treaties with Ecuador, France, Germany, Iceland, Ireland, Kazakhstan, Moldova, Mongolia, Peru, and Venezuela, as well as the new, but as yet unratified, treaty with Italy, provide for voluntary arbitration to have effect upon an exchange of notes. Canada's tax treaties with the Netherlands and South Africa also have voluntary arbitration provisions, but those are not conditional on an exchange of notes. The United States has eight additional income tax treaties with countries other than Canada that go beyond the OECD model treaty by contemplating a similar voluntary arbitration procedure to resolve deadlock between the competent authorities.<sup>21</sup>

submit itself to before the dispute arises. That advance commitment to mandatory arbitration requires no further consent of the competent authorities and is mandatory in that neither of the competent authorities is free to abandon the arbitration and pursue a remedy through an alternative procedure. International tax treaty disputes involve three parties, namely the two competent authorities and the affected taxpayer. It is the taxpayer who initiates the process. Therefore, both voluntary and mandatory arbitration can ultimately be pursued only with the implicit consent of the taxpayer. Both voluntary and mandatory arbitration procedures may also be described as "binding" if the disputing competent authorities and the aggrieved taxpayer are required to accept the determination of the arbitrator and are not free to deviate from it.

<sup>21</sup>The other U.S. tax treaties with voluntary arbitration provisions include those with France, Germany, Ireland, Kazakhstan, Mexico, the Netherlands, and Switzerland. The new U.S. tax treaty with Italy also has a voluntary arbitration provision, but the treaty is not yet ratified by Italy.

Notably, the voluntary arbitration provisions of paragraph 6 of Article XXVI of the Canada-U.S. treaty are not effective until there has been an exchange of notes between the treaty partners. To date, neither Canada nor the United States has implemented any such exchange of notes.<sup>22</sup> In Canada, the only arbitration provisions that are effective are those in its treaties with the Netherlands and South Africa, but the Canadian competent authority has indicated it will not consent to arbitration under those provisions until appropriate arbitration procedures are developed. That will likely not occur until the OECD completes its project on the mutual agreement procedure.<sup>23</sup> From the U.S. perspective, the reports of the Senate Foreign Relations Committee on that issue indicate that no exchanges of notes will occur until there has been an arbitration experience under the Germany-U.S. income tax treaty.<sup>24</sup> However, to date, the U.S. competent authority has resolved all of its cases with the German competent authority so there has been no voluntary arbitration under that treaty and the United States has not exchanged notes with any of its treaty partners.<sup>25</sup> As a result, none of the voluntary arbitration provisions in any of the relevant U.S. tax treaties is currently effective and the United States has no practical experience arbitrating any tax dispute with another nation.<sup>26</sup>

Moreover, even if the voluntary arbitration provision in Article XXVI(6) of the Canada-U.S. treaty was effective, as noted above it does not require that the matter be sent to arbitration if the competent authorities fail to compromise and reach agreement

<sup>22</sup>In a question and answer session on Oct. 28, 2004, in Toronto, the CRA confirmed that no exchange of notes for any of the Canadian treaties with voluntary arbitration provisions had yet taken place. See question 1 under "Mediation/Arbitration" at <http://www.cra-arc.gc.ca/tax/nonresidents/common/panel-e.html>.

<sup>23</sup>*Id.*

<sup>24</sup>See, e.g., the Technical Explanation of the Convention and Protocol Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income (article 26). See also Elaine Platt, "The Mutual Agreement Procedure in U.S. Income Tax Treaties — A Primer," (Nov. 14, 2003) *Tax Management International Journal*, vol. 32, no. 11, p. 593-605 at 600.

<sup>25</sup>Platt, *id.* at 600. See also Bruce Messenger and Kelli Winegardner, "Current CCRA-IRS Issues," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), p. 10:1-2.

<sup>26</sup>See "U.S. Officials Consider Pros, Cons of Including Arbitration in Model Treaty," (Sept. 15, 2004) *Tax Management Transfer Pricing Report*, vol. 13, no. 9, p. 467, quoting Patricia Brown, Deputy U.S. Treasury International Tax Counsel, on Sept. 3, 2004.

within a specified time. Resorting to the arbitration procedure would require the express consent not only of the taxpayer, but also of both competent authorities. It is in that sense, therefore, that the arbitration contemplated by that provision is consensual or voluntary, and not mandatory. It cannot be imposed on a recalcitrant competent authority that fails to compromise its position to reach agreement.

### Experience of the Competent Authorities

Recent experience of the Canadian and U.S. competent authorities suggests that, while many cases have been resolved successfully, the absence of a fallback mechanism to guarantee resolution of disputes put before the competent authorities under the mutual agreement procedure has indeed led to difficulties in resolving many other of those disputes in a timely manner. That is illustrated to some extent by some of the comments that have been made publicly, particularly by the U.S. competent authority on its frustrations with the existing procedures. For example, and by way of background, in June 2000 and January 2001, the official then designated as the U.S. competent authority, Carol Dunahoo, announced that the U.S. competent authority would reexamine its previous policy opposing arbitration as a means of resolving long-standing double taxation relief requests,<sup>27</sup> because U.S. opposition to arbitration could be viewed as inconsistent with the U.S. government's policy of seeking early resolution of tax disputes.<sup>28</sup> She stated publicly in February 2002 that "both taxpayers and tax authorities would benefit from a more pragmatic, flexible approach to competent authority negotiations."<sup>29</sup> Her frustration with the positions being taken by counterpart competent authorities was further evident in remarks made in November 2002. Dunahoo warned that the competent authority process "has reached a stage where I see it as very vulnerable." She indicated she had become "increasingly troubled about the postures of certain treaty partners that ignore essential requirements of competent author-

ity negotiations."<sup>30</sup> It is generally acknowledged that the Canadian competent authority is one of the U.S. treaty partners referred to that has taken positions viewed as unreasonable or not pragmatic by the U.S. competent authority.<sup>31</sup> Moreover, from the taxpayer's perspective, the absence of an effective arbitration provision has been cited as contributing to those difficulties. For example, in its July 2000 submission on the competent authority procedure, the TEI recommended a mandatory arbitration procedure to "put additional pressure on treaty partners to negotiate in good faith and to present positions that are reasonable."<sup>32</sup>

**All the states are required to do is 'endeavour' to resolve the case by mutual agreement.**

On the other hand, a senior official with the Canadian competent authority has recently described reports of problems and deteriorating relations between the Canadian and U.S. competent authorities as "vastly overblown."<sup>33</sup> Some of the published statistics may be consistent with that

<sup>30</sup>See Dunahoo's remarks made Nov. 18, 2002, as reported in "Treaty Partners' Revenue Focus Jeopardizing Competent Authority Process, Dunahoo Says," (Nov. 27, 2002) *Tax Management Transfer Pricing Report*, vol. 11, no. 5, p. 677.

