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International Tax Disputes Resolution through the Mutual Agreements and Arbitration Procedures

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List of Abbreviations

AC	Arbitration Convention
ADR	Alternative dispute resolution
APA	Advance Pricing Agreement
CA	Competent authority
CCA	Cost Contribution Arrangement
CTS	Council for Trade in Services
DTC	Double tax convention
ECJ	European Court of Justice
e.g.	exempli gratia, for istance
EU	European Union
EU MS	European Union Member States
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
IBFD	International Bureau of Fiscal Documentation
ICJ	International Court of Justice
i.e.	id est, that is
JTPF	EU Joint Transfer Pricing Forum
MEMAP	Manual on Effective Mutual Agreement Procedure
MAP	Mutual agreement procedure

MFN	Most favourite nation
MNE	Multinational enterprise
MOU	Memorandum of Understanding
OECD	Organisation for Economic Cooperation and Development
OECD MC	OECD Model Tax Convention
PCIJ	Permanent Court of International Justice
UN	United Nations
VCLT	Vienna Convention on the law of treaties
WTO	World Trade Organization

I. Introduction on research question

Disputes and conflicts from which disputes emerge are not wholly undesirable, they can have certain valuable characteristics. There is a widespread assumption that the proper function of law is to manage, rather than to avoid conflicts. That is not the premise from which this study proceeds. Rather it is assumed that in a successful legal system disputes should be avoided, or at least resolved quickly and peacefully.

The term "**conflic**t" has not the same meaning of the term "**dispute**". The former is used to identify a general unfocused hostility between parties, difficult to solve by the settling of a particular issue, the latter includes specific disagreement relating to a question of right or interest in which the parties proceed by way of claims, counter-claims, denials and so on.

The development and handling of tax disputes differs from the typical civil dispute in several ways. **Civil disputes** generally begins with a perceived injurious experience by one party and a consequent claim for restitution or compensation against the blamed party. No one of the parties has the formal power to make decisions about the dispute that are legally binding on the other party. Consequently, civil disputes usually begin as two-party bargaining situations but they are often framed in terms of the possibility of intervention by a third-party.

Tax disputes are fundamentally about the correct interpretation and application of the tax law and the administrative authority has the formal power to end the dispute by making a decision that is legally binding on the taxpayer. If the taxpayer rejects the auditor's claim, in whole or in part, then the issue is transformed into a dispute with negotiations or counterclaims by the taxpayer. The taxpayer's appeal moves the dispute out of the "audit arena", into the arena of an appeals officer or a court. As shown in this study, these characteristics of tax disputes, with the role of the parties, the taxpayer's perceptions of the attitudes and orientations of the tax authority, and other procedural factors affect the preferred strategies of the parties for resolving tax disputes.

It should be noted that the recourse to judgment is optional, a one further stage in the dispute settlement process, when dispute cannot be adjusted by negotiation. This is specially true in international law where no international tribunal has compulsory jurisdiction and if the parties desire to refer the matter for judicial settlement in an international tribunal, that reference can only be made with an agreement.

International economic law is essentially based on treaties on the reciprocal liberalization of market access barriers. Most international economic treaties include precise and detailed rules in order to maximize legal security for private investors, producers and traders; they usually provide also their own specific dispute settlement mechanisms to ensure that the specific treaty rules are interpreted and applied by experts in economic law and policy.

This study starts from a quick analysis of various dispute resolution mechanisms that are being used by parties in international commercial relationship, among which arbitration, mediation and conciliation have proven to be more popular ones, to a better understanding of this growing phenomenon as far as tax issues are concerned. International law provides the conceptual framework in which the international community and international relations are seen and understood, it is fundamental for the understanding of the conduct of international relations.

International tax law has a long experience in developing several procedures to deal with cross-border disputes, looking to resolve them both before they start and after they arise.

Compulsory jurisdiction, appellate review procedures and private access to international arbitration have been accepted in worldwide economic law but continue to be resisted by governments in most other areas of international law. Economic and political theory offers a number of reason why governments often find it politically easier to accept compulsory adjudication and judicial protection of individual rights in international economic relations than in other field of international law[1].

International economic transactions involve the exercise of individual rights (e.g. freedom of contract) and the transfer of such rights. Legal security and adjudication are obviously beneficial in this area because, e.g., they reduce transaction costs. Hence, both the EU MS and the USA have introduced domestic procedures under which export industries can petition the government to challenge the market access restriction of foreign states through international adjudication (e.g. in the WTO). In the field of tax law, by contrast, governments tend to view tax disputes primarily as a matter of domestic jurisdiction, rarely solved through inter-state adjudication.

As global trade and investment increase, countries have been more and more often involved in disputes on tax matters which, if left, remain unresolved and can result in unrelieved double taxation and a consequent obstacle to the free flow of goods and services.

A coherent and coordinated approach to international disputes implies, amongst other things, that the widely used mechanisms developed by international law has to be seen as a precious experience to implement similar techniques to resolve tax conflicts and ensure that double taxation will be avoided through an appropriate application and interpretation of tax conventions.

The purpose was principally to establish more transparent and effective relationships between tax authorities of different countries, towards a collaborative approach to application of tax treaties, proactive sharing of information and a general reduction of tax uncertainty.

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[1] E-U.Peretsmann, "National Constitutions and International Economic Law" in M. Hilf and E-U.Peretsmann (eds), *National Constitutions and International Economic Law* (Kluver: Deventer 1993), 46.

Commercial agreements between foreign investors and host countries, domestic investment laws, and bilateral treaties between capital-exporting and capital-importing states increasingly provide that disputes over the foreign investments shall be governed not only by the national law of the host state, but also by international law and “mixed” international arbitration procedures between the foreign investor and the host state.
Such “internationalization” of the dispute settlement procedures, and of the substantive law to be applied to the dispute, can promote the flow of capital and direct investments into host states in a mutually beneficial manner.

The analysis will seek to deal with the topic from international and comparative prospective focusing on the legislation of the two main tax dispute resolution mechanism, the mutual agreement procedure and the arbitration.

In recent years, the huge development of disputes resolution techniques alternative to transnational commercial litigation have lead up to the implementation of such mechanisms for solving or avoiding tax conflicts. Innovative researches[2], based on qualitative interviews and survey questionnaires, enjoyed valuable theoretical and practical insight into the attitude and choices of major international group of companies towards the various commercial disputes settlement mechanisms that are available.

The study itself is structured as follows. In **Part II** I shortly explore the most commonly used dispute resolution mechanism as far as commercial transactions are concerned. The purpose is to highlight a sort of pyramid up which parties of an “amicable dispute” climb, from the base of negotiation to the apex of the binding arbitration. It should be stressed that the various forms of settlement procedure are not stages through which the parties must progress. They are alternatives from which the parties involved choose the procedure most likely to yield a satisfactory solution. A rather different approach is taken by the tax dispute settlement procedures, where , a sort of course is set up by the applicable rules.

International disputes can originate from almost any contract or commercial transaction. Sectors from which many disputes originate include: aviation and transport, banking and financial services, commodities, construction and engineering, insurance and reinsurance, maritime, oil and gas, telecommunications and utilities. Some of the issues that commonly give rise to disputes include distribution agreements, employment, intellectual property,

[2] A valuable example of this kind of study is the research undertaken by PricewaterhouseCoopers in association with the School of International Arbitration, Queen Mary, University of London, “International Arbitration: Corporate attitudes and practices 2008” (available at: http://www.pwc.com/arbitrationstudy).

international boundary disputes, joint ventures, professional negligence and technology transfer.

Part III of this study try to identify the main critical general topics that are the most frequent sources of international tax disputes.

Conflicts in interpretation of tax treaties could assume different forms such as characterization or allocation conflicts. As a result, generally double taxation occurs, especially in the context of transfer pricing adjustments, where tax authorities in competing jurisdictions disagree over income allocations attributable to transfer pricing. Solving these problems with a preventive approach, e.g. through APA programs, can be considered as a method of international dispute settlement. The critical aspects is the need of a cooperative behaviour between CAs with opposite interests and a strong sense of "tax sovereignty" to mitigate. Cross-border tax cooperation is usually difficult to achieve because sovereign States are unwilling to accept constraints on their power to tax.

Resolving international tax disputes has become a major issue for businesses and tax administrations in Europe, they have increased both in number and complexity and this trend is expected to continue to evolve.

Conventionally we use to think about disputes resolution in term of wide-spread mechanisms as negotiation, mediation, adjudication, and appeals. These are the categories employed in the classic descriptions provided by legal doctrine. Therefore, there are other reactions after dispute arising: to ignore the conflict, thus, in a sense, resolving it. The notion of avoidance is that a party may change his behaviour on account of the dispute in such a way that his relationship with the other disputant is, at least temporarily, concluded.

Avoidance as "dispute processing" is different from avoidance "behaviour" adopted to prevent disputes from arising in the first instance[3]

This study is primary concerned with procedure for avoiding tax disputes and resolving tax conflicts. Much efforts is being put into the development of techniques for the management of conflict. **Part IV** is devoted to exploring the avoidance of tax disputes, as a "dispute processing" through the mutual agreement procedure (MAP) which is provided for in tax treaties following the OECD MC and which is the "traditional" mechanism for settling cross-border tax treaty disputes, and through the arbitration procedures. These mechanism and their results on tax disputes are analysed and compared under a legal and an economical perspective. Both of them imply strategic behaviours from two different parties, with opposite

[3] William L.F. Felstiner , "Avoidance as Dispute Processing: An Elaboration", *Law & Society Review*, Vol. 9, No. 4, (1975), 695

interests, joined only by the same general purpose of avoiding double taxation, that should lead them up to a balance point (i.e. the final agreement between the two CAs).

Trade and tax issue often proceed on two parallel lines, strongly connected, even though almost always separated. Nevertheless there are some overlapping where the interaction is a natural consequence. More in detail, a typical example of international agreement dealing with tax matters are within the WTO framework where, as a general principle, taxes risk to be considered as an obstacle to free trade, under certain conditions, in the observance of fundamental principles. The inclusion of tax issues in international trade agreements gives the opportunity to analyse **(Part V**) how tax disputes are solved not by tax authorities, as happens for tax treaty conflicts, but through an articulated dispute settlement mechanisms, and compare the WTO dispute solving process with the equivalent procedures provided for in tax law.

Arbitration, in particular, is a global phenomenon, defined as the preferred dispute resolution mechanism for cross-border disputes and appreciated for its effectiveness. Most of the bilateral investment treaties dealing with the protection of investments contain provisions concerning arbitration. On the contrary, few tax treaties include an arbitration clause. This is undoubtedly due to the basic principle that the States have the sovereign power to determine the criteria for taxation in order to define the tax jurisdiction and avoid double taxation, independently of the taxation of another State, within the limits imposed by international law. State are usually more sensitive to their fiscal sovereignty than to any other limitation of power. But this is not enough. An effective international cooperation and a reduction of tax barriers to trade need forms of dialogues between tax authorities to solve conflict that may arise in application and interpretation of tax law, even though this means a sacrifice in terms of fiscal sovereignty. Although the idea of using arbitration is thus gaining ground, many questions regarding the implementation of this dispute settlement technique are still open.

These are the premises of the analysis developed in rest of the study. **Part VI** includes “amicable” procedures for resolving tax disputes in developing cooperative relationships among tax administrations, ministries of finance and international and regional organisation, to optimize efforts towards more effective tax policies.

Recognizing the value of effective methods for settling international tax disputes, alternative to litigation, results in significant benefits, such as reducing the instances where a dispute leads to the termination of a commercial relationship, facilitating the administration of

international transactions by commercial parties and producing savings in the administration of justice by States.

The establishment of a legislative model dealing with tax disputes settlement methods that is acceptable to States with different legal, social and economic systems would contribute to the development of harmonious international social and economic relations as well as international peace.

II. Methods of settlements of international disputes: the basic framework

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1. Introduction on international disputes settlement

Despite the number of initiatives to negotiate international principles and rules governing relationships among States at the bilateral and multilateral level, transnational disputes is a sizeable and growing issue, at the centre of the attention of international organizations, such as the United Nations. Among the principles in accordance with which the members of this Organization have to act, they "shell settle their international disputes by *peaceful means* in such a manner that international peace and security, and justice, are not endangered" [4].

A "dispute" was defined by the Permanent Court of International Justice in the *Mavrommatis Case* of 1924 as a "disagreement on a point of law or fact, a conflict of legal views or interests between two persons"[5].

The criterion of "internationality" of a dispute lies in the "legal substance" of the conflict itself. It has been argued that international disputes are those in which the claims are based on international law. In other words, there is an international dispute settlement where the competent body or mechanism is constituted under and functions according to international rules, at least in part[6].

Commercial disputes in longer-term relationships arise quite all the time. In the domestic context parties who seek a binding method of resolving disputes through third-party

[4] Article 2(3) of the UN Charter. The "Charter of United Nations" was signed on 26 June 1945, in San Francisco, at the conclusion of the United Nations Conference on International Organization, and came into force on 24 October 1945. The Charter is the constituting instrument of the Organization, setting out the rights and obligations of member states, and establishing the United Nations organs and procedures. The primary United Nations organ for the settlement of disputes is the International Court of Justice (popularly known as the World Court); it was established in June 1945 by the UN Charter and began work in April 1946. The Court's role is to settle, in accordance with international law, legal disputes submitted to it by States and to give advisory opinions on legal questions referred to it by authorized United Nations organs and specialized agencies.

[5] *Mavrommatis Palestine Concessions Case* (1924), PCIJ, Ser. A, No.2, at.11.

[6] Anne Peters, "International Dispute Settlement: A Network of Cooperational Duties", 14 European Journal International Law, 1 (2003), 1.

intervention have the choice between a national public court and private arbitration. In the international context such a choice does not exist because there are no international public courts that handle international commercial disputes involving only private parties[7] Therefore, the choice for international private parties is between recourse to a national court and recourse to private international dispute resolution, namely international commercial arbitration or alternative disputes resolution (ADR) techniques. The latter are besides arbitration and litigation and the most widely known forms are conciliation and mediation. Such litigation has become ever more costly as modern commercial arbitration consumes high-cost services from specialised lawyers. The main cost to business, however, is the destructive effect of any litigation to relationships that were established at great cost and risk; sometimes, litigation also impacts negatively on a company's reputation which makes it in turn more difficult to establish new relationships. Establishing an international commercial relationship – formalised in contractual or corporate law format – is a very costly activity that is as yet not properly understood and accounted and building relationships across borders of culture, language, space, law and business styles is much more difficult than within a homogeneous business space.

In the planning of a complex international transaction, the avoidance of conflict situations is one of the determining elements; managing such disputes efficiently is a principal competitive asset of internationally active commercial operators.

With regards to dispute settlement, the general tend is that, among the various methods available (ranging from direct negotiation between parties, recourse to local courts and tribunal, conciliation and arbitration with the assistance of third parties), binding arbitration has become the preferred practice in many filed of international dispute resolution, including international investment or international commercial disputes[8], so that we can speak of "arbitral culture" as a generally-accepted principle and practice in a multinational treaty or agreement[9].

It should be stressed that principles and practices developed in the context of arbitrations between States[10] are also relevant to arbitrations between a State and a non-State party and, equally to commercial arbitrations between private parties.

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[7] The only exception is the European Court of Justice, which may deal with certain disputes between private parties under European Community law.

[8] The experience of the Iran-United States Claim Tribunal should be particularly mentioned in this respect. See P. Malanczuk, "The Iran-United States Claims Tribunal in the Hague – Some Reflections on a Unique Institution of International Dispute Settlement Moving towards the End of Its Work" in V. Götz, P. Selmer and R. Wolfrum (eds), *Liber amicourm Günther Faenicke – Zum 85*, Geburtstag (1998), 221.

[9] See Howard M. Holtzmann, "The Permanent Court of Arbitration and the Evolution of a Worldwide Arbitration Culture" in The International Bureau of the Permanent Court of Arbitration (ed.), *International Alternative Dispute Resolution: Past, Present and Future*, Kluwer (2000), 97

[10] They had been the focus of the First Hague Peace Convention for the Pacific Settlement of International Disputes, signed in 1899 during the First Hague Peace Conference.

Concepts developed for arbitrating commercial disputes involving private parties influence procedures for intra-States cases[11], because they have recognized as "fair and effective procedure for peaceful resolution of disputes between States concerning the interpretation, application ad performance of treaties and other agreement although they were originally designed for commercial arbitration"[12].

Thus, the methods of settlement of disputes will now be discussed regardless of whether the parties are public or private entities and whether the disputes are to be resolved in accordance with public international law or by application of a national law governing commercial transaction; ideas flows both from private to public experience as well as from public to private.

2. Alternative Dispute Resolution (ADR) techniques

Arbitration is the most known but not the sole method for peacefully resolving disputes; rather it is the procedure to be used when other dispute resolution procedures fail. The term "**Alternative Dispute Resolution" (ADR)** [13] is used to describe the wide range of methods that are available to contending parties, established by the "1899 Hague Convention on Pacific Settlement of International Disputes"[14] and modernized with the evolution of "dispute resolution culture". Projects such as the "Harvard Law School Program on Negotiation"[15] have drawn on practical experience and theoretical insights from fields such as "game theory" in order to develop both strategies for improving the change of success in negotiations and a framework within which the dynamics of negotiations can be analysed and understood.

The essence of all non-litigative methods of settling disputes is avoidance of formal litigation before courts or arbitral tribunals, replacement of the 'judge/arbitrator' by an independent

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[11] This, for example, in 1904 the "Interparliamentary Union" – an organization of members of various national legislative bodies – published a Declaration urging that disputes between States be arbitrated "in te same manner as disputes between individuals". Almost ninety years later, the Permanent Court of Arbitration embraced the same concept when it based its new Optional Rules for use in disputes between States on arbitration rules that had been prepared for commercial cases by the united Nations Commission on International Trade Law (the "UNCITRAL" arbitration rules).

[12] See International Bureau of PCA , ed., *Permanent Court of Arbitration – Basic Documents*, (1998), 45.

[13] Jean-Claude Goldsmith, Gerald H. Pointon and & Arnold Ingen-Housz (ed). " ADR in Business - Practice and Issues across Countries and Cultures", ICC Publication No. 963, 2006 Edition.

[14] The Hague Conventions were international treaties negotiated at the First and Second Peace Conferences at The Hague, Netherlands in 1899 and 1907. Signed on July 29, 1899 and entering into force on September 4, 1900, the Hague Convention of 1899 consist of four main sections and three additional declarations. The first section is titled "Pacific Settlement of International Disputes". See Erns-Ulrich Petersmann, "Centennial of the 1899 Hague Peace Conference and 1899 Hague Convention on the peaceful settlement of international disputes – 1999 Geneva Academy of International Economic law and Dispute Settlement", Oxford University Press, *Journal of International Economic Law* (1999), 185.

[15] See website: http://www.pon.harvard.edu/

third party and of the complex, intensely rule-bound procedure of litigation by less formal procedures of facilitating an amicable settlement.
Since conflict avoidance is actively practiced on the international, national, and private levels, some measure of fundamental similarity of legal institutions must already be in existence in most of countries. The legal systems with which an international transaction is connected may differ but some fundamental notions must be common to the legal systems with which the transaction is connected (e.g., the rule *pacta sunt sevanda* and the recognition of the *legal persona* of a corporation). The unifying attempts of conflict avoidance on the international level would not be possible if the parties to an international agreement or the national bodies sponsoring an international practice did not only share a similarity of outlook as to the fundamentals of the legal institutions with which the agreement or practice is concerned, but, beyond that, were in substantial agreement on the detailed rules applicable to those institutions. That is to say that the subject of conflict avoidance assumes the existence of a measure of agreement on fundamental legal principles amongst civilized nations.
A key feature of ADR techniques is their high degree of procedural flexibility. They provides the parties with full control over the dispute process. The parties may decide the number and the power of mediators or arbitrators, the appointment procedure, the place of settlement, and the applicable law in the dispute. In contrast, a trial before a national court must be conducted in accordance with the rules of that court. Further, public court proceedings are typically open to the public, and court decisions are published and readily available. Alternative proceedings, however, are held in private; details about the cases, including awards, are confidential[16]. Privacy may help companies to hide a number of facts from competitors and the public in general, such as trade secrets and know-how not guaranteed by patents or financial difficulties and other problems.

3. Conflict resolutions: preventive vs resolving methods

Two approaches are at the disposal of a conflict problem: the preventive approach of the *conflict avoidance* and the resolving method of *conflict solution*. The aim of the former is to avoid a situation in which a conflict is likely to arise; conflict solution, on the other hand, is concerned with a problem arisen in a particular legal relationship to be solved by judicial or legislative means. The relationship between the avoidance and the solution of conflicts is naturally close. Every system of conflict rules usually combines elements of conflict

[16] Nevertheless, the parties may choose to publicize arbitral decisions either to create precedents or to provide authoritative interpretations of standard contract terms.

avoidance and conflict solution. Traditionally, the "resolving method" is applied in the common-law countries where judicial pronouncements are the main source of law .
Nevertheless, general political and economic developments in the XX century[17] have created an atmosphere favourable to international conflicts avoidance that has assumed two different forms.

Firstly International Treaty or Convention[18] among states, by which they undertake to introduce uniform legislation giving these international agreements legislative force in the municipal jurisdictions. A convention may either aim at a complete and general unification of the law in a particular field, or it may have the less ambitious aim of laying down rules for the avoidance of a conflict of laws in a particular situation[19]. They have binding effects on parties in the countries which have embodied these measures into their domestic law.

Secondly uniform rules suggested by non-governmental bodies for adoption by trade association or individual contracting parties, within their autonomy, such as the "International Law Association"[20] or the "International Chamber of Commerce"[21], for general adoption by business association or for incorporation by individual contracting parties into their agreements.

International economic law is essentially based on treaties on the reciprocal liberalization of market access barriers. Most international economic treaties include precise and detailed rules in order to maximize legal security for private investors, producers and traders; they

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[17] International corporation has begun to make an increasingly insistent appearance in economic life, e.g. governmental agencies, such as the Bank of International Settlement, the Bank for International Reconstruction an development, the International Monetary Fund and the European Coal and Steel Community, and social and commercial contacts between nations and their citizens have become much closer than ever before as the result of the development of modern aviation and telecommunications.
[18] Examples of international conventions aiming at uniformity of law are the Brussels Convention of 1924, adopting the Hague Rules of 1921 on Bills of Lading; the Warsaw Convention of 1929 for the Unification of Certain Rules relating to International Carriage by Air; the Protocol on Arbitration Clause of 1923; the Convention on the Execution of Foreign Arbitral Clauses of 1927; the Geneva Uniform Laws of Negotiable Instruments (1930 and 1931) and the draft of a uniform law concerning international sale of goods proposed by the Rome Institute for the Unification of Private Law.
[19] On the duality of ways in which unification of laws may be achieved see Batiffol "Conflict Avoidance in European Law"
[20] Founded in 1873, The International Law Association's objectives, under its Constitution, are "the study, clarification and development of international law, both public and private, and the furtherance of international understanding and respect for international law". It has consultative status, as an international non-governmental organisation, with a number of the United Nations specialised agencies.
[21] The International Chamber of Commerce was founded in 1919 to serve world business by promoting trade and investment, open markets for goods and services, and the free flow of capital. ICC activities cover a broad spectrum, from arbitration and dispute resolution to making the case for open trade and the market economy system, business self-regulation, fighting corruption or combating commercial crime.

usually provide also their own specific dispute settlement mechanisms to ensure that the specific treaty rules are interpreted and applied by experts in economic law and policy.

Numerous international dispute settlement treaties[22]tend to distinguish the following ten complementary international dispute resolution methods, defining the conditions for their use: 1) negotiations; 2) good offices; 3) mediation; 4) international commissions of inquiry; 5) conciliation; 6) arbitration; 7) judicial settlement by permanent courts; 8) "resort to regional agencies or arrangements; 9)"other peaceful means of their own choice"[23] (Article 33 UN Charter); and 10) dispute settlement by the UN Security Council or by other UN organs or other international organizations. This list is by no means exhaustive and the development of new approaches to dispute settlement continue.

Some of these methods, the more frequently used to settle disputes regarding the interpretation or application of **tax treaties**, will be discussed in the following chapters.

Despite their undeniable value, the number of compromissory clauses in international treaties providing for the submission of disputes to the ICJ remains small and the existing clauses have been used rarely for the settlement of international economic disputes .

Among the motives behind the reluctance of States to submit trade disputes to an international court the doctrine identified the unwillingness of states to accept limitation of their economic policy discretion by third-party judgements[24]. Yet, this analysis does not explain why, in numerous post-war international economic treaties, governments have consented international judicial review of compliance with such treaties commitments by specialized disputes settlement bodies, such as GATT and WTO panels, the WTO Appellant Body, arbitration procedures in the WTO, the EC Court of First Instance, the EFTA Court of Justice, the NAFTA panels, arbitration under rules of the World Bank's International Centre for the Settlements of Investment Disputes (ICSID), or the International Law of the Sea Tribunal ad arbitration mechanism provided for in the Law of the Sea Convention.

Dispute settlement and judicial protection in the EC differ from the law of all other international organizations by the comprehensive jurisdiction and functions of the EC Court of Justice (ECJ), the comprehensive scope and comparatively greater democratic legitimacy of EC law, the close cooperation between national courts and the ECJ in the interpretation and enforcement of Community law and the active role of the EC citizens in the judicial development of EC law.

[22] E.g. 1966 World bank Convention on the Centre for International Investment Disputes (ICSID), the Law of the Sea Convention, the WTO Agreement on Pre shipment Inspection, the EC Treaty, the ECHR and NAFTA.

[23] Article 33 UN Charter.

[24] G.Jaenicke, "International Trade Conflicts before the Permanent Court of International Justice and the International Court of Justice" in E-U.Peretsmann and G. Jaenicke (eds), *Adjudication of International Trade Disputes in International National Economic Law* (Fribourg University Press 1992), 43.

Private investors and multinational enterprises often prefer to protect their rights themselves through international dispute settlement procedures, rather than have recourse to the possibly biased domestic disputes settlement mechanisms in the host state and, after exhaustion of the local remedies, to diplomatic protection by the home state, whose national political self-interests might differ from the private interests. Even if diplomatic protection should be finally granted, the often many years of dispute settlement proceedings are viewed by private investors as far too lengthy, too costly and too politicized.

Since the “world-wide” free trade agreements (like the WTO Agreement) and regional integration agreements among democracies (e.g. in the , EC, EEA an NAFTA) were negotiated and concluded as “package deals”, countries had no choice of “opting out” of the compulsory dispute settlement systems. International economic law and European integration law offer important lessons for the necessary reforms of the legal and dispute settlements system in tax matters.

In conflict avoidance, we have a great discipline founded on the existence of similarities between the legal systems of the world, a practical science which uses the only method which in the second half of the twentieth century can advance the science of the conflict of laws, namely, the comparative method. It is essential that the conflict of tax law systems everywhere should be retrieved from the narrow compass of tax issues which limited them and should be seen in their intimate functional relationship to international commercial law. This can only be done by the extensive use of the comparative method, with its broad international implications, in global conflicts relations.

Notwithstanding the many differences between the legal status, substantive law and procedures applied by the WTO and the ECJ on the one side and Tax authorities and Arbitration Boards, on the other, comparative analysis of the procedures and dispute settlement practices of these bodies are needed in order to examine, for instance, the different length of the proceedings, the intervention by third states, whether and how international courts should encourage a negotiated dispute settlement in the course of the court proceeding.

Such comparative analysis could suggest reforms of the tax treaties procedures and working methods and help the periodic review of a still imperfect tax dispute settlement system to prepare additional reforms.

The following paragraphs are an overview of the main methods for international disputes resolution, divided into three categories as summarized in the table below:

	TWO PARTIES	THREE PARTIES
NON-BINDING	***Negotiation***	***Mediation / Conciliation***
BINDING		***Arbitration***

4. Non-binding bilateral methods: negotiation (or consultation)

Negotiation is the means by which the large majority of international disputes are settled[25], it plays an important rule in the prevention, as well as the resolution, of conflicts. There is no general rule of international law requiring that negotiations be exhausted before a dispute is taken before a tribunal[26] but the ICJ itself observed that "before a dispute can be made the subject of an action at law its subject-matter should have been defined by diplomatic negotiations"[27]. It seems that in this case the Court was referring to an obligation which exist under general international law and was not claiming a right to impose one itself.

Negotiations are sometimes referred to in treaties as an obligation of prior consultation before action is taken[28], sometimes as a means of settlement[29], and sometimes as a preliminary to resort to other means of dispute settlement[30]. States have sometimes formalised negotiations, establishing permanent commissions[31] to deal with any problem that might arise from time to time in a given field (e.g. pollution, the use of boundary waters, etc.).

Legal scholarship[32] on negotiation has identified three different kinds of strategies:

1) "*softer* bargaining over position", when one party makes concessions to reach an amicable agreement and avoid conflict with the other side;

2) "*hard* bargaining over position", when a party wants to win on the other by taking extreme position and holding out longer;

3) "principled negotiations", when the problem is separated from the parties, they look for mutual gain, focusing on the merit of the negotiation problems rather than on personal relationship and positions, and the agreement reflects some fair standard independent of the naked will of either party.

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[25] United Nations, *Handbook on Peaceful Settlement of Disputes*, New York (1992), 9; P.H.Gulliver, "”Dispute and negotiation: a cross-cultural perspective", New York Academic Press, 1979; R.Fisher, W.Ury and B.Patton, "Getting to Yes, Negotiation Agreement Without Giving In", 2d ed. Penguin Books, 1991.

[26] Case concerning Land and Maritime Boundary between Cameroon and Nigeria, ICJ Rep. 1998 275 (Judgement of 11 June 1998), para.56.

[27] Mavrommatis Plestine Concessions Case (1924).

[28] NATO Agreement, 4 April 1949, art.4. See F.L. Kirgis, "Prior Consultation in International Law", Charlottesville (1983).

[29] Mexico-US Convention for the Recovery and Return of Stolen Vehicles and Aircraft 1981, art. VIII(1981).

[30] Treaty Concerning the Establishment of the Republic of Cyprus 1960, art.10.

[31] Perhaps the best known is the Canada-US International Joint Commission that may serve both as a forum for negotiation and for the quasi-judicial settlement of disputes by majority decision).

[32] See R.Fisher, W.Ury and B.Patton, "Getting to Yes, Negotiation Agreement Without Giving In", 2d ed. Penguin Books, 1991; R.Fisher, E.Kopelman and A. Kupfer-Schneider, "Beyond Macchiavelli", 1994; R.Fisher and S.Brown, "Getting Together. Building a Relationship That Gets to Yes", Boston 1988.

The first two strategies are clearly sub-optimal means of dispute settlement that risk leading to unwise agreements with high implementation costs and damaging the personal relationship between the parties. On the contrary, the “principled negotiations” helps to maintain a mutually beneficial relationship among the parties and helps to focus the final agreement on objective principles reflecting the “long-term” interests of all parties. It’s a fair standard for settling disputes over conflicts among their “short-term” interest.

The assistance by third parties (e.g. mediator or conciliator) in negotiation on the settlement of disputes is one of the technique recommended by negotiation theories for separating relationship issue from negotiations. If in the negotiation process there is a stronger party, it may be tempted to use its bargaining power unless the weaker party submits the dispute to previously agreed compulsory mediation or jurisdiction. This could be the case of a contract with a “multi-tiered dispute resolution clause” which provides for distinct steps, involving separate procedures, for dealing with and seeking to resolve disputes.

5. Non-binding third-party methods: mediation and conciliation

5.1 Overview

The various forums of dispute resolution can be seen as rational selection of those means that are most effective and appropriate for given disputes, far away from sometimes cumbersome and lengthy court proceedings, toward faster and less expensive methods. Negotiations are an appropriate means of dispute settlements but parties are not oblige to bring the negotiations to a favourable conclusion. In some disputes the degree of animosity between the parties is so great that direct negotiations are unlikely to be an effective approach to a settlement.

If the mutual agreement negotiations between the two parties do not come to a favourable conclusion, it may be useful to appoint an independent mediator or conciliator to submit proposal on how to resolve the difficulties.

The intervention of a third party who assumes the task of “reconciling the opposing claims and appeasing the feelings of resentment which may have arisen between the States at variance”[33]may greatly facilitate settlement of dispute.

Mediation is a triadic mode of dispute settlement, entailing the intervention of a neutral third party, either a State, an organisation or a person, accepted by the disputing parties, in an attempt to reconcile the claims of the contending parties and to advance proposals aimed at

[33] See Article 4 of the 1899 Hague Convention.

a compromise solution[34]. Mediation, in its best form, does not simply aim at ending a dispute, but at creating additional value: it's an opportunity for open dialogue between the disputants, with minimal procedural issues and the possibility of developing creative and mutually acceptable solutions, restructuring the relationship so it becomes as profitable for both parties as possible.

Mediators, as opposed to arbitrators and adjudicators, have no authoritative sanctions at their disposal. They have to encourage, facilitate and move the parties towards a – reasonable, workable, effective – settlement by renegotiation of their now malfunctioning deal. Typically, a mediator seeks to reduce the distance between the parties' positions and make the parties understand each other's point of view, in order that they may achieve a compromise solution.

The term "conciliation" has broad notion referring to proceedings in which a person or a panel of persons assists the parties in their attempt to reach an amicable settlement of their dispute.

Conciliation is the participation of a third party, an individual or a commission[35], with the task of investigating every aspect of the dispute, in an attempt to make an impartial elucidation of the facts, enjoying the confidence of the parties, and to propose a non-binding solution. After consulting all sides and evaluating the evidence, the conciliator draws up the terms of a resolution that is hopefully acceptable to all parties involved in the conflict.

Conciliation is, in effect, a non-confrontational problem-solving method that can be particularly useful when it is important to maintain good relations with a long-term partner.

Since the role of the conciliator is only to facilitate a dialogue between the parties and not to make a decision, there is no need for procedural guarantees. This flexibility is a crucial feature of the conciliation process, it can be adapted to the circumstances of each case and to the wishes of the parties.

Neither the mediator nor the conciliator is monitored by any central institution, they depend entirely on the good will of the parties for a smooth process of dispute resolution.

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[34] On mediation see: Witty, "Mediation and society", New York Academic Press, 1980; Carol J. Greenhouse , "Mediation: A Comparative Approach", Man, New Series, Vol. 20, No. 1, 1985, 90, published by *Royal Anthropological Institute of Great Britain and Ireland*; Julie Barker, "International Mediation: A Better Alternative for the Resolution of Commercial Disputes: Guidelines for a U.S. Negotiator Involved in an International Commercial Mediation with Mexicans", 19 *LOY. L.A. INT'L & COMP. L.Rev.* 1, 1996, 7, Christopher W. Moore, "The Mediation Process" 161 (2d ed. 1996); Klaus Peter Berger, "Integration of Mediation Elements into Arbitration - 'Hybrid' Procedures and 'Intuitive' Mediation by International Arbitrators" ", *Arbitration International*, Vol.19, No.3 2003, 387; Bettina Knötzl and Evelyn Zach, "Taking the Best from Mediation Regulations. The EC Mediation Directive and the Austrian Mediation Act", *Arbitration International*, Vol.23, No.4, 2007, p.663.

[35] Conciliation commission were provided for in a number of treaties made after the First World War, of which the France-Switzerland Agreement of 6 April 1925 was perhaps the most influential.

In 1922, the League of Nations adopted a resolution encouraging States to submit their disputes to conciliation commissions[36]. An increasing number of treaties include references to a compulsory application of the method. This means that once the treaty is ratified, any party may unilaterally submit a dispute to a conciliation commission.

While the procedure remains non-binding, it does create some political pressure towards settlement. Among disputes dealt with by commissions may be mentioned the Norwegian-Iceland dispute which gave rise to the "Jan Mayen Award"[37]where the conciliator said that its function is "to make recommendations to the two governments which in the unanimous opinion of the Commission will lead to acceptable and equitable solution of the problems involved".

The difference between "mediation" and "conciliation" does not appear to be too much meaningful, especially if the proceedings are confidential; the two terms are usually employed indifferently rather than as labels for distinct approaches to dispute settlement.

In the employment context, the British agency "ACAS"[38] distinguishes mediation as being a more "positive" form of third party intervention than conciliation. Under the ACAS system, unlike the conciliator, the mediator makes definite (non-binding) recommendations as to the terms of settlement of the dispute. A similar distinction appears to be drawn in the employment practices of Greece, Ireland, Italy, Portugal, and Spain[39].

In nearly all instances the uncertain borderline between the two types of dispute resolution means that in practice the two words are often used as if they are synonymous. They avoids any idea of winning or losing or of binding decision, instead focusing on *mutual agreement* on the basis of legal and political considerations at the parties' discretion.

If mediation or conciliation is to be employed, that decision should be made as early as possible. If the parties first negotiate by themselves, fail to agree, and then resort to mediation or conciliation, this will unduly prolong the process, and may prove infeasible within the time limits agreed upon for reaching an agreement, if any.

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[36] League of Nations, "Records of the Third Assembly – Text of Debates", 199.

[37] See (1981) 20 *ILM* 797; 62 *ILR* 108.

[38] Advisory Conciliation and Arbitration Service.