<sup>31</sup>E.g., anecdotal evidence suggests that the U.S. competent authority has had difficulties reaching agreements with its Canadian counterpart, in part due to Canada's insistence on settling disputes based on its somewhat rigid concepts of the applicable principles, in contrast to the more flexible, pragmatic approach generally adopted by the U.S. competent authority. That is borne out in part by the published CRA statements in paragraph 7 of its Information Circular 71-17R5, *supra* note 7, which explicitly states that the Canadian competent authority will negotiate with its counterparts in a "principled" manner. Moreover, and as one indicative example, those divergent approaches to the mutual agreement procedure were clearly evident to participants at the IFA meeting of its U.S. and Canadian branches in Washington on June 5-6, 2003. The Canadian competent authority representative, Jim Gauvreau, and the U.S. competent authority representative, Carol Dunahoo, participated in a panel discussion of two case studies. The two were quite far apart in their approaches to the cases and effectively agreed to disagree. The CRA itself, in its June 6, 2005, fact sheet announcing the MOU, has acknowledged some of the problems in its relationship with the U.S. competent authority — *see supra* note 1.

<sup>32</sup>TEI, *supra* note 8.

<sup>33</sup>Comments made by Bruce Messenger, chief economist of the CRA's competent authority services division, in an interview on Feb. 3, 2005, as reported in "CRA Uncut: An Interactive Forum With the CRA's Bruce Messenger," PricewaterhouseCoopers transfer pricing newsletter, issue 9, May 2005. At the time of those comments, it is likely that the Canadian

(Footnote continued on next page.)

<sup>27</sup>See "Dunahoo Says Competent Authority No Longer Opposed to Arbitration," (Jan. 24, 2001) *Tax Management Transfer Pricing Report*, vol. 9, no. 18, p. 631, reporting remarks made at the Jan. 12, 2001, meeting of the American Bar Association Section of Taxation.

<sup>28</sup>See "U.S. Will Not Adopt Arbitration Without Congressional Approval, Dunahoo Says," (Nov. 1, 2000) *Tax Management Transfer Pricing Report*, vol. 9, no. 13, p. 390.

<sup>29</sup>See Dunahoo's remarks to the Feb. 8, 2002, Tax Council Policy Institute, reported in "Dunahoo Urges Both Sides in Negotiations to Show Flexibility, Take Practical Approach," (Feb. 20, 2002) *Tax Management Transfer Pricing Report*, vol. 10, no. 20, p. 847-848.

view. The Canada Revenue Agency's 2004 progress report<sup>34</sup> indicates that during the year ended March 31, 2004, the Canadian competent authority accepted 239 new cases and resolved 233 cases, leaving a closing inventory of 197 unresolved cases. The prior year, 194 cases were accepted and 193 cases were resolved, suggesting the Canadian competent authority at least has been "keeping up" and not allowing its inventory of unresolved cases to increase substantially. During the 2001 to 2004 period, a total of 240 "negotiable" cases (that is, cases requiring discussions with a counterpart competent authority) were resolved by the Canadian competent authority, of which 195 were cases involving the U.S. competent authority. The U.K. competent authority was the next most common negotiating counterparty during that period, but with only eight cases. Clearly, the relationship with the United States has dominated the affairs of the Canadian competent authority. That is not surprising given that the United States is Canada's largest trading partner. During the year ended March 31, 2004, of the 233 cases resolved, 105 were "negotiable" and required the Canadian competent authority to engage in negotiations with another competent authority. Of those 105 cases, 97 were resolved giving the taxpayer full relief from double taxation, 5 were resolved giving only partial relief from double taxation, and 3 were resolved giving the taxpayer no relief from double taxation. Thus, 8 out of the 105 resolved cases during that year could be regarded as giving rise to an unsatisfactory or imperfect outcome from the taxpayer's perspective. Those figures do not indicate the extent to which the large "inventory" of unresolved cases are truly stalled or merely moving slowly through to resolution. However, they do paint a portrait of a competent authority process that appears to be working well for the most part to resolve many of the cases brought to it, albeit more slowly perhaps than most would desire. Statistics from the United States give a similar impression, with between 175 and 228 cases successfully disposed of annually by the U.S. competent authority between 1997 through 2001, with an average processing time in 2001 of 642 days.<sup>35</sup> As of 2003, the

and U.S. competent authorities were engaged in the "behind the scenes" discussions to improve their relationship that led to the signing of the MOU.

<sup>34</sup>*Supra* note 6 at pp. 11-22.

<sup>35</sup>In a Dec. 12, 2001, interview, Carol Dunahoo, the U.S. competent authority designate at the time, indicated that her department had resolved 189 cases in 2001. She described the relative success of her department in reducing processing time for competent authority cases closed during that year to 642 days on average. See Molly Moses, "Interview With U.S. Competent Authority Carol Dunahoo," (Dec. 12, 2001) *Tax Management Transfer Pricing Report*, vol. 10, no. 16, pp.

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average processing time was a little over two years to complete a competent authority case and Canada represented the largest number of competent authority cases by volume for the U.S. competent authority. In terms of value of cases, however, Canada was third, behind Japan and the United Kingdom.<sup>36</sup> In September 2004 it was reported that the U.S. competent authority had a caseload of about 200 cases, of which 40 percent were with Canada, still its largest negotiating counterparty by volume.<sup>37</sup>

### **The United States has no practical experience arbitrating any tax dispute with another nation.**

The mutual agreement procedure in the Canada-U.S. treaty in many cases does lead to a resolution of the tax dispute by the mutual agreement of the competent authorities. However, at least some cases are not resolved giving full relief from double taxation, at least some cases are stalled, and taxpayers are not guaranteed that an application for competent authority relief under the mutual agreement procedure will lead to a determinative resolution of their case.

#### **Shortcomings for the Taxpayer**

Despite the many advantages afforded to Canadian and U.S. taxpayers by the mutual agreement procedure in Article XXVI of the Canada-U.S. treaty and its many apparent successes, there remain several serious criticisms from the perspective of the taxpayers they are intended to serve, none of which are adequately addressed by the MOU.<sup>38</sup>

655-659. Additional U.S. statistics pointing to the volume of resolved cases between 1997 through 2001 are reported in Park, *supra* note 14.

<sup>36</sup>See Messenger and Winegardner, *supra* note 25 at 10:1-2.

<sup>37</sup>See comments by Patricia Brown, Deputy U.S. Treasury International Tax Counsel, quoted in "U.S. Officials Consider Pros, Cons of Including Arbitration in Model Treaty," *supra* note 26.

<sup>38</sup>Those problems have sometimes been summarized generally as the "black box" phenomenon. Competent authority requests "disappear" into an opaque black box from which either no solution emerges, a solution emerges long afterwards, or a solution emerges that is unexplained or unclear to the taxpayer. See, e.g., "Comments of the Business and Industry Advisory Committee (BIAC) to the OECD on the OECD Public Discussion Draft" (Oct. 25, 2004), p. 2, available at [http://www.uscib.org/docs/BIAC\\_Comments\\_Dispute\\_Resolution.pdf](http://www.uscib.org/docs/BIAC_Comments_Dispute_Resolution.pdf). See also "Draft OECD Competent Authority Report Suggests Manual on Preferable MAP Policies," (Aug. 4, 2004) *Tax Management Transfer Pricing Report*, vol. 13, no. 7, p. 305-306.

First, there is a lack of taxpayer involvement. When the taxpayer applies to the competent authority with a claim that the Canada-U.S. treaty has been misapplied by the other jurisdiction, the case, if taken up by the taxpayer's competent authority, is discussed among the competent authorities, but not with the taxpayer. The taxpayer's role is limited to providing information to the competent authorities. There is no formal right of participation in the government-to-government discussions and no opportunity to review or comment on any proposed settlement. The taxpayer is effectively shut out from the mutual agreement process and is forced to wait passively for an outcome.

Second, there is no assurance for the taxpayer that any settlement reached will be based on legal principles. The "pragmatic" approach favored by the U.S. competent authority, in particular, may raise concerns that the interests of the particular taxpayer may be sacrificed by the competent authority to facilitate settlement of some other taxpayer's dispute with the same counterpart competent authority in a form of "horse-trading." That concern is exacerbated by the absence of written reasons for the settlement outcome prepared by the competent authorities for review by the taxpayer to determine the basis for the agreement. The taxpayer may be justifiably concerned that the agreement reached on its behalf by its competent authority with the counterpart competent authority may not be based on the merits of the taxpayer's case, but rather on practical considerations extraneous to its circumstances, and may not be as favorable as could have been obtained.

Third, the mutual agreement procedure provides no guarantee that the competent authorities will reach an agreement. The Canada-U.S. treaty requires only that the competent authorities shall endeavor to reach agreement. Therefore, when committing to the mutual agreement procedure by making the application to the competent authority, taxpayers have no assurance that a solution will be reached. Taxpayers commit time and resources to the preparation of the application and effectively hold in abeyance their remedies under local law until the mutual agreement procedure runs its course. That may take years, during which the taxpayer is faced with uncertainty in not only the outcome of the discussions, but also whether there will be any outcome at all.<sup>39</sup>

<sup>39</sup>For double taxation cases, taxpayers would generally prefer a successful outcome of the competent authority discussions (*i.e.*, a solution that allocates the tax burden among the competing jurisdictions and fully relieves the double taxation) to an unsuccessful outcome that leaves the taxpayer only with its domestic remedies to avoid the double taxation. However, sometimes a taxpayer might actually prefer to

(Footnote continued in next column.)

As discussed below, mandatory arbitration has been put forward as a possible way to address those shortcomings in the mutual agreement procedure in Article XXVI of the Canada-U.S. treaty, which contains only a voluntary arbitration clause not yet in effect. Mandatory arbitration has been viewed by the U.S. competent authority as a potential solution that would promote resolution of disputes by discouraging intractable positions being taken by either competent authority, because "if you tell two governments that the [arbitration] panel is going to select one position or the other, then there may be an inclination to move closer together even before the case goes forward in arbitration."<sup>40</sup> As recently as January 13, 2005, the U.S. competent authority official stated he "thinks that having binding arbitration in a treaty would be a tremendous asset."<sup>41</sup>

### The MOU — Mandatory Arbitration of Facts

It is in the foregoing context that the Canadian and U.S. competent authorities have released the MOU and the subsequent "Next Steps" statement. The MOU is a brief, four-page document signed by the Canadian and U.S. competent authorities. Its stated purpose is "to establish principles and guidelines to improve the performance and efficiency of the mutual agreement procedure" in the Canada-U.S. treaty. It was published "to demonstrate our mutual commitment to improving the MAP process." That, in effect, acknowledges the recent difficulties the Canadian and U.S. competent authorities have experienced in actually reaching agreement on various issues brought to them by taxpayers.

The MOU begins by affirming that the fundamental purpose of the mutual agreement procedure is to

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resort to its remedies under the general tax law, rather than accept a potentially less advantageous outcome under the mutual agreement procedure. *E.g.*, when the issue is taxation not in accordance with the treaty (as opposed to double taxation), such as a withholding tax imposed on a payment that a nonresident taxpayer claims should be exempted under a treaty, the taxpayer might not be overly concerned with a failure of the competent authorities to resolve the matter, if the taxpayer is thereafter permitted to appeal the tax assessment under the general laws in a "second kick at the can." It is because of the potential for those circumstances that a taxpayer should be permitted either to elect to move the unresolved matter through to arbitration or instead abandon the mutual agreement procedure and resort to its domestic remedies.