[39] In contrast, Report of the Secretary-General, Settlement of Commercial Disputes, Preparation of Uniform Provisions on: *Written Form of Arbitration Agreements, Interim Measures of Protection, and Conciliation*, September 22, 2000, U.N. Doc.A/CN/WG.II/WP.110 (2000), points out that in other jurisdictions it is the conciliator who takes on the more active, evaluative role, while the mediator is expected to play merely a facilitative role. The distinction does not seem to exist in the other countries of the European Union (s*ee generally* www.eurofound.eu.int.emire) As the term "conciliation" is rarely used in the United States and Canada, the distinction between mediation and conciliation is meaningless for those countries. S*ee* Christopher W. Moore, "The Mediation Process" 161 (2d ed. 1996), defining conciliation as "the psychological component of mediation, in which the third party attempts to create an atmosphere of trust and cooperation that promotes positive relationships and is conducive to negotiations").

On the other hand, if a mediator is appointed at an early stage and the mediation process represents a modification of the bilateral negotiating process which otherwise would have taken place, mediation may not prolong, and could actually speed up, the process.

In the literature, mediation is discussed in contrast to adjudication[40] or to dyadic processes[41] as negotiation. Compared to adjudication, mediation is the "softer", conciliatory and flexible mode. Arbitration and adjudication both differ from mediation in their formal assertion of control over the disputants and in their power to implement control. Mediation opens the possibility of disputant's acknowledging their shared liability and the mutuality of the process is presumed to enhance the durability of the agreement. If we compare mediation and dyadic modes the first emerging quality is the role of the third party. The mediator is seen as asserting his authority over the dispute in such a way as to facilitate or influence its outcome. A mediator cannot compel the parties to reach a settlement, and a conciliator has no power to impose a compromise solution on the parties. Mediation ad conciliation require the consent and co-operation of the disputing parties in order to function. Any proposal from a mediator or conciliator need the acceptance of those parties, since such proposals are not of themselves binding.

While contrast between mediation and adjudication generally stress the relative informality of the mediation process, comparison with dyadic modes stress the potential retention of control by mediator. It should be emphasized that the range of process included under the word "mediation" is quite wide. Literature on mediation shows such a big range of procedures, outcomes and contexts. "Mediation" by itself might mean an occasional mitigation of circumstances, a "softer" process, as in an out-of-court settlement, or it might mean an escalation of tension, a "harder" process, as when two disputants fail to reach an agreement on their own, a step toward litigation or a step back. If mediation represents a wide range of procedures and styles around the world, it is because societies themselves differ, both in their own cultural features and in the nature of their ties to external sources of authority.

The potentially conciliatory atmosphere of mediation should not obscure the fact that mediation is confrontative. The disputants did not or could not obviate their conflict by unilateral or bilateral appeals for forgiveness. If the parties can settle themselves, there is no

[40] J.L.Gibbs, "The Kpelle moot", *Law and warfare* (ed.) P. Bohannan, Garden City: Natural History Press (1967); P.H.Gulliver, ""Dispute and negotiation: a cross-cultural perspective", New York Academic Press (1979); L. Nader, "Styles of court procedure: To make the balance", *Law in culture and* society (ed.) L.Nader, Chicago, Aldine Press (1969); Witty, "Mediation and society", New York Academic Press, (1980).

[41] J.F.Collier, "Law and social change in Zinacantan", Standford University Press (1973); K.F. Koch, "War and Peace in Jalémò", Cambridge, Mass: Harvard University Press (1974); L.Nader and Todd (eds), "The disputing process – law in ten societies", New York; Columbia University Press (1978).

need for a mediator. If they are determined to go to the court, there is no room for mediation either. It is only when both parties are ready in principle to solve the common problem but do, usually after repeat efforts, not feel any longer capable of solving it themselves bilaterally, that mediation is a practical option.

While mediation, as a process of reaching agreement, is a growing issue in domestic laws, its potential remains to be unlocked in relation to international conflicts.

In a commercial setting, mediation has proved successful in a very large number of cases. Whether it would be comparably successful in resolving disputes arising under international treaties is more questionable.

When the dispute involves questions of treaty law, as opposed to simple commercial considerations, persuasion may be less effective. It may be useful for countries to consider use of mediation on a "ad hoc" basis.

The growth of international mediation, during the 1980s, the 1990s, may be attributable, at least in part, to an increased perception that international commercial arbitration had become too costly and long and often presented certain obstacles, particularly when the amount likely to be in dispute was small in relation to the c each party could expect to incur or when the parties to a dispute wished to continue having beneficial business relationships[42].

5.2. Mediation and conciliation in international law

5.2.1 Background

As already stressed, the main feature of the conciliation procedure is its flexibility and adaptability to the will of the parties. Consequently legislative rules could be considered not necessary, contractual rules, indeed, are sufficient to provide certainty to conciliation process.

By the late 1970s, the increase in the worldwide use of ADR in general, and mediation or conciliation, in particular, led to the desire to create uniform rules that govern the process of international commercial mediation. The parties were more and more encouraged to seek non-adjudicative dispute settlement methods, important for fostering economy and efficiency in international trade.

In many countries, the legal rules affecting conciliation took differing approaches on issues such as confidentiality and evidentiary privilege and exceptions thereto. Over the last twenty years, many states have adopted legislation to deal with some of the most pressing issues

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[42] Julie Barker, "International Mediation: A Better Alternative for the Resolution of Commercial Disputes: Guidelines for a U.S. Negotiator Involved in an International Commercial Mediation with Mexicans", 19 *LOY. L.A. INT'L & COMP. L.Rev*. 1 (1996), 7.

concerning mediation[43]. This legislation often began to look like a confusing quilt of laws that create different rules for all the different areas in which mediation or conciliation is supposed to take place. Uniformity on such topics helps to provide greater integrity and certainty in the conciliation process. The benefits of uniformity have been evident to the international community. Moreover, the conciliation process might benefit from the establishment of non-mandatory legislative provisions that would apply when the parties mutually desired to conciliate but had not agreed on a set of conciliation rules.

In order to address these matters many International Organisms decided to deal with the topic to support the increased use of conciliation. In particular, the United Nations Commission on International Trade Law (UNCITRAL) adopted the UNCITRAL Conciliation Rules by General Assembly Resolution 35/52 on December 4, 1980 In the US, after many years of preparation and a lot of discussion, the National Conference of Commissioners on Uniform State Laws (NCCUSL) finalized a draft Uniform Mediation Act, which it approved at its annual conference in August 2001 and recommended for enactment in all states of the United States. In Europe, the EU Commission published a “Green Paper on Alternative Dispute Resolution in Civil and Commercial Matters” (including employment and consumer law) in April 2002. Hearings were held in February 2003 to discuss the more than 160 responses the Commission had received so far to the questions raised in the Green Paper.

The following paragraph deals with a significant example of model law for uniform rules in respect of the conciliation process established to encourage the use of conciliation and ensure greater predictability and certainty in its use through well-defined procedural steps.

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[43] States of the United States that have adopted mediation statutes that are intended to have across-the-board application include: ARIZ. REV. STAT. ANN. § 12-2238 (West 1993); ARK. CODE ANN. § 16-7-206 (Michie 1993); CAL. EVID. CODE § 1115 *et seq.* (West 1997); IOWA CODE § 679C.2 (1998); KAN. STAT. ANN. § 60-452 (1964); LA. REV. STAT. ANN. § 9:4112 (West 1997); CODE ME. R. § 408 (1993); MASS. GEN. LAWS ch. 233, § 23C (1985); MINN. STAT. ANN. § 595.02 (West 1996); NEB. REV. STAT. § 25-2914 (1997); NEV. REV. STAT. § 48.109(3) (1993); N.J. REV. STAT. § 2A:23A-9 (1987); OHIO REV. CODE ANN. § 2317.023 (West 1996); OKLA. STAT. tit.12, § 1805 (1983); OR. REV. STAT. § 36.220 (1997); 42 PA. CONS. STAT. ANN. § 5949 (West 1996); R.I. GEN.LAWS § 9-19-44 (1992); S.D. CODIFIED LAWS § 19-13-32 (Michie 1998); TEX. CIV. PRAC. & REM. CODE ANN. § 154.053 (c) (1999); UTAH CODE ANN. § 30-3-38(4) (2000); VA. CODE ANN. § 8.01-576.10 (Michie 1994);WASH. REV. CODE § 5.60.070 (1993); WIS. STAT. § 904.085(4)(a) (1997); WYO. STAT. ANN. § 1-43-103 (Michie 1991). Furthermore, see *e.g.*, Costa Rica Ley No. 7727, *Resolución Alterna de Conflictos y Promoción de la Paz Social* (Law on Alternative Resolution of Disputes and Promotion of Freedom from Social Unrest); Hong Kong Arbitration Ordinance, Cap. 341, § 2A (1997); India Arbitration and Conciliation Act (1996); Singapore International Arbitration Act, arts. 16 and 17 (2002); *Livre Vert sur les Modes Alternatifs de Résolution des Conflits Relevant du Droit Civil et Commercial,Réaction de la Chambre de Commerce et d'Industrie de Paris*, 7, n. 4 (2002). Before 1998, the mediation rules of California were spread over seven different California codes. This represents only a very small sample of the existing legislation in the area of conciliation.

5.2.2 The UNCITRAL Model Law on International Commercial Conciliation

On 24 June 2002, UNCITRAL adopted its final draft of the Model Law on International Commercial Conciliation (hereinafter "MLICC," "Model Law" or "Law")[44]. On November 19, 2002, the General Assembly of the United Nations adopted a Resolution recommending that all countries give due consideration to the enactment of this Model Law "in view of the desirability of uniformity of the law of dispute settlement procedures and the specific needs of international commercial conciliation practice."

The Model was realized in view of the desirability of uniformity of the law of dispute settlement procedures. It is an answer to specific needs of international commercial conciliation practice to assist States in designing dispute resolution processes that are intended to reduce costs of dispute settlement, foster maintaining a cooperative atmosphere between trading parties, prevent further disputes and inject certainty into international trade.

These Rules, created to offer parties an internationally harmonized set of rules suited for international commercial disputes, were also used as a model by many institutions that were drafting their own rules for offering conciliation or mediation services. During the preparation of the Model Law, some 90 States, 12 intergovernmental organizations and 22 non-governmental international organizations participated in the discussion.

The Model Law contains a set of provisions, including definitions, procedures and guidelines, that could be enacted as a single statute or as a part of a law on dispute settlement. It stats, as usual, with the scope of the Model and that it defines "conciliation" in general terms and determines the range of matters covered in the following articles.

Where the parties have not adopted rules on procedural aspects of the conciliation, the Model designs "default" provisions on the process, useful also to assist parties where the agreed procedure suffers some lacks. The provisions in the Model are designed to leave the parties and conciliators free to carry out the conciliatory process as they consider appropriate, finding a balance between protecting the integrity of the conciliation process and providing maximum flexibility and party autonomy. In particular, the Model has been structured to avoid situations where information from conciliation proceedings spill over into arbitral or court proceedings.

The last provisions of the Model Law (articles 12-14) address post-conciliation issues to avoid uncertainty resulting from an absence of statutory provisions governing those issues[45].

Such provisions are considered an effective tool especially for States with limited familiarity with conciliation as a method of dispute settlement.

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[44] Eric van Ginkel, "The UNCITRAL Model Law on International Commercial Conciliation - A Critical Appraisal", *Journal of International Arbitration*, 21 (1), 2004.

[45] See *Guide to enact UNCITRAL Model Law on International Commercial Conciliation of the United Nations Commission on International Trade Law*

The Model is primarily directed to executive branches of Governments and legislators but it should also provide useful insight to other actors of the text, including commercial parties, practitioners, academics and judges. This is confirmed by the Guide annexed to the Model, an explanatory material that accompanies the text of the Model itself. Some issues are not settled in the Model but are addressed in the Guide, which is designed to provide an additional source of inspiration to States enacting the Model Law. It might also assist States in considering which provisions of the Model Law, if any, might have to be varied to accommodate particular national circumstances[46].

5.2.3 Mediation and conciliation in tax treaties

Supplementary dispute resolution mechanisms, other than arbitration, can be implemented in tax treaty interpretation activity, on an "ad hoc", basis as part of the mutual agreement procedure. Mediation, indeed, is a successful procedure to resolve domestic dispute and its extension to international field could be effective.

In tax matters some techniques have been seen as forms of non-binding "mediation" in which a third party, that generally does not have any independent decision making power, assists the CAs in reaching a decision before an issue would have to be submitted to arbitration.

The OECD Commentary to Article 25 OECD MC distinguishes among two supplementary possibilities at the disposal of the CAs to reach a decision together with the mutual agreement and the arbitration procedures, that will be analysed in the following chapters of the present study.

The first mechanism is the mediation, to solve disagreements about the *merits* of the two different positions. The mediator has the task to help the parties to better understand the two positions. For this purpose he has to listen to each CA and then present its final observation on the "strengths and weaknesses of each side"[47].

The other tool is provided for solving *purely factual* issue, especially during judicial procedures. An independent "Expert" intervenes to make factual determination which are then submitted to the court.

In addition, paragraph 4 of Article 25 of the OECD MC and paragraphs 4 and 59 of the Commentary on that Article foresee the possible formation of a "joint commission" appointed especially for a speedier and more streamlined oral exchange of opinions between CAs

[46] See *Guide to enact UNCITRAL Model Law on International Commercial Conciliation of the United Nations Commission on International Trade Law*, Part Two, para.2.

[47] See OECD Commentary to Article 25, paragraph 86, the 2008 updated version.

6. Binding third-party method : arbitration

Arbitration is a binding, non-judicial, and private means of settling disputes based on an explicit agreement by the parties involved in a transaction[48]. Such an agreement is typically embodied in the terms of a contract between the parties. Alternatively, if the contract is silent about the dispute-resolution method, the parties can select the method when the dispute arises. Arbitration entrusts the settlement of a question to one or more persons who derive their powers from the private agreement. Unlike judges in public courts, who must follow fixed rules of procedure and apply the laws of the land, arbitrators can dispense with legal formalities and may apply whatever procedural rules and substantive law best fit a case. Arbitrators should be neutral and independent from the parties who have appointed them. All modern international arbitration rules require the arbitrators – and not only the Chair – to be independent from the parties. In commercial and investment arbitration, the issues to be decided are quite often complex and technically or economically challenging; the experience shows that independent arbitrators are very capable of understanding these issues if the party representatives explain them in an adequate form. Independence connotes an absence of inappropriate personal or financial links with a party. However, independence does not mean that the arbitrators must be devoid of doctrinal predispositions. The parties could thus very well select arbitrators in (foreign) government positions or the publications of whom seem to be in line with the arguments that the party will bring in the arbitration proceedings. The concept of independence, as understood in modern arbitration, would, however, not allow current officials, employees or consultants of a party to the proceedings to act as arbitrators. It could be useful to impose in the arbitration agreement neutrality and independence on the arbitrators by specifically stating that they should be impartial and independent from the governments of the States or from the parties at the time of accepting the appointment and should remain so during the entire arbitration proceedings until the arbitration decision shall have been rendered or the procedure shall otherwise have been

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[48] Mahmoud Reza Firoozmand, "The use of qualitative research techniques in studying arbitration: a comment on a study of corporate attitudes towards international arbitration", 17 *The American Review of International Arbitration* (2006) 1, 149; Walter Mattli , "Private Justice in a Global Economy: From Litigation to Arbitration", *International Organization,* Vol. 55, No. 4, The Rational Design of International Institutions, (2001), 919; Gaillard and Savage, "Fouchard, Gaillard and Goldman on International Commercial Arbitration"(1999), No. 18; Simpson and Vox, "International Arbitration", (London: Stevens & Son; 1959), 250; Oellers and Frahm, "Judicial and Arbitral Decision: Validity and Nullity", in Bernhardt (ed), *Settlement of Disputes, Encyclopedia of Public International Law* 1, 118; Paul D. Friedland, "Arbitration Clause for International Contracts", *Juris Publishing Inc*, (New York) (2007).

terminated. Instead of an arbitration board, parties can agree to accept the jurisdiction of an international court to settle their disputes through predetermined procedural rules.

Experience in commercial international arbitration shows that the rules of arbitration procedure are best set by the arbitrators themselves, more specifically by the Chair. Under the agreed arbitration clause, it may well be possible that the parties, probably lacking experience with the problems encountered in international arbitrations, may establish rules not suitable for the conduct of an arbitration or not addressing possible procedural incidents.

Arbitration becomes "international" when the parties to a dispute reside or conduct their main business in different countries. The term "commercial" in international commercial arbitration is broadly conceived and covers activities such as sale of goods, distribution agreements, commercial representation of agency, leasing, consulting, transportation, construction work, joint ventures, and other forms of industrial or business cooperation[49].

Arbitration is an institution of international law developed during the latter part of the nineteenth century. The origins of the modern arbitration are usually dated from the Treaty of Amity, Commerce and Navigation[50] (1794) but the decisive step towards the typically modern form of arbitration was taken by the United States and Great Britain in the 1871 Washington Treaty[51]. For more than a century, arbitration has been praised as a real alternative to dispute resolution before domestic courts due to its procedural flexibility. It is this flexibility which offers numerous opportunities to tailor the arbitral procedure according to the needs of each particular dispute.

Recourse to international commercial arbitration is the now standard response of corporate actors when faced with a transnational dispute they can not solve on their own. Arbitration has over the last three decades become the main method for settling such disputes if negotiation does not work; few parties ever wish to litigate against their partner, now adversary, before its domestic courts. It is, in the broadest term, an attempt to bring the Rule of Law into international relations ant to replace the use of courts with the routine of agreed binding settlements.

An important distinction is that between "*ad hoc* arbitration", for the settlement of a particular dispute, and "institutional arbitration", for the settlement of a class of disputes. *Ad hoc* arbitration does not rely on the supervision or formal administration of an arbitration centre. Institutional arbitration, in contrast, is done under the "aegis" of an arbitral centre, usually

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[49] See United Nations Commission for International Trade Law (UNCITRAL) Model Law, Art. 1 (1).

[50] The so-called "Jay Treaty". See 1 *BFSP* 784. For the This treaty set up mixed tribunals consisting of equal number of members appointed by each of the two States, with an umpire in the event of disagreement, to consider claims by nationals of Great Britain and United States. For an historical account of arbitration after 1794, see J.L. Simpson and H. Fox, "International Arbitration", London (1959), Chapter I, 1-17.

[51] It established a collegiate tribunal o arbitrate the Alabama Claims (1872). The tribunal was heralded as a great success and its example was followed in subsequent disputes, such as the Behring Sea Fur Seal Case (1983) and the British Guiana-Venezuela Boundary dispute (1897). See G. Schwarzenberger, "International Law as applied by International Court and Tribunals", vol.IV, London (1986), Part I, 1-94.

according to the institution's own rules of arbitration. There are a great number of international arbitration institutions that provide an institutional context, practical support and procedural rules; the most established are the International Court of Arbitration (ICA) of the International Chamber of Commerce (ICC)[52], the London Court of International Arbitration (LCIA)[53], and the Arbitration Institute of the Stockholm Chamber of Commerce (SCC Institute)[54][55].

Another difference to be underlined is that among "optional" arbitration and "obligatory" procedure. The former only open the possibility for an arbitration procedure and make the submission of a specific case subject to the consent of both parties; the latter would provide for the unilateral referral of a case to an arbitration board without giving the other party the right to oppose this.

The relationship between arbitration and other ADR procedures is not free from doubt. While some consider arbitration a sub-species of ADR, others differentiate between dispute resolution before domestic courts, arbitration and ADR[56]. Arbitration is frequently characterized as an instrument of 'dispute settlement' rather than a way of 'dispute resolution'. These linguistic aspects are of more than a mere terminological nature. In fact, they reflect the role of arbitration in the context of ADR.

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[52] Founded in 1919, the ICC is a business organization offering a wide range of services to firms engaged in international trade and investment, including commercial dispute resolution. The ICC has established several commissions and special committees to address major issues relating to international commerce, such as intellectual property, competition law, taxation, transportation, telecommunications, the environment, and briber.
A major organization within the ICC is the ICA, established in 1923

[53] The LCIA, another long- established arbitration institution, was inaugurated in 1892 as the London Chamber of Arbitration on the initiative of the Corporation of the City of London and the London Chamber of Commerce and Industry. The LCIA is somewhat less involved in arbitration proceedings than the ICA. Its main function is to select arbitrators or to confirm party-nominated arbitrators. The LCIA fixes the arbitrators' fees and ensures that the arbitrators comply with the procedural time- table and respect all other rules of LCIA arbitration.

[54] Established in 1917, the SCC Institute's main role is to act as an authority to appoint arbitral tribunals.
The rules of the SCC Institute require that a tribunal deal with a case in an "impartial, practical, and speedy fashion," give all parties "sufficient opportunity to present [their cases]," and reach a decision "no later than one year after the case has been referred to the arbitral tribunal.". The development of the SCC Institute into a major center of international commercial arbitration dates from the 1970s when the United States and the Soviet Union agreed that trade contracts between the two countries should contain a clause providing for arbitration according to the rules of the SCC Institute.

[55] Another major institution is the American Arbitration Association. Its focus is primarily on domestic arbitration; for this reason, it is omitted from the discussion in this study. Yearly, it handles about forty thousand domestic and two hundred international arbitration cases. Many more arbitral institutions have been set up in the past decade, notably in Asia, the Middle East, and North America More specialized arbitration is offered, for example, by the Society of Maritime Arbitration (New York), the Grain and Feed Trade Association (London), and various stock and commodity exchanges.

[56] See Sanders, "Quo Vadis Arbitration?"(1999), 354; Redfern and Hunter,"Law and Practice of International Commercial Arbitration"(3rd edn., 1999), No. 1-51; Berger, "Understanding Transnational Commercial Arbitration", Central (ed.)(2000), 5; Gaillard and Savage, "Fouchard, Gaillard and Goldman on International Commercial Arbitration"(1999), No. 18.

Every arbitration requires the existence of a "dispute" between the parties[57]; a mere 'conflict' or 'difference of opinion' seems to be insufficient for an arbitration. A 'dispute' turns out to be a narrower sub-species of 'conflict'.

It is virtually impossible to draw an exact distinction between the two concepts, as they overlap. Cain and Kulcsar[58] raised the possibility that the very concept of "dispute" is inadequate:

> *The concept of dispute has typically been conducted inductively, by method of abstracted empiricism; more naively, disputes have on occasion been treated as self-existent, as phenomena which do not need to be constructed theoretically but which self-evidently are.*

Nevertheless, differentiation is important for an understanding of the arbitral process.

While arbitration is generally regarded as an effective method of resolving major disputes in international contracts it is costly and time-consuming. The parties to an arbitration have to pay the arbitrators, the tribunal's registrar and other officials and meet other expenses thus making it generally more expensive that other ADR techniques or judicial settlements. For this reason it is often thought of as a last resort to be employed when all else fails. Having an appropriate dispute resolution clause, providing for different "stages", involving separate procedures (e.g. negotiation, mediation, conciliation, etc.) for seeking to resolve conflicts, may often result in the settlement of the dispute by a specified and relatively cheap and cost-effective procedure without the necessity of resorting to arbitration.

Like national and international court, arbitration tribunals may issue awards requiring a certain performance, changing a legal right or status, as well as declaratory awards. While it is uncontested that the issues presented in arbitration can – and indeed should – be decided in most cases with a majority decision, it is not inconceivable that no result is accepted by a majority of the arbitrators. In this situation, the Chair should be empowered to take the decision alone (as in article 25 of the ICC Rules of Arbitration).The arbitration decision is communicate to the party within a fixed period of time, e.g. the Rules of Arbitration of the International Chamber of Commerce provide for a time limit of six months. Nevertheless, in the real world, the time limit can't be met so easily. Merely the scheduling of a meeting for different persons coming from different countries, even disregarding the wishes of the parties, may make it impossible to meet that requirement of time.

An indispensable element of arbitration is the expectation that arbitral awards are reasoned and final and will be honoured by the parties: they have to constitute the definitive settlement

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[57] For example, the wording of Article 7(1) of the UNCITRAL Model Law on International Commercial Arbitration is representative of many arbitration laws in using the term 'dispute' to characterize the relationship between two or more parties.

[58] M.Cain and K.Kulcsar, "Thinking disputes: an essay on the origins of the dispute industry", *Law Soc. Rev*, 16 (1981-2), 375.

of the dispute, otherwise arbitration would be a futile exercise. International arbitration is based on the principle that, as a rule, the decision of the arbitration tribunal definitely solves the dispute between the states[59]. Under Article 54 of the 1899 Hague Convention and Article 81 of the 1907 Hague Convention, the awards, duly pronounced and notified to the parties, settle the dispute definitely and without appeal, except if it is agreed by the parties themselves. When the losing party refuses to comply with the award, a new international law disputes arise that needs to be resolved by means of peaceful settlement again[60]: negotiation, arbitration, with the establishment of another arbitration board or referring such matters to an international court (e.g. ICJ). These bodies, however, have only the power to annul the award for serous procedural errors or want of jurisdiction or to maintain that the losing party has to comply with the obligation arising from the award[61]

[59] See United Nation, "Handbook on the Peaceful Settlement of Disputes between States" (1992), para 168;
[60] Giorgio Sacerdoti, "Appeal and Judicial Review i International Arbitration and Adjudication: the Case of the WTO Appellate Review", in Petersmann (ed), *International Trade Law and the GATT/WTO Dispute Settlement System* (1997), 248.
[61] Simpson and Vox, "International Arbitration", (London: Stevens & Son; 1959), 250; Reisnam, "Nullity and Revision", Yale Univ. Press (1971), 265; Oellers and Frahm, "Judicial and Arbitral Decision: Validity and Nullity", in Bernhardt (ed), *Settlement of Disputes, Encyclopedia of Public International Law* 1, 118.

III. International Tax Disputes

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1. Introduction

The quick increase in number and complexity of tax laws all over the world, of international trade and investments and related phenomena under the general heading of Globalization have multiplied complexity and uncertainty in the business and private environment, situations in which international tax disputes can arise, both between taxpayers and governments but also, and in some ways, more importantly, between governments themselves.

The effort that individuals and businesses make in optimising their tax position trigger a corresponding answer from the legislators to protect their national budgets, and from courts that resort to anti-avoidance judgments, which leads to more sophisticated tax planning and less certainty.

The struggle for revenue among the tax authorities of various countries is inevitably becoming more fierce. Individuals are caught between the opposing tax authorities and are faced with the threat of double taxation.

The existence of a comprehensive tax treaty between two states does not eliminate the possibility of double taxation. Tax authorities my encounter difficulties and obstacles in simply trying to ensure the application of the tax treaty, as well as in those cases where for their own good reason the states may disagree on the interpretation of the treaty provision, e.g. concerning certain operative terms such as royalties or dividends. If disputes arise as to the treaty's meaning or its application in particular circumstances which cannot readily be resolved, the objective of the treaty itself may be frustrated. These disputes may involve

differing income characterization rules, transfer pricing issues, disagreement about the existence of a permanent establishment, or more generally, diverging views on the appropriate exercise of potential taxing rights by the source country jurisdiction and the corresponding obligation of the residence country to provide double tax relief.

Disputes regarding the interpretation or application of tax treaties may arise in a domestic context between the taxpayer and the competent tax authority or in an international context between two states. Therefore we can identify two kinds of tax disputes depending on the taxpayer involvement: indirect disputes and direct disputes.

More in detail, an "indirect international tax treaty dispute" [62] is defined as a dispute that originates in a municipal context and is subsequently transformed to an international dispute initiating a mutual agreement procedure and eventually settled through legal means, as arbitration or juridical settlement.

Conversely a "direct international tax treaty dispute" is from the outset a dispute between the two contracting states and no specific taxpayers are directly involved. Such disputes should be resolved through diplomatic means, such as negotiation or conciliation Normally, international tax treaty disputes originate from disputes between taxpayer and the competent tax authority, consequently these conflicts should not be defined only as disputes between states but disputes that involves taxpayers that are directly interested in the resolution of the tax treaty disputes[63].

This is a very ticklish area for many states: raising issues of national sovereignty if there should be seen to be winners and losers.

The tax treaties regularly include a mechanism for the resolution of such cases, referred to as the mutual agreement procedure, which implies that the tax authorities of the two states shall attempt to reach agreement on such mutually consistent tax measures as would eliminate the double taxation.

The present chapter discusses the most critical international tax issues which usually constitute the source of cross-border tax disputes. These are the double (non) taxation, conflicts in interpretation and application of tax treaties and transfer pricing rules, they are all strictly interrelated (e.g. conflicts in interpretation of transfer pricing rules lead to double (non taxation) and a consequent tax treaty override) but they are also notable topics deserving autonomous analysis in an international tax disputes analysis.

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[62] Nii Lante Wallace-Bruce, "The Settlement of International Disputes", Martinus Nijhoff Publishers, The Hague (1998), 13. This could be the case when a taxpayer is of the opinion that it has not be treated in accordance with the treaty provisions in one or both of the contracting states. The taxpayer firstly files a complaint with its state of residence and then, if the complaint has not been resolved, requests such a state to move the dispute to the international field.

[63] See Gerrit Groen, " Arbitration in bilateral Tax Treaties", 30 *Intertax* 1 (2002), 3

2. Double taxation and double non-taxation

2.1 Double taxation

International tax disputes may arise when two or more countries claim tax jurisdiction over the same taxpayers, tax base or transactions. Such overlap results from inconsistent national definitions governing the source of income or from ambiguity regarding the residence of the taxpayer. Consequently, the taxpayer becomes the victim of economic double taxation. Although international tax disputes involving double taxation pose a number of problems, the most critical and substantial sources of dispute are transfer pricing and other allocation questions (e.g. partnership tax treatment)

International double taxation normally results in a global tax burden which is higher that the one that would have applied to such income if it had not been generated in a cross border situation. Consequently it distorts tax conditions of trade competition and restricts cross border investment.

Double taxation is no more a problem confronting only big multinational groups, today smaller businesses and even private persons moving abroad also experience double taxation. This development has led several international institutions and tax experts to address the question of how double taxation issues between different states can be resolved.

Double taxation means the inclusion of the same income in the tax base by more than one tax administration, when either the income is in the hands of different taxpayers (economic double taxation, e.g. associated enterprises) or the income is in the hands of the same juridical entity (juridical double taxation, e.g. permanent establishments).

Its harmful effects on the development of international trade and investment flows are so well known that it is scarcely necessary to stress the importance of eliminating, whenever possible, the obstacles that double taxation presents to the development of economic relations between countries[64].

The need to eliminate double taxation of profit transfer is expressly recognised by international organisations, having as their aim the development of harmonious economic relations among their member states. This idea lead to the 1963 Recommendation of the OECD Council, calling upon the governments of its member states to conclude treaties for the avoidance of double taxation on the basis of the OECD MC.

The main purpose of the OECD MC is to settling on a uniform basis the most common problems that arise in the field of international (juridical) double taxation. The OECD MS

[64] See "Introduction" to the OECD MC (1995) and OECD Guidelines on Transfer Pricing, par.4.2

have developed a Tax Treaty Model to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in any activities in other countries through the application by all countries of common solutions to identical cases of double taxation[65].

DTCs are international agreements imposing obligation upon the treaty partner states, aimed mainly at allocating of taxation rights with a view to avoid double taxation in cross border transactions. They are applauded as being beneficial to both the taxpayer and the governments involved because the treaties establish clear ground rules that govern income tax matters regarding foreign trade and investment. It is up to the contracting states to choose how tax treaties become part of their domestic tax law, either by an Act of Parliament or automatically giving them direct effect in the internal law sphere.

DTCs prevent double taxation only within their scope and the object of application[66], they do not eliminate all double taxation cases between the two contracting states.

It should be also noted that, as professor Lang asserts, the assumption according to which the general tax treaty purpose is the prevention of double taxation is primarily of didactic value, inappropriate for the solution of specific interpretation issues[67].

2.2 Double non-taxation

Double non-taxation cases are themselves common and are often the goal of sophisticated tax planning, even though without "improper" use of a treaty[68]. Avoidance of double non-taxation may also be seen as a way to promote fair competition and reduce distortion of the market and thereby to promote the exchange of goods and services and the free movement of capital and persons.

Partial or full double non-taxation arises when the contracting states does not tax a particular item of income due to different reasons. A categorization of reasons for double non-taxation has been put forward by legal doctrine as follows:

- double exemption under domestic tax law
- double exemption, or limitation of taxing rights, under tax treaty
- double exemption according to the combination of both domestic and treaty provisions
- double exemption caused by different tax treaty interpretations

[65] See "Introduction" to the OECD MC (1995)

[66] This includes the personal scope of application that is defined in articles 1 and 4(1) of the DTCs modelled after the OECD MC, with respect to the taxes covered, listed in article 2

[67] Michal Lang, "General Report", 89a *Cahiers de Droit Fiscal International* (2004) IFA, 81.

[68] Professor Stef van Weeghel, has defined "improper" the tax treaty's use that "have the sole intention to avoid tax of either or both the contracting states and must defeat fundamental and enduring expectation and policy objectives shared by both states and therewith the purpose of the treaty in a broad sense.". See Stef van Weeghel, "*Improper Use of Tax Treaties (with particular reference to the Netherlands and the United States)*), (Kluwer Law International, The Hague, 1998), 258.

In the first two cases the double non-taxation in the results of the two countries' will and it does not need any countermeasure. As a rule, the contracting states divide the rights to tax among themselves without obliging each other to actually exercise these, this being a matter of the sovereignty of the Contracting States.

Moreover, double non-taxation may arise in situation where the state that has taxing rights under a DTC does not tax an income; tax treaties do not impose obligations on the Contracting States to exercise their taxing rights. Where a double exemption arises due to inconsistency between the double tax treaty and the domestic tax law the result could not meet with the wish of the exempting country.

The double non-taxation as a result of a misunderstanding between the two contracting states is the most problematic case and a major source of international tax treaty disputes. Double non-taxation may occur, for example, when both contracting states consider themselves not entitled to tax the income under the DTC provision, because of the application of different distribute rules.

In the last years, there has been an increasing focus in the international tax debate on whether or not avoidance of double non-taxation is a purpose of the OECD MC or of its Article. Paragraph 52 of the Partnership Report states that one of the basic purposes of the OECD MC is to prevent double non-taxation. Therefore, avoidance of double non-taxation has rarely been recognized as a purpose of the OECD MC, but only as an undesired effect of the application of the treaty.[69]

As a matter of practice, if contracting states want to exclude cases of undesirable double non-taxation in their bilateral relations, they may mutually oblige themselves through international law to tax a certain situation in any event in one of the two states. Some states are familiar with provisions which they try to integrate in all DTCs they conclude in order to prevent double non-taxation[70]. Other states do no have a uniform treaty policy, even if the DTCs they have concluded regularly contain provisions that aim at preventing double non-taxation in certain areas[71]. Finally some states have a need for special provisions only in connection with certain states[72].

The mutual agreement procedure can be considered as a measure to avoid cases of double non-taxation. Although the wording of Art. 25(3) OECD MC does not refer explicitly to the fact that the contracting states may make use of the mutual agreement procedure to deal with

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[69] Michael Lang (ed.), Avoidance of Double Non-Taxation (Linde Verlag, Vienna, 2003), 5.

[70] These include, for instance, "limitation on benefits" provisions mostly adopted by the USA to link the application of withholding tax reductions to the taxation in the state of residence; or the "switch-over" clauses , included in German treaties, that provide for a shift from the exemption to the credit method in case of income subject to low or no taxation at all.

[71] See for example Luxembourg DTC network that includes several "subject-to-tax" clauses.

[72] E.g. South Africa. For a complete analysis see International Fiscal Association, "Cahiers de droit fiscal international", vol. 89a (Sdu Fiscale & FinancieÈ le Uitgevers, Amersfoort, 2004)

cases of double non-taxation, para. 2 of the OECD Commentaries to Art. 7 recognizes that tax authorities should agree "on mutually consistent methods" of dealing with problems of double non-taxation, using, where appropriate, the mutual agreement procedure provided for in Art. 25, instead of adopting unilateral interpretations.
The following chapter deals with the different "conflicts" between competent authorities that may lead to situation of double (non) taxation and consequently to international tax disputes. They have been named variously by the legal doctrine, we try to identify the main characteristic and the cause of the disagreement between the tax authorities as a first step towards the dispute resolution.

3*. Conflicts in the application and interpretation of tax treaties*

3.1 Overview

Tax treaties are designed to deal with such double taxation by distributing the taxing rights in respect of the various categories of income between these two countries. Despite the existence of a tax convention, double taxation may, however, arise where contracting states come to different results regarding the *allocation* of taxing rights because of different tax treaty application, such as from other circumstances: the *characterization* of payments (for example, interest versus dividends), the *classification* of entities (for example, as transparent or not transparent) or different *interpretations* of bilateral tax treaties; each situation that emerges from different interpretation of treaty provision can be considered a *"conflict of qualification*", a widely used expression, especially with the OECD's Report on Partnership[73], which, however, has no legal definition.
The present paragraph is intended to provide a general overview of the two most controversial issues in tax treaty practice concerning different interpretations and applications by the contracting states of the double convention's provisions, thus creating double (non) taxation and consequent possible international tax disputes: conflicts of income's characterization and conflict of income's attrbution. It is out the purpose of this discussion what it might be an appropriate solution to these "conflicts" in conformity with the purpose and object of tax treaties.

[73] OECD, *The Application of the OECD Model Tax Convention to Partnerships* (Paris, 1999).

3.2 Conflict of characterization of income

In an international tax conflict there is either a problem of the relevant facts (often in a transfer pricing dispute) or of a treaty interpretation by the Contracting States because when applying the provisions of tax treaty, taxpayers, tax authorities and courts may have different facts in mind or they can interpret the double convention differently. The day-to day application of international tax treaties involves some degree of interpretation and engage various bodies and organs.