<sup>40</sup>"Dunahoo Says Competent Authority No Longer Opposed to Arbitration," *supra* note 27. This comment was focused on "last best offer" or "baseball" arbitration.

<sup>41</sup>Robert Green, speaking at the Jan. 13, 2005, OECD conference in Washington, as reported by Chris Netram, "U.S., OECD Officials Discuss International Tax Developments," *Tax Notes Int'l*, Jan. 24, 2005, p. 305.

resolve double taxation or taxation contrary to the tax treaty, and that when a taxpayer invokes the mutual agreement procedure the resolution of the double taxation is accomplished at the discretion of the competent authorities. Accordingly, in the first section of the MOU, both parties commit to the principle that resolution of those disputes should be possible in all cases. That can be interpreted as an acknowledgement by the Canadian and U.S. competent authorities that their previous failures in some cases to actually reach agreement are not acceptable and are not intended to be repeated. In furtherance of that principle, the parties agree that “the positions advanced by the Competent Authorities in each case should be well documented, have merit, and follow the principles of consistency and reciprocity.”<sup>42</sup>

***The MOU provides explicitly that the competent authority officers ‘shall look for appropriate opportunities to compromise.’***

To facilitate reaching agreement on the facts of a particular case, the parties agree to “accept a transaction as structured by the taxpayer and only consider disregarding or restructuring a transaction in exceptional cases.”<sup>43</sup> Moreover, if after six months the parties are unable to agree on the underlying facts and circumstances of a particular case, “they shall agree to refer the case to a joint panel comprised of tax administration officials,” and “an agree-

ment reached as to the facts of the case will be binding” on the respective competent authorities. That is the limited mandatory arbitration feature of the MOU referred to above. The MOU provides that the details of the fact determination procedure will be set forth in a separate memorandum of understanding. The only detail evident in the MOU itself is that the tax administration officials who will form the joint panel are to be chosen by the assistant commissioner of appeals for the CRA and the chief of appeals for the IRS.

To facilitate reaching agreement on the substantive issues of a particular case, the MOU provides explicitly that the competent authority officers “shall look for appropriate opportunities to compromise.” If resolution is still not possible, the MOU provides that “the appropriate first level managers” will jointly undertake a detailed review of the case. If the matter is not resolved within two years from its date of acceptance, the most senior officials from each of the competent authorities “agree to meet, or, if more appropriate, agree to have their subordinates meet, in order to resolve the case.” In other words, to resolve substantive issues, the matter is referred up the chain of command within each competent authority, but no provision is made for mandatory arbitration of the dispute if the most senior officials from each competent authority fail to resolve the issue.

The second section of the MOU deals with procedural issues. Each party agrees to identify and remove when possible any of its administrative procedures and practices that impede or delay the process of resolving a dispute. In addition, the parties agree to interpret “notification” in the Canada-U.S. treaty in a broader and more inclusive manner and to develop a separate MOU addressing a number of issues surrounding notification.

The third and final section of the MOU identifies a number of substantive issues that have in the past resulted in the parties failing to resolve disputes.<sup>44</sup> The parties commit to reach an agreement establishing guidelines to be applied in resolving cases on

<sup>42</sup>Without making too fine a point of it, the heading for that part of the MOU is “Positions shall be Principled, Reasonable and Consistent.” Moreover, in paragraph 7 of the CRA’s Information Circular 71-17R5, *supra* note 7, it is stated twice that the Canadian competent authority negotiates in a “principled, fair and objective manner.” Yet the substantive part of the MOU text does not describe the positions as needing to be “principled,” only that they be well documented, have merit, and follow the principles of consistency and reciprocity. In a sense, that dances around one of the historical problems between the Canadian competent authority, which has generally preferred to adopt a “principled” approach to its discussions, and the U.S. competent authority, which has generally taken a much more pragmatic approach, as was discussed above.

<sup>43</sup>That could be a very important clarifying principle. There might well be tension between the manner in which U.S. tax law generally permits or requires a transaction to be taxed based on its economic substance, and Canadian principles that look to the formal legal arrangements. The MOU appears to say that the competent authorities should adopt a “form over substance” approach in determining the facts, although it is not clear what is meant by the “exceptional cases” that would permit a transaction structure to be disregarded or restructured.

<sup>44</sup>The specific troublesome issues enumerated in the MOU include: (1) an arm’s-length compensation for consignment manufacturing operations; (2) whether a business is integrated to the point when a profit-split method is appropriate and, if so, the relative value of contributions made by related parties toward the generation of profit; (3) the presence of nonroutine intangible assets and the determination of an arm’s-length value; (4) whether a permanent establishment exists and the amount of profit to be attributed to the PE; (5) whether a transaction is properly characterized as a service versus a license of intangibles; (6) the amount of compensation, if any, upon either the closure or relocation of a business and the allocation of associated closing costs; and (7) appropriate relief when the laws of the source and residence country are in conflict.

those specific issues and to designate representatives, including experts outside their own respective competent authority organizations, to assist in developing those guidelines.

Thus, the MOU is essentially an affirmation by the Canadian and U.S. competent authorities that they must work more effectively together to reach agreement on issues on which they have had difficulty reaching resolution. It is clear that further discussions are contemplated: first, to develop two additional MOUs dealing with a binding procedure (effectively a mandatory arbitration procedure) to determine the underlying facts of a case when agreement on the facts is otherwise not able to be reached, and on various issues surrounding notification; second, to create a set of guidelines to resolve historically troublesome substantive matters; and third, to identify and remove procedural obstacles that impede or delay the process of resolving cases. The first priority, as stated in the July 28, 2005, "Next Steps" document, is to prepare the MOU that will establish a binding procedure to determine the underlying facts. Importantly, however, the MOU does not contemplate the development of a mandatory arbitration procedure to resolve nonfactual substantive issues. Instead, the MOU clearly sets out a process that involves meetings of successively higher level officials of each competent authority who must attempt (but are not required) to resolve the dispute, a process that falls short of mandatory arbitration.

### Mandatory Arbitration as a Solution

It is evident that many of the problems that have been identified with the mutual agreement procedure in Article XXVI of the Canada-U.S. treaty could potentially be addressed by the introduction of a mandatory arbitration clause. The section below reviews the limited experience elsewhere with mandatory arbitration of tax treaty disputes and considers some of the theoretical advantages and disadvantages of mandatory arbitration that have previously been considered in the literature.

#### European Experience

While, as noted above, there is no direct North American experience with mandatory arbitration as a possible solution to the problems with the mutual agreement procedure, there is some experience in Europe. In particular, on July 23, 1990, the governments of the European Community signed the European Arbitration Convention<sup>45</sup> (the EU Arbitration Convention) providing arbitration procedures to

be used in resolving transfer pricing disputes between the signatory states. Articles 7 through 12 of the EU Arbitration Convention provide that competent authorities who cannot reach agreement on a particular dispute within two years must establish an "advisory commission" consisting of two representatives from each country party to the dispute and an even number of independent persons appointed from a list. The advisory commission is charged with delivering an opinion on the disputed issue. The taxpayer is permitted to appear before the advisory commission. Once the opinion is rendered, the competent authorities have a further six months to make their own agreement (which can deviate from the opinion of the advisory commission). Failing that, the opinion becomes binding on the disputing parties.<sup>46</sup>

### Unfortunately, experience with the multilateral EU Arbitration Convention has been limited.

Unfortunately, experience with the multilateral EU Arbitration Convention has been limited. First, as noted above, its application is limited to transfer pricing disputes — its dispute resolution procedures do not apply more generally to other tax disputes that may arise between European states. Second, by its terms the EU Arbitration Convention applied only for a five-year period that expired on December 31, 1999, but which has now been reactivated as from November 1, 2004, with final ratification of the extension protocol.<sup>47</sup> Third, as of September 2004, only a single transfer pricing dispute (between France and Italy) had been referred to an advisory committee and limited details of that case have been released publicly.<sup>48</sup> The paucity of cases suggests

<sup>46</sup>The provisions of the EU Arbitration Convention are described and commented on in more detail in Couzin, *supra* note 9 at 14-15, and Platt, *supra* note 24 at 601.

<sup>47</sup>See S.B. Huibregste and R.H.M.J. Offermanns, "What is the Future of the EU Arbitration Convention?" (March/April 2004) *International Transfer Pricing Journal*, vol. 11, no. 2, p. 76-87 at 78; and Luc de Hert, "A New Impetus for the Arbitration Convention?" (March/April 2005) *International Transfer Pricing Journal*, vol. 12, issue 2, p. 50-55 at 50.

<sup>48</sup>At the Sept. 3, 2004, meeting of the U.S. and French branches of IFA, Pascal Saint-Amans, the French competent authority who was one of the arbitrators in that case, made a number of comments and observations that were reported in "French Competent Authority Details First Arbitration, Says Process Works," (Sept. 15, 2004) *Tax Management Transfer Pricing Report*, vol. 13, no. 9, p. 473. While the speaker did not identify the parties, the article noted that an Electrolux official had previously confirmed the case involved two of its affiliates. The double taxation is believed to have resulted

(Footnote continued on next page.)

<sup>45</sup>*Convention on the Elimination of Double Taxation in Connection With the Adjustments of Profits of Associated Enterprises* (1990) (90/436/EEC).

that the possibility of mandatory arbitration has successfully encouraged the European competent authorities not to adopt unreasonable positions and to resolve their disputes within the mutual agreement process.<sup>49</sup> It may also be that the complexity of the procedures and its costs (which by the terms of the EU Arbitration Convention are borne by the disputing member states), particularly given the somewhat unwieldy size of the required advisory committee, may have deterred the competent authorities from resorting to the arbitration procedure. In any event, practical experience with arbitration under the EU Arbitration Convention is rather limited and it is not possible to conclude whether the procedures it prescribes are an appropriate model for the Canadian and U.S. competent authorities.

**Officials from both Canada and the United States have favored a form of 'baseball' arbitration for transfer pricing cases.**

The only bilateral income tax treaty that provides for mandatory arbitration as a fallback to the mutual agreement procedure is the Austria-Germany income tax treaty, which was signed August 24, 2000, and became effective January 1, 2003. Article 25(5) of that treaty provides as follows:

In the event that any difficulties or doubts arising as to the interpretation or application of this Convention cannot be resolved by the competent authorities by mutual agreement as set forth in the preceding paragraphs of this Article within a period of three years from the date of commencement of the proceedings, *at the request of [the taxpayer], the States shall be under obligation to submit the case to arbitration* as defined by Article 239 of the EC Con-

vention with the Court of the European Communities. [Emphasis added.]

from a profit allocation between a manufacturing affiliate and a distributing affiliate. The speaker noted it took 18 months to choose the arbitration panel. Procedural issues were then addressed including choice of a chair, where and when to meet, selection of a member to take notes and post papers, and how to officially deliver the decision. Costs escalated due to document translation, travel expenses, and various other fees. The final decision was 40 pages long and included a dissenting opinion. The decision may be published eventually, but the taxpayer wishes to resolve its similar transfer pricing disputes with Belgium, Germany, and Spain before consenting to publication.

<sup>49</sup>The U.S. competent authority, Carol Dunahoo, has indicated that her European counterparts have told her the presence of the arbitration provisions in the EU Arbitration Convention has encouraged them to resolve cases themselves more quickly. See Moses, "Interview With U.S. Competent Authority Carol Dunahoo," *supra* note 35.