One of the most controversial issues in tax treaty practice is the determination of certain undefined treaty terms' meaning: different interpretation of the same term by the two contracting states might lead the income being characterized differently for tax purpose.

When the two contracting states characterize income differently and, therefore, apply different articles of the tax treaty to the same income conflicts may arise.

As a matter of practice, there are many situations non covered by tax treaties. The attribution of a payment to a certain class of income is particularly difficult where the treaty does not expressly define that term. In such cases the Contracting States often apply their own domestic law and the payment could be subject to different treaty provisions. The long debate on how to interpret a tax treaty's categories of income when they are not defined by the treaty and when the contracting states use them in different ways had been settled by the OECD Partnership Report and, subsequently, by the amendment to the OECD Commentaries of March 2000[74].

According to the 2000 version of the OECD Commentary[75], the residence State should accept the source State's categorization of the income and give relief accordingly for the source state's tax, although the State of residence would have classified the income in another class. The residence state, when applying Article 23 OECD MC, does not have to categorize the income, this is a duty of the state of source.

This "new" OECD approach to conflict of qualification solves most of conflict of qualification but does not removes all of them[76].

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[74] John Avery Jones, "The 'One True Meaning' of a Tax Treaty", *Bulletin for International Bureau of Fiscal Documentation* (2001), 220 and Klaus Vogel, "Conflict of Qualification: The Discussion is not Finished", *Bulletin* (2003), 41.

[75] OECD Commentary to Article 23, para 32.1 et seq. It suggests a new interpretation on Article 23 on order to avoid double taxation and double non-taxation in such cases of qualification conflicts.

[76] For an in-depth study see John Avery Jones, "Conflict of Qualification: Comment on Prof. Vogel's and Alexander Rust's Articles", *Bulletin* (2003), 184.

3.3 Conflict about the identity of the person receiving income (conflicts of attribution)

The cases of divergent understandings of tax treaties may deal with *the person* who is deriving the relevant income. It is the legislature that decide who will be considered as a taxable person and this decision may be different from state to state. As a consequence, the contracting states attribute an income to different individuals or companies thus creating qualification conflicts.

The attribution of income to the correct person(s) is fundamental not only for the application of tax treaties but also for the identification of the applicable treaty(ies).

The core of the issue is the person who is to be considered the taxpayer with regard to a given item of income. If the states disagree on the identity of the taxpayer, double taxation (or double non-taxation) may occur. This is for example the case in which the source state levies tax on a given person as the person who earns the income, whereas the residence country considers another person as the taxpayer and refuses to grant to the latter person double taxation relief since that person has not been subjected to taxation in the source country.

Many of the distributive treaty provisions refer to the taxpayer as the person the pertinent type of income is "derived by"[77], "paid to"[78] or received[79] ; articles 7 and 21 use only the preposition "of". The OECD MC and the Commentary do not provide any further guidance on how to determine which person can be considered as the taxpayer. Tax treaties are based on domestic attribution decisions, they do not take any independent attribution decision but, as a consequence of the identification of the taxpayer by domestic law, tax treaty allows these persons to enjoy the benefits it provides. In other words, those to whom income is attributed pursuant to domestic law are also to enjoy the benefits of the treaty.

This means that, if in accordance with the domestic law of the contracting states, different persons are deriving the same relevant income, it is not the tax treaty that will solve the conflict[80]. As a result, where controversial decisions are taken, double (non) taxation may occur and an international tax dispute arises. With the help of amicable dispute settlement procedures (e.g. MAP), it should be possible at least to avoid double (non) taxation in great majority of qualification conflicts.

[77] See OECD MC, Articles 6, 13, 14,15, 16 and 17.
[78] See OECD MC, Articles 10, 11, 12, 18 and 19
[79] See OECD MC, Article 20.
[80] See Michael Lang, "CFC Regulations and Double Taxation Treaties", 57 *Bulletin* 2 (2003), 51.

4. Transfer-Pricing Disputes

4.1 The arm's length price

Transfer pricing problems involve disputes between two sovereign nations who both claim the jurisdictional right to tax the same income.

Transfer pricing issues arise when a tax authority of Country A determines that corporation X, within A's taxing jurisdiction, has been shifting X's profits to X's "associate enterprise," corporation Y, which is located in another tax jurisdiction. If A determines that X and Y have been making transactions not at "arm's length," or at an unfair advantage, A will then subject X to a price adjustment based on "arm's length principles" thereby increasing X's taxable income. However, X's associate enterprise, Y, in Country B, will still be subject to B's existing level of tax under B's tax laws. Unless B accepts A's upward price adjustment on X and implements a corresponding downward adjustment of Y's income, the income of X and Y will be, in the aggregate, subject to double taxation.

A relevant difference with respect to the recent past is that `transfer pricing' issue, once a problem circumscribed to major multinational companies, now involves important new economic realities found in the emergent countries (e.g. China, India) as well as, also significantly, medium- and small-sized economic groups. The proliferation of direct foreign investment and consequently, of intercompany transaction flows, between parties resident in different countries, but connected by an interdependency of such kind as to constitute a group, lead transfer pricing issue to grow rapidly. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits, even if the use, and sometimes the abuse, of transfer pricing policies in the tax strategies of MNEs doesn't have to be underestimated. Factors other than tax considerations may distort the conditions of commercial and financial relations established between associated enterprises (e.g. conflicting pressures relating to customs valuations, anti-dumping duties, cash flow requirements within a multinational group). In the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration an appropriate adjustment is achieved by establishing the conditions of the commercial and financial relations that OECD countries would expect to find between independent enterprises in similar transactions under similar circumstances[81]. The arm's length principle follows the approach of treating the

[81]In March 1979, the OECD tax affairs committee published a report on `*Transfer Price and Multinational Enterprises*' that provided a definition of free-market prices as `the consideration that would be agreed upon between independent enterprises for similar or identical operations on the open market'. The document also indicated the methods for calculating the consideration. The OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (2001) are intended to be a revision of this previous report.

member of a multinational group as operating as separate entities rather than as inseparable parts of a single business.

The 1979 OECD Report define the “arm’s length price” as “the price which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market” (OECD Report, para. 2).

As regards the methods used to identify the “arm’s length” price, multinational groups retain the freedom to apply any criteria that satisfy the arm’s length principle; a generalized preference has been maintained worldwide for so-called traditional transaction methods (namely: the `Comparable Uncontrolled Price Method', the `Resale Price Method' and the `Cost Plus Method'). The acceptance of the `alternative methods'[82] is more varied.

Because transfer pricing is not an exact science, it will not always be possible to determine a single correct arm's length price, it may have to be estimated within a range of acceptable figures. No one method is suitable in every possible situation and the applicability of any particular method need not be disproved. However the aspect of greatest relevance refers to the ways in which the methods themselves are applied[83]. The “nominal” application of the same method by two different subjects (tax authorities and/or taxpayers) can reach quite different results. These differences become one of the main critical issue for taxpayers and tax administration, both interests in avoiding disputes risks.

To support the arm's length nature of intra-group transactions, both the taxpayer and the tax administration have different possibilities for obtaining evidence. These range from the “internal comparables”, readily available within the company or group to “external comparables” that can be found from a variety of sources, including searches of databases[84]. Tax administrations should evaluate domestic or non-domestic comparables with respect to the specific facts and circumstances of the case.[85]

The existence of different sets of national transfer pricing rules laying down that transactions between taxpayers under common shareholder control should be taxed as if they had taken place between independent taxpayers represents a large administrative burden on taxpayers and a source of potential tax disputes. International tax disputes arise in a context

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[82] These are mainly the so-called `income' methods identified by OECD (`profit split method' and `transactional net margin method') as alternatives to the principal methods. However in some countries, alternative methods are used, as mentioned but not suggested in OECD documents (e.g. the `Economic Sector Gross Margin Method') as well as internally formulated methods. It is appropriate in this context to mention OECD's preference for the application of method is referring to the application of a normal value to single operations (`transactions-based method') with respect to those centred on the division of profits between verified subjects, the so-called `profit-based method' in vogue in the US.

[83] For a comparative analysis of the approach taken by the single countries, see the recent work by Deloitte, `Strategy Matrix for Global Transfer Pricing' (2007).

[84] Germany and Austria, for example, use a pan-European database. United States provide a number of databases which can be used for transfer pricing purposes and which are generally accepted by local tax authorities. In Spain, the Iberian database SABI provides data on some 940,000 Spanish companies. The Chinese financial authorities have collected a significant series of data in databanks that cannot be consulted by external subjects.

[85] COM(2005) 543 final, COMMISSION OF THE EUROPEAN COMMUNITIES, Brussels, 7.11.2005.

of double relationship involved in transfer pricing cases: the first dispute is between the taxpayer and his competent tax authority; the second one is between the tax authorities of the two states involved in the case. National procedures offer little (or no) guarantee to result in a symmetrical determination of the arm's length price as the common basis of primary and correspondence adjustments. As the tax dispute does not get adequately resolved in domestic environment, an international procedure involving both countries is needed to resolved the unrelieved international double taxation.

4.2 Advance pricing agreements (APAs)

4.2.1 Overview

In the light of limited resources available, tax administrations need to maximize administrative efficiency and enterprises, on the other hand, are confronted with varying and often extensive documentation requirements and are also more and more exposed to penalties for non-compliance with such documentation requirements or the arm's length principle. The common objective is to enables both tax administrations and business to allocate and use their scarce resources as efficiently and effectively as possible.

Many jurisdictions have had, for some time, procedures (e.g. rulings) enabling the taxpayer to obtain some degree of certainty regarding how the law will be applied in a given set of circumstance. APAs are intended to supplement traditional administrative, judicial and treaty mechanisms for resolving transfer pricing disputes. By agreeing a method of calculating transfer prices, a tax administration provides an enterprise with a ruling that protects the enterprise with regard to subsequent tax audits.

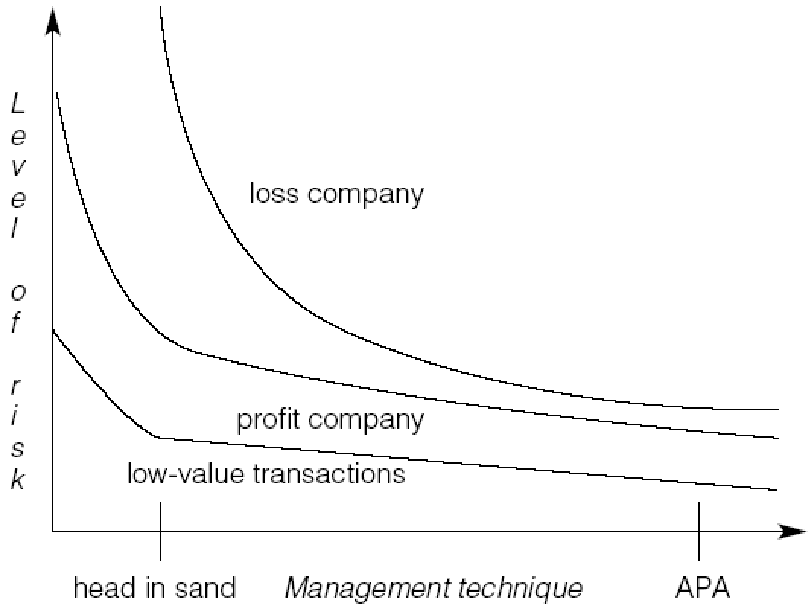
An advance pricing agreement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. methods, comparables and critical assumption as to future events) for determining the transfer price(s) for those transactions over a fixed period of time[86]. The critical point is that an APA does not set the price; rather, an APA is an agreement on the methodology for determining transfer prices within an acceptable range.

An APA programme can assist taxpayers by eliminating uncertainty through enhancing the predictability of their tax liability with respect to international transaction for a specific period of time. The programme could substantially reduce the tax authorities' administrative burden by preventing costly and often time-consuming examinations and the disputes of major transfer pricing issues. In addition an APA program can be a useful risk-management tool for

[86] For further reference on APAs see, "Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure" at www.oecd.org/taxation

taxpayers and can give reasonable certainty that the taxpayer will not be subject to a transfer pricing investigation. An APA is depicted as a management technique to reduce risk, where the reduction in risk is most significant for the high-value transactions of loss-making and profit-making companies, compared to the other extreme of the "head in the sand" approach. The value in obtaining an APA is much less for low-value transactions.

Figure 1: Transfer pricing risk: how a taxpayer may utilize an APA as a key risk-management tool[87]



APAs are an exemplary method of dispute avoidance because they often prevent the need for a dispute between tax administrations over the transactions included in the APA.

Taxpayer and tax authorities work together cooperatively in order to reach a mutually acceptable transfer pricing method and result. Taxpayers voluntary disclose extensive and sensitive information about their operation and methods to educate the tax authority about their businesses; they prepare and disclose analyses of themselves, their markets and their competition that heretofore are rarely, if ever, made available to tax authority.

APAs usually start with the taxpayers' decision to request an APA. As a general rule, taxpayer may request a bilateral, multilateral, or, if appropriate, a unilateral APA. A bilateral or multilateral APA involves a request for an APA between the taxpayer and the tax authority,

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[87] Figure 1 is based on an exhibit in PricewaterhouseCoopers and Inland Revenue, "Advanced Pricing Agreements", 79 *Chartered Accountants Journal* 57 (No. 2, 2000), at 58.

accompanied by a request for a mutual agreement procedure of the relevant income tax treaty (or treaties) between competent authorities. Bi and multilateral APAs are considered as the most efficient tool to prevent double taxation and consequently costly tax disputes[88], creating an "assurance in advance" for taxpayer that a consistent approach will be taken by the governments involved in a cross-border transaction. They can currently be obtained under the mutual agreement article contained in the relevant bilateral tax treaty or multilateral tax treaty. This means that bilateral and multilateral APAs are available only between treaty partners as the MAP under tax treaties needs to be invoked.

A Unilateral APA, on the contrary, involves only an agreement between the taxpayer and the tax authority but it is considered to be more practical in terms of taxpayer and government resources; bilateral APAs take two for four times as long to complete as unilateral APAs[89]Unilateral APAs can frequently be negotiated under the advance or binding ruling regime that exists in a particular country, although such a ruling is unlikely to have any impact beyond the borders of the country in which the ruling was obtained. A major difference between this form of advance agreement and bilateral/multilateral APAs is that it can be concluded without informing or involving other interested jurisdictions.

APAs are available in 21 countries[90]; in addition, the binding query and the binding advance ruling for general tax purposes may be used for transfer pricing in Argentina and Finland respectively. Norway's situation is somewhat mixed.

The following paragraphs will provide a closer look at the European and US APAs provisions by the developing best practices.

4.2.2 APAs Recent Developments in the European Union

Since the late 1990s, some European countries have come to appreciate the solution offered by APAs for avoiding transfer pricing disputes, strengthened their legislation and developed relevant controls. The first prototype provisions were introduced in Belgium in 1993, but fully developed only eight years later, in 2002[91]. APAs programmes were established in the United Kingdom[92] and France[93] in 1999 and in the Netherlands[94] in 2001. Italy adopted

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[88]COM(2007) 71 final, Commission of the European Communities ,Brussels, 26.2.2007, 2.5.17.

[89] *Section of Taxation's Committee on Transfer Pricing, Comments Regarding the Advance Pricing Agreement Program*, Washington, February 17, 2005.

[90] Australia, Austria, Belgium, Canada, China, Colombia, the Czech Republic, Denmark, France, Germany, Israel, Italy, Korea, Mexico, the Netherlands, New Zealand, Peru, Spain, Switzerland, the United kingdom and the United States.

[91] The concept of unilateral "upfront decision", which include APAs in the sense of the OECD's interpretation, has existed since 1993. Both the procedural rules and the practice were revisited in 1999 (s. 345 ITC, Royale Decree of 3 Mat 1999) and in 2002 (Act of 24 December 2002).

[92] See Secs. 85-87 of the Finance Act 1999 (FA 1999).

legislation providing for "international rulings" in 2004[95]. Germany issued draft guidance on APAs in 2000 with the finalized guidance published on 5 October 2006[96].

Tax administrations organise APA programmes in different ways from each other and this leads to many practical problems on timing of requests, provision of information, difference in treatment between administrations etc.

Some diversity in APA practice is to be expected, but through increasing globalization, pressure will come to bear on countries to harmonize their practices and to more closely align their APA programs.

Despite these rather uncoordinated national initiatives, in order to find pragmatic solutions to this problem, on June 2002, the Commission of European Community established the EU Joint Transfer Pricing Forum (JTPF). It consists of one expert from the tax administrations of each Member State and ten experts from business, working on the basis of consensus, and produces pragmatic, non-legislative solutions within the framework of the OECD Transfer Pricing Guidelines to the practical problems posed by transfer pricing practices in the EU. The main achievements of the JTPF in its first term of activity were its conclusions and recommendations on issues related to the Arbitration Convention and on certain related issues concerning mutual agreement procedures under double tax treaties between Member States[97].

Examination of transfer pricing documentation for associated enterprises in the EU was the main activity of the JTPF from January 2004. The first significant result from the works performed by the JTPF in this field was the Code of Conduct adopted by the Council on 27 June 2006, on transfer pricing documentation for associated enterprises in the European Union[98]. Recently, on 26 February 2007, the European Commission announced that it had adopted new EU-wide guidelines on advance pricing agreements (APAs)[99] aimed at avoiding transfer pricing disputes and increasing legal certainty for companies. These guidelines have

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[93] See Statement of Practice 4 A-8-99 of 7 September 1999. The APA procedure was initiated on an experimental basis in 1997 when
the procedure introduced in the same year regarding headquarters companies (Statement of Practice 13 G-1-97 of 21 January 1997) created a precedent for intra-group invoicing, under which an enterprise could request an advance arrangement with the FTA on a unilateral basis.

[94] See APA Decree No. IFZ2001/292M, now replaced by the Decree of the Underminister of Finance f 11 August 2004, no. IFZ 2004/124M,

[95] Art. 8 of Legislative Decree 269 of 30 September 2003, converted into Law 326 of 24 November 2003.

[96] 5 October 2006, IV B 4 – S 1341 - 38/06, at 27

[97] The JTPF's conclusions and recommendations were taken as the basis for a Commission communication4 on the activities of the JTPF from October 2002 to December 2003, including a proposal for a Code of Conduct for the effective implementation of the Arbitration Convention and certain related issues of the mutual agreement procedure under double tax treaties between Member States, which was published on 23 April 2004. The proposed Code of Conduct was adopted by the Council on 7 December 2004.

[98] Company frequently complain about the onerous and divergent documentation obligation with which they have to comply in such cases in the different member States involved. This Code standardises the documentation that multinationals must provide to tax authorities on their pricing of cross-border intra-group transactions.

[99] European Union COM (2007) 71 final, Brussels, 26.2.2007

been endorsed by the EU Council of Ministers of Economy and Finance (ECOFIN) on 5 June 2007.

The new APA guidelines explain how EU member states should conduct the APA process, provide a very detailed description of how each step of such process should be conducted so that it is performed as efficiently as possible and describe how some specific problems could be resolved. The guidelines also provide some practical information[100] which can allow a taxpayer to better approach and prepare for the APA process. Their aim is to render the APA processes more efficient and expedient and, as a consequence, to encourage the use of APAs in the European Union. Compliance with the guidelines should allow amelioration of the main issue raised by the APA procedure; this all sounds good, but do companies really stand to gain from concluding APAs with tax administrations?

In order to shed more light on this question, it is worthwhile looking at the experience of companies with transfer pricing documentation. EU-based companies can opt for providing one central blueprint of the company/group's activities for the whole EU area (the so-called 'Masterfile[101]') to the relevant tax administrations. The degree of disclosure and how to deal with requests from tax administrations then becomes a key issue for these companies. The latter should of course not be penalised for being more transparent and their increased info-sharing, especially as documentation-related penalty protection, is one of the key drivers for complying with the Masterfile system in the first place. Nevertheless, some member states seem to consider the Masterfile a convenient way to obtain extra information from companies for an audit. Companies should for instance be aware that, as part of the Masterfile, a list of (all relevant) Cost Contribution Agreements existing within the group, as well as (the relevant) APAs and Rulings covering transfer pricing aspects as far as group members in the EU are affected, must be disclosed. Tax practitioners at EU-based companies generally feel that local tax administrators are very often simply unaware of the APA methodology prescribed by the OECD and there appears to be a clear lack of APA specialists in a number of Member States. The message of business practitioners is that the training of local field inspectors should be a key priority for tax administrations in Europe. Only then can the inherent advantages of APAs become more apparent.

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[100] For example: a tentative list of information to provide with the APA submission and a tentative list of standard topics addressed in the final agreement.

[101] See Council of the European Union, Resolution on a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD), Annex Section I, Brussels 20 June 2006 To prevent groups having to take a country-by-country documentation approach with all its inherent downsides, on 27 June 2006, the European Council approved the Transfer Pricing Documentation Code of Conduct as proposed by the European Commission. The Code of Conduct encourages member states to implement the EU Transfer Pricing Documentation (EU TPD) approach, allowing taxpayers to avoid transfer pricing penalties if they maintain:

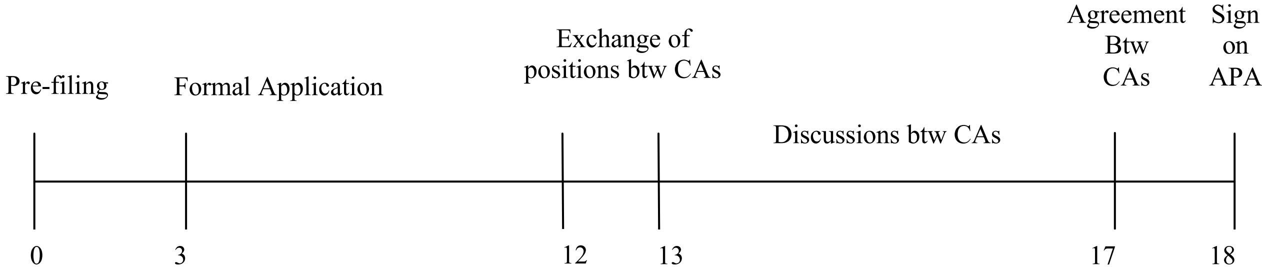
• a ‘masterfile’ of standardised information; and

• ‘country-specific’ versions of standardised documentation for each member state in which the taxpayer has related party transactions, including documents relevant for that country only.

One of the main obstacles to the provision of an APA is the length of time necessary to complete the APA negotiation. The average length of time to conclude an APA was between two and three years. This was seen, by the business actors as unnecessarily long[102].

The Guidelines want to be comprehensive and detailed, Appendix C provides a tentative timetable for the APA process, given only for illustrative purpose, that can help tax administrations and taxpayers keep the time to negotiate an APA as short as possible. This timetable (Figure 2) provides for a 12-months period, as regards the evaluation of the APA, and additional 6 months for the negotiation, drafting and formal conclusion of the APA

Figure 2: Tentative timetable (in months) for APAs as from Appendix C to the Guidelines



This Guidelines could be considered as a by-product of increasing globalization and are possibly a first step towards a form of multilateral approach in applying for and concluding APAs. This is an aspect that could fit within the ambit of a World Tax Organization

4.2.3 APAs Recent Developments in the US

Even though, as described in the previous paragraphs, the concept of APA has been known in Europe since the mid 1990s, the overseas experience of adopting provisions regarding APAs was generally more proactive. Japan was the first Member country of the OECD to establish an APA procedure in 1987, with the United States being the second in 1991. Then

[102] See Taxud/E1/EM/WB, DOC: JTPF/020/BACK/2005/EN, "Summary of Business replies to the APA questionnaire", Meeting of Tuesday 20 September 2005. One company's APA negotiation had taken 5 years. Another company's had taken 8 years. Simpler APAs took less time to negotiate. Unilateral APAs were faster to negotiate but provided less certainty so the cost/benefit analysis was unchanged. See also Taxud/E1/EM/WB DOC: JTPF/020/BACK/2005/EN "Summary of Member States replies to the APA questionnaire", Meeting of Tuesday 20 September 2005.

numerous non-European countries and bodies introduced rules or guidelines regarding APAs, including Canada (1993), Pacific Association of Tax Administrators (PATA) (1994 with BAPA Guidelines[103], reviewed in 2004), OECD (1995 Guidelines), Australia (1995), Mexico (1995), New Zealand (1995) and Korea (1996)[104]

Since 1991, with the issuance of Rev. Proc. 91-22, 1991-1 C.B. 526, the IRS has offered taxpayers, through the APA Program, the opportunity to reach an agreement in advance of filing a tax return on the appropriate transfer price method to be applied to related party transactions[105]. An IRS team headed by an APA team leader is responsible for the consideration of each APA.

It is the policy of the United States, as reflected in §§ 2.08 and 7 of Rev. Proc. 2006-09, to encourage taxpayers that enter the APA Program to seek bilateral or multilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (the“unilateral” APA). A perfect example of an unsuccessful multijurisdictional APA application is given by the long-running dispute between IRS and GlaxoSmithKline (GSK), which resulted in the largest settlement in IRS history. The IRS questioned the transfer pricing methods relating to taxpayer’s intercompany transactions and an adjustment under § 482 was proposed. GSK initially, in 1994, sought to resolve their differences through the APA program[106]. At that time, the APA process was relatively new and, unfortunately GSK and the IRS were not able to come to an agreement. Later GSK sought redress through the MAP as outlined in the US-UK tax treaty. The IRS and HM Revenue & Customs in the UK made competing and contradictory claims regarding the transfer pricing policy of Glaxo Group. This discussion was terminated in July 2003. Very little information is available and it is not possible to know how and why the negotiation broke down[107].

The US APA process can be broken into five phases: (1) application; (2) due diligence; (3) analysis; (4) discussion and agreement; and (5) drafting, review, and execution. One of the longstanding criticisms of the programme is the time to complete this process, in part because significant transfer pricing issues have not been raised by the IRS when their tax

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[103] Bilateral Advance Pricing Agreements Guidelines of Pacific Association of Tax Administrators (formed by Australia, Canada, Japan and the United States).

[104] For an historical overview see V. Amerkhail, “Advance Pricing Agreements – A Little Historical Background”, 12 *Tax Management Transfer Pricing Report 21* (17 March 2004), 1023; s. Grotherr, “Internationaler Vergleich der Verfahren für Advance Pricing Agreements”, *Internationale Wirtschafts-Briefe (IWB) (*2005), F.10 Gr.2, 1823: K.Mank and N. Dagnese, “Verrechnungspreisentwicklungen im lateinamerikanischen Subkontinent”, *Internationales Steuerrecht* (IStR) 20/2006, 713.

[105] The Secretary of the Treasury reports annually to the public concerning Advance Pricing Agreements (APAs) and the APA Program.

[106] See *GlaxoSmithKline Holdings (Americas) Inc v Commissioner*, 117 TC 1,2 (2001).

[107] On September 2006 the IRS and GSK announced a settlement concerning the transfer pricing dispute for the tax years 1989 to 2000 and an agreement concerning tax years 2001 and 2005 (IR-2006-142)

returns are audited As shown in Figure n.3[108], the median time for executing a new unilateral APA was 16,7 months in 2007[109], lower than in previous years, and also the median time for executing a new bilateral/multilateral APA decreased to 42,3 months in 2007, having been 45,4 months in 2006[110].

Figure n.3: Months to Complete APAs

All New		**All Renewals**		**All Combined**	
Average	38.2	Average	25.5	Average	33.7
Median	35.9	Median	26.6	Median	31.2
Unilateral New		**Unilateral Renewals**		**Unilateral Combined**	
Average	18.7	Average	13.3	Average	16.0
Median	16.7	Median	12.2	Median	14.6
Bilateral/Multilateral New		**Bilateral/Multilateral Renewals**		**Bilateral/Multilateral Combined**	
Average	44.7	Average	35.4	Average	42.0
Median	42.3	Median	38.3	Median	40.4

By their very nature, bilateral and multilateral APAs take more time to complete because they require the participation of other tax authorities. However, the overall time to complete a bilateral or multilateral APA was still almost four years at the end of 2007, which is a significant length of time for any taxpayer.

These figures suggest that while the IRS has implemented some important changes in the administration of the APA programme, it still requires a significant amount of time to obtain an APA. Given the backlog of cases from previous years, one should not expect to see significant improvements in the time to complete APAs in the next few years.

While the number of APAs has grown over the years, the programme has not been as successful (as was initially anticipated), and has failed to become a mainstream option for US taxpayers. There are a number of reasons for this failure. Apart from the time required to complete an APA, that is significant and costly, most US companies are reluctant to make the IRS their "business partner" with respect to such an important aspect of their international operations. The latest Annual Report shows that the initiatives implemented for the APA

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[108] See the ninth Announcement and Report Concerning Advance Pricing Agreement, Secretary of the Treasury, 27 March 2008. "The first report covered calendar years 1991 through 1999. Subsequent reports covered separately each calendar year 2000 through 2006. This ninth report describes the experience, structure and activities of the APA Program during calendar year 2007. It does not provide guidance regarding the application of the arm's length standard.

[109] Compared to 22,9 months in 2006, 17,9 months in 2005 and 21,0 months in 2004.".

[110] 49,3 months in 2005 and 48,0 months in 2004.

programme over the past few years may have had some positive effects in terms of increasing the use of the APA programme by taxpayers and by reducing the time it takes to complete APAs.
Additional improvements are encouraging taxpayer to use APAs. The IRS, on May 21st 2008, released a revenue procedure that expands the scope of issues that may be covered by an APA. The new guidance[111] would specifically include the attribution of profits to a permanent establishment and the determination of effectively connected income among the issue that may be resolved through an APA. The ability to seek an APA for the attribution of profit to a PE has not always been clean, but in the past there have been informal confirmation that bilateral APAs would be available to address the level of profits attributable to branches for certain Treaty countries. Recently, the IRS's Office of Associate Chief Counsel stated that four US Agreements[112] fully implement the Authorized OECD Approach, which calls for the application of arm's length principle to determine profits attributable to a PE. Conversely, most US treaties provide for a "reasonable allocation" of expenses, which is not perfectly consistent with the approach of the OECD.

4.3 Corresponding and secondary adjustments in the mutual agreement procedure

A corresponding adjustment can eliminate (or mitigate) double taxation in cases where one tax authority increases a company's taxable income (i.e. makes a primary adjustment) as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction.
Transfer pricing adjustments made under domestic law may give rise to so-called "*secondary adjustments*". A "secondary adjustment" can be defined as a "further transfer pricing adjustment made by the tax authorities to reflect a secondary transaction i.e. the secondary consequences of a primary adjustment. Such adjustments in effect reconcile the financial situation of the enterprise with the consequences of the primary adjustment"[113].
The secondary adjustment would arise when the transfer pricing adjustment is considered to be an overpayment and, therefore, a benefit conferred either directly to a non-resident parent or to another non resident person by the parent.
There are three main kinds of secondary transactions: 1) constructive dividends, 2)constructive equity contributions, and 3) constructive loans.[114] The amount of the benefit

[111] Rev. Proc. 2008-31, that modifies current guidance on APA as embodied in Rev. Proc. 2006-9.
[112] The UK Treaty, the Japan treaty, the German Protocol and the exchange of notes with Belgium.
[113] Cfr "Secondary Adjustment", IBFD International Tax Glossary (2005), 357.
[114] Shirley D. Peterson and Frances M. Horner, "Secondary adjustments and related aspects of transfer pricing corrections", IFA Congress Seminar series, vol. 19b., at 3.

conferred may be deemed to be e.g. a dividend paid to the non-resident, or an interest-bearing loan, thereby giving rise to withholding tax issue.
In other words, the identification of a “secondary transaction” may lead to a secondary adjustment, such as additional dividend withholding tax or capital tax. The OECD MC does not deal with secondary adjustments, and thus neither forbids nor requires a member country to make a secondary adjustment. As a matter of practice many countries do not apply the concept of secondary transactions, which may again cause double taxation that cannot be resolved, except by the grant of a credit or other form of relief or by mutual agreement procedures.
Article 25 OECD MC provides means to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation, and especially those resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9 OECD MC.
As already seen, it is Art. 9(1) OECD MC that allows the tax authorities of a contracting state to revise unilaterally the accounts of an enterprise (so called “primary adjustment”) if, as a result of the special relations between the associated enterprises, the accounts do not reflect the true taxable profits in that state. In addition, the following paragraph, number 2, of Art. 9 OECD MC provides that the other contracting state is to make a “corresponding adjustment”. The Commentary of the OECD MC makes clear that the State from which a corresponding adjustment is requested should comply with the request only if that State "considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length". Consequently the State that has proposed the primary adjustment bears the burden of demonstrating to the other State that the adjustment "is justified both in principle and as regards the amount." Both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases.
The secondary transaction goes on step further. The purpose of a secondary transaction is “to make the actual allocation of profits consistent with the primary transfer pricing adjustment”. Due to a secondary transaction, “the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly”. In terms of financial statements, where the primary adjustment adjusts the profit and loss account, the secondary transaction adjusts the balance sheet[115].
However all these adjustments are not made automatically by the other state because they is not exclusively legally binding on the other state. The non-mandatory nature of the adjustments is necessary so that one tax administration is not forced to accept the

[115] Paras. 4 .67 through 4.77 of the OECD Transfer Pricing Guidelines

consequences of an adjustment by another State. It also is important to guarantee and maintain the fiscal sovereignty of each country.

After the "primary adjustment" the taxpayer may bring its complaint to the competent tax authorities of the state in which it is resident. If the complaint is justified, the competent tax authorities must seek to resolve the complaint through mutual agreement with the competent tax authorities of the other contracting state. The corresponding adjustments to be made in pursuance of paragraph 2 of Article 9 thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount[116].

Furthermore, a mutually agreed upon settlement between the competent authorities in respect of a transfer pricing adjustment can be set in motion:

1) if the other state does not accept the need to make a corresponding adjustment; or

2) when an eligible enterprise believes that the transfer pricing adjustment made by one country is not in line with the applicable treaty; or

3) where States do not include Article 9(2) in their bilateral treaties[117]. MAP is indeed not dependent on the existence of the "corresponding adjustments" clause of Article 9(2) in the particular bilateral treaty.

Paragraphs from 10 to 12 of the OECD Commentary to Article 25 specifically address the relationship between Articles 9 and 25, including where there is no equivalent to paragraph 2 of Article 9. The mutual agreement procedure can be used to achieve corresponding adjustments where the bilateral income tax convention between two Contracting States does not include a provision comparable to paragraph 2 of Article 9. States should always be seeking to avoid economic double taxation resulting from adjustments made to profits by reason of transfer pricing because it is, at least, not in accordance with the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25[118].

Through the mutual agreement procedure, tax administrations can address a transfer pricing issues in a non-adversarial proceeding, often achieving a negotiated settlement in the interests of all parties involved.

While corresponding adjustment and mutual agreement procedures are able to resolve most transfer pricing conflicts, considering the difficulties in finding arm's length prices and the necessity to avoid international tax disputes, national legislators and international bodies, as we have seen above, have facilitated the use of APAs since the introduction of transfer

[116] See OECD Commentary to Article 25, para.10.

[117] As is usually the case for Conventions signed before 1977.

[118] See the 2008 Update To the OECD Model Tax Convention, Paragr.12 Commentary on Article 25, 18 July 2008.

pricing rules into the domestic tax law and the continuous implementation of guidelines and annual reports on APAs practice.

4.4 OECD guidelines for uniform transfer pricing rules

It is not rare that taxpayers and tax administrations reach differing determinations of the arm's length conditions for controlled transactions given the complexity of some transfer pricing issues and the difficulties in interpreting[119] and evaluating the circumstances of individual cases. The OECD's Centre for Tax Policy ad Administration has been actively involved in developing procedures to deal with cross-border tax disputes. The work on avoiding disputes culminated in the publication of Chapter 4 and the Annex to the *OECD Transfer Pricing Guidelines*[120] The Guidelines¸ focuses on the main issues of principle that arise in the transfer pricing area, were intended to help tax administrations and taxpayers by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and taxpayers and avoiding costly litigation. They provide guidance for corresponding adjustments, seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties, and for the resolution of transfer pricing cases in mutual agreement proceedings between OECD Member countries and, where appropriate, arbitration proceedings.

The "administrative approaches to avoiding and resolving transfer pricing disputes" are described in the fourth chapter of the Guidelines**.** The OECD examines different administrative procedures that could be applied to reduce transfer pricing disputes and for avoiding double taxation. Section B discusses three aspects of transfer pricing compliance by tax administrations that can have impact on how tax administrations in other jurisdictions approach the mutual agreement procedure process and

determine their administrative response to ensuring compliance with their own transfer pricing rules.

1) Examination practices: in practice tax authorities should be flexible in their approach and tie transfer pricing analysis to taxpayer's business realities.

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[119] See 1995 Guidelines, paragr.15.

[120] These Guidelines are a revision of the OECD Report *Transfer Pricing and Multinational Enterprises* (1979). They were approved by the Committee on Fiscal Affairs on 27 June 1995 and by the OECD Council for publication on 13 July 1995. The 1979 Report elaborated on the arm's length principle as set out in Article 9. Other reports address transfer pricing issues in the context of specific topics: *Transfer Pricing and Multinational Enterprises – Three Taxation Issues* (1984) and *Thin Capitalization*.