The principal advantage for the Canadian and U.S. competent authorities and taxpayers of adopting a mandatory arbitration procedure in the Canada-U.S. treaty is guaranteed resolution of bilateral tax disputes. As long as the competent authorities are bound to arbitrate the dispute after failure to reach a resolution under the mutual agreement procedure within a specified period of time (with or without further taxpayer consent to the arbitration process) and as long as the parties are required to accept the result of the arbitration, resolution of the dispute is assured. That would presumably over time reduce the inventory of unsettled competent authority cases (amounting to 197 total unresolved cases for the Canadian competent authority as of March 31, 2004, and ranging from between 425 and 499 total cases for the U.S. competent authority at the end of years 1997 through 2001 and about 200 cases as of September 2004).<sup>50</sup> In addition, because every unsettled competent authority case implicitly suggests either unrelieved double taxation or misapplication of the relevant tax treaty, the elimination of unresolved cases would presumably reduce the extent to which Canadian and U.S. taxpayers are subject to double taxation or inappropriate application of the Canada-U.S. treaty.

**Advantages of Mandatory Arbitration**

Another advantage of implementing a mandatory arbitration procedure is the incentive effect it would have on the competent authorities to put forward reasonable positions and to achieve resolution of disputes through the conventional mutual agreement procedure. Indeed, the U.S. competent authority has stated "a provision for mandatory, binding

<sup>50</sup>See page 13 of the CRA MAP Program Report, *supra* note 6, and the IRS statistics reproduced at the end of the article by Park, *supra* note 14. For the September 2004 caseload number, see "U.S. Officials Consider Pros, Cons of Including Arbitration in Model Treaty," *supra* note 26.

arbitration could expedite the processing of double tax cases by putting pressure on the competent authorities to find other ways to resolve the disputes.<sup>51</sup> In explaining the reasons why the U.S. competent authority reversed its long-standing opposition to mandatory arbitration clauses in U.S. tax treaties, Carol Dunahoo stated:

Once we started looking at the issue and considering what an arbitration process might involve, we realized that an arbitration provision in a treaty can be quite successful without cases ever necessarily going to arbitration. We realized that arbitration could actually be a very useful tool for us to have in conjunction with the competent authority process and not to replace the competent authority process. . . . Our counterparts in a number of EU member states have reported to us that the presence of an arbitration provision in [the EU Arbitration Convention] has encouraged them to find ways to resolve these cases themselves more quickly. . . . Our goal would not be to replace the competent authority process with arbitration but rather to use it to make the competent authority process itself more efficient and more effective.<sup>52</sup>

That feature of mandatory arbitration would be intensified in a “last best offer” or “baseball” form of arbitration. In that procedure, the arbitrator is required to resolve the dispute by accepting the final position of either of the parties and is not permitted to reach a solution by finding some middle ground. That system of arbitration strongly encourages parties to put forward reasonable positions that are likely to be acceptable to an independent and objective third party. Officials from both Canada and the United States have favored a form of “baseball” arbitration for transfer pricing cases in particular.<sup>53</sup>

A further advantage of a mandatory arbitration procedure is that it provides an opportunity for increased taxpayer involvement through a quasi-judicial process. As noted above, the conventional mutual agreement procedure is exclusively a government-to-government negotiation that effectively shuts the affected taxpayer out of the process.

<sup>51</sup>See “Arbitration Provisions Unlikely to Appear in Treaties Where Most Needed, Brown Says,” (Mar. 20, 2002) *Tax Management Transfer Pricing Report*, vol. 10, no. 22, pp. 920-921.

<sup>52</sup>See Moses, “Interview With U.S. Competent Authority Carol Dunahoo,” *supra* note 35.

<sup>53</sup>See comments by Brian Ernewein of the Canadian Department of Finance and Patricia Brown of the U.S. Treasury International Tax Counsel, at the June 3, 2005, announcement of the MOU, as reported in Sheppard, *supra* note 3 at p. 967.

Arbitration, on the other hand, introduces an independent third-party decisionmaker, analogous to a judicial panel, to whom the taxpayer as well as the two competent authorities can contribute submissions. In fact, it is possible for an arbitration to be established on a basis that makes it closely analogous to a judicial proceeding, with submissions made by each side of the dispute in the adversarial format of English common law proceedings. Alternatively, an inquisitorial format favored by civil law European nations, in which the decisionmaker asks questions of the respective parties, can be used. The “judicial” style of mandatory arbitration format could potentially be very attractive to taxpayers, especially in transfer pricing or other matters that involve highly confidential or proprietary information. It offers a means of resolving the treaty dispute within a private process that could afford greater confidentiality of sensitive competitive information than a public proceeding within the conventional legal system.

### Disadvantages of Mandatory Arbitration

The Canadian and U.S. governments may be concerned that the delegation of decisionmaking responsibility under mandatory arbitration to a third party would in effect erode the sovereignty of the government parties to the treaty. The argument is that a sovereign country should not delegate functions and decisionmaking authority that are inherently governmental. For example, the U.S. competent authority has acknowledged that tax dispute arbitration would be a “hard sell” within government, including Congress, whose members have been concerned about giving up sovereignty to arbitrators.<sup>54</sup>

**Mandatory arbitration is likely to be a more effective means of achieving the goals set out in the MOU.**

However, if sovereignty is understood to mean that a state is autonomous and is not dependent on another state for its existence, mandatory arbitration of unresolved tax disputes should not be considered a threat to state sovereignty. Indeed, that a state enters into tax treaties and agrees in advance to resolve disputes under those treaties through mandatory arbitration as a last resort should be considered an exercise of its sovereignty and not a

<sup>54</sup>See comments of Patricia Brown, Deputy U.S. Treasury International Tax Counsel, in “U.S. Officials Consider Pros, Cons of Including Arbitration in Model Treaty,” *supra* note 26.

limitation of it.<sup>55</sup> In Canada, the negotiation of any tax treaty provision that would implement a mandatory arbitration procedure would be accomplished by the Department of Finance, Tax Legislation Division, and would be approved by Parliament through passage of legislation to enact the treaty amendment. In the United States, the delegation of decisionmaking authority to an arbitration board contemplated by a mandatory arbitration provision in the Canada-U.S. treaty would be approved by the U.S. Senate under the requirement that all international treaties to which the United States is a party obtain Senate approval.<sup>56</sup> In the sense of enacting or giving effect to a mandatory arbitration provision, both Canada and the United States would be exercising their sovereignty as independent nations. The real issue for governments is not sovereignty, but rather the extent to which a mandatory arbitration procedure could result in a government losing control over the revenue consequences of tax treaty dispute settlements. For the United States, that is unlikely to be a serious concern. For Canada, on the other hand, as a smaller country with proportionally larger tax revenue at stake, it might be a matter that would give rise to some reluctance to embrace a mandatory arbitration provision.

**The real issue for governments is not sovereignty but losing control over the revenue consequences of tax treaty disputes.**

A more practical shortcoming of a mandatory arbitration dispute resolution mechanism is the potentially limited precedential value of arbitrated decisions. All treaty disputes from which a taxpayer seeks relief under the mutual agreement procedure are historical in the sense that they deal with the taxation of the taxpayer's actual income in prior years. Disputes may be resolved in a more forward-looking manner, however, if the competent authorities agree to a particular method for allocating the jurisdiction to tax the income of the taxpayer in future years. Such a forward-looking agreement may be possible between the competent authorities when they successfully resolve the dispute for prior years through the conventional mutual agreement procedure. When the competent authorities fail to

reach agreement, however, and the matter is resolved through mandatory arbitration, it would seem less likely that both competent authorities would agree to assess the taxpayer in future years in a manner consistent with the arbitrated decision imposed on them that is binding upon them by the treaty only for prior years. That is principally a concern for taxpayers, who may invest considerable resources to pursue a mandatory arbitration process to resolve issues from prior years, but who may not obtain from the arbitrated decision a method that can be applied to future years to avoid the same dispute from arising again.<sup>57</sup> One possible way to address or mitigate that concern would be for the competent authorities to request the arbitrator to provide declaratory relief, that is, to determine a set of guiding principles or methods that may be applied to the particular taxpayer's circumstances in future years.<sup>58</sup>

Another concern expressed against treaty rules that would require the competent authorities to reach agreement within a specified period of time, failing which the matter would be resolved through mandatory arbitration, is that it might rush the competent authorities into unwise or unprincipled agreements.<sup>59</sup> It is evident from the substantial inventory of unresolved cases that both the Canadian and U.S. competent authority offices are already heavily burdened with high caseloads and may suffer from some degree of understaffing. If mandatory arbitration is required within a relatively short time, leaving insufficient time for the competent authorities to reach resolution of the dispute through the conventional mutual agreement procedure taking into account the possibly inadequate resources available to the competent authorities, the concern is that an agreement might be made hastily to avoid arbitration. While taxpayers, of course, favor accelerated resolution of their disputes, it would not necessarily be in the interests of taxpayers if the mutual agreement procedure is given too little time before arbitration is required. Arbitration is intended to provide a fallback dispute resolution mechanism when the competent authorities have exhausted their efforts to reach agreement

<sup>55</sup>See Gerrit Groen, "Arbitration in Bilateral Tax Treaties," *supra* note 14 at 3.

<sup>56</sup>The U.S. competent authority has repeatedly acknowledged that its recent support of mandatory arbitration provisions in U.S. tax treaties is always subject to the overriding requirement of Senate approval. See Moses, "Interview With U.S. Competent Authority," *supra* note 35.

<sup>57</sup>That problem was expressly raised by a U.S. taxpayer at the Feb. 8, 2002, Tax Council Policy Institute Conference. See "Dunahoo Urges Both Sides in Negotiations to Show Flexibility, Take Practical Approach," *supra* note 29.

<sup>58</sup>Declaratory relief awards have been suggested by Park, *supra* note 14 at 232.

<sup>59</sup>See Michael Durst and Robert E. Culbertson, "Arbitration to Resolve Difficult Double Taxation Disputes: The U.S. and Its Trading Partners Should Seize the Moment," (July 26, 2000) *Tax Management Transfer Pricing Report*, vol. 9, no. 7, pp. 211-213.

and remain deadlocked. Arbitration is not intended to be invoked when the failure to reach agreement has resulted from one or both of the competent authorities simply not having had sufficient time or resources to devote to the taxpayer's particular matter or as a substitute for the existing mutual agreement procedure. However, with the increased staffing of the Canadian competent authority office in recent years<sup>60</sup> and service improvements that have been made by the U.S. competent authority,<sup>61</sup> the possibility of premature, imprudent agreements is not likely to be a significant concern for Canadian and U.S. taxpayers.

### Recommended Mandatory Arbitration Framework

Mandatory arbitration offers a fallback, last-resort mechanism to resolve tax treaty disputes that cannot be resolved successfully or in a timely manner through the conventional mutual agreement procedure in the Canada-U.S. treaty. The presence of a mandatory arbitration procedure would promote settlement of cases by encouraging both competent authorities to put forward positions that are reasonable and objectively justifiable. Moreover, it would provide a fallback method to resolve stalled cases when reasoned negotiations prove unsuccessful. The MOU, in fact, recognizes the utility of mandatory arbitration by virtue of its adoption of that process to resolve factual disputes. It is unclear why the MOU does not go further and commit the Canadian and U.S. competent authorities to develop a suitable mandatory arbitration procedure for resolution of substantive issues.

***It would not necessarily be in the interests of taxpayers if the mutual agreement procedure is given too little time before arbitration is required.***

This article suggests that the Canadian and U.S. competent authorities should consider extending the scope of the MOU in future discussions to provide for a mandatory arbitration process to resolve substantive issues. It is submitted that the main objective affirmed by the MOU, namely that all cases referred to the competent authorities should ultimately be

resolved one way or another, is best achieved through the adoption of a suitable mandatory arbitration procedure. Although there are a number of different forms that process could take, this article suggests as a starting point that Canada and the United States could consider a mandatory arbitration procedure with the following principal features:

- Arbitration should be both compulsory and binding on both competent authorities and on the taxpayer.<sup>62</sup>
- Arbitration should be initiated if the competent authorities fail to reach agreement under the conventional mutual agreement procedure within two years from the date the taxpayer first applies for competent authority relief.<sup>63</sup>
- After the two-year period allowed for the mutual agreement process, the taxpayer should have the right to consent to the unresolved dispute proceeding to arbitration. In other words, if the dispute remains unresolved after the specified time period, the taxpayer may choose either to abandon its claim for competent authority relief or allow the matter to proceed to mandatory arbitration.<sup>64</sup>
- The arbitration panel should be composed of three independent and qualified persons, one appointed by each of the competent authorities and the third appointed by agreement of the first two appointees.<sup>65</sup>

<sup>62</sup>There should be no ability for the competent authorities to deviate from the decision of the arbitration panel as permitted by the EU Arbitration Convention. The binding nature of the arbitration follows the format of the ICC recommendations, *supra* note 9, and the IFA study, *supra* note 10.