2) The rules on burden of proof and the implication for the behaviour of the tax administration and the taxpayer. Tax administrations and taxpayers should be prepared to make a good faith showing that their own determination of transfer pricing is consistent with the arm's length principle, regardless of where the burden of proof lies.
3) The fairness of the penalty system : an “appropriate” levels of penalties (i.e. the penalties are proportionate to the offence)mat play a role in improving compliance in the transfer pricing area,

The OECD Guidelines, Section C, discuss the most serious concerns expressed by taxpayers with the mutual agreement procedure, as it affects corresponding adjustments. The list of these problematic aspects, as arisen in the 1995 OECD analysis, is the following (in Chapter IV.1.4 of the present study they are examined separately):

1) the time limits provided by treaty or domestic law for making corresponding adjustments;
2) the length of mutual agreement proceedings;
3) the taxpayer specific right to participate in the MAP process;
4) the development and publication of domestic rules and procedures for utilizing the mutual agreement procedure. issues relating to the collection of tax deficiencies and the assessment of interest on those deficiencies or overpayment.

Furthermore, the Guidelines propose the use of simultaneous tax examinations by two (or more) tax administrations to expedite the identification, processing, and resolution of transfer pricing issues, describe some possibilities for minimising transfer pricing disputes between taxpayers and their tax administrations, developing safe harbours or certain taxpayers or determining in advance a transfer pricing methodology and conditions for the taxpayer to apply to specified controlled transactions (APAs procedure).

Section G considers briefly the possibility of the use of arbitration in tax disputes to resolve transfer pricing issues. The OECD had already discussed the use of arbitration procedures in detail in its 1984 Transfer Pricing Report[121]. In this study I attempt to conduct a thorough analysis of the available dispute resolution procedures including the means proposed by the 1995 OECD Guidelines and the way there have been administered and developed in domestic and international tax law.

[121] OECD Report *Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure* (182), para 41 e*t seq.*

4.5 The EC Multilateral Transfer Pricing Convention (outline)

The share of trade between associated EU-based enterprises is a percentage of total intra-Community trade so high that the EU cannot afford to be indifferent towards the transfer pricing tax issues of intra-community transactions. The need to find a solution to this problem in the specific context of the European Community was recognised already in the Seventies with the Commission Proposal for an Arbitration Directive.

Notwithstanding the acknowledgement of the arm's length principle as the basis for determining transfer pricing, disputes arises when the tax administrations of different Member States apply and/or interpret the principle differently. Unrelieved international double taxation of income between enterprises of Member states goes contrary to Articles 2 and 3 EC Treaty, on the general objective of the European Community to establish an Internal Market, and to Article 220 EC Treaty that ask Member States to enter into negotiations for securing the abolition of double taxation within the Community.

On 29 November 1976 the EC Commission submitted a proposal to the European Council[122] for a directive on arbitration procedure in connection with the adjustment of transfer of profits between a associated enterprises, a remarkable step for at least two reasons. First, it makes arbitration mandatory for the Contracting States to eliminate double taxation. Second, it establishes a binding procedure, based on the existing traditional MAP along the lines of Article 25 OECD MC, which could be set in motion by the taxpayers concerned and ensure the taxpayer's right of the elimination of double taxation.

The directive was not adopted essentially because most of the EU Member States did not want to give up their tax sovereignty binding themselves to the arbitral awards, especially in view of the absence of a common set of substantive transfer pricing rules.

After twelve years of negotiations and despite the doubts expressed by certain countries regarding the fact that the text did not bring suitable solutions concerning a series of issues, on 23 July 1990, the Council signed the draft Convention, became effective as 1 January 1995, after months after the deposit of the last instrument of ratification, for a five-years term according to Article 20 of the Arbitration Convention.

Although procedures to resolve disputes involving transfer pricing adjustments are, in many cases, already provided for under the mutual agreement procedures set out in bilateral tax treaties, In the second chapter of the third Part of this study the Arbitration Convention will be examined as one on the most effective means to eliminate the double taxation that can arise in the event of adjustment of profits of associated companies. As will be shown, the

[122]COM(76) 611 def. Publication courant of the EC 21 December 1976, no. C 301

supposed key advantages of the Arbitration Convention is to provide a *time limit* to reach a solution and, in the absence of an agreement, to impose a *binding solution* on the CAs.

IV. Current Systems used to resolve tax disputes

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1. The Mutual agreement procedure (Art.25 OECD MC) as a preventive tool

1.1 *Tax treaty interpretation and the mutual agreement procedure*

A bilateral tax treaty allocates the taxing power for different types of income between the state of source and the one of residence and provides for the mode of elimination of double taxation either by a credit or exemption system. Despite the existence of a tax treaty, double taxation may arise if the contracting states interpret a provision of the treaty differently or characterize the same income in different way or classify different entities as taxpayer[123]. This could easily happen because double taxation treaties are often negotiated between countries with quite dissimilar legal systems, with often different legal institutions and with a different legal vocabulary.

The interpretation and application of a tax treaty provision takes place at the level of the taxpayer and the tax authority in connection with the assessment of the taxpayer's income. If the taxpayer and the CA disagree on the interpretation and/or application of a tax treaty provision, the taxpayer usually has two possibilities: submitting the issue to a court or, where the CA's interpretation gives rise to double taxation, request to enter into the mutual agreement procedure with the authority of the other country, the primary role of which is to solve disputes involving the application and interpretation of tax treaties, as provided in almost all modern tax treaties

Also without a request from a taxpayer, when the CAs interpret a particular treaty provision divergently, according to their own domestic law, they may try to reach a joint interpretation of the issue concerned, through the so-called "interpretative mutual agreement" (Article 25(3), first sentence, OECD MC).Such problems, however, could be reduced if the treaty contains specific definitions, expressly mentioned in the wording of an article[124], or when reference is given to the meaning of terms under domestic law[125].

The mutual agreement procedure is a special procedure outside domestic law aimed at resolving the dispute on an amicable basis, i.e. by agreement between the competent authorities[126] of the contracting states, in cases where tax has been charged, or is going to

[123] The application of the OECD Model Tax Convention to Partnership, Issues in International Taxation, No. 6 (Paris: OECD, 1999).

[124] See, for example, "interest" in Art.11(3) and "royalties" in Art.12(2) of the OECD Model.

[125] See, for example, Art.6(2) and Art.10(3) of the OECD Model.

[126] See OECD MEMAP: "The competent authority for each country is typically identified in the Definition Article of the tax convention (for example, under Article 3 of the OECD Model Tax Convention). A typical designation would be "the Minister of Finance or his authorised representative" or "the Secretary of the Treasury or his delegate". The authority is usually delegated within a tax administration to a level that will administer a country's MAP program".

be charged, in disregard of the provisions of a tax treaty, with a view to securing the uniform application and interpretation of the tax convention in both countries[127].

This procedure, which is found in almost all income tax treaties in force today, is usually comprised of four paragraphs and it is based, with minor differences, on Art. 25 of the OECD MC, Art. 25 of the UN MC and similar articles in various other model income tax conventions. My analysis is focused on the provisions of the OECD MC.

In international treaty practice, mutual agreements on the interpretation of treaty terms are playing a more and more important rule. The use of the MAP is expressly recommended in the OECD MC in particular situations concerning with double taxation (section II). The structure and the functions of Art.25 OECD MC are dealt with in section III. Unfortunately, as will be shown in section IV, more questions will be raised than solved as most of the problems appear to have never arisen, or if they have arisen, have not been the subject of any official published report. The OECD performs good offices in this regard by contributing to the development of appropriate rules (section V). Finally, section VI compares the legal and economic features of the MAP and of arbitration, highlighting the rule of the new compulsory procedure in the 2008 version of the OECD MC.

1.2 Mutual agreement procedure in the OECD MC

The OECD MC provides for a MAP to resolve difficulties arising from the application of bilateral tax treaties in the broadest sense of the term. In practice, it is primarily used to eliminate situations contrary to the provisions of the relevant tax treaty. This may relate to a variety of situations, the most frequent of which concern double taxation and are listed in the Commentaries to the OECD MC.

Particular areas in which MAP cases usually arise are:

1. consideration of the appropriate transfer pricing methodologies to be applied to cross-border transactions between related persons/associated enterprises;
2. the determination of appropriate attributions of profits to the permanent establishment of enterprises; and
3. characterization for entitlement to benefits under the Convention, determination of a permanent establishment or of residence
4. thin capitalisation.

Historically, the majority of the cases of "taxation contrary to a convention" have been issues of transfer pricing where companies of a multinational enterprise incurred economic double

[127] Michael P. Bricker, " Arbitration Procedures in Tax Treaties. A first Israeli Tax Treaty includes an Arbitration Clause – But do such clauses really matter?", 26 *Intertax* 3 (1998), 97. Gerrit Groen, " Arbitration in Bilateral Tax Treaties", 30 *Intertax* 1 (2002), 3.

taxation due to an adjustment to their income from intra-group transactions by one or more tax authorities[128]. The MAP can apply to resolve issues covered by Arts. 7 and 9 of the OECD MC and would determine to what extents profits arise in the tax jurisdictions involved.

The *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (OECD 1995)[129] recommend, wherever possible, the conclusion of an advance pricing arrangements (APA)[130] between the competent authorities through the mutual agreement procedure of the relevant treaty. Bilateral or even multilateral APAs are legally achievable by an MAP in accordance with the relevant applicable income tax treaty. Although bilateral APAs do not differ from MAPs, they are nevertheless "future-oriented", at least in the beginning. In this regard, treaty provisions like Art.25(1) of the OECD MC are the legal framework for APAs, and not Art.25(3) as the OECD has stated, as the latter provision (discussed in more detail in section 2.4) specifies the rules for a consultation procedure.

Enterprises also request MAP assistance for non-transfer pricing cases, including disputes over such issues as existence of a permanent establishment, the amount of profits attributable to a permanent establishment[131], or the application of a tax treaty's withholding tax provision to their income.

Cases of dual residence are the most common occurrences for which individuals require MAP assistance. Quite frequently, a taxpayer can be considered to be a resident of two treaty countries because domestic tax laws apply different tests for when residence is gained or lost. If unresolved, the taxpayer could be subject to taxation not in accordance with a convention and therefore liable for tax on the same income in both countries. A tax treaty tries to solve this problem by avoiding double taxation through a list of "tiebreaker" rules that determine with which of the two countries the person has the greater connection. Moreover, these tiebreaker rules do not always give a result because there may be different interpretations taken by the two countries. Paragraph 2 of Art. 4 in the OECD MC assigns to the competent authorities the duty of resolving difficulties by mutual agreement according to the procedure established in Art. 25. The wording of Art. 4(2) may imply a "*pactum de*

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[128] Sunghak Baik and Michael Patton, "Japan Steps Up Transfer Pricing Enforcement: Joins the APA Fray", 11 *Tax Notes Int'l, 1995, 1271.*

[129] Chapter IV, Section F, paragraph 4.163.

[130] An APA is defined in the first sentence of paragraph 4.124 of the Transfer Pricing Guidelines as "an arrangement that determines, in advance of controlled transaction, an appropriate set of criteria (e.g. method, comparables and appropriate adjustment thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time". It is also stated in paragraph 4.132 that "The concept of APAs also may be useful in resolving issues raised under Article 7 of the OECD Model Tax Convention relating to allocation problems, permanent establishment, and branch operations".

[131] See OECD *Report on the Attribution of Profits to Permanent Establishment.* Part I, paragraph 183: "There will inevitably be some cases where tax administrations disagree over whether the results produced by the host country method are consistent with the arm's length principle. The Mutual Agreement Procedure is available to resolve such differences. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorized OECD approach. Rather it reflects the fact that the attribution of "free" capital to a PE can be a very difficult and complex issue."

contrahendo" by obliging the competent authorities to achieve a result to solve cases of double residence. In other words, if the issue is not solved by the other tiebreaker tests, it should be solved by mutual agreement to help avoid double taxation.

Furthermore, the mutual agreement procedure provides a mechanism under which the tax authorities of the contracting states can resolve questions concerning the characterization of income[132], which necessarily means that one country or the other will disregard its domestic classification principle. When a taxpayer is uncertain whether the convention covers a specific item of income, or is unsure of the characterization or classification of an item related to a cross-border transaction, it may approach the competent authority for clarification through the procedure of Art.25.

1.3 Art. 25 of the OECD MC: its structure and purpose

1.3.1 Overview

Art. 25 of the OECD Model performs three functions: it provides a disputes resolution mechanism in relation to the application of the provision of tax treaties to specific cases (referred to below as "the specific case provision"); it allows the countries to settle on common interpretations and applications of their tax treaty (referred to below as "the interpretative mutual agreement"); and it allows them to resolve cases of double taxation not otherwise dealt with (referred to below as "the legislative mutual agreement"). The second and the third procedures, provided in Article (3) and (4) of OECD MC, differ from the first in not necessarily requiring the taxpayer's involvement. They are procedures entirely at the initiative of the CAs that can communicate directly to resolve difficulties or doubts regarding the implementation of the Convention.

Therefore, not only does the mutual agreement procedure allow taxation contravening a treaty provision to be corrected in an individual case, but it can also be used to attain general agreement on clarifying and supplementing relevant bodies of law. All three procedures can apply to specific cases but the interpretative and legislative provisions assume that a difficulty or doubt once resolved, or double taxation once eliminated, will apply in other similar cases, whereas the specific case provision is essentially limited to the particular case, especially when a specific case involves a small number of taxpayers, and may arguably not rise to the level of a general applicable interpretative agreement.

[132] For example, the characterization of an amount as a "royalty" (covered by Art. 12) or "income from personal services" (covered by Arts. 7 or 17) affects whether or the extent to which a source country has jurisdiction to tax the amount under the OECD Model. The characterization issue is highlighted by the case of *Boulez v. Comm.* (1984), 83 TC 584 (USTC).

1.3.2 The specific-case provision (Art. 25, paras. 1 and 2)

The first area set out by the MAP article is covered by paragraphs 1 and 2. They apply to situations where a taxpayer believes that the action of one or both contracting states resulted or will result for it in "taxation not in accordance with the provision of the Convention".

In other words, the "specific case" provision introduces a special procedure outside the domestic law that can be instituted by a taxpayer only in cases where tax has been charged, or is going to be charged, in disregard of the provisions of an applicable tax treaty[133]. Only actual cases where it is argued that the actions of one or both of the Contracting States has resulted in taxation not in accordance with the tax treaty can be brought into a MAP. It is necessary that a tax has been paid, assessed or otherwise determined or that the taxpayer has been informed by the tax authorities that they intend to tax him on certain elements of income.

The first stage of the procedure, opened with the presentation of the taxpayer's objections[134], takes place exclusively at the level of dealings between the taxpayer and the competent authority of his state of residence. The case must be so presented within three years from the first notification of the objectionable taxation. The taxpayer can bring his case irrespective of the existence of other remedies available under domestic law.

In order for a taxpayer to ask for MAP from his competent authority in cases of taxation not in accordance with the treaty provision, it is generally sufficient if the taxpayer establishes that such taxation is "probable". Further guidance on the probability of inappropriate taxation is provided in paragraph 12 of the Commentary on Art.25 of the OECD MC. It notes that the taxpayer must, and that it is sufficient if he does, establish that any acts or decisions of one or both of the contracting states, whether of a legislative or a regulatory nature, and whether of general or individual application, will be contrary to the provisions of the Convention, and that this taxation appears "as a risk which is nor merely possible but probable".

The competent authority is then under an obligation to consider whether the objection is justified, and if it appears to be justified, take action on it and resolve it itself by making an appropriate adjustment or, where this is not possible, by mutual agreement with the other competent authority ("second stage"). Under the current MAP clause, when a dispute is submitted to the competent authority, it is required only to seek a solution and it is not obliged to find one[135]. The process does not guarantee the settlement of the conflict and it is only a *pactum de negotiando*.

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[133] Commentary to the OECD Model, Art..25, para.7.

[134] For this purpose, it does not matter whether or not the taxpayer has exhausted all the remedies available to him under the domestic laws of each of the contracting states. Pending litigation under domestic law should be suspended. See Commentary to the OECD Model, Art.25, paras.19, 23-24.

[135] See Art. 25(2) of the OECD Model, which reads: "The competent authority *shall endeavour*, if the objection appears to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual

The second stage of the procedure, opened with an approach to the other competent authority by the tax authority to which the taxpayer has applied, takes place at the level of dealings between states. Under the second paragraph of Art.25 of the OECD MC, the competent authorities are obliged to negotiate and use their best endeavours to resolve the problem, but do not have the duty to achieve a result. The legal position of the taxpayer himself in the procedure is not spelled out in Art.25. It has no specially defined obligation to participate, give evidence or proof any kind, but it is not possible to see how the procedure could be effected if the taxpayer were to be totally uncooperative. A notable feature of the mutual agreement procedure is its lack of formality and the consequent introduction in some countries of domestic guidelines to regulate the procedural framework[136].

It is in essence a diplomatic procedure, except that the negotiation is normally conducted directly between the tax authorities themselves and not through regular diplomatic channels. The contracting states authorize and mandate their revenue authorities to endeavour to resolve by negotiation their disputes in individual cases of interpretation and application of their common treaty rules.

The second paragraph, in its last sentence, enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. To have any value at all, a mutual agreement should be binding on the tax administrations, that is to say, the CAs should be prevented, in the process of assessing the taxpayer's eventual return, from taking a position different from the one agreed in the MAP. Absent such binding force, the best the taxpayer can get is some comfort which is of little use.

1.3.3 The interpretative mutual agreement (Art. 25, para. 3, first sentence)

The mutual agreement procedure may also be independently instituted by a competent authority without having to rely on a previous initiative by a taxpayer. Agreements of an interpretative character involve general difficulties and doubts between the competent authorities as to the interpretation or application of the treaty not necessarily associated with a particular taxpayer. In International Treaty Law, this term is used to establish the authority of the dispute settlement body to decide on all conflicts arising from the treaty concerned.

agreement with the competent authority of the other Contracting State…". See also Art.25(3) of the OECD Model, which reads: "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…". The limitation of the current MAP clause have been acknowledged in the Commentary to that article (see paragraph 45).

[136] See, for example, the US Rev. Proc. 96-13, 1996-3 I.R.B. 31 (16 January 1996), or the German Circular on International Mutual Agreement Procedures in Tax Matters, BstBl. I 1997, IV C 5 – S 1300 – 189/96 (1 July 1997).

Here, as in the specific case process, the competent authorities are instructed to "endeavour to resolve" the issue and no settlement is guaranteed.

These MAP discussions frequently relate to a topic of a *general nature* which concern, or may concern, a category of taxpayers rather than a specific taxpayer's case. For example, the competent authorities may rely on this MAP to reach agreement on the definition of the term used in the convention or to agree upon procedures for granting the relief called for by the convention.

Specifically, the OECD Comm on Art.23 makes a distinction between conflicts resulting from a different interpretation of facts or a different interpretation of the provision of the Convention and the conflicts of qualification based on different provisions of domestic law. In the former case, states should use the provision of Art.25, para. 3, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation[137].

The mutual agreement procedure described in the first sentence of Art.25(3) can be also considered a measure to avoid cases of double non-taxation. The wording of Art. 25(3) does not refer explicitly to the fact that the contracting state may make use of the mutual agreement procedure to deal with cases of double non-taxation. However, para. 2 of the Commentaries to Art.7 recognizes that tax authorities should agree on mutually consistent methods of dealing with problems of double non-taxation, using, where appropriate the mutual agreement procedure provided for in Art.25, instead of adopting a unilateral interpretation of basic principles. These agreements, resolving general difficulties of tax treaty interpretation or application, are binding on administrations as long as CA do no modify or rescind the agreed solution[138].

Even though the interpretative procedure aims at improving the application of the convention, possible problems arise as to the implementation of these agreements into the domestic context, mainly because of their substantial effects on the tax treaty's rules.

1.3.4 The legislative mutual agreement (Art. 25, para. 3, second sentence)

The provision contained in the second sentence of paragraph 3 states that the competent authority of the Contracting States "may…consult together for the elimination of double taxation in cases not provided for in the Convention". The OECD Committee on Fiscal Affairs ("CFA") has recognized the increasing importance of extending the MAP to cases not provided for in the treaties[139]. Indeed, paragraph 42 of the CFA Report notes that issues arising under Art. 23(3) "may well become more important in the future because of work being done on attribution of profit to a permanent establishment", concerning, in particular,

[137] See paragraph 32.5 of the Commentaries on Art.23.
[138] See paragraph 54 of the 2008 Update to the OECD MC Commentaries.
[139] Report on "Improving the Resolution of Tax Treaty Disputes" adopted on 30 January 2007.

"the allocation of profit between branches of the same taxpayer in different States, such as the attribution of capital to bank branches"[140].

The legislative mutual agreements raise more significant problems in their implementation than the "specific case" provisions and are therefore only exceptionally entered into by the competent authorities. More in particular, in some OECD countries there is the constitutional principle of strict legality that makes it questionable whether an administrative procedure on its own may interpret the treaty so as to possibly extend its scope.

As will be shown in the following paragraph, constitutional barriers seem to prevent the introduction of binding interpretation by means of any agreement reached by administrative authorities. Accordingly, the agreement would be valid under international law from the moment it is concluded, though binding in a domestic context only after the ratification

Another fundamental problem is perhaps that a widespread use of the legislative mutual agreement process would give the tax administration an unduly large influence both in relation to the legislative and judiciary branches, and in respect of business operations in the private sector; it highlights the need to surround such a ruling mechanism with appropriate checks and balances. Transparency and publicity appear to be strong safeguards against such a negative development.

1.4 Evaluation of the mutual agreement procedure: effectiveness and weaknesses

1.4.1 Overview

International law generally allows for three methods to resolve international conflicts arising from treaty interpretation: negotiation between the contracting states, decisions rendered by an international court and binding international arbitration. The mutual agreement procedure of DTTs is in essence a diplomatic method of settling cases of taxation not in accordance with the treaty, where negotiation is conducted directly between the tax authorities. How effective is this machinery?

The MAP incorporated in the OECD MC and the UN MC is adopted in almost all tax treaties concluded. However, it contains fatal drawbacks. It is widely recognized that the MAP has

[140] The Report goes on in paragraph 43, as follows: since such branches are not resident of the countries involved in the potential disputes over profit attribution, the MAP foreseen in paragraphs 1 and 2 of Art. 25 is not available and the only potential MAP relief from double taxation arises, instead, under paragraph 3. Indeed, paragraph 37 of the Commentary on Art. 25 notes that the second sentence of paragraph 3 of Art. 25 might be used to help disputes in the PE context described above, and encourages its use to avoid double taxation. However, paragraph 37 goes on to point out some problems for some contracting states in applying this paragraph – states where domestic law prevents the treaty from being "complemented on points which are not explicitly or at least implicitly dealt with". Also a number of states do not include the second sentence of paragraph 3 in bilateral treaties for this or other reasons.

not been very effective in resolving disputes[141], since, even if countries are successful reaching an agreement, it is a diplomatic solution based on negotiation and compromises.

1.4.2 Legal rights of the taxpayer and corresponding obligations of the CA

Under the MAP provision modelled after the OECD MC, the taxpayer is entitled to present his case to the CA of the State in which he is resident, and apply for the starting of the MAP, but not to initiate it himself, this is reserved to the CA which are the two parties of the MAP process.

The provision may not offer the affected taxpayer the legal right of participating in the mutual agreement procedure proper of Art. 25(2), as the treaty provision institutes a procedure between states[142]. But under Art. 25(1) it acquires an autonomous international right of presenting its specific case to the competent authority of the Contracting State of which it is a resident and, according to the OECD interpretation, this authority has a corresponding obligation to deal with it through a mutual agreement procedure. In particular the OECD Commentary reads "it will be incumbent on (that competent authority), indeed it will be its duty – as clearly appears by terms of paragraph 2 – to set in motion the mutual agreement procedure proper"[143].

The problem with the MAP is that once the procedure has been initiated, the negotiations are left to the CAs of the States concerned thereby restricting the rights of the taxpayer who requested the MAP. As the 1984 OECD Report notes[144], taxpayers are not entitled to take part in the MAP , they are allowed to present only facts and arguments they contend. Although the OECD MC grants the taxpayer the right to initiate the mutual agreement procedure if he considers that the actions by one or both of the Contracting States will result

[141] Gustaf Lindencrona, " How to resolve international tax disputes? New approaches to an old problem", *International Tax Review* 5 (1990), 266; Berndt R. Runge, " Mutual Agreement Procedures and the Role of the Taxpayer", *International Transfer Pricing Journal* (2002), 16; Mario Züger, " Conflict Resolution in Tax Treaty Law", 30 *Intertax* 10 (2002), 342; Zvi Altman, *Dispute Resolution under Tax Treaties* (Amsterdam: International Bureau of Fiscal Documentation, 2005); Bruno Gibert, " Statement of Practice on Cross-Border Dispute Resolution – France Significantly Improves Tax Security for International Transactions", *European Taxation* (2006), 355; Jeffrey Owens, " OECD Proposal To Improve the Resolution of Tax Treaty Disputes", 47 *European Taxation* 6 (2006), 270.

[142] James Mogle, "Competent Authority Procedure", 23 *Geo. Wash. J. Int'l L.& Econ* (1990), 725 (discussing the advantages of a proactive participation in mutual agreement procedures by taxpayers: "it permits a taxpayer to influence a competent authority's decision independent of face-to-face meetings between competent authorities; a taxpayer necessarily has a far better understanding of the facts of its case and is in a better position to explain the arm's length nature of a proposed income allocation: finally, the independent interest that the taxpayer has in the resolution of the mutual agreement procedure ensures that it will be able to dedicate more resources to the negotiations than could the competent authorities themselves"). Dale Wickhalm and Charles Kerester, "New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?", 58 *Tax Notes* 1992, 339: "any bilateral or multilateral treaty should provide for binding arbitration to resolve disagreements between competent authorities which allows the participation of the taxpayer and whose decision will be published".

[143] OECD Commentary, Art. 25 Comm. 21 and 25.

[144] See paragraphs 96-98.

in taxation not in accordance with the provisions of the Convention, after the procedure has been set in motion, the taxpayer has no legally enforceable claims against the CA for the initiation of MAP and even if the procedure starts he is no longer involved. MAP discussions are a government-to-government process in which there is generally no direct taxpayer involvement[145]. It is desirable for taxpayers to be informed by his national tax authority about the progress of the proceedings and even consulted with respect to the position that such authority should take in the negotiations and how such position should be documented[146]; however, under the provisions of the OECD MC , the taxpayer enjoys no right to be heard or otherwise involved in the proceeding.

This means that CAs may sign an agreement on the basis of their mistaken understanding of the facts, at the end, the taxpayer may find his case solved or not solved without being made aware what the precise reasons have been. At least three parties, including the two CAs and the aggrieved taxpayer, share a vested interest in the MAP outcome. Unfortunately, the foreign tax authority is absent from a domestic tax adjudication, the taxpayer is absent from competent authority negotiations, and no party has any means to bring all three parties together. Thus, domestic adjudications are not binding on a foreign tax jurisdiction, and successful CAs agreements are not binding on a dissatisfied taxpayer.

While it is true that the MAP is a government-to-government procedure, this should not rule out taxpayer involvement. With this regard, to increase the effectiveness of the MAP, the OECD MEMAP encourages CAs to communicate the terms and conditions of the agreement to the taxpayer as soon as possible and anyhow prior to the exchange of letters among CAs confirming the resolution of the MAP case. Thanks to this communication, the taxpayer unsatisfied by the terms or the conditions of the agreement, may be entitled to withdraw from the MAP process and pursue other domestic redress mechanisms still available. On the contrary, if the taxpayer is satisfied by the resolution, he usually accepts the MAP results in writing and agrees to withdraw its domestic objections – if any - or to refrain from seeking any further recourse on the same issue and years. After this acceptance and the letters exchange, the CAs should give resolution effect in its jurisdiction[147].

The new OECD MC provisions on arbitration process give the taxpayer a formal position in such procedure. As later discussed, the taxpayer may present his position to the arbitrators in writing and, with the permission of the arbitrators, may also present his position orally during the arbitration proceedings.

The inability of the current MAP to provide for all steps possible to facilitate a final resolution of issue arising under treaties has been one of the principal obstacles to ensuring an

[145] MEMAP para. 3.3.2.

[146] MEMAP “Best Practice” n.13.

[147] MEMAP para. 3.8

effective procedure[148]. The contracting states are only required to exert efforts; they are not obliged to reach agreement under it, let alone to reach one within a given time period, and there is no guarantee for the individual taxpayer that they will succeed[149]. This results sometimes in protracted procedures during which the taxpayer has to live with uncertainty. Although in practice, agreement is often reached, in some situations the mutual agreement procedure is closed by an agreement to disagree: possibly because two competent authorities are afraid of creating a precedent detrimental to their respective economies or the amount in dispute is simply too high and the CAs are reluctant to forgo a substantial amount of revenue.

Some doubts exist whether Art. 25(2) OECD MC imposes on the authorities of the states of residence a legal obligation to set the mutual agreement procedure in motion, where its wording introduces a condition that is *prima facie* discretionary ("if the objection appears to it to be justified"). Most competent authorities reduce the legal right of the taxpayer to "the sole right of requiring that the authorities should decide, within the scope of their due discretion, whether mutual agreement procedure should be started"[150]. Art. 25 does not oblige the competent authorities to enter into an MAP at the request of the taxpayer. The willingness to enter into an MAP will depend on the particular policy of a country and how it interprets the mutual agreement article of its bilateral treaties. Some competent authorities will only consider such an agreement for cases that require the resolution of "difficulties or doubts arising as to the interpretation or application of the Conventions"[151]. The desire of the taxpayer for certainty of treatment is therefore not, in itself, sufficient to pass the above threshold.

1.4.3 Payment of taxes in pending procedures

Art. 25 OECD MC does not give an absolutely clear answer as to whether a taxpayer-initiated mutual agreement procedure is obliged to pay the tax amount in dispute pending

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[148] Dale Wickhalm and Charles Kerester, "New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?", 58 *Tax Notes* 1992, 339. They criticize the confidential nature of existing dispute resolution measures on the grounds that they do not offer any guidance as to generally applicable law and that they subject competitors to unequal treatment.

[149] An important example of a failed MAP is the "Glaxo Smith Kilne Group" (GSKG) case where the US Internal Revenue Service (IRS) and HM Revenue & Customs (HMRC) in the UK made competing and contradictory claims regarding the transfer pricing products. GSKG attempted to settle the US dispute, first through direct discussion with the IRS and subsequently through discussion between the US and the UK authorities under the terms of the double tax convention between the two countries. On January 2004, the IRS issued a "Note of Deficiency" claiming additional taxes for the tax years 1989-1996. Paul Rooney and Nelson Suit, "Competent Authority", 49 *Tax Law* (1996), 675. Arvid A. Skaar, "Tax Policy Forum: The Legal Nature of Mutual Agreements under Tax treaties", 5 *Tax Notes Int'l* (1992), 1447 (arguing that the greatest risk for the taxpayer is that the competent authorities may refuse to institute the mutual agreement procedure simply because they disagree with the taxpayer).

[150] Kock, *Mutual Agreement – Procedure and Practice*, General Report IFA Congress 1981, Berlin, LXVIa CDFI, 109.

[151] See OECD Transfer Pricing Guidelines for *Multinational* Enterprises and Tax Administrations, Annex n.3.

resolution of the MAP. The absence of specific rules enabling the suspension of tax collection during cross-border dispute resolution proceedings creates an additional financial burdens for taxpayers and, consequently, an impediment to request the application of MAP. Such a collection of tax will impose temporary double taxation whilst the MAP is in progress because the same profits have been subject to tax in both jurisdictions. This is also an issue of liquidity for the taxpayer.

According to the JTPF, the suspension of tax collection is regulated at a legal level in so far as domestic procedure are concerned. In the context of a cross-border dispute resolution procedure, specific legal or administrative provisions are only provided for in a few countries, although many tax administrations can suspend the collection of taxes on a discretionary basis, in order to avoid double payment, even if specific provisions for suspension during mutual agreement procedure do not exist. Country practices reflect different views. A good example is given by France: whatever the procedure concerned, according to French tax law, "the time period for establishing the corresponding taxation is suspended from the opening date of the amicable procedure until the end of the third month following the date of notification to the taxpayer of the agreement or notice of disagreement between the competent authorities"[152]. This system applies to procedures starting from 1 January 2005 onward. Thus, any tax assessment made by the French tax authorities that has given rise to an application for recourse for elimination of double taxation may not be claimed for payment pursuant to a tax collection notice until the signature of an agreement between the authorities (or a notice of disagreement) pronounced with regard to the French company. This provision is extremely favourable to the taxpayer and it should systematically encourage the taxpayer to use such a procedure as soon as possible, and this is one of the main reasons why OECD considers suspension of tax pending resolution of an MAP a desirable policy[153].

In general, differences in the practical application of the MAP by the states involved may create legal uncertainty for the taxpayer. To improve the transparency of the MAP process, the OECD has made available to the public, via its website, "*Country Profiles on Mutual Agreement Procedure*" of all OECD member countries (and some non-OECD economies[154]), which contains information about the competent authorities' contact details, domestic guidelines for MAPs and other useful information both for tax authorities and taxpayers. However, since most of tax authorities are still getting experience in dealing with cross-border tax issues, there has been limited guidance and experience in the use of these procedures. Thus, the lack of precedents may discourage taxpayers from pursuing an MAP in tax treaty interpretation cases.

[152] Art. L189A, *Livre des Procédures Fiscales.*
[153] OECD Report on "Improving the Resolution of Tax Treaty Disputes", paragraph 29.
[154] Argentina, China, Russia and South Africa.

EU Member States are recommended by the EU Commission to take all necessary measures to ensure that the suspension of tax collection during cross-border dispute resolution procedures under double tax treaties between Member States can be obtained by enterprises engaged in such procedures, under the same conditions as those engaged in a domestic procedure although these measures may imply legislative changes in some Member States[155].

1.4.4 Costs and timing

Complex cases can be costly for the taxpayer, not only in respect of professional costs but also in relation to the cost of interest on the eventual tax due. While an MAP can provide relief from double taxation, no relief is provided for penalties and interest, which can be significant if the disputes goes back a number of years. This is frequently the case in transfer pricing matters and taxpayers are often of the opinion that an MAP is not cost effective when interest costs are significant.

MAP is costly non only for the taxpayer but also for the tax administration. Taxpayers ask for special service from the government which is of no use to other conflicts. The procedure needs high qualified personnel to solve in the better way issues that are often complex and time-consuming, on which the taxpayer has a real and substantial interest

MAP process should not favour the rich and powerful but should be equally accessible to all. However, one should recognise that it is not only the applicant that benefits from the agreement. The CA gains, too, because it is saved considerable effort in obtaining relevant information and because it is likely to avoid costly and lengthy litigation. The cost analysis should reflect also this aspect.

A serious shortcoming of the mutual agreement procedure is the absence of any time limit within which the negotiation should be completed[156]. In most planned actions and transactions, time is of the essence and the risk of serious delays in the process of obtaining an agreement will often deter taxpayers from using this facility.

Again, it is a balancing process: the risk of not getting the agreement in time against the risk of later controversy and litigation.

In general, it can be stated that MAPs have advantages regarding timing over a unilateral appeal procedure. They usually last between two and five years whereas an appeal and

[155] Code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (2006/C 176/02), *Official Journal of the European Union*, 28/07/2006

[156] For example, negotiations take on the average two years in Belgium but may last longer as ten years in other contracting states (e.g. France). For Belgium: Coremans J., *Mutual Agreement Procedure and Practice*, Belgian Report, 1c., 213. For France: Senate session of 18 October 1991, concerning the EC Convention Ratification Bill: "En pratique, cela peut aller jusq'à huit ans, voire dix ans".

subsequent court litigation through all instances could easily last more than ten years. Although the MAP may itself take some time, it is generally less than litigation and cheaper.
The time taken to complete a MAP varies according to the complexity of the facts and the circumstances of the case. The OECD, in the Annex 1 to the MEMAP, suggests an approximate timeline for MAP process, that can be divided into three different stages as follows:
1) the "evaluation stage" (about 4 months): first contacts between the two CAs and their decisions to enter into MAP consultations;
2) consultation and negotiation between the two CAs (about 18 months): the issuance of the "position paper" by the CAs that received the request from the taxpayer and the response by the other CA
3) MAP (about 7 months): the final Memorandum of Understanding and its approval by the taxpayer, the exchange of closing letters between the CAs and the implementation of the agreement.

Timing	Procedure
3 years form the notification of the domestic act	Taxpayer request for MAP
1 month	the CA inform the other CA of the request
to be established by the CA (hp: 1 month)	the taxpayer provides information to the CA
1 month	the CA decides to accept/reject to start MAP
1 month	the other CA decides to accept/reject to start MAP
6 months	issuance of position paper by the CA
6 months	response to the position paper by the other CA
6 months	negotiation between CAs (face-to-face meetings…)
2 months	MAP document: Memorandum of Understanding
1 month	Taxpayer's approval
"as soon as possible " (hp: 1 month)	Exchange of closing letters
3 months	Implementation of Mutual Agreement

1.4.5 MAPs and domestic recourse provisions

Several interesting and complex issues, which may affect the implementation of the mutual agreement, arise about the interaction between MAPs and the domestic recourse provisions. Under the first paragraph of Art. 25 of the OECD Model, a person who considers that the

actions of one or both contracting states result or will result for him in taxation that is not in accordance with the provisions of the treaty may present his case to the relevant competent authority, *irrespective of the remedies provided by the domestic law of those states*. This does not mean, however, that both an MAP and the procedure under domestic law may necessarily be pursued simultaneously in all cases. The parallel existence of domestic and international procedures raises interesting issues of the legal relationship between the two formally autonomous remedies, and opens extra avenues for the taxpayer. But the relationship is not resolved in a uniform way and the choice may not be available in all countries. Rather, this is a question to be answered by domestic law. Contracting states have found a variety of solutions to this problem. In particular, some countries require the taxpayer to waive his right to a domestic remedy *before* the start of an MAP (e.g. Sweden[157]). Other countries make the implementation of a mutual agreement dependent on the taxpayer's acceptance and his waiver of domestic remedies, (e.g. Germany[158]).

In general, in most of the OECD countries, two different processes are available to mitigate or contest an assessment made by the audit function of the tax authority. The taxpayer may object to the assessment and the determination of the issue moves to the competent administrative authority. If the objection is not successful, the taxpayer may choose to proceed to litigation in the domestic tax court. Alternatively or simultaneously[159], the taxpayer may choose to proceed to the competent tax authority section and request implementation of the MAP under the applicable tax treaty. There are advantages to each alternative, due in part to the differing objectives of each process, and in part to the relationship between the two processes. The objective of the MAP is to eliminate incidences of double taxation; the objective of litigation is to reach a decision based on the facts and the domestic tax law, without necessarily concerning itself with double taxation.

If the taxpayer decides to select the MAP route first, and the two competent authorities cannot reach an agreement, or the agreement reached is not acceptable to the taxpayer, the litigation route is still open to the taxpayer. If the taxpayer decides to start with the domestic route (appeal first to the tax authority and then to the tax court) and is unsuccessful in the

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[157] The practice of the Swedish Ministry of Finance is to require that the assessment of the taxpayer is "final" before a mutual agreement is concluded.

[158] A decree of German Minister of Finance (Ministry of Finance, decree of 13 July 2006 – IV B 6 – S 1300 – 340/06) regulates the national implementation of MAP decisions and provides that, after the result of an MAP has been presented to the taxpayer, he must decide whether he will accept the proposed MAP decision and abandon his domestic rights or whether he will reject the decision and continue the domestic proceedings. Thus, theoretically at least, the MAP decision does not necessarily have any effect on the taxpayer.

[159] A taxpayer may commence the two procedures, with the plan to pursue his claim before the court (assuming the time limit is still open) if he is not satisfied with the agreement reached between the competent authorities. He may, alternatively, pursue his claim under the MAP after the case has been finally adjudicated by the domestic court.

courts, the judgment may adversely affect the taxpayer's prospects of eliminating double taxation through the MAP.

The OECD's recent work on the new paragraph 5 of Art. 25, analysed below, indicates the approach to the relationship between existing domestic legal remedies and arbitration that would be the most consistent with the basic structure of the mutual agreement procedure[160]. If domestic remedies are still available, the CA either requires that the taxpayer agree to the suspension of these remedies or, if the taxpayer does not agree, will delay the MAP until these remedies are exhausted. If the MAP is conducted and agreement is reached, the taxpayer may reject such agreement and pursue domestic remedies that had been suspended. Experience with the MAP has shown that in most cases where agreement has been reached by the competent authorities, the taxpayer accepts such agreement. Should the taxpayer favour the agreement reached in the MAP to apply, then he must renounce the exercise of domestic legal remedies as regards the issue covered by the agreement. If domestic legal remedies are pursued and are exhausted in one Contracting State, only the MAP in the other Contracting State is available, as most countries consider it impossible to override such a final decision through the MAP. The same basic rules apply to arbitration: it would not be helpful to submit an issue to arbitration if it is known in advance that one of the countries is limited in the response that it could make to the arbitral decision[161].

An agreement reached in MAP is not reviewable by any court. The taxpayer who disagree with the outcome of the MAP cannot contest it through the courts but he usually will be able to lodge an appeal against the administrative measure by which the agreement is implemented.

1.4.6 Effects on existing treaty provisions and constitutional issue

Another complex question is whether mutual agreement can modify tax treaties. Once a mutual agreement between competent tax authorities is reached, it gains binding legal force under international law. This follows from the principle that mutual agreements can be seen as modifications or amendments to the treaty. However, since in most domestic law mutual agreements only have the status of administrative regulations, such agreements can only clarify existing tax treaties; it cannot substantially modify them. They are binding on the tax administration but not on the taxpayer and the courts because they are lacking parliamentary

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[160] OECD Report on "Improving the Resolution of Tax Treaty Disputes", paragraph 59, reads: "the legal remedies would be suspended pending the outcome of the mutual agreement procedure involving the arbitration of the issues that the competent authorities are unable to resolve and a tentative mutual agreement would be reached on the basis of that decision. As in other mutual agreement procedure cases, that agreement would then be presented to the taxpayer who would have to choose to accept the agreement, which would require abandoning any remaining domestic legal remedies, or reject the agreement to pursue these remedies."

[161] Commentary to Model Tax Convention, Article 25, para. 76.

consent as required by most of constitutional laws[162]. Nevertheless, there are administrative interpretations[163] that support the opinion that such agreements can also modify existing treaties. As a matter of fact, according to Art. 31, para. 3, VCLT, "any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provision" must be taken into account. To give these provisions the meaning that treaties could be amended simply by interpretation by the authorities ignores the fact that, according to the standard legal opinion, only the authority competent to conclude a treaty is also entitled to modify it. The contracting parties involved in the MAPs do not add obligations to the tax treaty but only discuss the different administrative policies. The tax authority is not competent to conclude or to alter a tax treaty without the consent of the legislature. A mutual agreement is neither a statute, because it has not gone through the procedures for making a statute, nor secondary delegated legislation made under the authority of a statute, but merely an agreement which can bind the competent authorities but not the courts.

The same arguments can be put forward for the second sentence of Art. 25 (3), which typically authorizes the competent authorities to "consult together for the elimination of double taxation in cases not provided for in the Convention". It appears that these agreements actually amend the treaty, in violation of the regular amendment process and the provisions of constitutional law. This provision is deemed to violate the constitutional rules that treaties must be ratified by law and that any imposition or relief of tax must be based on statutory law[164]. It is legally impossible for a body adjudicating a dispute to introduce new legal provisions in the matter at hand because it conflicts with the constitution of most of the States. The third paragraph of Art.25 seems to open the door to "anybody" who wished to challenge the tax treaty rules, at least as far as it may concern the right to which MAP may apply (i.e. double taxation). I think it can explain why "legislative MAP" remains very marginal in the MAP practice.

All the interpretative mechanisms can be very difficult for a number of reasons, for example the fact that there is no globally consistent definition of key tax terms or that there could be a difficult negotiation between governments with quite different legal systems. Alternative dispute resolution options such as arbitration need to be considered, especially where the cost and risks associated with litigation are excessive. The OECD performs good offices in this regard contributing to the development of appropriate rules.

1.5 OECD works and proposals to improve the mutual agreement procedure

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[162] See Lehner in Klaus Vogel, *Double Taxation Conventions.* Commentary 1997, Article 25, m. no.109.

[163]See Klaus Vogel, *Double Taxation Conventions.* Commentary 1997, Introduction, m. no.82c.. *Loukota*, "Beteiligungsertragsbefreiung für ausländische Unternehmen?", SWI (1991), 5(6).

[164] See, for example, Arts. 68, 110(1) and 112(2) of the Belgian Constitution.

Since its creation, in 1960, the OECD has played a leading role in helping governments avoid friction over tax disputes through the development of a network of more than 2,500 bilateral tax treaties among more than 200 countries. The application and interpretation of these treaties may themselves, however, lead to disputes. The OECD has agreed recommendations that will significantly improve the way in which these disputes are resolved. The methods of resolving international tax disputes are of the highest importance. Today, the mutual agreement procedure is by far the most common one. As shown in the previous paragraph, it does, however, have disadvantages, especially when seen from the taxpayer's point of view. There is no guarantee that a double taxation in a specific case is eliminated and the position of the taxpayer is both ambiguous and weak.

In order for the MAP to be a more workable mechanism, a few improvements could be made. The proposal published by the OECD during the past years had as its main goal to ameliorate the settlement procedure in this respect and to supplement the mutual agreement procedure with a tool, principally an arbitration clause, which will settle all cases unresolved by the negotiation between the competent authorities.

In 2003 the OECD's Committee on Fiscal Affairs ("CFA") formed a Working Group[165] charged with examining the effectiveness of the MAP, including consideration of other dispute resolution techniques that might be used to supplement the operation of the MAP. As a first step, the Working Group realized the "Country Profiles of Mutual Agreement Procedure"[166], which contain information from the OECD countries and some non-OECD economies about domestic guidelines of MAPs and other useful data.

A significant advance has been made by the OECD Committee on Fiscal Affairs, which published its reports "*Improving the Resolution of Tax treaty Disputes*" and "*Manual on Effective Mutual Agreement Procedures (MEMAP)*"[167] on 7 February 2007. The report that was released by the CFA in February 2006 and subject of a public consultation in Tokyo in March 2006 proposes to amend Art. 25 of the OECD Model to include a supplementary dispute resolution mechanism in the form of a mandatory binding arbitration procedure to settle issues if the MAP concerned does not produce agreement between the competent authorities within two years from the presentation of the case. This is an additional dispute resolution technique, which, however, must be an integral part of the MAP and should not constitute an alternative route to solving tax treaty disputes between states.

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165 See OECD website: www.oecd.org. The working group consists of government officials with expertise in tax treaties and transfer pricing, working in close cooperation with businesses.

166 They can be found on the OECD website at the CTPA's Dispute Resolution homepage (www.oecd.org/ctp/dr).

167 An on-line resource (www.oecd.org/ctp/memap) to explain the MAP process and to describe "best practice" for effective MAP.

The changes to Art. 25 will also involve the development of a new OECD Model Commentary on the MAP article to provide guidance on the proper application of that provision, to promote consistency and to improve its operation.

The Working Group has paid particular attention to ways to ensure that the MAP process will be sufficiently efficient, avoiding barriers to the use of the MAP as described above. The proposed changes to the OECD Model's Commentary on Art. 25 address a number of substantive and operational aspects; for example, they clarify topics such as the transparency of the procedures, the role of the taxpayer in the process and the cost of the procedure. Substantive issues include the scope and the purpose of the MAP article, its interaction with domestic law and time limits. They also encourage the suspension of the collection of contested taxes pending resolution of the MAP and the appropriately coordinated treatment of interest and penalties, which prevents the taxpayer from being liable to double taxation on the amounts in question during the procedure.

2. The Arbitration as a resolving tool

2.1 Tax Arbitration: an overview

As discussed in the previous chapter, the prevailing opinion in the OECD countries regarding the nature of an MAP is that it is merely an "internal proceeding" between two or more CAs which does not directly affect the legal position of a taxpayer.

In the case of an MAP failure in which no agreement can be reached, the possibility should be created for both the tax authority and the taxpayer to refer the matter to an arbitration body.

Therefore, unlike an MAP, an arbitration proceeding is not just an internal matter between governments; it also affects the taxpayer's rights and must follow basic procedural rules.

Arbitration is an alternative dispute resolution mechanism by which a dispute between two or more parties can be settled by some other alternative process outside the formal court system. Generally, it is a structured and binding process in which the disputing parties select an arbitrator and are bound by his decision[168].

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[168] It has been argued that precisely this feature, which distinguishes the Arbitration Convention from the traditional mutual agreement procedure, would have the effect that the former will be unlikely to be applied in practice, see Berndt Runge, "The German View of the Prevention and Settlement of International Disputes on Tax Law", 1 *Intertax* 1997, 3. Jürgen Kilius, "The EC Arbitration Convention", 10 *Intertax* 1990, 437, reviewing the history of multilateral arbitration provisions for tax conflicts, suggesting that arbitration represents a step towards multilateral cooperation on double taxation issues, and noting recent treaty negotiations that would permit bilateral arbitration if both states agree; *Seminar on: Resolution of Tax Treaty Conflicts by Arbitration,* (Florence: IFA Congress, 1993), discussing the use of arbitration in international tax disputes and the need for procedural safeguards; David Tillinghast, "Choice of Issues to be Submitted to Arbitration Under Income Tax

Arbitration has a quite long tradition in trade and investment disputes, as discussed in chapter…of this study, involving private parties and governments. The problems with the mutual agreement procedure generated pressure for the introduction of a quasi-judicial procedure. The International Chamber of Commerce (ICC) has also been committed to encourage governments to accept compulsory arbitration in international tax conflicts since it issued a position paper on the subject in 1984, and it encourages all governments to negotiate bilateral or multilateral conventions for arbitration of tax disputes. Consequently it has been a subject of discussion in the OECD and international community whether the arbitration system is suitable for tax disputes and the OECD itself, in its 1984 Report, listed the advantages of the arbitration, compared with the mutual agreement procedure, as follows:

1) saves taxpayer from uncertainty and delay
2) reduces the cost involved by a lengthy MAP
3) resolves a dispute while information is still fresh
4) it is speedy: needing compliance with no administrative rules and enjoying a fast decision-making process
5) if taxpayer is allowed to participate or presents evidence, it reduces misunderstanding
6) arbitration are semi-experts, not bound by the strict interpretation of domestic law
7) reduces the likelihood that governments may disregard precedents.

Arbitral awards are usually confidential; the publication of the decisions of the arbitration board is to be encouraged as a means of facilitating and expediting the future settling of disputes, and suitable bases for such publication (e.g. redaction, taxpayer's consent, etc.) should be explored. One of the important aims of the tax treaty experts which can issue opinions is to foster uniformity in the interpretation of identical treaty provisions. To that purpose, the opinions of the arbitrators, irrespective of whether they are followed by the court or authorities that requested the opinion, should be published.

Arbitration is generally referenced as being very successful in avoiding double taxation, not necessarily because the actual arbitration process is a better procedure to resolve tax disputes. The success of tax arbitration appears attributable largely to the fact that the arbitration phase might have a dissuasive effect on those CAs that prefer to resolve their disputes between themselves, without intervention of a neutral advisory committee. Moreover, countries do not like to relinquish jurisdiction over issues affecting their tax base to independent arbiters and prefer to enter into bilateral agreements. This, in turn, of course

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Conventions", Herb Alpert and Kees van Raad, *Essays on International Taxation - in honour of Sidney I. Roberts* (Kluwer, Deventer 1993, 444 pp.), p. 349, commenting that "among the broad range of tax specialists both within and without government (if not necessarily among members of Congress or its staff), there seems to be a growing consensus that arbitration should be made available as the ultimate dispute resolution mechanism in appropriate cases".

leads to swift resolution of CA cases. Tillinghast comments on mechanism to resolve tax disputes with the United States IRS: "Among a broad range of tax specialists both within and without government (if not necessarily among members of the Congress or its staff), there seems to be a growing consensus that arbitration should be made available as the ultimate dispute resolution mechanism in appropriate cases"[169].

There is an increasing number of bilateral tax treaties that provide for arbitration, with specific, non homogeneous, clauses, despite the provisions of the OECD MC in force at the time of the signatures. Furthermore an EU Convention provides for compulsory arbitration in transfer pricing cases if the CAs do not succeed in reaching a mutual agreement.

The European Union's contributions to cross-border dispute resolution methods are significant regarding transfer pricing issues. Specifically, an MAP relating only to the transfer pricing disputes is set out in the *Convention 90/436/EEC*, adopted in 1990[170] and extended by a protocol signed in 1999[171], *on the Elimination of Double Taxation in Connection with the Adjustment of Profit of Associated Enterprises* (the "EU Arbitration Convention")[172] as an option if agreement is not reached under the MAP within two years. In 2004, the *EU Joint Transfer Pricing Forum* (JTPF)[173] undertook a study on the number and content of pending MAPs under the Arbitration Convention in relation to the Member States[174]. As at 31 December 2004, 109 pending cases had been reported[175]. The improvement of the arbitration procedure became a priority for the EU JTPF, and this led to the *Code of Conduit for the effective implementation of the arbitration convention*, which was adopted by the ECOFIN Council on 7 December 2004[176].

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[169] David Tillinghast, "The Choice of Issues to be Submitted to Arbitration under Income Tax Convention", *Intertax* 4 (1994), 160.

[170] Entered into force on 1 January 1995 between the 12 Member States of the European Union at that date (excluding Austria, Finland and Sweden). For a comprehensive discussion of the origins, development, and legal and procedural framework of the Arbitration Convention, see Luc Hinnekens, " The European Tax Arbitration Convention and its legal framework", *British Tax Review* (1996), pp 132 and 272; Dirk Schelpe, "The Arbitration Convention: Its Origin, Its Opportunities and Its Weakness", 2 *EC Tax Review* 1995, 68.

[171] Published in Official Journal C 202/01 of 16 July 1999.

[172] The origin of the Arbitration Convention was the Commission's 1976 proposal for a directive to eliminate double taxation in respect of transfers of profits between associated enterprises in different Member States (Official Journal (EC), C 301, 21 December 1976) and the White Paper of 1985 on the completion of the Internal Market. Following negotiation in the Council, the Commission's proposal was transformed from a directive into an inter-governmental convention, signed on 23 July 1990).

[173] The EU JTPF consists of an expert from each Member State and 10 experts from business. The OECD Secretariat participates as an observer.

[174] JTPF/011/back/rev1/2005/EN.

[175] France was the Member State most concerned with the process (65 cases), followed by Germany (49 cases), the Netherlands (33 cases) and the United Kingdom (30 cases). The first case decided under the Arbitration Convention involved Italy and France (opinion dated 19 May 2003).

[176] The intention of the Code of Conduct is to ensure a more uniform application by the EU Member States of the EC Arbitration Convention. The application of the Code of Conduct should resolve disputes within a maximum of three years. It provides for common procedures, in particular regarding the practical operation of the MAP and transparency towards taxpayers and practical arrangements for the second phase of the Arbitration Convention, i.e. the "arbitration procedure", that must be followed if tax authorities do not reach mutual agreement within two years. The Code of Conduct also recommends that no tax should be collected during cross-border dispute

In the following, section 2 gives an overview on the existent arbitration clauses in tax treaty and specially emphasis is put on the arbitration clause included in the recent protocol to the income tax treaty between US and Germany that includes provision calling for mandatory arbitration of certain issues if the CAs of the two countries were unable to agree a solution under the MAP within a fixed period time. Section 3 is concerned with the arbitration procedure in transfer pricing matters, with particular reference to the EU Arbitration Convention, its features and effectiveness. Finally, section 4 analyzes the link between the MAP and the arbitration after the addition of a new paragraph to the Article 25 of the OECD MC to settle unresolved disputes, through a mandatory binding arbitration provision.

2.2 Arbitration Clauses in Bilateral Tax Treaties

In recent years, many countries have included arbitration provisions in their tax treaties through a specific clause in their MAP article[177]. It is an "*ad hoc"* procedure to strengthen the MAP , the sense it does not rely on the supervision or formal administration of an arbitration centre, as in international law practice. The parties are "on their own", they are not bound by time limits set by arbitral institutions, and their proceedings are not monitored by any central body. The parties can leave the issuance of arbitration procedures to their arbitrators or develop their own rules and design their own arbitral management, either in the treaty clause or after a dispute has arisen. Alternatively, the parties may simply adopt or adapt the rules of one of the major arbitration centres but, again, without entrusting the administration of the arbitration to such centres.

The biggest difference between an "ad hoc" arbitration in a commercial agreement and an arbitration clause for solving tax disputes is the source of the arbitration provision itself: a private agreement in the first case and an International Convention in the second case. Consequently, prerequisite for successful use of ADR or ad hoc arbitration in business relationship is the existing of a contract between the parties. On the contrary, the tax arbitration procedure is granted by the existence of a bilateral tax treaty, on the base of the procedures established between the contracting States.

An increasing number of tax treaties have an arbitration clause, and certain countries, like the United States, have been quite active in pursuing implementation of arbitration proceedings in settling the tax disputes. For example, in the treaty between Germany and Austria there is one of the most notable arbitration clause, providing for mandatory binding arbitration by the ECJ on a wide range of tax treaty issues, in the case of unsuccessful MAP.

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resolution procedures and that the EU Member States should apply the Code of Conduct to the dispute settlement provisions in their tax treaties with each other.

[177] The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations indicates that over 60 bilateral treaties contain arbitration provision.

The United States, as well, has had optional arbitration under its tax treaties with Germany and Mexico and limited mandatory arbitration – only on the facts of the case – with Canada, but they have not been used. In 2006, the United States undertook further steps towards mandatory arbitration in the protocols to its tax treaties with Germany[178] and Belgium.
The German-USA treaty, concluded in 1989, has been the real breakthrough of arbitration in international tax disputes. Its importance lies both in the factual provision of the arbitration clause and in the fact that two of the most important powers of the democratic, industrialized word have taken this step.
The inclusion of arbitration provisions into an income tax treaty represents a novel approach to the settlement of tax disputes between countries. Use of arbitration to resolve disputes that arise under the Tax Treaty offers both the U.S. and the German government, as well as affected taxpayers, the opportunity to gain a "final decision" by a neutral and depoliticized tribunal. As a result, the governments and the taxpayers have the potential to realize a fair and consistent application of the terms of the Tax Treaty. The most relevant strongpoint of this clause is that the decision must be based upon the treaties of the contracting states, which means that the procedure is truly legal. The awards are more predictable for the taxpayer and it is possible to establish precedents that are of interest both to the treaty partners and others[179].
On December 28, 2007, the "Protocol Amending the Convention Between the United States 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" (the 2006 Protocol) entered into force. The 2006 Protocol modified certain provisions of the Convention between the US and Germany; among other things, it revises Article 25 (Mutual Agreement Procedure) of the Convention to provide for mandatory arbitration of certain cases if the CAs of the two countries were unable to arrive at a solution under the MAP of the treaty within two years form the date of the submission of a case to them. The Protocol requires binding arbitration if the dispute involves one of the following issues:

- residence of a natural person;

[178] The arbitration clause is to be found in Art. 25, paras. 5 and 6, as amended in 2006 by Art. XIII of the Protocol: "Where, pursuant to a mutual agreement procedure under this Article, the competent authorities have endeavoured but are unable to reach a complete agreement in a case, the case shall be resolved through arbitration concluded in the manner prescribed by, and subject to, the requirements of paragraph 6 and any rules or procedure agreed upon by the Contracting States". As explained in the Technical Explanation to the 2006 Protocol: "Article XIII of the Protocol deletes paragraph 5 of Article 25 (Mutual Agreement Procedure) of the Convention, providing for voluntary binding arbitration, and replaces it with new paragraphs 5 and 6, which introduce a mandatory binding arbitration procedure."
[179] Karyn Weinberg, "Arbitration Procedures in the United States – Germany Income Tax Treaty: the Need for Procedural Safeguards in International Tax Disputes", 12 *B.U. Int'l L.J.* 1984, p.180.

- existence of a permanent establishment in either the US or Germany;
- determination of business profits;
- associated enterprises; and
- royalties.

The competent authorities may also agree to submit any other matter governed by the mutual agreement provision to binding arbitration. The presenter of the case (the taxpayer) and any other persons whose tax liability to either state may be directly affected by resolution of the dispute (concerned persons) must agree not to disclose information received during the arbitration. Procedural rules and principles governing the arbitration proceeding contemplate a "best offer" or "baseball arbitration" format[180]. Each CAs should submit in writing its "proposed resolution" of the open issue and a "position paper" with its arguments in favour of that solution. They have also the possibility to rebut the other side's arguments through a reply submission (in writing). Hearings are forbidden. The arbitral decision will be a simple one-line determination: the panel chooses one of the two positions, it cannot reach a third different conclusion of the issue.
In this process, the taxpayer is totally out of any involvement and this approach has been justified with the final aim of a more rapid and efficient resolution of unagreed case. In any case, the taxpayer's rights are always guaranteed by the possibility to not accept the results of the arbitration and to pursue other remedies.
Arbitration is also a feature prescribed in the MAP article of some double tax conventions[181]; procedures are to be established by an exchange of diplomatic notes or by agreement of the competent authorities.
In 2005 Canada and US entered into an "Memorandum of Understanding" (MOU) which has an arbitration-like feature to determine the *facts of a case*. Where two competent authorities cannot agree on the facts within six months of commencement of negotiations, the case must be referred to a panel of officials drawn from each administration's appeals function. Findings of fact by the panel will be binding on the competent authorities. On September 21, 2007, the US and Canada signed a protocol, which includes arbitration provisions similar to the ones provided in the 2006 protocol to the income tax treaty between US and Germany.

We can note that, generally, the more inclusive and enduring economic relationship between two countries, the more likely such parties will seek to resolve or prevent their tax disputes in ad hoc arbitration clauses or through ADR techniques. Parties involved in an ongoing

[180] An example of a "baseball arbitration clause" could be the following: "Each party shall submit to the arbitrator and exchange with each other, in accordance with a procedure to be established by the arbitrator, its best offer. The arbitrator shall be limited to awarding only one or the other of the two positions submitted".
[181] See, for example, the MAP article of 14 Canadian tax conventions.

mutually beneficial economic relationship are less likely to rely on highly institutionalized forms of dispute resolution than parties with no anticipated future relationship, that is, parties that are not repeat players or do not belong to some close-linked trading community. This happens both in commercial dispute settlement and in tax conflicts resolution for two main reasons. Parties in a continuing relationship are anxious to maintain good relations and are therefore likely to be interested in reaching a quick and amicable settlement. Moreover, parties in a continuing relationship typically have good information about each other's past behaviours and this knowledge may be useful to manage tax conflicts.

The growing importance of an effective resolution of disputes has been reflected in the OECD proposal for including an arbitration clause in all tax treaties, following the OECD MC, as a further step where MAP, provided for in Article 25, is unsuccessful. The arbitration procedure recently introduced by OECD in its MC will be analysed hereinafter as an example of a multi-tiered dispute resolution clause.

2.3 The transfer pricing arbitration

2.3.1 Overview

As we have noticed in the Part II, the setting of an arm's length transfer price tends to be a very difficult exercise. This did not present a significant problem for taxpayer in the past, because tax administration showed little interest in transfer pricing till some 30 years ago, when it became suspicious that foreign and domestic multinationals were exploiting the imperfection of the imperfection of the arm's length principle and thereby avoided paying their fair share in resident-state taxes.

A tax authority can almost always question the appropriateness of the decision of the taxpayer on transfer pricing evaluations and sustain a transfer pricing adjustment. However it is far from certain that a corresponding adjustment to the profits of the other related party to the transaction will be accepted by the other tax administration and taxpayers are not assured that their profits will not be taxed twice. The interest of the parties involved is not always the fair attribution of taxing rights. Furthermore, multinational enterprises are faced with tax authorities with different domestic rules, which in many cases will result in them having a different approach to transfer pricing and to the procedures for dealing with tax disputes. While the same transfer price is not accepted in all the tax jurisdiction involved, double taxation may occur giving rise to an impediment to trade.. This means that the international allocation of profit is governed by an imperfect tool, as the arm's length principle, and it is the interest of the taxpayer and the responsibility of the states to assure the avoidance of double taxation with respect to transfer-pricing adjustments. Such double

taxation has distorting effects on the development of harmonious economic relations between States.
For transfer pricing, as for other international taxation problems, a satisfactory result can no longer be hoped for when an attempt to resolve them is made unilaterally by through domestic law. The elimination of international double taxation requires a bilateral or multilateral consensus. Most bilateral double taxation treaties include a provision for corresponding downward adjustments of profits of the associated enterprise concerned but do not impose a binding obligation on the Contracting States to eliminate the double taxation. Compared with income tax treaties the advantage of the AC is that the duration of the procedures is limited and that there is a result obligation.
The mutual agreement procedure is used in cases where double taxation exists as a result of the enforcement of domestic law with respect to transfer pricing. CAs negotiate corresponding adjustments in transaction between affiliate companies where transfer pricing adjustment have been made in one of the countries while no corresponding adjustments is made in the other country, thus permitting the fair tax to be levied. A number of cases have been brought under the mutual agreement procedure in double taxation convention in order to adjust transfer-pricing issues between countries. However, as we have already noted, the limits of the MAP have become apparent and instead the use of arbitration has begun to draw attention.
Although MAP and arbitration may provide short-term assistance in alleviating acute problems, such “case-by-case” resolution will not solve the underlying problem of discordant transfer pricing policies. Nonetheless, even though the essential problem is properly the subject for bilateral treaty negotiations, individual cases may provide a basis on which to build international understanding of what is at stake in transfer pricing. Regardless of international acceptance of the arm's length standard, the standard is not an end in itself, but a means that provide a rational basis on which to establish which country may claim the right to certain tax revenues. The differences of opinion between tax jurisdictions therefore represent little more than differences as to what the term "arm's length" actually means. The ultimate solution, however, may be reached only by international agreement on uniform rules. It has been argued that transfer pricing cases lend themselves better to arbitration than to any other method for resolving international tax disputes thanks to the active role played by an independent third, with a good expertise in the economic analysis of transfer pricing facts[182] . Arbitral awards are usually confidential; the publication of the decisions of the arbitration board is to be encouraged as a means of facilitating and expediting the future

[182] Luc Hinnekens, “ The European Tax Arbitration Convention and its legal framework”, *British Tax Review* (1996), 140.

settling of disputes, and suitable bases for such publication (e.g. redaction, taxpayer's consent, etc.) should be explored.

2.3.2 The EU Arbitration Convention

2.3.2.1 Overview

Transfer pricing is not only a major issue in the international tax arena but also a complex obstacle for the Internal Market which hampers efficiency, effectiveness, transparency and simplicity[183].

On 23 July 1990, the Ministers of Finance of the 12 EU Member States, namely Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom, signed the "Convention on the elimination of double taxation in connection with the adjustment of profits of associate enterprises", the so-called Arbitration Convention (AC)[184], that came into effect only on 1 January 1995 for a five-year period according to Art. 20 of the AC, , after the ratification by all national parliaments[185]. The original proposal for a directive to eliminate double taxation in the case of transfer pricing issue was presented by the Commission in 1976 and, after long negotiation, it was transformed from a Directive into the inter-governmental Convention signed in 1990. The Convention has suffered from the fact that its extension was conditioned on the deposit of the instruments of ratification of the Protocol by all of the Contracting States. This took more than four and a half years to complete and it was, therefore, a source of some uncertainty as to whether or not and how the Convention would apply in the "interim" period.

On 25 May 1999 a Protocol was issued amending the AC to the effect that the Convention shall be extended for a further five-year period and shall automatically be extended every five years for a five-year period, unless a Contracting State objects[186]. Italy and Portugal were the last Contracting States to ratify the Protocol. As Portugal deposited its instrument of

[183] COM(2001) 582 final, at. 283.

[184] Convention 90/463/EEC of 23 July 1990, *Official Journal* L 225, 20 August 1990, at.10

[185] A specific "Treaty of Accession" was concluded in 1995 to extend the AC to Austria, Finland and Sweden, after they joined the EU. See: "Convention of 21 December 1995 on the accession of the Republic of Austria, the Republic of Finland and the Kingdom of Sweden to the Convention on the elimination of double taxation in connection with the adjustment of profit of associated enterprises", *Official Journal*, 26/1, 31 January 1996.

[186] Objections have to be notified to the Secretary General of the Council of the European Union at least six months prior to the expiration of any five-year period. Accordingly, objections to an extension until 2010 should have been notified by 30 June 2004 at the latest. As this does not appear to be the case, the Convention should remain in force for a further five years until 2010 (at least).

ratification on 29 July 2004 and Italy on 4 August 2004, the Protocol entered into force on 1 November 2004[187], with retroactive effect as of 1 January 2000[188].

As was the case for Austria, Finland and Sweden, in order to extend the scope of the Convention to the new Member States, a separate Convention for the Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic to the Arbitration Convention of 8 December 2004, was entered into.

The AC refers to the situation where the tax authorities of one EU Member State unilaterally adjust profit of a company in its residence state with respect to a transaction with a related enterprise in another EU Member State. In these case, the AC provides for a binding expert opinion on the elimination of the double taxation in question when the CAs cannot reach mutual agreement within a period of two years, unless the taxpayers agree to extending this time-limit. Unlike the mutual agreement procedure, the AC actually obliges EU Member States to eliminate double taxation and thus improves the conditions for cross-border activities in the Internal Market. Similar to the Commentary to the new Article 25(5) of the OECD MC, the EU Arbitration Convention provides for the possibility for the States to exclude recourse to arbitration in the event "one of the enterprises concerned is liable to a serious penalty" " under an administrative or legal ruling in relation to those of its acts which led to the transfer pricing adjustment. As a result, taxpayers convicted of tax fraud or evasion will, effectively, not be able to take advantage of the AC. This is consistent with the provisions governing the mutual agreement procedure.

It has been argued that arbitration should not be regulated by means of a convention, under international public law, but rather through a directive, that is an EC legal instrument[189]. The main difference between a multilateral convention and a directive is that, under a multilateral convention, the EU Member States maintain their tax sovereignty. Indeed, from a multilateral

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[187] This protocol provides that the extension of the Convention takes effect the first day of the third month following the month in which the instrument of ratification is deposited by the last signatory state.

[188] This means that any pending request made under the Convention from this date should, in principle, follow the rules that are provided for this in the Convention. Theoretically, Contracting States could be required, in certain circumstances, to set up an advisory commission immediately on 1 November 2004, as the two-year period to reach an agreement under the MAP has expired. However, according to at least one commentary, certain CAs have announced that they will only apply the Convention from the date of its ratification by their own Member States (See S.B. Huibregtse and R.H.M.J. Offermanns, "What is the Future of the EU Arbitration Convention?",11 *International Transfer Pricing Journal* 2 (2004), p. 77) There is one exception to this retroactive application, i.e. the period between 1 January 2000 and 1 November 2004 is not taken into account in determining whether or not a case has been presented
within the three-year period discussed below..

[189] At least some commentators are not in favour of a change of the Convention into a directive because of (i) the "stability" of a convention, which requires the consent of all the Contracting States, and (ii) the risk of inconsistent national implementation of a directive (Huibregtse and Offermanns, *supra note,* 82).

perspective, the EU Draft Arbitration Directive of 1976[190] addressed the same topics as those covered in the Convention, however, due to a lack of support at the level of the Member States and to the reluctance of Member States to give up their sovereignty in this field, especially in view of the absence of a common set of substantive transfer pricing rules, the Draft Directive has not been finalized..It has been seen as excluding the ECJ's jurisdiction, because the ECJ has, in principle, no jurisdiction to interpret and enforce provisions of a convention. and the European Committee's ability to initiate an infringement procedure against a Member State's failure to comply with its obligation under the Convention[191]. Formally, a convention is not subject to Community law, although more recently the ECJ decisions state that treaties should not be interpreted contrary to or in violation of Community law, and it is argued that double taxation in and of itself may be an obstacle to trade in the Common Market[192]

The Arbitration Convention requires the Member States to eliminate such double taxation on the basis of a mutual agreement, or on the basis of the decision of the advisory commission. In any event, the Arbitration Convention aims at guaranteeing the elimination of double taxation resulting from a profit adjustment within three years from the date the case was submitted to the competent authorities. Transfer pricing issues are not specifically referred to in the AC, although they are the ones that normally lead to "adjustment of the profit of associated enterprises". The AC can be considered comparable in ranking as a *lex specialis* compared to a *lex generalis*, within treaty context: the former will have priority in application over the latter.

Some scholars have argued that the AC might applied in other situation of adjustments such as in the case of domestic thin capitalization rules[193] however the arbitration procedures under the AC provides specific conditions[194] that could have problematic feature in the case of thin capitalization rules.

Although procedures to resolve disputes involving transfer pricing adjustments are, in many cases, already provided for under the MAP set out in bilateral tax treaties, the greater

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[190] Proposed Directive submitted to the Council of 29 November 1976, *Official Journal*, C 304, 21 December 1976, 4.

[191] Terra-Wattel, "European Tax Law", 3rd ed., Deventer: Kluver Law International (2001), 407. The authors also pointed out the potential delay in its implementation compared to a Directive because, since it is in the form of a treaty, signatories has to wait for the last signatory to notify the Council of the conclusion of its national ratification procedure. However, it could be argued that the goal of the AC, i.e. eliminating double taxation situations, is relevant for Community law and could lead to ECJ jurisdiction to ascertain whether impediments to Community law have in fact arisen from the AC.

[192] Lankhorst-Hohorst GmbH v. Finanzambt Steinfurt, 12 December 2002, C-324-00.

[193] F.Piltz, "General Report", IFA Cahiers de droit fiscal International, *International aspects of thin capitalization*, Vol. LXXXIb, Deventer : Kluver (1996) ; G.Michielse, « Netherlands Report" IFA Cahiers de droit fiscal International, *International aspects of thin capitalization*, Vol. LXXXIb, Deventer : Kluver (1996).

[194] Namely: 1) a direct or in direct participation in the management, control or capital of an enterprise in another EU Member State; or 2) conditions made or imposed between the two enterprises in thei commercial or financial relations that are different from those that would be made between independent enterprises. (Article 4(1) AC).

advantage of the AC lies in the fact that it requires CAs to resolve a case submitted to them, providing a *time limit* to reach a solution and, in the absence of an agreement, imposing a *binding solution* on the relevant tax authorities by a third independent party.

During the first five years period, a total of about a hundred cases were initiated[195]but to date only one case (between French and Italian tax authorities) has been brought before an advisory commission that delivered its opinion on 19 May 2003[196].

Even though the limited use of the AC could be seen as a sign that the mere existence of a mandatory arbitration procedure may encourage CAs to reach a mutual agreement before losing their control over the case, some aspects of the procedure had to be improved.