<sup>63</sup>Two years is suggested as an appropriate time frame because it is slightly longer than the average time taken by the U.S. competent authority to resolve cases during 2001 (642 days). Two years is also the standard in the EU Arbitration Convention and is suggested by the ICC (*supra* note 9), the IFA study (*supra* note 10 at 94), and the TEI (*supra* note 8). Two years is also the period established in the MOU after which substantive disputes are to be referred up the chain to the most senior officials. On the other hand, article 25(5) of the Austria-Germany income tax treaty uses three years, while others have proposed one year (Ribes, *supra* note 14) and even six months to one year (Michele Markham, "The Resolution of Transfer Pricing Disputes Through Arbitration" (2005), *Intertax*, vol. 33, issue 2, p. 68-74 at 73).

<sup>64</sup>Requiring the taxpayer's consent is consistent with the EU Arbitration Convention, the ICC proposal (*supra* note 9), the IFA study (*supra* note 10 at 94), and the Austria-Germany income tax treaty. See also Tillinghast, *supra* note 14 at 93-94, and the comments made above, *supra* note 39.

<sup>65</sup>The suggested method of appointment is consistent with the ICC proposal (*supra* note 9) although the ICC draft article provides for not less than three arbitrators. The TEI also calls for three arbitrators chosen in that manner (*supra* note 8).

(Footnote continued on next page.)

<sup>60</sup>See the description of staffing increases in late 1998 and 1999 and again in 2001, at pages 7-8 of the CRA MAP Program Report, *supra* note 6.

<sup>61</sup>See the efforts to reduce the time for a case to reach resolution described above in Moses, "Interview with U.S. Competent Authority Carol Dunahoo," *supra* note 35.

- The taxpayer should have comprehensive rights to participate in the proceedings of the arbitration, including the right to be represented by counsel, to present evidence, to make submissions of argument, and to question witnesses.<sup>66</sup>
- Written reasons should be prepared by the arbitration panel in support of its decision, but the reasons should remain private and not be disclosed other than to the two competent authorities and the taxpayer.<sup>67</sup>
- The arbitrators should be permitted to resolve the dispute in a manner they consider fair and

The IFA study provides for three arbitrators appointed by the Permanent Court of Arbitration in The Hague (*supra* note 10 at 95). Ribes (*supra* note 14 at 403) calls for three arbitrators appointed from a list of experts selected by the OECD. Tillinghast (*supra* note 14 at 97) suggests three or, at most, five arbitrators. The EU Arbitration Convention requires at least six appointees to its advisory commission.

<sup>66</sup>Both Tillinghast (*supra* note 14 at 94) and Park (*supra* note 14 at 232) argue strongly for full taxpayer involvement. Markham (*supra* note 63 at 74) also favors allowing taxpayers the opportunity to present oral and written arguments. The ICC proposal (*supra* note 9) and the TEI recommendations (*supra* note 8) also favor taxpayer participation, but in a somewhat more passive role of responding to information requests and questions from the arbitration panel. The IFA study would permit the taxpayer to submit at least one memorandum and one rebuttal memorandum, along with witness statements and expert reports when appropriate (*supra* note 10 at 98).

<sup>67</sup>Requiring written reasons is likely to impose a degree of rigor on the analysis of the arbitrator that might not be present if the decision were not subject to the scrutiny of the parties. Written reasons might also facilitate resolution of the dispute in a forward-looking manner. While Platt (*supra* note 24 at 602) and Markham (*supra* note 63 at 74) both recommend that the written reasons should be published, the author suggests they remain private to preserve confidentiality, notwithstanding the loss of precedential value.

appropriate, not constrained by a “last best offer” or “baseball” format.<sup>68</sup>

- The costs of arbitration should be shared equally by the two competent authorities, while the taxpayer should bear its own costs for counsel retained and submissions made.<sup>69</sup>

A full-blown mandatory arbitration procedure as suggested above goes beyond the voluntary arbitration currently provided for in Article XXVI(6) of the Canada-U.S. treaty. It is therefore likely to require amendment of the Canada-U.S. treaty, rather than the mere exchange of notes contemplated by Article XXVI(6). For that reason, the actual implementation of a mandatory arbitration procedure is likely beyond the jurisdiction of the Canadian and U.S. competent authorities. Nonetheless, it is open to them to seek agreement on the framework of a procedure that can be recommended to their respective governments. Many taxpayers in Canada and the United States look forward to the release of a subsequent MOU that takes that further step toward mandatory arbitration. ♦

<sup>68</sup>The objective is to arrive at the best, most reasonable outcome. Avoiding the “last best offer” format arguably allows the arbitration panel more flexibility to arrive at a solution that best fits the circumstances.

<sup>69</sup>Most mandatory arbitration proposals recommend that the costs associated with mandatory arbitration be shared equally by the two competent authorities, but not the taxpayer. See the ICC draft article 25.1 paragraph 11 (*supra* note 9), the TEI proposal (*supra* note 8), Ribes (*supra* note 14 at 404), Tillinghast (*supra* note 14 at 99), and Markham (*supra* note 63 at 74). Park (*supra* note 14 at 227) does not go so far, but does reject the “loser pays” model. The EU Arbitration Convention shares costs equally among the two governments. In contrast, the IFA study would share the arbitration costs equally among the two competent authorities and the taxpayer (*supra* note 10 at 99). In an adversarial model, the most significant costs are likely to be those relating to submissions made to the arbitration panel. Generally, those costs should be borne by those who incur them. The “loser pays” model of allocating litigation costs is usually intended to discourage frivolous or unmeritorious claims by opportunistic litigants, which should not be an issue in the context of tax treaty disputes involving two competent authorities.