Aware of the practical problems resulting from the implementation of the AC during its first period of existence, the European Commission proposed in its Communication of October 2001 establishing the EU Joint Transfer Pricing Forum (JTPF). The task of the JTPF is to ensure a more uniform application of transfer pricing practices in the European Union and to improve the concrete application of the AC by proposing a non-binding political commitment, setting out detailed rules for the implementation of the Convention. After its first year of work, the JTPF adopted its first report at the end of 2003, including a proposal for a **Code of Conduct** for the effective implementation of the Arbitration Convention. This proposal was taken up by the European Commission, which issued a communication[197] by which it invited the ECOFIN Council to adopt the Code of Conduct[198]. An agreement on the text has been reached on 7 December 2004 and its key points will be examined in the following paragraphs of this study. The JTPF has noted that the Code of Conduct, although resolves a significant portion of the interpretive issues related to the Convention, does not address some issues that might discourage the use of the AC by the business community: 1) the interest to be paid by the taxpayer and/or the CAs in the context of a MAP; 2) the penalty regime in respect of transfer pricing adjustments, and 3) no action has been recommended about the interaction between the mutual agreement and arbitration procedures with administrative and judicial appeals, except for the suspension of tax collection during cross-border dispute resolution procedure. The Code recommends that Member States take all necessary measures to ensure that enterprises engaged in such procedures can benefit from the

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[195] The details are reflected in Table 48 of the EU Commission Staff Working Paper of 23 October 2001.

[196] The French-Italian case concerned profit allocation between a manufacturing affiliate and a distributing affiliate. The main observations are included in the minutes of the meeting held by the JTPF held in Brussels on 19th June 2003.

[197] COM(2004) 297 final, 23.4.2004: "Communication on the work of the EU JTPF from October 2002 to December 2003 and on a proposal for a Code of Conduct for the effective implementation of the Arbitration Convention (90/436/EEC of 23 July 1990)."

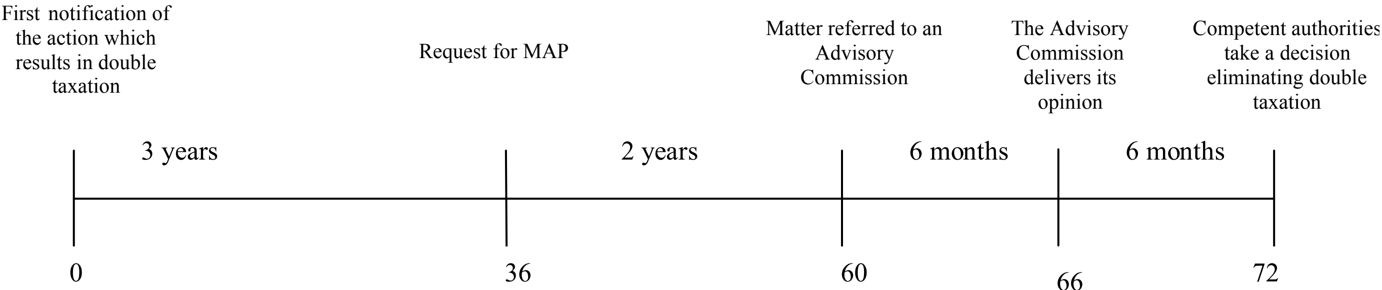
[198] Code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, (2006/C 176/02), *Official Journal of the European Union*, 28 July 2006.

suspension of tax collection under the same conditions as those engaged in a domestic appeals (or litigation) procedure.

2.3.2.2 The procedure

The procedure provided for by the AC is structured in three steps, after a preliminary phase in which the CA contacted reconsiders the case: 1) the mutual agreement phase (Art.6); 2) the mandatory advisory commission procedure (Art.7); 3) the CAs decision (Art.12).

The steps of the AC can be illustrated in the following timetable (expressed in maximum months):



2.3.2.2.1 The mutual agreement phase

If an enterprise considers that the transfer pricing principles have been violated, it may, within *three years* "of the first notification of the action" that would result or is likely to result in double taxation, present its case to the competent CA of which it is an enterprise or in which its permanent establishment is situated . The Code of Conduct proposes as a common starting point for the three-years period the date of the "first tax assessment notice or equivalent" as the starting point for the three-year period. Chapter 2 of the Code of Conduct further provides that "*a case will be regarded as having been submitted according to Article 6(1)"* if certain information is provided, a list of which is contained in the Code of Conduct[199].

[199] These are: 1) identification of the enterprise of the Contracting State that presents its request and of the other parties to the relevant transactions; 2) details of the relevant facts and circumstances of the case; 3) identification of the tax periods concerned; 4) copies of the tax assessment notices, tax audit report or equivalent leading to the alleged double taxation; 5) details of any appeals and litigation procedures initiated by the enterprise or the other parties to the relevant transactions and any court decisions concerning the case; 6) an explanation by the enterprise of why it thinks that the principles set out in Article 4 of the AC have not been observed; 7) an undertaking that the enterprise shall respond as completely and quickly as possible to all reasonable and appropriate requests made by a competent authority and have documentation at the disposal of the CAs; and 8) any specific additional information requested by the CA within two months upon receipt of the taxpayer's request.

The Convention requires that an attempt must first be made by the respective competent authorities to resolve the double taxation issue by means of the MAP of their tax treaties Provided that the complaint is well founded, the CA itself must endeavour to resolve the case and if it is not able to arrive at a satisfactory solution, the CA shall start a MAP with the CA of any other States concerned, with a view to the elimination of double taxation. The third part of the Code of Conduct suggests a modus operandi for the first stage of the procedure, which includes rules and guidelines on how a MAP should be conducted The Code proposes a tentative time frame for MAP (including the exchanges of position papers), all appropriate means for reaching an agreement as fast as possible (i.e. regular arrangement of face-to-face meetings between CAs) and standards of "best practice" (as those on language issues), and the information to be provided to taxpayers on all significant developments in the course of the procedure EU Member States agree to apply the recommendation to implement these provisions of the Code also to MAP under income tax treaties between EU Member States.

If no agreement can be reached within two years, or a shorter time agreed by the CAs and the associated enterprises concerned [200],the CAs must submit to an arbitration committee. In practice it is still to be seen whether the two-year limit is as hard and enforceable as it seems and should be. Taxpayers have informally reported on Member State practices extending that two-year term by arguing that the term had not commenced yet, as not all information was obtained, or Member States have requested taxpayers to extend the term voluntarily.

The AC obligates the CAs to hand over jurisdiction to an arbitration or advisory commission for final decision and avoidance of double taxation if they do not achieve that result themselves within a two-year period.

2.3.2.2.2 The mandatory advisory commission procedure

Where the first phase does not lead to an agreement that eliminates the double taxation, within two years from the date on which the case was first submitted to one of the CAs, the CAs must designate an advisory commission charged with delivering its opinion on the case in question within six months from the date the matter was referred to it. The AC allows the CAs six months to establish an advisory commission which shall consist of at least its Chairman, one member from each of the respective countries plus an even number of independent experts to be appointed by mutual agreement[201].

Detailed rules for the arbitration phase, e.g. on which CA takes the initiative to establish the advisory committee, where the advisory commission is to meet, who is to provide the secretariat assistance, what should be and who will support the cost of the procedure, what

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[200] AC, Art.7(4).
[201] AC, Article 9(1).

should be the content of the opinion and what are the conditions for its publication, are proposed in the fourth part of the Code of Conduct. The two-year time period starts running after filing the request and after two years within which no avoidance has been obtained. At that time, the case qualifies for review by the advisory commission.

Where the case has already been submitted to a domestic court, the two-year period will be computed from the date on which the judgment of the final court of appeal is given[202]. The combination of both processes is not possible if the domestic law does not allow the CAs to derogate from the decisions of their judicial bodies; in this case the taxpayer is required to make a choice between a domestic judicial procedure and the dispute settlement method provided for by the AC before a judicial decision has been delivered.

The inter-action of domestic legal procedures with the Arbitration Convention has been recognised by many observers as a difficult area and the positions of not all EU Member States are clear. It was

considered that this situation can lead to long delays in the application of the AC and the consequent elimination of double taxation. For these reason the EJTPF has decided firstly to clarify the *status quo* and secondly to identify improvements in this area that can be made to ensure the better elimination of double taxation in the EU. The first step is dated February 2008 and is a questionnaire to assess the situation prevailing in each Member State. They are asked to clarify their position over what is meant by Article 7(3)[203] of the AC and how their tax administration applies that Article in practice [204].

To ensure that sufficient information is provided to enable the competent authority to assess whether the case is "well founded" and to give taxpayer sufficient legal certainty, the Code of Conduct provides that the two-year period will commence on the later of the following two dates: a) the date of the tax assessment notice and b) the date on which the CA receives the request for a MAP and the minimum information listed in the Code of Conduct .

The Advisory Commission may request the enterprises and the CAs concerned to provide it with information, documents or evidence, and each enterprise may ask to appear or be represented before the Advisory Commission.

The solution of the case is the hands of an advisory commissions that issues a document containing its conclusion which initially have the legal status of an "opinion" , as it is the CAs

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[202] AC, Art 7(1).

[203] This paragraph states: "Where the domestic law of a Contracting State does not permit the competent authorities of that State to derogate from the decisions of their judicial bodies, paragraph 1 shall not apply unless the associated enterprise of that State has allowed the time provided for appeal to expire, or has withdrawn any such appeal before a decision has been delivered. This provision shall not affect the appeal if and in so far as it relates to matters other than those referred to in Article 6.".

[204] "EU Joint Transfer Pricing Forum Questionnaire on the Interaction between MAP and Judicial Appeals. Art. 7.3 of the Arbitration Convention" Brussels, February 2008, *DOC: JTPF/024/BACK/REV1/2007/EN.*

that will eventually decide on the final elimination of double taxation, and which, later, can be transformed in a "mandatory award", if the CAs fail to reach agreement

2.3.2.2.3 The CAs decision

This advisory committee's opinion is, at first, not binding and the CAs are allow to deviate from it thereafter should they both agree, as provided in Article 12(1). CAs have authority to accept another outcome of the issue, provided the alternative solution also guarantees for full avoidance of double taxation. If, however, within six months from the date of the opinion, the CAs fail to reach an agreed alternative solution on this subject, ensuring the elimination of the double taxation in accordance with transfer pricing principles, they shall be obliged to act in accordance with the arbitrators opinion that, in this way, is transformed into an award. Thus the CAs may, even at this stage, take matters into their own hands, as they may still deviate from the committee's opinion, provided double taxation is eliminated based on the arm's length principle. The CA is allow to levy less tax than interpreted by the arbitration board but not extend the taxation claim beyond the binding limits defined by the arbitration decision. In other words, after an arbitration award has been issued, only those mutual agreement are admissible according to which the tax levied are less then allowed under the tax treaty as interpreted by the arbitration board[205].

As subjects to international law, EU Member States are obliged to ensure that their respective CAs act in accordance with the decision of the arbitration body, when the opinion becomes legally binding.

2.3.3 The OECD position

The possibility of the use of arbitration in unresolved tax disputes has been recognized by the OECD but in its work on Transfer Pricing Guidelines, the Committee on Fiscal Affair pointed out that such procedure is not universally accepted by all OECD and has agreed to undertake a study of this topic and to supplement the Guidelines with the conclusions of that study when it is completed[206].

In the light of the recent increase in potentially controversial transfer pricing question, the OECD cannot leave the solution of these problems at the sole adjustments authorized in the articles 9(1) and 7(2) of its MC. OECD has analyzed the introduction of a tax arbitration procedure as an appropriate addition to the OECD MC. In 2003 the CFA created a working group charged with examining ways to improve the effectiveness of the MAP; several

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[205] Mario Züger, *Arbitration under Tax Treaties* (Amsterdam: International Bureau of Fiscal Documentation, 2001), 99.

[206] OECD Guideline, 4.171.

supplementary techniques, ranging from an advisory opinion to a more formal arbitration process, have been considered. Through a questionnaire on dispute resolution issued to the business community, the OECD requested taxpayer to comment on international dispute resolution mechanisms other than MAP, for example arbitration and mediation. The OECD has been commended for its proposal to introduce binding arbitration as a means to resolve tax treaty disputes that CAs are unable to resolve through the MAP. The business community generally strongly supported the view that arbitration could be a useful complement to MAP in promoting the resolution of tax treaty disputes. The ability of taxpayers to initiate arbitration of cases that are unresolved after two years of MAP has been seen as a possibility both to increase the likelihood that cases would be resolved in MAP and to afford the taxpayer and governments the certainty of a definitive ruling by an impartial tribunal in the event they are not[207].

It should be stressed that the new OECD works have been focused on solving cross-border tax disputes with a broad scope that includes treaty disputes in general, not just transfer pricing issues. As already examined in chapter 1, the arbitration provision and changes to the OECD Commentary on the MAP article have been included in the 2008 update to the OECD MC.

Together with the new Article 25(5) of the OECD MC, the OECD published the following documents: the revision of existing paragraphs 45 to 48 and new paragraphs 49 to 69 of the Commentary to Article 25 of the OECD MC, and "Sample Mutual Agreement on Arbitration" together with comments thereto.

Although they may be seen as a step in the direction of the acceptance of arbitration as a means of resolving transfer pricing disputes, the new arbitration clause cannot be used until the contracting states have both agreed to this via an exchange of diplomatic notes. Another consideration is that, at best, these provisions only apply on a bilateral basis, when a multilateral or even a global procedure is required.

2.4 Arbitration of unresolved issued in a mutual agreement case: the new paragraph 5, Art.25 OECD MC, : a multi-tiered dispute resolution clause

2.4.1 Overview

In February 2007, the OECD published the Report adopted by its Committee on Fiscal Affairs (CFA) on 30 January 2007, "Improving the Resolution of Tax Treaty Dispute". The main feature of the OECD Report is to supplement the current dispute resolution mechanism – the mutual agreement procedure – by mandatory arbitration. The OECD Report calls for

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[207] See "Comments of the Securities Industry Association on OECD Proposal fro Improving Mechanisms for the Resolution of Tax Treaty Disputes", March 3, 2006.

the insertion of a new paragraph 5 in Article 25 of the OECD MC, provides amendments to the Commentary to the Model Tax Convention and a draft of a Mutual Agreement on Arbitration to be entered into by the Contracting States to set out the specifics of the arbitration procedure.

In the process leading to the proposal to supplement the MAP by arbitration a lots of obstacles had to be removed; several national 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. In addition, by introducing arbitration as a supplement to the already regulated MAP, arbitration can be provided for simply by adding paragraph 5 to the existing Article 25 of the OECD MC, which avoids the need for fundamental renegotiations of the tax treaty. Given that there is still reluctance in some countries with respect to tax treaty arbitration, the OECD Report allows such countries to introduce arbitration only for a narrowly defined range of issues, such as transfer pricing, but not for others. Despite the existence of such doubts, the 2008 update to the OECD MC has introduced a mechanism that allows a taxpayer to request the arbitration of unresolved issues that have prevented competent authorities from reaching a mutual agreement within a fixed period of time. As far as transfer pricing cases are concerned, Member States are recommended to co-ordinate the scope of Article 25(5) OECD MC with their obligations under the European Arbitration Convention[208].

As shown in the previous chapter, the OECD's recent works aim at improving the existing MAP process, rather than creating an alternative mechanism for resolving tax treaty disputes between states, in order to resolve undecided MAP cases. In the case where the competent authorities are unable to reach an agreement under the MAP within two years, the unresolved issue will be solved, at the request of the person who presented the case, through an arbitration process[209]. The most important disadvantage of the MAP procedure as compared to the arbitration process is that once the procedure is initiated there is no guarantee that the dispute will be resolved. Looking to help OECD Member States to develop

[208] Commentary to Model Tax Convention, Article 25, para. 67 and "Code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises", Article 3(4).

[209] Luc Hinnekens, " The European Tax Arbitration Convention and its legal framework", *British Tax Review* (1996), 141: "The idea of tax dispute resolution by international arbitration is not new. It was supported at a very early stage by some internationalists and also by resolutions of international professional organisations such as IFA, and business organisations such as BIAC an ICC."; Gustaf Lindencrona, "How to resolve international tax disputes? New approaches to an old problem", *International Tax Review* 5 (1990), 266. *Juridical interpretation of treaties concerning double taxation and necessity or advisability of establishing an international fiscal jurisdiction,* (Zurich: IFA Congress, 1951); *Seminar on: Effectiveness of current competent authority procedures for relief of international double taxation: future developments,* (Brussels: IFA Congress, 1978); *Seminar on: Resolution of Tax Treaty Conflicts by Arbitration,* (Florence: IFA Congress, 1993); BIAC Position paper (1971), *Proposed Amendment to Article 25 of the Draft Convention Mutual Agreement Procedure*": "In the event that consultation between the competent authorities of the Contracting States does not result in agreement, the claim shall be submitted to arbitration by a joint commission".

internationally accepted arbitration procedure, the new paragraph 5 of Article 25 of the OECD MC reads as follows:

"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 action of one or both of the Contracting States have resulted for the person in taxation not in accordance with the provision 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 issue arising from the case shall be submitted to arbitration if the person so requests. These unresolved issue 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 law of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph"[210]

2.4.2 The Procedure

2.4.2.1 Request from the taxpayer

Together with the new Article 25(5) of the OECD MC, the OECD published an Annex on the "Sample Mutual Agreement on Arbitration" to help countries to implement the arbitration process when concluding their bilateral agreement. The CAs may of course provide procedural rules that are additional to, or different from the OECD sample agreement, according to the treaty partners' preferences. In the following part of this paragraph we go through the five different steps suggested by the OECD to solve a tax treaty dispute thanks to the action of a third independent body.

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[210] This is the revised version of the proposed new paragraph that was included in the Public Discussion Draft of 1 February 2006. The changes to the paragraph mainly reflect the decision not to require a waiver of domestic remedies as a condition for initiating the arbitration process. The text of the footnote which would appear on the same page reads: "*In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For this reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 47 of the Commentary on the paragraph. As mentioned in paragraph 54 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals.*"

Under the OECD guidelines, the taxpayer can start the arbitration proceedings by filing a request for arbitration with one of the CAs no earlier than two years after the date on which the case was presented by the CA seized pursuant to Article 25(1) of the OECD MC to the other CA. The request must be in writing and be accompanied by a statement in writing of each of the persons who either made the request or is directly affected by the case (in the case of a transfer pricing dispute: the affiliated company that has entered into the challenged transaction with the taxpayer) that no decision on the same issue has already been rendered by a court or administrative tribunal of the Contracting States[211].

Within ten days, the competent authority which received the request for arbitration must send a copy of the request and accompanying statements to the other competent authority.

2.4.2.2 Terms of reference

No later than three months from the request for arbitration has been received by both CAs, they have to agree on the "*Terms of Reference*" for the case and communicate them to the taxpayer. The Terms of Reference is the documents containing the questions to be decided by the arbitration panel and some administrative matters such as the place of arbitration[212], the language of the arbitration and the briefing schedule.

The CAs are free to draft the Terms of Reference in such a way that the whole case, and not just certain specific issues, is submitted to arbitration[213].

Since the arbitration process will be initiated only if the CAs have failed to find a solution under the MAP, it would not be strange if the CAs could not agree on the specific issues and questions to be resolved by the panel. If the Terms of Reference have not been communicated to the taxpayer within three months after the request for arbitration has been received by both CAs, the CAs and the taxpayer may, within one month, communicate in writing to each other the "*Tentative Terms of_Reference*", a list of issues to be resolved through arbitration.

2.4.2.3 Appointment of arbitrators

Within three months after the Terms of Reference have been received by the taxpayer (or, in the case of Tentative Term of Reference, within four months after the request for arbitration

[211] "Mutual agreement on the implementation of paragraph 5 of Article 25" para.1, in OECD Sample Mutual Agreement on Arbitration (2008), para.1.

[212] The OECD doesn't provide for the place, of arbitration, neither in its Commentary not in the Sample Mutual Agreement on Arbitration. They merely mention that the logistical arrangements will be the responsibility of the CA to which the case giving rise to the arbitration was initially presented by the taxpayer. This failure may have the effect that it remains uncertain which national arbitration law is applied to the tax treaty arbitration procedure.

[213] Mutual agreement on the implementation of paragraph 5 of Article 25" para.1, in OECD Sample Mutual Agreement on Arbitration (2008), para.10.

has been received by both CAs), the CAs shall each appoint one arbitrator. Within two months of the latter appointment, the arbitrators will appoint a third arbitrator: the Chair.
The Tentative Terms of Reference will be revised by the arbitrators and communicate, within one month after the appointment of all arbitrators[214], to the CAs and to the taxpayer. This revised version shall constitute the Final Terms of reference for the case unless the CAs agree on different Terms of reference and communicate them to the arbitrators and the taxpayer, within one month after the revised version's receipt by the two CAs.

2.4.2.4 Arbitration decision and MAP

The arbitrators must communicate their decision to the CAs and to the taxpayer within six months after the Chair's declaration that he has received all the information necessary to begin consideration of the case. If the communication is not notify in time, the CAs may agree to extend that period by no more than six months or, if they fail to do so, they must appoint new arbitrators, within one month from the end of the period.
The OECD identifies two opposite approaches on the arbitrators final decision. Tax treaty partners can decide to resolve their disputes on the base of an "independent opinion" from the arbitrators, left free to reach their own decision, based on a reasoned analysis of the facts involved and applicable legal sources, or a "last best offer" decision. This is the situation where each party is required to submit its best offer and the arbitrators are required to choose one or the other[215]. The contracting states have at their disposal a number of intermediate solutions between these two positions. The sample agreement included in the OECD Annex follows the first approach but it also provides for an alternative process based on the "last best offer" clause, to be adopted for a particular dispute, on case-by-case basis, after it has arisen.
Within six months from the communication to the CAs, the arbitration decision has to be implemented by the CAs drawing up a MAP. Only an agreement between the two CAs, even if based on a third party decision, can definitely close the dispute.

[214] Each CA must appoint one arbitrator within three months after the Terms of Reference have been received by the taxpayer or, if the CAs cannot agree upon the Terms of Reference, four months after the request for arbitration has been received by both CAs. Within two months of the latter appointment, the arbitrators so appointed must appoint the third arbitrator who will function as the Chair. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed will be appointed by the Director of the OECD Center for Tax Policy and Administration within ten days of receiving a request to that effect from the taxpayer. The same procedure applies if the replacement of an arbitrator becomes necessary. Any person, including a government official of a Contracting State, may be appointed as arbitrator unless that person has been involved in prior stages of the case. Since the arbitration provision in question contemplate a panel of three arbitrators, this would open up the possibility that each arbitrator would opt for a different solution. There are a number of areas in which the three arbitrators could disagree (e.g. the correct arm's length royalty to be charged to a licensee). The OECD solution in such a case would be to have the opinion of the Chairman of the arbitral panel prevail.

[215] This clause is known as baseball arbitration because salary disputes in US Major League Baseball are resolved by this means.

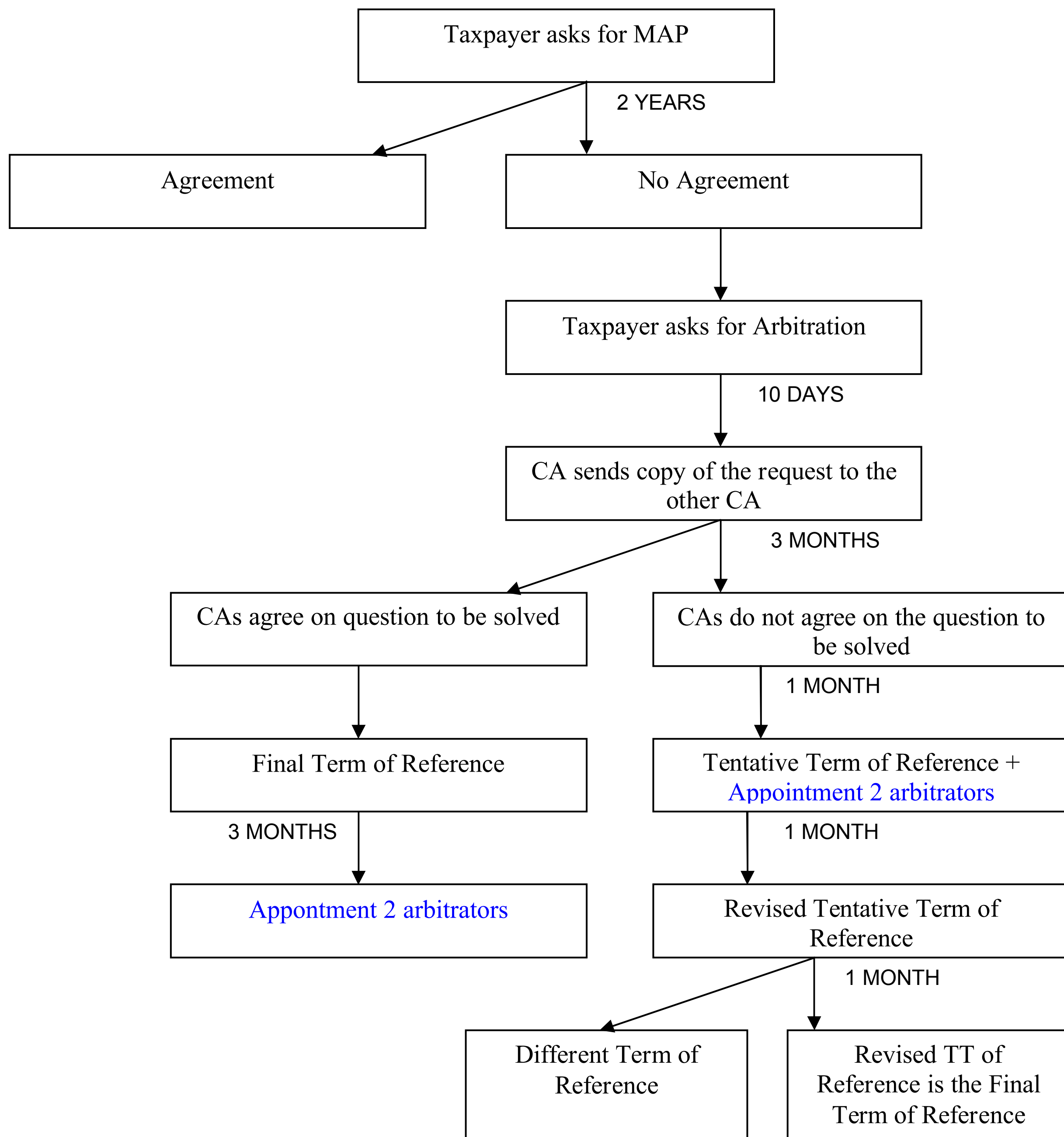

Figure 1: *Dispute settlement procedure proposed by the Annex to the 2008 Update to OECD MC - From the taxpayer's request for a MAP to the arbitrators' appointment.*

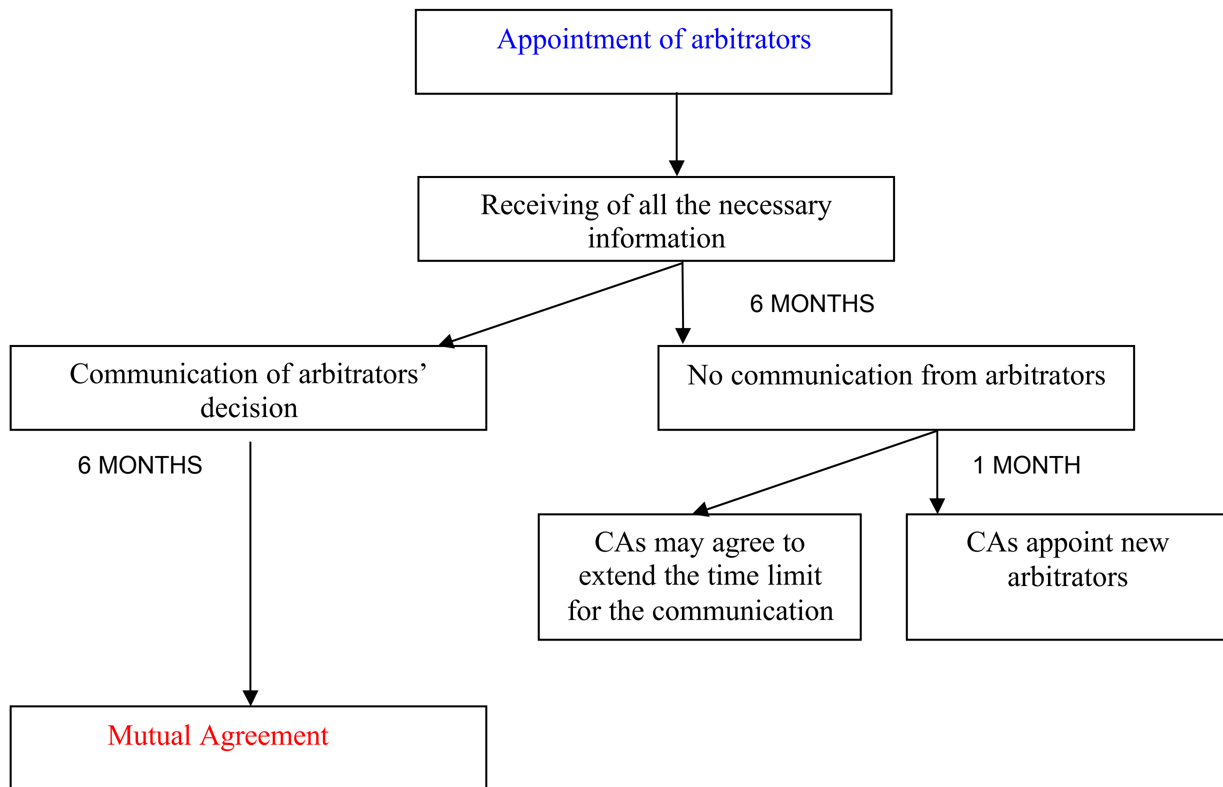

Figure 2: *Dispute settlement procedure proposed by the Annex to the 2008 Update to OECD MC - From the appointment of the arbitrators to the final agreement.*

Table 1: Approximate periods for the Arbitration Procedure

Timing	Procedure
2 years	Consultation for reaching a Mutual Agreement
10 days	Copy of the Taxpayer's request for Arbitration to the other CAs
3 months	Terms of Reference
3 months	Appointment of 2 Arbitrators
(to be defined by the arbitrators)	All information reception by Arbitrators
6 months	Arbitrators' decision communication
6 months	MAP
TOTAL : about 3 Years and 1 month	

2.4.3 The combination of MAP and arbitration process

On the question of the relation between the MAP and the arbitration procedure, the new paragraph 5 establishes that the possibilities of the first must be fully exhausted before starting the latter. The tax treaty arbitration is not an independent judicial dispute resolution mechanism but rather a supplement to the MAP. As a consequence of this characterisation, Where the MAP is not available, e.g. because of the existence of serious violations involving significant penalties, paragraph 5 is not applicable[216].

The arbitration is 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, a resolution of the case will still be possible by submitting those issues to arbitration. The meaning of this provision must be that an effort must be made to find a solution by mutual agreement. If, however, a solution is not found, the contracting states may use the arbitration procedure. This means that arbitration cannot be used from the outset. On the other hand, it must also mean that no contracting state should feel obliged to give up its position on a legal question to reach a mutual agreement by compromise.

Once the arbitration process has provided a binding solution, the competent authorities will proceed to conclude a mutual agreement that reflects that decision. This last step of the procedure is a further confirmation on the nature of the arbitration procedure, as an integral part of the MAP process that finishes with the signature of a mutual agreement by the CAs.

It should be stressed that the CAs, notwithstanding the institution of the arbitration, are always free to reconsider the issue(s) pending before the arbitrators and reach agreement. As long as the arbitrators have not rendered their decision, the competent authorities can reach agreement on such issue(s), thereby bringing the arbitration procedure to an end.

2.4.4 Interaction between arbitration procedure and domestic legal proceedings

The arbitration procedure is generally independent of legal remedies available under domestic law. Article 25 (5) OECD MC provides only for suspension of domestic legal remedies that have not been exhausted. For the arbitration process to be effective and to avoid the risk of conflicting decisions, as in the case of investment treaty arbitration, the taxpayer, when filing a request for arbitration, must supply a declaration signed by it and any affiliated party affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the Contracting State: a person cannot pursue simultaneously arbitration procedure and domestic legal remedies. Such remedies are suspended pending the arbitration and the procedure following the arbitration decision. The agreement of the CAs following the arbitration decision is presented to the taxpayers

[216] Commentary to Model Tax Convention, Article 25, para. 68.

who would then have to choose between such agreement, which would require abandoning any remaining domestic remedies, or reject the agreement to pursue such remedies[217].

In some States, in order to implement an arbitration process, domestic legal remedies should no longer be available. In this case, the taxpayer could waive the right to pursue domestic legal remedies before arbitration can take place with the assurance that sufficient legal safeguards will be granted to him as regards his participation in the arbitration process to meet the requirements that may exist under domestic law[218].

2.4.5 Taxpayer rights and the effectiveness of the arbitration process as a dispute resolving tool

In contrast to the old sample mutual agreement procedure, which encourage but does not require the elimination of double taxation, the arbitration process as from Article 25(5) OECD MC should provide for a mandatory resolution of unresolved MAP issues, binding on both CAs compulsory and binding arbitration. Such compulsory and binding characters of the arbitration process are limited by the power of the taxpayer on the procedure itself. Firstly, the taxpayers has the right, but not the duty, to initiate arbitration. Recourse to arbitration is compulsory for the CAs and therefore not automatic: the person who presented the case may prefer to wait beyond the end of the two-year period or simply not to pursue the case[219]. As a consequence, despite the existence of an unresolved issue that prevents the conclusion of a mutual agreement, the taxpayer can decide not to request for the arbitration. Nevertheless, where the CAs have reached an agreement that does not leave any "unresolved issue" about the tax treaty's application, no arbitration procedure can be initiated by the taxpayer, although he is unsatisfied by the agreement[220].Secondly, paragraph 5 provides that the arbitration decision is binding on both States but on condition that any "person directly affected by the case" accepts the mutual agreement that implements the arbitration decision. This "veto" power of the taxpayer gives him a new position in the procedure. If the taxpayer is satisfied by the solution of the case, he usually accepts the MAP reflecting the arbitral process and agrees to withdraw its domestic objections – if any - or to refrain from seeking any further recourse on the same issue and years. Failure of the CAs to assess the taxpayer in accordance with the arbitration decision would result in taxation not in accordance with the tax treaty and as such, allows the taxpayer to seek relief through domestic legal remedies or by making a new request for arbitration. If the taxpayer is

[217] Commentary to Model Tax Convention, Article 25, para. 59.
[218] Commentary to Model Tax Convention, Article 25, para. 80.
[219] Commentary to Model Tax Convention, Article 25, para. 73.
[220] Commentary to Model Tax Convention, Article 25, para. 64.

unsatisfied by the mutual agreement that implements the arbitration decision, he can only pursue the domestic mechanisms still available.

In contrast to the original MAP proceedings, where the affected taxpayers have no official status and are normally excluded from any involvement, the new Article 25 has strengthened the position of the taxpayers in the procedure giving them the opportunity to present their views to the arbitration board in writing and, with the permission of the arbitrators, orally during the arbitration proceedings.

The taxpayer has no legal right to require implementation of MAP but with the new rules the CAs are forced to implement arbitration procedure also in cases in which they refuse to do so. For this reason, the arbitration is a mandatory procedure that, on the one hand, cannot be denied to a taxpayer invoking it, and that , on the other hand, cannot be initiated without taxpayer consent.

The research of on adequate dispute solving procedure to permit appropriate resolution of often difficult and complicate issues goes through a greater involvement of the taxpayer. Both the model the OECD MC arbitration provision and the EU Convention give the taxpayer a far greater role, as far as contemplating a far less summary procedure. The new approach allows countries to include a “multi-tiered dispute resolution clause” in their bilateral tax treaty. This is a clause which provides for distinct stages, involving separate procedures, for dealing with and seeking to resolve disputes. The recommended cross-border conflicts settlement rules encompass any of the following techniques:

– negotiation;
– mediation;
– conciliation;
– arbitration.

In addition, different personnel are involved in the different stages of the dispute resolution procedure: the competent authorities of the contracting , the arbitrators appointed as provided in the double tax treaty and the taxpayer, with his new role in the procedure. One of the main reason for the employment of a multi-tiered dispute resolution clause like the one proposed by the OECD lies in the great diversity of possible disputes in complex international situations. It’s obvious fact that a dispute resolution clause inserted into a tax treaty is designed to deal with future disputes. These future disputes can involve very different issues and bear very different monetary values. In consequence a multi-tiered dispute resolution procedure is likely to contain, in one tier or another, an appropriate procedure for each type of dispute which may arise.

Perhaps the most challenging question concerning the new arbitration procedure concerns its enforceability. This is a matter which is taken up on the next paragraph of this work.

3. Mutual Agreement vs arbitration in tax matter

3.1 The Legal Nature of the two procedures

3.1.1 MAP as a non-binding bilateral tax negotiation process

The mutual agreement procedure provided for in Article 25 OECD MC, and adopted in almost all Tax Conventions, is a direct negotiation between competent tax authorities in order to solve specific issues as the application of domestic tax law and tax treaty is incapable of resolving the problem, The purpose of the MAP is that where either of the contracting states takes any action not conforming to the convention, the correction of such action should be achieved by consultation between the administrative authorities of the states as the parties to the convention concerned, thereby avoiding any international double taxation caused by the action in dispute.

If the emphasis is put on the fact that MAP procedure is based on negotiation, the MAP may sometimes result in summarizing the point at issue into a mutual "compromise", depending on the bargaining power of the CAs. A mutual agreement can be concluded only if both states agree, thus, each state has a veto power.

The MAP is an amicable means by which actors resolve or manage international tax disputes and search for mutually acceptable agreements that satisfy joint goals. The aim must always be to resolve problems at the lowest level as quickly as possible to prevent small conflicts from escalating into serious disputes.

A key feature of MAP is its high degree of procedural flexibility. MAP provides the parties with full control over the negotiation process. The parties may design procedures that best fit their cases. Typically, the negotiation through the MAP process seeks to reduce the distance between the parties' positions and make the parties understand each other's point of view, in order that they may achieve a compromise solution, without the presence of any third independent party.

Entering into a MAP on the basis of a tax treaty can be seen as a "blank mandate" to an administrative authority to decide on the content of tax law, not only when it is not conforming to tax convention but especially when the CAs consult together for the elimination of double taxation in cases non provided for in the tax Treaty (Art.25, par.3). MAP is in practice tended to double taxation caused by the enforcement of the respective domestic laws of the contracting states and thus urges the alteration of the contents of such domestic laws. At this connection, the United States adopted a special procedure[221]that does not allow to proceed with the MAP for any case which is expected to be resolved on the level of the

[221] US Revenue Procedure 91-23, Section 11.02(e).

domestic laws of the other state. This is a problem extensible to the arbitration procedure adopted in addition to the MAP.

MAP is usually a mandatory phase before any arbitration proceeding can be initiated. Arbitration can only starts if negotiation has been requested and a fixed period of time has elapsed thereafter.

3.1.2 Arbitration as a binding third-party method

It is anticipated that arbitration procedures can be characterized as "quasi-judicial" dispute resolution methods and they must be distinguished from strictly judicial methods, on the one hand, and non-judicial methods, on the other. Juridical procedures rely on third persons to reach a mandatory solution, like arbitration procedures, but courts are permanent institutions that resolve a dispute according to pre-existing procedural rules through judges appointed for a certain time, not for a specific case, and that have to be independent of the parties. Non-judicial methods can take the form of negotiations (e.g. the MAP under Art.25 of the OECD MC), mediation or conciliation[222]; however, in contrast to arbitration procedures, they are not aimed at a mandatory dispute settlement.

In an arbitration procedure, once it has been started, a decision can be rendered without the assent of the states. This could create problems for states whose domestic law does not permit domestic court decisions to be overruled even by international obligations.

The OECD MC arbitration, as made it clear by the OECD itself, is not an alternative independent judicial dispute resolution mechanism but rather a supplement to the MAP that serves to enhance its the effectiveness with the guarantee of the solution to the case by means of a binding decision by independent third persons Tax treaty arbitration is mandatory; no prior authorisation by the CAs is necessary. Once the requisite procedural requirements have been met, the unresolved issues must be submitted to the arbitrators for decision[223]. In that respect, OECD MC arbitration differs from arbitration clauses already provided for by several existing tax treaties where arbitration requires prior agreement of the CAs.

According to the OECD, the possibility of submitting a dispute to arbitration should be a general principle. The OECD distinguishes between *issues* and the *case*[224]*.* Where the CAs cannot reach an agreement *on one ore more issues* that prevent the resolution of a case, this will still be possible by submitting *those issues* to arbitration. If agreement has been

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[222] See Art.44(3) of the German-Denmark tax treaty and Art.41(3) of the German-Sweden tax treaty. See also Para.47 of the Commentary on Art.25 of the OECD Model, suggesting the possibility of calling upon the Committee on Fiscal Affairs to give an opinion on the correct understanding of the provisions in dispute where special difficulties of interpretation arise as to particular points.

[223] Commentary to Model Tax Convention, Article 25, para. 45.

[224] Commentary to Model Tax Convention, Article 25, para. 46.

reached on some but not all the issues, the taxpayer is prevented from submitting the issues on which agreement had been reached to the arbitrators even if the taxpayer is dissatisfied with the result. Only the remaining unresolved issues may be submitted to the arbitrators for decision. This means that:

- the *resolution of the case*, on the basis of the arbitrators' determination of the disputed issue(s), continues to be reached through the MAP and remains the responsibility of the competent authorities; and
- the *resolution of a particular issue*, which is preventing the agreement in the case, is handled through the arbitration.

The arbitration procedure does not result in the *case* to be decided by the arbitrators; rather the *issues* upon which the CAs have been unable to reach agreement are decided by the arbitrators for the CAa' benefit. As a consequence, preliminary issues already decided by the CAs cannot be reopened by the arbitrators; the CAs' decision, eventually based on the arbitrators' determination of the disputed *issues*, is binding on the arbitrators. The CAs will decide the *case* and thereupon close the MAP. This limitation of the arbitrators' power distinguishes tax treaty arbitration under the OECD MC from other forms of arbitration where the jurisdiction of the arbitrators extends to resolving the whole case[225]

One mail question arise concerning the nature of the new proposed dispute resolution article: does the role of the taxpayer deprive the supplementary tax dispute resolution mechanism of the typical "arbitration" nature providing for the final non-enforceability of arbitrators decision?

The status of the taxpayer in tax treaty arbitration differs from the status of the claimant in commercial arbitration in several ways and of the taxpayer in the mutual agreement procedure.

Under most commercial and investment arbitration rules the two parties involved each nominate an arbitrator and these arbitrators designate the presiding arbitrator. In multiparty arbitration, it is usually an appointing authority (such as the International Chamber of Commerce (ICC) or the London Court of International Arbitration (LCIA)) that nominates all arbitrators.

The OECD Arbitration provides for a different solution: while the taxpayer can initiate the arbitration process, he will not be involved in the appointment of the arbitral tribunal. Each competent authority appoints one arbitrator and the Chair will be appointed either by common consent or by an appointing authority. It can well be argued that the taxpayer's interest will be aligned with the interest of one of the governments, and that an independent Chair could protect any separate interest that the taxpayer might have.

[225] Commentary to Model Tax Convention, Article 25, para. 46.

In consequence of the “last word” of the taxpayer on the binding effect of the mutual agreement incorporating the arbitration solution, when the agreement is achieved by means of the arbitration, the essential character of the mutual agreement remains the same. This arbitration procedure has only the aim to allow the CAs to reach a conclusion on the unresolved issues that prevent an agreement from being reached. After the arbitrators decision[226] the CAs are obliged to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision “by reaching a mutual agreement on the case that led to the arbitration”. This means that, in practice, parties will have to expend time and resources in an arbitration process that will lead to a mutual agreement that could not be accepted by the taxpayer.

The arbitration as included in the MAP process is essentially consensual; the dispute is not included in an adversarial juridical arena but it’s exposed to procedures designed to promote compromise, in particular where skilled arbitrators are interposed between the parties. What is enforced is not co-operation and consent but participation in a process from which co-operation and consent might come. The distinction between a “typical” arbitration procedure, as described above, and the arbitration provision added by the OECD in its MC is evident. Is it proper to include this new procedure into the group of “arbitral means”? In my view is more appropriate to define it as a “mediation”, with a special pluri-personal mediator, or at least as an “hybrid” mean that add a first stage of arbitration with a second stage of a ruling procedure.

3.2. Economic analysis: efficient cooperative behaviour of tax authorities

The MAP process is necessarily a process of “give-and-take”, where the tax authorities of the two contracting states must be willing to work together in cooperation in order to reach a mutually acceptable interpretation method and result. The mutual agreement procedure was born out of the desire to resolve tax treaty interpretation issues both fairly and more efficiently.

A given economic agreement is *efficient* if there can be no rearrangement that will leave someone better off without worsening the position of others. Complete neutrality is probably not possible but, from an efficiency perspective, the highest possible level of neutrality should be pursued. Other values, like equity, may justify a deviation from this rule in specific

[226] In the 2008 Update to the OECD MC, paragraph 20 of the sample agreement deals with the case where the competent authorities are able to solve the unresolved issues that led to arbitration before the decision is rendered: “the case shall be considered as solved under the mutual agreement procedure and no arbitration decision shall be provided”.

situations. It should be noted that, in an international context, the actions of governments are greatly limited by the actions of other governments.

The MAP is an instrument for avoiding tax disputes before the domestic courts and it needs three actors – the two competent authorities and the taxpayer – to make the "optimal" choice. Both tax authorities of the two contracting states in their strategy attempt to maximize total government revenue, including taxes, interests and penalties, net of audit and other administrative costs. Even though the taxpayer is excluded from parts of the MAP process, the competent authorities recognize that the taxpayer is a stakeholder and client in the mutual agreement procedure[227]. As a matter of fact, if the terms and conditions of the resolution are not satisfactory to the taxpayer, he may be entitled to withdraw from the MAP process and pursue other domestic redress mechanisms still available. This greatly simplifies the analysis by reducing the compliance problem to a simple "comply-not comply" decision. Thus, the MAP process is seen as a "game" with levels of compliance, tax and penalty assessment determined by the interaction between the taxpayers and competent authorities of two different countries. The game is considered to be solved when an "efficient" equilibrium, as defined above, is reached. Such an equilibrium involves the interpretation, chosen by the competent authority of the state of residence, and the one chosen by the source country. It is the best response to each other so that neither the competent authorities nor the taxpayer have an incentive (unilaterally) to change their strategy.

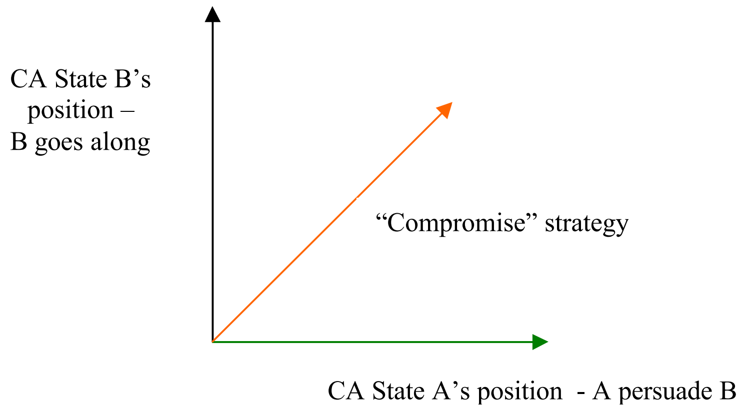
This analysis is mathematically very complex and extremely technical and it is outside the scope of the present study. The purpose of the present research is to illustrate that the introduction of the mutual agreement procedure into a game theory that explicitly integrates taxpayers and competent authorities offers considerable opportunities for an evaluation of the MAP's effectiveness that are not possible in the standard analysis of the enforcement of the law.

Equity also becomes important in increasing the use and the effectiveness of the mutual agreement procedure. It seems to be beyond doubt that MAPs may increase the equity of the international tax system. If interpretations differ, an individual is being treated unequally and this might be an effective deterrent to cross-border activities.

In most experimental studies of two-party bargaining, the two ideal-type strategies available to the parties are: 1) insist on one's own position and try to *persuade* the other party to go along with it at the expenses of its interest; or *viceversa* capitulate and go along with the other party at the expenses of one's own interests ("persuading" strategy) , and 2) attempt to *reach a compromise* position that *partially* meets the interests of both parties that "can live with" this solution ("compromise" strategy).

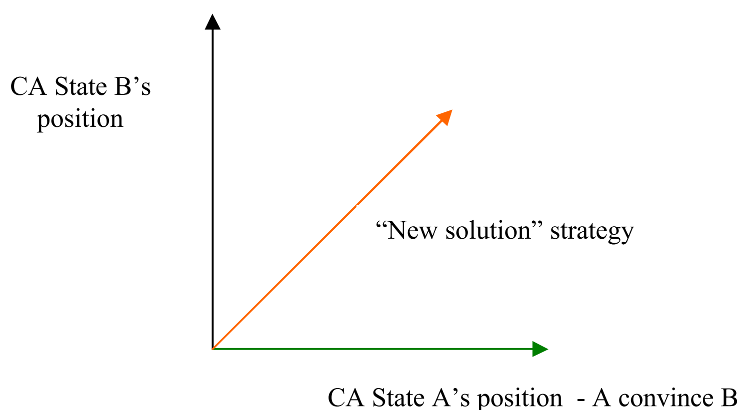
[227] See OCSE MEMAP paragraph 3.7.

Fig.1: Disagreement strategies: A persuades B to go along or A and B reach a compromise position



Even if the parties reach a compromise on a resolution of a dispute, they may still disagree about the reasoning and legal interpretation leading to the decision. If we add the "consensus" on the correctness of the interpretation or application of the tax treaty we can identify other two ideal-type strategies: 1) attempt to **convince** the other party of the correctness of its own position; or *viceversa* be convinced and go along with the other party at the expenses of one's own interests ("convincing" strategy), and 2) work to find a **new solution** both parties can agree is correct ("new solution" strategy), i.e this strategy is adopted by the CAs of the contracting states that consult together for the elimination of double taxation in cases not provided for in the Convention, according with the second sentence of paragraph 3, Art.25 OECD MC ("legislative" MAP).

Fig.2: Agreement strategies: A convince B or A and B find a new solution



There is a fifth solution that is not a strategy but a genuine choice to change the opinion, when one party is not convinced by the other but spontaneously understands that the other party's position is legally correct.

The "game" between the CAs of the two countries can be represented as follows:

	CA State B		
CA State A		Go Along	Insist
	Go Along	Compromise Strategy (c)	Persuading or Convincing strategy (a)
	Insist	Persuading or Convincing strategy (a)	New Solution Strategy (c)

In two-party bargaining, both persuading and convincing to go along are "**assertive**" strategies (a); reaching a compromise and agreeing on a new correct position are "**cooperative**" strategies (c).

Because parties in a MAP are both administrative authorities and, as we have seen, the taxpayer is not a "party" *strictu senso* in the procedure, they are more likely to prefer "agreement strategies" to reach a legal correctness instead of a compromise that leave disagreement about correctness unresolved.

Even though the taxpayer is excluded from parts of the MAP process, taxpayers and tax administrations are all committed to a streamlined and effective MAP process. The CAs recognize that the taxpayer is to be considered as a "client" in the MAP process[228] because if the terms and conditions of the agreement are not satisfactory to the taxpayer, he may pursue other domestic redress mechanisms still available, with a negative result for the amicable procedure. In addition, the new paragraph 5 to Article 25 OECD MC submits the binding character of the arbitration decision to the taxpayer approval. This new position of the taxpayer in the MAP process adds a new endogenous variable in my analysis, affecting the CAs strategic preferences. Taxpayers preparing for a MAP are aware they can influence the CAs' decisions, even though they have no direct formal power to determine the MAP outcome. The more taxpayer believes he can play this role in the decision process the more likely CAs are to prefer "cooperative" strategies because they can no more end a dispute by holding firm to their position. Against "assertive" strategies is also the goal of taxpayer of completing the procedure quickly, minimizing the time and effort involved.

[228] OECD Manual on Effective Mutual Agreement Procedures (MEMAP), February 2007

The *Game Theory*[229] teaches that the principle of predictable "tit-for-tat" offers the "best strategy" for promoting reciprocal cooperation among egoists in a decentralized context where, as in many fields of international law, there is no central authority that can enforce agree international rules .

In order to increase the mutual gains from cooperation and reduce transactional costs, social contract theories emphasize the mutual advantage of agreed rule-making and compulsory dispute settlement and enforcement mechanisms in many international areas.

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[229]Game theory is a branch of applied mathematics that is used in the social sciences (most notably economics), biology, engineering, political science, international relations, computer science (mainly for artificial intelligence), and philosophy. Game theory attempts to mathematically capture behavior in strategic situations, in which an individual's success in making choices depends on the choices of others. Although some developments occurred before it, the field of game theory came into being with the 1944 book *Theory of Games and Economic Behavior* by John von Neumann and Oskar Morgenstern. This theory was then developed extensively in the 1950s by many scholars.

V. Tax disputes settlement: tax *vs* non-tax treaties

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        2.2.4 Compliance phase
3. Dispute settlement and third parties: a comparison between WTO and tax treaties systems
4. Interaction of the dispute settlement mechanism in the GATS and the mutual agreement procedure

1. Tax issues within trade and investment agreements

Income tax treaties and trade agreements are closely related, they have the same underlying principal goal of facilitating international trade and investment[230]and achieving a more efficient allocation of global resources and they employ similar rules to reach that goal. In particular, the GATT[231] permits member countries to impose taxes on imported goods, both at the border (tariffs) and after the goods have entered the country (internal taxes). The GATT members agree, however, to limit or "bind" many of their tariffs at fixed levels[232]. These tariff bindings are backed up by a "national treatment" or non-discrimination obligation applicable to internal taxes on goods: Member States are prohibited from imposing internal taxes on imported goods that are less favourable than the internal taxes they impose on similar domestic goods[233].

Apart from various customs duties and indirect taxes on goods and services, such as excise taxes, the determinations of transfer prices not in accordance with the arm's length principle have been regarded as practices not in accordance with the obligations under Art.XVI.4

[230] International trade agreements explicitly have the goal of facilitating international trade and investment. For example, the North American Free Trade Agreement, art. 102, declares its objectives, among others, to be to "eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services between the territories of the Parties" and to "increase substantially investment opportunities in the territories of the Parties.". Similarly, the preamble to the WTO Agreement declares that the agreement is "directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations." Tax Treaties also have the goal of facilitating international trade and investment. See, e.g., Model Tax Convention on Income and on Capital art. 1 commentary, para. 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."; Federal Income Tax Project: "The principal function of income tax treaties is to facilitate international trade and investment by removing - or preventing the erection of - tax barriers to the free international exchange of goods and services, and the free international movement of capital and persons."

[231] General Agreement on Tariffs and Trade, October 30, 1947, 55 U.N.T.S. 194 (hereinafter "GATT")

[232] See GATT 1947, art. 2.

[233] See GATT 1947, art. 3(2)

GATT[234]. The underlining idea is the following: “if free trade is to function, the prices charged in the international product markets must not be distorted”[235].

The way in which taxes are levied or states support their resident enterprises can have a great influence on international trade. For this reason, for example, importing states are entitled to impose “tax adjustments” on importing goods, creating the same tax treatment between imported products and domestic products[236].

The WTO is one of the main international forum that can be consulted to avoid trade barriers deriving from domestic tax rules. Its jurisdiction includes tax disputes on measures that are restrictive of trade and competition. It could be an effective tool to evaluate domestic tax regimes’ conformity with international law and to solve multilateral tax conflicts.

Disputes at the WTO imply inconsistency between WTO rules and domestic as well as international tax laws. They mainly involve differential treatments of imported goods in relation to “like domestic products”, in violation of the rule on “national treatment on internal taxation and regulation”[237].

The jurisdiction of WTO in the area of direct taxation disputes have been rather limited[238] compared with disputes over indirect tax, probably because of the reluctance of the States in recognizing the WTO arbitration role over national tax matters. The most notable example because of the panel’s interpretation of WTO rules, is offered by the DISC, FSC and ETI proceeding which have been refereed to as a “nuclear trade war” in the literature. In the first dispute the panel held that the US “Domestic International Sales Corporation” program constituted an “export subsidy” within the meaning of Art.XVI(1) GATT[239]. In the second proceeding, initiated by the EC against US in 1997, both the panel[240] and the Appellate Body[241] once again decided that the tax advantages granted to “Foreign Sales Corporations” has to be considered illegal within the meaning of Art. 1(1) of the Subsidies Agreement. The EC complaint was essentially based on preferential treatment deriving from the US exemption of American goods export from income taxes.

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[234] BISD 23S/114 12 November 1976, “Income Tax Practices Maintained by France”, L.4423; BISD 23S/127 12 November 1976, “Income Tax Practices Maintained by Belgium”, L.4424 and BISD 23S/137 12 November 1976, “Income Tax Practices Maintained by The Netherlands”, L.4425.

[235] Wolfgang Schön and Max Planck, “World Trade Organization Law and Tax Law”, *IBFD Bulletin,* (July 2004), 283.

[236] Art.II (2)(a) GATT and footnote to art. III GATT

[237] Art.III GATT.

[238] Only nine out of a total of 341 initiated at the WTO, until 31 March 2006.

[239] Panel Report, “United States Tax Legislation (DISC)”, presented to the Council of Representatives on 12 November 1976 (L/4422), BISD, Suppl. 23 (1976), 98.

[240] Panel Report, “US – Tax Treatment for Foreign Sales Corporations”, WT/DS108/RW, 8 October 1999.

[241] Appellate Body Report, “US – Tax Treatment for Foreign Sales Corporations”, WT/DS108/AB/R, 24 February 2000.

A third judgement ruled against US tax law; the panel[242] and the Appellate Body[243] found that the "Extraterritorial Income" provisions constitutes a subsidy. After three different legal defeats, the US were obliged to rewrite their rules on international taxation, introducing a territory-based approach to income taxation with appropriate transfer pricing rules and indirect consumption tax adjustments.
This dispute makes clear the strong effect of the WTO decisions on domestic and international tax law of the WTO Members.

Notwithstanding the close relationship between international income taxation and international trade, the academic literature[244] and international agreements historically have failed to link the two subjects. This separation of disciplines is useless because international tax policy can have an enormous impact on international trade[245].
This was the starting point of the "Harmful Tax Competition" studies[246], based on the idea that the counterpart of the tax systems development caused by economies globalisation is the born of harmful preferential tax regimes to attract investments. Tax systems could have a distortive effect on international trade of mobile productive factors.

The interaction between these two fields of international law that this chapter would like to analyse is the influence of the international trade law on the tax treaty law, with reference to dispute settlement procedures. There are notable differences in approach to dispute settlement and extent to which agreements are binding, in addition to the fact that whereas WTO rules are negotiated multilaterally, international tax rules are based on bilateral treaties. The long history, experience and development of economic dispute resolution mechanisms could be helpful to understand the direction engaged by the OECD and the treaty partners towards a more "legalistic" approach for tax solving conflicts. Consultation and negotiation between designated tax officials from the relevant countries are no more the only chance for resolving a tax dispute but, as in other international filed, only the first step of a more constructed and binding procedure.

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[242] Panel Report, "US – Tax Treatment for Foreign Sales Corporations, Recourse to Article 21.5 of the DSU by the European Communities" WT/DS108/RW, 20 August 2001, Para. 8.37 et seq.
[243] Appellant Body Report, "US – Tax Treatment for Foreign Sales Corporations, Recourse to Article 21.5 of the DSU by the European Communities" WT/DS108/AB/RW, 14 January 2002, Para. 81 et seq.
[244] See Richard J. Vann, "A Model Tax Treaty for the Asian-Pacific Region?", 45 *Bull. for Int'l Fiscal Documentation* 99, 109 (1991). The author notes noting that tax treaties are usually written in their own terms without any clear connection to trade policy.
[245] A State can use discriminatory income tax measures directly to undercut the commitments it makes in international trade agreements. See Joel Slemrod, "Free Trade Taxation and Protectionist Taxation", *National Bureau of Econ.*, Research Working Paper No. 4902, 1994; Joel Slemrod, "Comments on John Mutti, TRIMS, Policy Change, and the Role of the GATT", in *Analytical and Negotiating Issues in the Global Trading System*, Alan V. Deardorff & Robert M. Stern eds., 1994.
[246] See "Harmful Tax Competition. An Emerging Global Issue", OECD (1998).

The OECD in its 1999 Transfer Pricing Guidelines mentions GATT and its successor WTO[247] as two international agreements where “sophisticated procedures and institutions” have been developed to resolve conflicting views. The OECD has mentioned a link between trade dispute settlement mechanisms and tax conflicts resolutions tools. It might be desirable to reconsider the latter on the base of the longest experience f the former.

The next chapter goes through the framework of the existing dispute settlement mechanism in the multilateral system of the World Trade Organization (WTO) with the purpose of drawing some advices from its well-defined and clear procedural rules, tested by practice over more than a decade.

2. The WTO dispute settlement procedures

2.1 Overview

The main interest and purpose of WTO is the promotion and the facilitation of free trade of goods and services among the member states. It operates to eliminate barriers to international trade. Despite or, it better to say, “because of” the existence of complex legal framework in which the international relations evolve, the interests of every member of international community is not often satisfactorily accommodated.

Disputes arise to make adjustments and create order. In the WTO context, they arise because one or more members challenge a policy maintained by another member that allegedly breaks WTO agreements. A first procedure for settling disputes was created, under the old GATT, to ensure compliance with the obligation established by the agreement.

The GATT dispute settlement was based on diplomatic negotiations, promoting compromise. It was a weak system because it required consensus by both sides at each step of the procedure, meaning that single objection could block the ruling.

Believing that the dispute settlement process under GATT could be improved through the creation of a more structured and solid process, the contracting parties agreed during the Uruguay Round to implement a new **Dispute Settlement Understanding** (DSU)[248] , made up of twenty-seven articles and four appendices, applicable to disputes between members on their rights and obligations under all Agreements of the WTO order[249].

[247] The WTO was born on 1 January 1995, with the conclusion of the last and longest GATT round, the Uruguay Round, which lasted from 1986 to 1984. Whereas GATT has mainly dealt with trade in goods, the WTO and its agreements cover trade in services , and in traded intellectual property.

[248] *See* “Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, WTO Agreement”, Annex 2, *Legal Instruments – Results of the Uruguay Round*, 33 I.L.M. 1226 (1994) (hereinafter “DSU”).

[249]DSU, art.1

The WTO members have established a dispute settlement system characterized as essential for the achievement of a prompts, satisfactory and positive solution of conflicts between members on the application of WTO agreements[250].

Its worldwide compulsory jurisdiction, the speedy conclusion of WTO panel procedures within normally less than one year, and the WTO appellate review system are often recommended as a models for reforming other international dispute settlements procedures. The progressive extension of WTO law in international trade for service and intellectual property, and the new solid framework for trade dispute settlement, show the general need for coordinating the law and dispute resolving procedures of international community.

The WTO dispute settlement process provides five different ways to resolve conflicts: consultation, good offices, mediation/conciliation, arbitration and adjudication. Arbitration procedure is included in several WTO agreements[251]; in the DSU it is considered only as an "alternative means of dispute settlement" , useful for "certain disputes" on issues "cleared define by both parties"[252].

Countries prefer the establishment of a WTO panel instead of the use of more informal and simplified ATR because of the their mutual trust in the WTO rule of law[253]. Moreover, a dispute between WTO members can be resolved through arbitration only if they mutually agree do start this procedure.[254] This DSU requirement of mutual consent does not exist for the establishment of the adjudication panel. The consent between the parties in a dispute is always seen as difficult and time-consuming. The DSU arbitration rules are vague, they do not establish procedural steps, time limits and no appeal is possible against the arbitrators decision.

Taking into account these limitations of Article 25 of the DSU we will proceed to assess the most important features of the DSU adjudication process, instead of the arbitration proceeding, comparing, where possibile, its main stages with the tax dispute resolution procedures, for taking critical starting points .

2.2 The WTO adjudication procedure

WTO dispute settlement mechanism is articulated into three steps: a political phase of the consultation process, a legal phase of a first quasi-judicial proceedings before a panel and a

[250] DSU, art.3, para 2-4 and 7.
[251] Eg. Article 8.5 of the Agreement on Subsidies and Countervailing Measures (SCM).
[252] DSU, art.25.
[253] See Marc Busch, "Democracy, Consultation, and the Paneling of Disputes under GATT", 44 *J. Conflict Resolution* (2002), 425.
[254] DSU, art.25.2.

second possible judicial instance of appellate review, and a final step of the compliance for an effective solution of the dispute.

2.2.1 Consultations vs MAP

The first stage is a confidential[255] consultation between the governments concerned, to seek a mutually agreeable solution. A WTO member can present a written request for consultation, when its rights may have been violated. Within thirty days from such a request the discussion should start and only after 60 days after the date of the request's receipt, the complaining party may ask for the legal procedure[256].

A special provision on multilateral consultations is not provided in the DSU but only under the GATS[257] when bilateral consultations have failed to achieve a satisfactory solution.

Amicable procedures as good offices, conciliation and mediation, examined in Part I of the present work, are the basis of the system, they assist the parties in developing a dispute resolution[258] and they are still always possible, even when the case has progresses to other steps.

This is also the OECD approach when it advices to include in the tax treaty arbitration clause the possibility for the CAs to solve under the mutual agreement procedure all the unresolved issues described in the Terms of Reference , at any time before the arbitrators have delivered a decision. In this case, the dispute shall be considered as closed and no arbitration decision shall be provided.

Dispute settlement process is not designed to be contentious and should not be interpreted as such[259].

The WTO priority is to settle disputes, preferably through consultation. In accordance with information published on WTO website, by July 2005, only about 130 of the nearly 332 cases had reached the full process. Most of the rest have either been notified as settled "out of court" or remain in a prolonged consultation phase[260].

If the parties are not able to find a solution they can also ask the WTO Director-General to mediate or to assist them in any other way to settle the dispute[261].

Under the Article 25 of the double Tax Treaties in force, where there's no yet an arbitration clause, the parties (the CAs) are under no obligation to find a solution during the MAP process and they consult each other without any time limit, leaving the taxpayer in uncertainty. Moreover, there is no mediator that can help them to solve the dispute. Thanks

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[255] DSU, art.5.2.
[256] DSU, art. 4.7.
[257] Art. XXII:2 General Agreement on Trade in Services.
[258] DSU art.5.3. and 5.5.
[259] DSU, art. 3, para.10.
[260] See the WTO website: http://www.wto.org/wto/index.htm.
[261] DSU, art. 5.6.

to the new paragraph 5 added to Article 25 OECD MC, if any solution has not been reached within 2 years, it is the taxpayer that can initiate the arbitration proceedings, it's not a power left to one of the two CAs.

2.2.2 Panel of experts vs arbitrators: the procedure and the role of the parties

If consultations are unsuccessful in solving the dispute, the "legal phase" starts: the complaining party can immediately request the establishment of a panel[262] of experts to the "Dispute Settlement_Body" (DSB), that is the "administrator" of the DSU's rules and procedures[263], for its considerations.

This organ consist of all WTO members and its wide range of powers includes the abilities to establish the panels, to accept or reject their findings or the results of an appeal and to monitor the implementation of the rulings or recommendations. It can also authorize suspension of concessions when a country does not comply with a ruling. DSU takes its decisions in accordance with customary rules of interpretation of public international law[264].

A panel establishment request may be rejected by the DSB only once, on the base on the "negative consensus" rule[265].

The Chairman of the DSB, consulting the parties, draws up the *Terms of Reference* of the panel that has to examine the compliant in the light of the relevant provision in the WTO agreement in question. Formally the panel helps the DSB make rulings or recommendations but its solution is difficult to overturn because it can only be rejected by consensus in the DSB.

Before the circulation of the report to the WTO Members and to the DSB for final disposition, the panel adopts an "interim decision" to give the parties the possibility to make final comments or request for clarification and to further address specific issues to the panel[266].

This intermediate phase could be useful also in the tax arbitration proceeding to increase the possibility that arbitrators' final decision will be accepted by the taxpayer. Within a period of time set by the arbitral body, CAs and taxpayer could submit written comments and requests to review precise aspects of the interim report prior to communication of the arbitral final decision.

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[262] DSU, art.6. Panels are like tribunals but unlike in a normal tribunal, the panellists are usually chosen in consultation with the countries in dispute. Only if the two sides cannot agree does the WTO director-general appoint them. Panels consist of three (possibly five) experts from different countries who examine the evidence and decide who is right and who is wrong. The panel's report is passed to the Dispute Settlement Body, which can only reject the report by consensus. Panellists for each case can be chosen from a permanent list of well-qualified candidates, or from elsewhere. They serve in their individual capacities. They cannot receive instructions from any government.

[263] DSU, art.2, para1.

[264] DSU, art.3, para.2.

[265] DSU, art. 6.1.

[266] DSU, art.15, para.1

The panel should report within six months from the date the terms of reference are agreed[267] and its findings, that include all arguments made by the parties during the interim review stage[268], are automatically adopted by the DSB unless either there is a consensus against adoption or a party appeals against the report. The possibility of an appellate review of the panel's decision is one of the most distinctive aspects of the WTO legal process.
In the tax arbitration phase, as proposed by the OECD, the parties (CAs) have only the duties to agree on the Terms of reference for the case, to appoint two of the three arbitrators and to present in writing to the arbitrator their own reply to the questions expressed in the Terms of Reference; they do not interact with the arbitrators. In the tax arbitration is the taxpayer itself that makes the request for the procedure, not the governments representatives, as in the WTO mechanism. This is why the taxpayer is allowed to present his position to the arbitrators in writing, to the same extent that he can do so during the consultation phase, and in addition, with the permission of the arbitrators, orally during the arbitration proceedings.
It's in evidence that, in the WTO dispute settlement procedure, parties play an active role both the ones directly involved and any member having notified the panel its interest in the proceeding (this subject will be discussed later on).
They are allowed to be heard by the panel and to submit materials[269] and the panel itself should consult parties regularly to give them an opportunity to develop mutually satisfactory solution to the dispute[270]. The panel can consult the parties to follow working procedures other than the ones established in the Appendix 3 to the DSU[271]and, transmitting its interim decision, allows parties to make additional comments on the prospected solution of the dispute. The existence of a "first draft", describing facts and arguments too the two sides, as already underlined, gives the parties an other chance to express their comment and help the panel in writing its findings and conclusions with a good level of certainty.
Moreover, parties have the right to participate fully in the DSB meeting in order to ensure again their voice are heard[272] and WTO members can always comment and express their views on a panel report. The panel may also consult scientific or technical experts if the raised matters so required. This is a further help for the panel and a further guarantee of a well-founded final report.

[267] In case of urgency, including those concerning perishable goods, the deadline is shortened to 3 months.
[268] DSU, art.15, para.3.
[269] DSU, art.10.
[270] DSU, art. 11, para.2.
[271] DSU, art.12, para.1.
[272] DSU, art.16, para1.

2.2.3 Appeal

The right of an appeal, absent in the tax dispute settlement process, guarantees an high level of certainty and legality to the whole procedure, useful especially with regards of disputes related to highly juridical issues. Appeal may be made to the Appellant Body, established by the DSB, only for question of law and legal interpretation in the panel report. DSB automatically adopts Appellate body reports, unless it decides by consensus not to adopt the report.

The following table summarizes the estimated timing of the first two phases of the WTO dispute settlement mechanism :

Approximate periods for the first two stages f a WTO dispute settlement procedure[273]

Timing	Procedure
60 days	Consultation, mediation, etc.
45 days	Establishment and composition of the Panel
6 months	Final panel report to parties
3 weeks	Final panel report to WTO members
60 days	Dispute Settlement Body adopts report
TOTAL= 1 Year (without appeal)	
60-90 days	Appeals Report
30 days	DSB adopts Appellate Body report
TOTAL= 1 Year and 3 (or 4) months (with appeal)	

If we compare this table with the one in Part IV of the present work[274] that summarize the approximate time limits suggested by the OECD for the tax arbitration process, it's clear that the WTO mechanisms is three times faster than the tax treaty dispute settlement procedure.

2.2.4 Compliance phase

Once the decision has been adopted by the DSB, it is *binding* for the parties that must accept it unconditionally[275]. They have got a "reasonable period of time" for the effective compliance with the panel or Appellate Body reports[276]. If this time passes without any result on the

[273] Published on the WTO website (http://wto.org).
[274] Chapter 2, para 2.4.2.4
[275] DSU, art.17.14.
[276] DSU, art.21.3. The reasonable period of time is estimated in 15 months.

solution of the dispute, a new panel can verify the lack compliance, if the complainant so requests[277]. The remedies available in the case of assessed non-fulfilment could be temporary compensation, suspension of concessions or other obligations to induce compliance[278]: compensation is considered only as solutions while the measure at issue has not been removed[279]; if no voluntary compensation is offered, the only remedy still available is the suspension of concessions and other obligations.

3. Dispute settlement and third parties: a comparison between WTO and tax treaties systems.

Traditionally international legal relations are bilateral and inter-State, that means one state owns a duty to another and the latter is the only state entitled to take action against the former.

That's what happens in international tax conflict resolution: it is a "government-to-government" process in which there is generally no direct taxpayer involvement. In the same manner, an individual can obtain protection from trading practices only if his government initiates an action against the injuring state.

They are both procedures among states, which start with a consultation procedure and, where a solution is not find in an amicable way, they give to a third independent party (the panel and the Appellant Body or the arbitrators) the power to solve definitively the dispute.

The complexity of international relations has given a more central role to third-party's interest in the settlement of a dispute between two other states. We have to keep in mind that dispute settlement, unlike multilateral negotiations, does not encourage issue linkage which might otherwise sponsor efficient bargaining outcomes among multiple parties[280].

In this paragraph we focus our attention on the role of the "third parties" in the WTO dispute settlement mechanism and compare it with the corresponding rules in tax dispute settlement procedure.

As a preliminary considerations, we start with a definition of "third party" in International Law[281]. The VCLT defines "third State" indirectly, as a "State not a party to the treaty"[282] ,

[277] DSU, art.21.5
[278] DSU, art. 22.
[279] DSU art.22.1.
[280] Christina L. Davis, "International Institutions and Issue Linkage: Building Support for Agricultural Trade Liberalization", *American Political Science Review* 98 (2004), 155.
[281] On this notion see in detail: Christine Chinkin, "Third Parties in International Law", Oxford University Press, Monograph Series in International Law (1993).
[282] VCLT, art. 2.1, lett.i).

that is, under the definition of "party to a treaty ", a State which did not express its consent to be bound… and for which the treaty is not in force"[283].

The doctrinal studies have identified three categories of states[284]:

i. parties to the treaty;
ii. states totally extraneous to the treaty;
iii. a third intermediate category, in its turn formed by: "negotiation states", which took part in drawing up and adoption of the text of the treaty[285]; "contracting state", which has consented to be bound by the treaty, whether or not the treaty has entered into force[286]; and "states entitled to become a party", not expressly defined in the VCLT but mentioned in several paragraphs of article 77.

Tax disputes settlement procedures, as provided in tax treaties, have been extensively criticized because of the "passive" role in which the party affected by the unfair measure, the taxpayer, has been relegated. We have already remarked that taxpayer has neither the right for the establishment of a mutual agreement procedure nor to obtain the elimination of a measure that contravenes treaty principle leading to double taxation. He has no right to be involved in the procedure, supplying the CA with necessary details on the case to be solved, and he is not informed on the reasons under the decision.

The tax dispute settlement procedure is decided by the contracting states in their tax treaty, concluded on a bilateral basis. Specific conflicts may therefore arise in situations where more than two States are involved. The OECD MC, and in particular the mutual agreement procedure as written in article 25, does not provide any general and consistent solution to the problems raised by multi-parties cases. Experience shows that the MAP is not often practicable when more than two states are involved[287].

The most notable examples of "multi-parties" involvement in a tax dispute settlement procedure are multilateral APAs and the AC that are not bilateral agreements but a multilateral instruments as the WTO DSU. In these two proceeding we cannot talk about a "third-party" involvement in the case. Under the AC rules, a CA receiving the taxpayer request has to resolve the case by mutual agreement with the CA of "any other Contracting State concerned"[288]. It's, from the beginning, a multiple parties procedure whereas transfer pricing adjustments have consequences on the different enterprises of a multinational group. A satisfying solution, i.e. the elimination of any double taxation regarding a transaction

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[283] VCLT, art. 2.1, lett.g).
[284] Malgosia Fitzmaurice, "Third Parties and the Law of Treaties", 6 *Max Planck Yearbook of United Nation Law* (2002), 43.
[285] VCLT, art. 2.1, lett.e).
[286] VCLT, art. 2.1, lett.f).
[287] See OECD Report on Triangular Cases, adopted by the OECD Council on 23 July 1992, para.58.
[288] AC, art.6.2.

between associated enterprises, need the cooperative behaviour of all countries interested by the case.

Apart from multilateral APAs and AC process, in case contracting states believe that frequently the source of their conflicts lies in a particular third state, i.e. their most frequent commercial partner, they can use the option offered under articles 35 and 36 of the VCLT. According with these rules, there could be certain effects emanating from the (tax) treaty on third states that expressed intention to accept such rights or obligations.

A different approach is adopted by the WTO where the interests of members other than the parties shall be fully taken into account during the panel process[289]. More in detail:

- every member, having a well-founded "substantial trade interest"[290] in the case, can be joined in the consultations[291] *before* it is officially designated as a "third party";
- any member having notified its interest in a matter before a panel to the DSB is designed as "third-party". It is allowed to deliver written or oral testimony before panels[292] and the Appellate Body[293] and to receive the first submission of the complainant and the defendant.

By participating as a third-party, a government wishes to influence the outcome of the dispute and prevent a discriminatory settlement between the parties that would undermine its own share of the disputed market.[294].Empirical studies found that it's more likely that a country with large export becomes co-complainants that countries with sizable export that are affected only indirectly by the defendant's policy. The latter could become "third-parties" to save their market shares rather than their export volumes[295].

Third parties are considered as "strategic actors", directly engaged in the dispute settlement procedure, that can interpret the case and, within the "terms of reference" as defined by the parties, draw attention on particular arguments not otherwise raised. This could be considered as a further opportunity to avoid potential disputes arising from third parties on the same matter .

An evident difference between tax and trade dispute settlement mechanisms is the legal framework on which they are based: a bilateral treaty clause and a multilateral agreement

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[289] DSU, art.10.1.

[290] In *US-Section 306*, Canada explains that the definition in DSU art. 4.11 "is not limited to an immediate commercial interest but rather is wide enough to encompass both commercial and systemic interests" (WTO Document WT/DS20078).

[291] DSU, art.4.11.

[292] DSU, art.10.2.

[293] DSU art.17.4.

[294] Kyle Bagwell and Robert W.Staiger, "Multilateral Trade Negotiation, Bilateral Opportunism, and the Rules of GATT/WTO", *Journal of International Economics* 63 (2004) 1.

[295] Chad Bown, "Participation in WTO Dispute Settlement: Complainants, Interested Parties and Free Riders", *World Bank Economics Review* 19 (2005) 2.

respectively. As a consequence, third parties are differently involved in the two proceedings: completely out from the bilateral approach adopted by the tax treaties and entitled with participating rights under the multilateral WTO agreements.

An exception to this general rule is represented by multilateral tax treaties, a not much widespread practice but object of some feasibility studies [296]. In a context where the number of multinational corporate groups located in more than two countries is increasing day after day and many regulatory area are being dealt with globally by government, the bilateral tax treaties approach seems inconsistent. A multilateral treaty makes it easier to plan multinational trade operations and to solve more effectively the so-called “triangular cases”.

Certainly it is not possible to think about a replacement of all double tax conventions with a single tax treaty administered by a central international organization. The feasibility of a multilateral treaty depends much on the size of the group of contracting states and on the similarity of their tax systems and economic position[297]. As a matter of fact, a good example of positive experience with multilateral treaty is the Nordic Tax Treaty[298], signed by countries with very important economic relations and extensive cross-border activities. The negotiation of multi-party agreements is undoubtedly more complex and changes are burdensome since they need the approval by all Parliaments.

The MAP in a multilateral context is worth mentioning: how does it fit with the rules of Article 25 OECD MC? The Nordic treaty has adopted the following solution[299]. In order to achieve uniformity in interpretation and application of the multilateral tax treaty the MAP procedure include a further step: the result of a bilateral consultation must be communicated to the other contracting states and where one of these states asks for a multi-party consultation it shall take place without delay.

The feasibility of developing a multilateral income tax convention has usually been rejected on account of the notable differences in the tax policies among countries, even though Victor Thuronyi proposes a structure for a multilateral treaty as, among other, an opportunity for establishing a new international tax order[300].

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[296] See Victor Thuronyi, “International Tax Cooperation and a Multilateral Treaty”, 26 *Brooklyn Journal of International Law* (2001), 1641.

[297] See Kees van Raad, “Options for Greater International Coordination and Cooperation in the Tax Treaty Area”, *Bulletin* (2002), 248

[298] The first Convention between the Nordic Countries for the Avoidance of Double Taxation with respect to Taxes on Income and Capital was signed in 1983 by Denmark, Finland, Iceland, Norway and Sweden and it substituted all the bilateral tax treaties between the Nordic countries.

[299] See Nordic Treaty Art.28, para.4 (Mutual agreement procedure).

[300] See Victor Thuronyi, “International Tax Cooperation and a Multilateral Treaty”, 26 *Brooklyn Journal of International Law* (2001), 1641.

4. Interaction of the dispute settlement mechanism in the GATS and in the MAP

The third part of the OECD Commentary on Article 25 goes further the text of the tax treaty and analyses the interaction between the MAP and the dispute resolution mechanism provided by the General Agreement on Trade and Services (GATS), a treaty of the WTO, entered into force on 1995.

According to Article XIV GATS, violations of the "*most favourite nation clause*" (MFN)[301] arising from agreements on the avoidance of double taxation are exempted from the GATS discipline altogether. In other words, the GATS cannot override income tax treaties and a Member State can act inconsistently with the MFN obligations whenever the measure in question "*falls within the scope*" of a tax convention. This is a limit to the application of MFN to direct tax covered by the exclusion and a limit to the jurisdiction of the GATS.
It is not clear which kind of measure related to taxes "falls within the scope" of Article XXII (3) and in particular if this article is applicable to all measures related to taxes covered by all or also by only some provision of the tax treaty. Nevertheless, if the disagreement concerns with whether a measure "falls within the scope " of a tax convention, the matter could be brought unilaterally to the attention of the Council of Trade in Service (CTS), which has to submit the conflict to arbitration for a final binding decision[302].

Another doubt can arise concerning the footnote at GATS Article XXII (3) [303]. It provides a special treatment for disputes related with tax treaties that predate the time of the entry into force of the GATS. In particular, the footnote states that the submission of the matter to the CTS needs the *consent of both parties.* As a consequence a unilateral decision is not enough and the resolution of the claim would be subject to the general dispute settlement procedure applicable to trade in service.

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[301] GATS Article II: "1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country. 2.A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions. 3. The provisions of this Agreement shall not be so construed as to prevent any Member from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.

[302] GATS, Article XXII (3): "A Member may not invoke Article XVII, either under this Article or Article XXIII, with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between Members as to whether a measure falls within the scope of such an agreement between them, it shall be open to either Member to bring this matter before the Council for Trade in Services.[302] The Council shall refer the matter to arbitration. The decision of the arbitrator shall be final and binding on the Members.".

[303] GATS, Article XXII (3), Footnote 11: "With respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to such an agreement.".

The OECD Commentary advice treaty partners to resolve these difficulties through negotiating *ad hoc* rules for:

- extending the application of the above mentioned footnote to treaties concluded after the entry into force of the GATS, and
- ensuring that issues relating to "tax covered" are dealt with through the MAP rather than through the dispute settlement mechanism of trade agreements.

Moreover, both GATS and tax treaties deal with the non-discrimination provisions, even though the former provides generally much broader rules than the latter. Problems can arise concerning the arbitration procedure applicable to national treatment-related disputes on double taxation. If an income tax measure of a country discriminates against the service suppliers of another country, the complaints would fall under both the WTO jurisdiction because of the violations of the "national treatment clause"[304] and the relevant tax treaty with a non-discrimination clause (like Article 24 OECD MC). This overlap in jurisdiction is solved by the explicit provision inserted in Article XXII:3 GATS that allows tax treaty to prevail. As a consequence this matter is not subject to the dispute resolution mechanisms provided by Articles XXII and XXIII of the GATS.

So, the MAP is a procedure for resolving also disputes if a tax measure of a state causes infringement of
on obligation under the GATS but the MAP is available only for bilateral conflicts. If the tax measure at issue injures the rights of more than one country, all the affected parties would be required to initiate their own bilateral dispute settlement process, with a consequent increase in the number of efforts and costs.

[304] GATS Article XIV (e): "…nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures: (e) inconsistent with Article II, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.".

VI : Dispute settlement as part of a wider International tax cooperation system

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1. Overview on tax cooperation

This chapter try to show the link between International law of dispute settlement and cooperation policies among States. Cooperation is the joint action of two ore more subjects and goes further on "coexistence" or "coordination". It means proactively working together, serving objectives that cannot be attained by a single actor.

While a dispute itself implies a non-cooperative behaviour, some cooperative procedures between countries are necessary for conflicts settlement.

The *Game theory*[305] teaches that the principle of predictable "tit-for-tat"[306] offers the best strategy for promoting reciprocal cooperation among egoists in a decentralized context where, as in many fields of international law, there is no central authority that can enforce agreed international rules.

In order to increase the mutual gains from cooperation and reduce transaction costs, social contract theories emphasize the mutual advantages of agreed rule-making and rule-enforcement agencies. At the national level, all states have established governments and courts that provide for compulsory dispute settlement procedures and enforcement mechanisms. At the international level, however, as discussed in previous chapters of the present work, the classical "international law of coexistence" lack central rule-making and compulsory dispute settlement and enforcement mechanisms in many areas.

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[305] R.Axelros, "The evolution of Cooperation" (Basic Books, 1984), 180.

[306] The strategy, based on the English saying meaning "equivalent retaliation" ("tit for tat"), is the following: cooperate on the first move and then copy your opponent's last move for all subsequent moves. The basic idea is that, in the context of an iterated prisoner's dilemma, you're often best off starting out "nice" and then shadowing the other side's moves. If the other side screws you, you screw him right back. But if your opponent starts cooperating, you don't hold a grudge: you relaunch cooperation as soon as he stops acting against your interests. An agent using this strategy will initially cooperate, then respond in kind to an opponent's previous action. If the opponent previously was cooperative, the agent is cooperative. If not, the agent is not. It has three characteristics that account for its impressive performance: it is nice (cooperates on the first move), retaliatory (punishes defection in the prior move with defection) and forgiving (immediate return to cooperation). Tit-for-tat is a way of securing cooperation from agents that may be tempted to do you wrong.

A general duty for cooperation, without any specific legally binding obligation, could be seen as a flexible help for avoid and/or resolve disputes in amicable way. Nevertheless it has been considered more effective to define fixed procedures for cooperation that grant rights and duties whose non fulfilments constitutes unlawful acts.

In particular, the most common cooperative mechanism is the rules based on Article 26 OECD MC under which information may be exchanged between competent authorities of the two contracting states for the implementation of the domestic tax law and the application on specific provisions of tax treaty[307]. The next article, number 27, provides the rules under which treaty partners may agree to mutual assistance in the collection of taxes.

The relationship between articles 25, 26 and 27 OECD MC is governed by the principle of cooperation between tax authorities to endeavour to avoid or resolve international tax conflicts, applying correctly double tax conventions and to help each other in the domestic collection of taxes activity.

International tax cooperation is not only provided in double tax treaties. The OECD has recently published a Report on Tax Cooperation, starting from the core idea that countries are working together to prevent abuses of the global financial system in a wide range of areas, including taxation, and it is still working to improve the speed of response to emerging global tax risks[308]. The principal means and documents developing cooperative tax practice will be discussed in the following chapters.

Duties of cooperation in general, and of peacefully dispute settlement in particular, play a crucial role in the battle of tax avoidance and of double taxation. The OECD Global Forum on Taxation, which consists of OECD and non-OECD economies, is working to ensure the implementation of high standards of transparency and information exchange in an equitable way, permitting fair competition between all countries.

Dispute settlement is a device for promoting and maintaining cooperative international regimes. One of the primary function of dispute settlement is to generate and disseminate the information that is necessary for the maintenance of cooperation.

A tax dispute settlement mechanism, as MAP or arbitration, also could facilitate and promote the convergence of expectation that is necessary for cooperation.

This chapter presents some specific forms of tax cooperation, other than amicable dispute settlement mechanism (dealt with in the third part of the present work), which, in addition to the intrinsic general duty of cooperation in tax dispute settlement, jointly develop a network of relationships and interdependences between different states with the purpose of improving domestic rules effectiveness and tax compliance.

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[307] See OECD Commentary on Article 26, paragraph 2.

[308] See OECD's Current Tax Agenda 2008 (www.oecd.org/ctp)

2. Exchange of information

International tax cooperation includes many aspects as facilitating effective exchange of information, with special care to the access to bank information, combating corruption and harmful tax practices, improving cooperation between tax and non-tax authorities, as anti-money laundering bodies. The "effective" exchange of information depends of the availability of relevant information to CAs and the quality of that information[309]. The lack of effective exchange of information is seen as one of the key factors in judging whether a regime set up by a country that refuses to supply information to other countries may have potentially harmful effects on the tax systems of the other countries[310].

Generally speaking, in order to mediate any transaction, parties must exchange some minimum amount of information, namely the initial terms upon which both is willing to conclude the transaction. The parties may be said to negotiate if they exchange relevant information in addition to this minimum amount. In other words, the exchange of information is the starting point of a cooperative behaviour.

Exchange of information is defined by the OECD as an "important tool in fighting non-compliance with the tax laws in an increasingly borderless world"[311].

An effective exchange of information is a fundamental base for international tax cooperation and mutual assistance between countries in assessment and collection of taxes but it needs to guarantee protection of the legitimate interests of taxpayer as far as confidentially is concerned. The exchange of information is not always based on obligations This is the case, for example, if the information is not *necessary* (Art. 26(1) of the OECD Model) or *may not be of interest* (Art. 1 (1) of the EC Mutual Assistance Directive, of 19 December 1977) for taxation in the other country. All international instruments restrict the purposes for which the information may be used and include well founded reasons for declining to provide information exchange between tax authorities.

Hereinafter we go through the legal framework for tax information exchange, developed by bilateral tax treaties, EC Mutual Assistance Directive 77//799 and the OECD/Council of Europe Multinational Convention on Mutual Administrative Assistance in Tax Matters, with the purpose of underlining the cooperative aspects of the different mechanisms more than the procedural mechanisms.

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[309] See OECD Global Forum on Taxation, "A Process for Achieving a Global Level Playing Field" (2004).

[310] United Nation Department of Economic and Social Affairs, "International Cooperation in Tax Matters" (New York: united Nation, 1998), para.26, and OECD, "Harmful tax Competition: An Emerging Global Issue", (Paris, OECD, 1998), para.64.

[311] See OECD website at: www.oecd.org

It should be noted that there are other international agreements dealing with exchange of information and cross-border cooperation between tax authorities[312] but their analysis go further the scope of the present analysis.

2.1 Article 26 OECD MC

In the context of double tax treaties, international exchange of information is based on Article 26 OECD MC and is included in bilateral convention with the purpose of facilitating the correct application of the treaty or the domestic laws of the contracting states[313].

The existence of an article dedicated to this form of cooperation between states stresses the importance of establishing a mechanism to prevent fraud and tax evasion, providing contracting states with a sufficient legal basis to legitimize the request to the other state to provide information of relevant importance for tax purposes.

The cooperative behaviour could be enacted through different mechanisms, the OECD Commentary illustrates three of them: "on request", under specific request for information by the other contracting state, "automatically", that means systematic communications between

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[312] E.g.: the EC Directive 76/308 on Mutual Assistance in the Recovery of VAT Claims; the Nordic Pact Multilateral Convention on Administrative Assistance in Tax Matters (1989), the EU Convention on Mutual Assistance in Criminal Matters (1989).

[313] Article 26 OECD MC reads as follows: 1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2. 2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred
to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. 3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation: *a*) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State; *c*) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*). 4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information. 5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.".

the two authorities, or/and "spontaneously, for that information supposed to be of interest of the other party.

As the mutual agreement procedure, the exchange of information is another means at disposal of the tax authorities to achieve the correct application of the provision of tax treaty. It's also helpful to interpret domestic law in a manner non contrary to the requirement of tax conventions.

It is important to underline that the conclusion of a treaty containing an exchange of information clause gives only the normative basis permitting a contracting state to require the other to comply with its obligation under the relevant article of the treaty. The parties have to set the procedures for implementing the duty/right of exchange of information and documents; they are not requested to go beyond their administrative practice or to supply information not available under the domestic law.

Countries should find a balance point between the domestic limits on the access to confidential information and the risk to be considered as an harmful preferential regime country where the lack of effective exchange of information crosses over an acceptable threshold. Some countries, such as Switzerland, have made a reservation on Art. 26 of the OECD MC limiting the scope of the article only to information necessary for carrying out the tax treaty provision, save for acts of fraud.

Article 26 has been changed in 2005 to reflect international trend in this area as emerging in the OECD Model Agreement on Exchange of Information on Tax Matters (see below) and in the OECD "Improving Access to Bank Information for Tax Purposes". According with these documents, access to information held by banks or other financial institutions should not be denied merely because it is too burdensome or time-consuming, the CA of the other contracting states have the power to require and obtain all relevant information to the determination, assessment and collection of taxes covered by the agreement, the recovery and enforcement of tax claims, or the investigation or prosecution of tax matters[314].

As emerged in the cross-border tax dispute settlement mechanisms, international agreements on administrative assistance between states can reach a more effective result on a multilateral level. On an integrated collective basis the goal can be achieved more effectively. The difference between the solution adopted by a bilateral tax treaty and a multilateral agreement is that the latter provide a more comprehensive legal framework for the exchange of information and documents, really helpful for joint investigations involving more than two countries.

[314] See Article 1, OECD, "Agreement on Exchange of Information on Tax Matters".

In the following paragraphs there will be a quick overview on some multilateral legal instruments ensuring exchange of information, strengthening the possibilities for collaboration among tax authorities. They reflect the growing importance of exchange of information and other forms of co-operation between tax administrations in an increasingly borderless business and financial world.

2.2. The Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The OECD and the Council of Europe developed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (hereinafter: Multilateral Convention), entered into force in 1995, currently joined by 13 countries[315]. It provides for a broad range of tools for tax authorities, covering all taxes. Its purpose is not only to facilitate exchange of information. The Convention covers all taxes, provides for assistance in tax collection, allows multilateral simultaneous tax examinations and participation in tax examinations in other countries.

More in detail, the Multilateral Convention provides for the exchange of information relevant to:

- the assessment and collection of taxes
- the recovery and enforcement of tax claims
- the prosecution before and administrative authority
- the initiation or prosecution before a judicial body[316]

The scope of the Multilateral Convention is broader than bilateral assistance under tax treaties or any other international regulations on exchange of information. The Multilateral Convention provides one of the most comprehensive and efficient instruments to counteract international non-compliance in today's high integrated economy.

In addition, articles 19 and 21 of the Multilateral Convention, includes important restrictions on exchange of information as extensive safeguards to protect the confidentiality of the data exchanged.

2.3 The OECD Model Agreement on Exchange of Information on Tax Matters (TIEA)

The successful OECD initiative to counter the distorting effects of harmful tax competition on international trade has been extended to the implementation of the commitments to transparency and effective exchange of information with tax havens.

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[315] In detail: Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Sweden, the United Kingdom and the United States (on 18 April 2008 Germany signed the Convention).
[316] Multilateral Convention, Article 4.

These country usually do not develop a treaty network for avoiding double taxation because transactions with these countries are not damaged by double taxation problems. The lack of rule like Article 26 OECD MC was one of the reason because communication with tax havens did not occur or tended to be "hostile". The 1998 OECD Report on Harmful Tax Competition identifies "the lack of effective exchange of information" as one of the key criteria in determining harmful tax practices. As a consequence, the OECD gave a special mandate to the Global Forum Working Group on Effective Exchange of Information ("the Working Group")[317] for developing a legal (non binding) instrument useful to achieve this aim.

The outcome of the Working Group was the drafting of a **Model Agreement on Exchange of Information on Tax Matters** (TIEA), for both multilateral and bilateral treaties or agreements. This in an instrument to implement the "standard" of an "effective" exchange of information for the purpose of OECD's project on harmful tax practices. As noted above, this model gives the authority to obtain information held by bank and other financial institutions. This provision has been reflected also in the 2005 OECD MC version but it should be stressed that the inclusion of this rule in a bilateral agreement with a tax haven modifies one of the key factors of the business competition.

The current global financial crisis, in particular, together with recent tax evasion scandals have been a strong incentive for stabilizing word financial systems and, consequently, for fighting tax evasion through an increasing transparency in cross-border transactions. As a result and the end of October 2008 some 16 new bilateral agreements on exchange of information as been signed between OECD countries and the British Virgin Island, Guernsey and Jersey[318].

It seems, however, that tax havens are far from stopping to exist. A commitment to effective exchange of information and transparency could be enough to remove a country from the OECD's list of uncooperative tax havens but their low tax rates are presumably substantially more important for the major multinational enterprises' purpose[319]. Many TIEAs already in force are affected by some limitations and are applicable only for information on "demand", rather that automatic exchanges[320].

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[317] The Working Group consisted of representatives from OECD Member states and delegates from Aruba, Bermuda, Cayman Island, Cyprus, Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

[318] These new agreements mark an important step forward in efforts to bring greater transparency to cross-border financial transactions

[319] Colin Powell, "The Five Essential Issues Facing Offshore Financial Centres", in Rajiv Biswas (ed), *International Tax Competition: Globalization and Fiscal Sovereignty* (London: Commonwealth Secretariat, 2002)., 221.

[320] See e.g. TIEAa USA- Cayman Island and USA-British Virgin Islands, where the taxpayer under investigation must be identified as well as the nature of the information requested, the purpose for which the information is sought, the entity that is believed to have the information and reasonable grounds for believing that the requested information is available in that jurisdiction.

Another important result of the OECD project against unfair tax competition is the creation, in 2004, of a Global Forum on Taxation, consisting of OECD and non-OECD countries, which is intended to achieve " a global level playing field based on transparency and effective exchange of information in tax matters"[321], in a way that is fair, equitable and permits fair competition between all countries, without distinction on their size or their OECD membership.

Tax cooperation with tax havens is more and more a key factor to grant a fair competition between states, based on legitimate commercial considerations rather than on secrecy and lack of transparency.

2.4 The European Mutual Assistance Directive

Exchange of information between EU Member States may occur on the bases of both a Directive and the tax treaty provisions. On 19 December 1977, indeed, the Council of the European Communities adopted Directive 77/799/EEC of 1977 on Mutual Assistance between CAs of the Member States in the direct taxation field.

The Directive provides the famework for more uniformity with respect to mutual assistance and exchange of information within the European Union, integrating the existing provisions in bilateral tax treaties, so as to help CAs apply their tax laws more effectively.

The scope of this directive was extended by the Council of the European Communities to cover VAT from 1981[322] and to excise duties in 1993[323] so that the Directive currently covers both indirect and direct taxation.

It provides for three types of information exchange: on request, spontaneous, and automatic. It also provides safeguards to ensure that any exchange of information respects taxpayers' confidentiality.

A Council report on tax fraud of June 2000[324] noted that the existing EU directives and regulations were inadequate for the combat of fraud, which in the direct tax area involves, in particular, problems of under-invoicing and over-invoicing (especially in transfer pricing matters).

The Council on 26 April 2004 adopted a Directive[325] related to direct taxation (income tax, company tax and capital gains tax), that is designed to speed up the flow of information between the tax authorities of Member States. The Directive updates and rectifies

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[321] OECD Global Forum on Taxation, "A Process fro Achieving a Global Level Playing Field" (2004).
[322] Council directive 79/1071/EEC
[323] Council Directive 92/12/EEC
[324] Council documents 8053/00 and 8668/00
[325] Based on the Commission proposal COM(2003) 446 of 28/07/2003.

weaknesses in the existing Directive 77/799/EEC and enables Member States to co-ordinate their investigative action against cross-border tax fraud and to carry out more procedures on behalf of each other.

3. Assistance in the collection of taxes

The “third-member” of the OECD MC articles’ group dealing with mechanisms for administrative cooperation between States is **Article 27** on “Assistance in Collection of taxes”.

The existence of such a kind of provision is needed to overcome the territorial limits of tax collection, since exercise of tax claim in other States infringes the general principle of territorially limited State sovereignty. In a globalized economy, where taxpayers may have assets throughout the world, tax administrations will have to work together as if they belonged to the same state, thus giving rise to a singular process of administrative internationalization[326].

The tax authority of the contracting state is authorize by such a rule to collect a tax debt on behalf of the tax authority of the other contracting state, remitting the amounts to the foreign country, or to take conservancy measures to ensure the collection of that debts, within the limitation imposed on the States provided in paragraph 8, Article 27 OECD MC.

A characteristic of the administrative assistance is intended to have very wide scope.

As a matter of fact, assistance is not restricted by the residence or the nationality of the taxpayer or of the other persons involved; the provision is applicable non only to residents of the requested State but alto to resident of third countries with property for which recourse is available in the requested State. Moreover it also possible to extend assistance to cover taxes other that the ones to which the tax treaty generally applies.

The possibility of strengthening international tax collection assistance is given either through bilateral agreement including a rule like Article 27 OECD MC, or else by signing the **Multilateral Council of Europe and OECD Convention of 1988** (hereinafter “1988 Convention”)[327] . The need to include provisions on assistance in the collection of tax debts in the tax treaty arises where a country has not acceded to the 1988 Convention.

This special Convention has been developed with the declared purpose of “promoting international cooperation for a better operation of national tax law, while respecting the

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[326] Abelardo Delgado Pacheco, “La asistencia mutua entre Administraciones Tributarias”, *Impuestos* (1990), 162

[327] The Parties to the Convention are presently Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland, Sweden, the United Kingdom, and the United States. Canada and Ukraine have signed the Convention and are awaiting ratification.

fundamental rights of taxpayers". It is one of the most complete and effective tool at disposal of tax administration non only for fighting against international tax avoidance and evasion not only but also to ensure the better implementation of tax law (e.g. granting tax relief and simplify administrative procedures).

The 1988 Convention also comprises clauses on exchange of information, including simultaneous tax examinations and tax examinations abroad, assistance in recovery, including measures of conservancy and service of documents (Articles 11-16). These three forms of assistance cover all the significant types of measure which it is envisaged could be taken by the CA of one country in cooperation in the carrying out of the duties of the CA of another country. The measures taken may relate to the various stages of the process of taxation: assessment, examination, collection, recovery and enforcement of a tax covered by the Convention[328].

In order to assist in the implementation of this form of assistance, the OECD has recently developed a Manual based on Article 27 and The 1988 Convention. The Committee on Fiscal affairs addressed the Manual to the tax administration involved in the assistance activity and it could be useful for developing domestic directions following the Model.

It should be noted that States are aware of the costs of such operations and that there is no international principle establishing the obligation to cooperate with another state to collect tax claims. However the increasing interdependence of the economies is eliminating the borders also for tax issues and tax cooperation, in all its different forms and mechanisms, between States is becoming necessarily a common interest.

[328] "Joint Council of Europe OECD Convention On Mutual Administrative Assistance in Tax Matters - Explanatory Report" (1988), 20.

VII Conclusions

In recent years there has been renewed emphasis on alternative dispute resolution mechanisms as a means to avoid the use of contested hearings in tax cases. These procedures are believed more likely to result in an outcome tailored to individual circumstances and to be accepted by the parties as well as reducing delay and costs.
Previous researches has, however, raised questions about whether amicable dispute resolving tools, as provided in international tax law, can be considered as effective devices for a final decision on a tax dispute. The mutual agreement procedure, in particular, has been often accused to be an "incomplete" procedure, without valuable outcome in term of "costs versus benefits". Like others, I raise concerns about some of the limitations of the present approach to tax disputes resolution. In particular, the ADR systems effectiveness is restricted by a "natural" domestic approach unwilling to involve an independent third party as "arbitrator or mediator" with the power of decide on one country's right to tax. This is often seen as an unacceptable limitation of tax sovereignty, with direct effects on distribution of tax revenues and on the egoistic aim of national welfare maximization.
On the other side, avoiding of double taxation and fighting against tax evasion and avoidance are common goal of different governments, they require a cooperative behaviour and coordination efforts and a consequent partial restriction on tax sovereignty. In this scenario I have concluded that the strategic interaction between different tax authorities can be represented by a "coordination game" where the two actors have incentives to conclude an agreement in order to limit the costs of a tax disputes, in a wide-sense. How tax disputes are resolved involves a careful strategic game, with a distributive conflict, in which the relevant information is exchanged, and each country negotiates for what it perceives to be its rightful income tax base. The breakdown of negotiation can lead to costly litigation for the taxpayer in both jurisdiction.
If a country becomes known as one that historically has refused to compromise in tax dispute negotiations, even the hint that a multinational corporation will lose any of the tax benefits of doing business in that country may lead it to conduct its business elsewhere.
Conversely, if MAP is perceived to working well, attractiveness of the tax regimes is enhanced. In other words, those countries known to act more reasonably in negotiations may be able to attract more business, ultimately mitigating any tax base erosion they may encounter by capitulating in individual cases.

In this work, I draw upon a research study by contrasting the dispute resolution schemes in international economic sphere, marked out by a quite long and successful tradition, and the

existing mechanisms at disposal of tax actors for cross-border tax complaints avoidance or settlement.
An unsuccessful consultation between the countries in a trade dispute (i.e negotiation) opens the possibility of a mediation by the WTO director-general before taking any other action. This is generally not provided for in tax treaties and, consequently, without turning to arbitration the dispute remains unsolved. WTO dispute solving procedure is more structured and grants a high level of certainty and legality. The procedural differences have been examined in Part IV but, as a matter of practice, the non-binding nature of some aspects of tax dispute settlement procedures whets the distance between the two schemes. In particular, while the OECD MC allows taxpayers to present written or oral arguments in person or through a representative, the reality is that the CAs usually complete the process through written correspondence or in person, often with no input from the taxpayer.
Moreover, despite the OECD's caution that each MAP case be viewed individually, because the road leading to the negotiating table can be long and difficult, tax authorities have an incentive to settle as many of the same "types" of disputes as they can in a single session.
Another practical issue is the limited number of high-skilled human resources generally available in the domestic authority "international tax team". They have already to fulfil any other obligations deriving from their membership in different International Organizations (e.g. European Union) with waste resources and with effects on the decision, during the tax treaty negotiation, of undertaking further binding commitments, e.g arbitration on unresolved disputes. As a consequence an arbitration clause would be included in a tax treaty only if it has been valued as strongly useful with that particular counterparty. This is an issue of trade-off between costs of domestic resource involved in the procedure (e.g. dedicated specialists) and benefits from an efficient and satisfying resolution of tax disputes and from the avoidance of overburdening judicial systems. The dilemma has no univocal solution for all countries, having different preferences and assets, and sometimes it needs to be officially solved, through *ad hoc* studies, before tax treaty ratification[329].

A part from a quite uniform use of legal means for the dispute settlement (i.e. consultation, negotiation, mediation and arbitration), differently implemented in trade and tax laws,

[329] For example, starting from 2001, any proposal connected with changes in Italian tax treaties has to be furnished with an in-depth numerical analysis on costs (e.g. lower withholding tax rates) and economic benefits (e.g. employment increase) deriving from the establishment of the new rules. The resources required to the tax administration by this kind of studies are not consistent with the current internal organization so that the conclusion of new international agreements on tax matters has become more complex and time-consuming. Such procedures can be comparable only with the analysis developed by the US tax administration, supporting the improvement of their tax treaty network. Efficient results are more difficult to be obtained by a smaller structure as the Italian one.

another remarkable feature of cross-border tax conflicts resolution is its “bilateralism”, in contrast with many international multilateral procedures (e.g. WTO DSU).
ADR mechanisms are a precious device for dealing with the problem of lack in international law or divergent interpretation or application of rules, which are often not amended despite changes in the relevant environment. But including the resolution of tax disputes in a wider general project of international cooperation among tax authorities of different countries, there is a need of a multilateral approach that grant the involvement of all the parties concerned with the issue under dispute. In international trade, countries want to balance the interests of their importers and exporters, that’s one of the goal of the MFN clause in bilateral agreements. On the other side, the MFN treatment has favourable effects on third states without granting any concessions themselves; multilateral agreement prevent such a disequilibrium. In international taxation the MFN clause is not mandatory and as a matter of practice it is rarely used. Even though governments do not need for multilateral tax agreements and however their feasibility depends on factors already mentioned in the present work, a multi-party disputes resolution agreement could have a facilitating role for solving complex tax issues, often involving multination group of companies.

Both OECD and EU countries have been working on sever initiatives that suggest an increased willingness to cooperate in the tax area on a multilateral basis. This shows that the major industrialized countries seem interested in building a more systematic multilateral framework for taxation. In this context, EU Arbitration Convention’s process represents the most complete model of a method for resolving double taxation disputes, as it appropriately accommodates the goals of efficiency, transparency and certainty in resolution of tax disputes. It builds on the concepts of MAP but if double taxation in not eliminated within a reasonable period of time binding arbitration is enforced. It suffers the big disadvantage of limed application to transfer pricing adjustments. The recent OECD initiatives for an overcoming of the most notable limits of the tax disputes resolution mechanisms have recognized the special role of tax arbitration as a complementary tool, an incentive to speed up the mutual agreement procedure which is however a mark of a responsible tax administration. Tax arbitration could be a completion, not an alternative to the MAP, encouraging the negotiation process work more effectively. The success of the arbitration clauses is in inverse relation to the number of cases that will move from the negotiation stage to the arbitration phase.

Implementation of mandatory, binding dispute resolution tools in international tax law should be a clear sign that countries agree that tax treaty disputes must not remain unresolved. Resolving a dispute implies “coordination” , meaning a situation in which the two parties can

realize mutual gains making mutually consistent decisions. This is part of a wider international tax dialogue among national tax officials within a general cooperative approach in tax matters. This superior goal denies the contention that relinquishment of fiscal sovereignty is a valid justification for refusing to implement collaborative procedures.

Undoubtedly, there is a room for improving the practical application of the existing tax disputes resolution mechanism. At minimum the commitment to adopt arbitration clause, following paragraph 5, Article 25, OECD MC, in bilateral agreement that will be (re)negotiated should be honoured. If costs and resources are indeed a valuable obstacle, a simplified arbitration mechanisms (e.g. "last-best-offer" where an arbitrator is asked to choose between the two written CAs positions, without any formal meeting) could be explored.

An attempt could also be made to design an international dispute resolution procedure in the form of a multilateral agreement. In a recent in-depth study, Zvi Daniel Altman has supported the idea of an International tax tribunal so I do not believe that it is useful to discuss extensively this proposal that I am afraid it will never be realized. Nevertheless, a sufficient international consensus could be achieved to establish a "Dispute Settlement Body", consisting of all countries that wish to cooperate by signing an ad hoc multilateral agreement, to administer a sole arbitration procedure, following the WTO DSB model with suitably changes. This could be an effective tool for dispute resolution process, with binding effects on the parties and with an active role of both the countries directly involved in the disputes and any country having notified the arbitrators its interest in the proceeding.

Such a rule is consistent with each country's sovereignty, taxpayers and CAs would benefit from a feaster procedure and more certainty on the dispute resolution and, at the same time, the DSB would be a table around which country have to closely cooperate. These joint efforts could also lead to new approaches in comparative tax law and policy analysis.

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