The Effectiveness of Mutual Agreement Procedures as a Means for Settling International Transfer Pricing Disputes

This article addresses the current status quo of the mutual agreement procedure, tackling the various issues related to article 25 of the OECD Model Convention and the EU Arbitration Convention (90/436). Certain obstacles to a proper functioning of the MAP are also addressed, including the underlying reasons of why the MAP has been an ineffective process and double taxation persists even where a MAP is put in effect.

1. Introduction

Mutual agreement procedures (MAPs) are international remedies to prevent economic and juridical double taxation and are typically implemented within the scope of bilateral tax treaties. In this respect, effective dispute resolution by the competent authorities under the existing tax treaty procedures is an important aspect of the international law obligation of good faith implementation of a tax treaty as a whole. While the existing procedures would generally be able to resolve outstanding disputes, in some situations cases cannot be satisfactorily concluded.

However, it is clear that the MAP will continue to be the basic mechanism for the resolution of international tax disputes, as the existing MAP has provided and will continue to provide a generally effective and efficient method for dealing with these issues. The objective of a MAP is to ascertain the taxpayer’s claim to be taxed in accordance with the provisions of an applicable income tax treaty. These cases will typically arise when the countries involved cannot agree in a particular situation that the taxation by both states is in accordance the treaty. Transfer pricing in particular seems to provide fertile ground for international disagreements, as related adjustments inherently lead to double taxation. At the OECD level, the increase of transfer pricing-related disputes has not gone unnoticed, and has actually been an area of concern. Therefore, the OECD has launched several initiatives that serve to both assist tax authorities and taxpayers by clarifying the process of reaching avoidance of double taxation and make relief of double taxation more accessible.

One of these initiatives culminated in comprehensive guidance to tax authorities on MAPs, namely the Manual on Effective Mutual Agreement Procedures (the MEMAP). As is indicated in the MEMAP, transfer pricing adjustments are the best examples of double taxation, and historically the majority of MAP cases has been associated with transfer pricing where the associated companies of a multinational enterprise group incurred economic double taxation due to an adjustment to their income derived from intra-group transactions by one or more tax administrations.

2. Analysis of Mutual Agreement Concepts

Generally speaking, the main reasons for economic double taxation to arise as a result of transfer pricing adjustments are the implementation of different domestic transfer pricing rules; conflicts of classification and evaluating the facts of individual cases; application of different transfer pricing methods; and selection of incompatible comparables.

2.1. Current status quo of MAP instruments for resolving international transfer pricing disputes

In general, it is required under tax treaties that a taxpayer demonstrate that the actions of one or both of the contracting parties have resulted or would result in either economic or juridical double taxation. In terms of international transfer pricing disputes, there is no clear determination as to which remedy is to be sought first under both tax treaties and domestic law. Thus, taxpayers may initiate the MAP process while pursuing domestic law remedies. However, in most transfer pricing cases, the competent authorities will not be willing to initiate discussions with the other contracting state as long as domestic remedies are pursued by the taxpayer.

1. OECD Ctr. for Tax Policy and Admin., Improving the Process for Resolving International Tax Disputes (27 July 2004), ch. 1 Introduction, para. 9
3. OECD Ctr. for Tax Policy and Admin. supra n. 1, sec. A., Arbitration of Unresolved Issues in a Mutual Agreement Case, para. 8
A transfer pricing case must also be submitted to the competent authorities within a specified time frame. Under article 25 of the OECD Model Convention (OECD Model), a transfer pricing case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention. In addition, a parent company or subsidiary that presented a transfer pricing case to the competent authority of a contracting state may request arbitration for unresolved issues of a transfer pricing case which was earlier submitted to the MAP. This request in general must be made within a period of two years by the taxpayer, as the arbitration process is not an automatic mechanism. Therefore, the status of MAPs is, on a limited basis, up to the taxpayer, but the consequent negotiations are held among the competent authorities.

2.1.1. Domestic transfer pricing rules and the corresponding adjustment

Although the arm’s length principle represents a common ground for international business among the related parties, legislative transfer pricing rules vary from one country to the next. Also, transfer pricing disputes can so readily surface by virtue of domestic rules, and the corresponding adjustment is the single means to eliminate economic double taxation arising in transfer pricing cases. Article 25 of the OECD Model provides a mechanism to enable the competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only issues of juridical double taxation but also those of economic double taxation and especially those resulting from the inclusion of profits of associated enterprises under article 9(1); the corresponding adjustments to be made in pursuance of article 9(2) thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount.6

A corresponding adjustment, which in practice may be undertaken as part of the MAP, can mitigate or eliminate double taxation in cases where one tax administration increases a company’s taxable profits (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. It is also possible that the first tax administration will agree to decrease (or eliminate) the primary adjustment as part of the consultative process with the second tax administration, in which case the corresponding adjustment would be smaller (or perhaps unnecessary).7 Under article 9(2), a tax administration should make a corresponding adjustment only insofar as it considers the primary adjustment to be justified both in principle and in amount.8

At this point, an interesting question arises: should the taxpayer repatriate the funds after a corresponding adjustment? Assume that the tax authorities of State A have concluded an audit with an upward transfer pricing adjustment of EUR 10 million for Company X, a subsidiary in State A, for an intra-group transaction, and the tax authorities of State B agreed to make a corresponding adjustment for Company Y, the parent company in State B. Company X paid the additional tax and penalties in State A and Company Y was refunded the tax earlier paid in State B. In such a case, assuming Company X paid EUR 2 million tax and penalties, it is not clear whether Company Y should repatriate the funds (EUR 8 million in this case). Some countries, such as the United Kingdom, recommend that any repatriation of funds be made only as part of a MAP.

2.1.2. Conflict of classification and evaluation of the facts of individual cases and related parties

Economic double taxation may also occur as a result of different interpretations of the facts underlying a specific case. It is possible that taxpayers and tax administrations may reach differing determinations of the arm’s length conditions for the controlled transactions under examination, given the complexity of some transfer pricing issues and the difficulties in interpreting and evaluating the circumstances of individual cases.9 An examination of the issues on which the competent authorities have had difficulties reaching an agreement reveals that these are typically matters of treaty interpretation or of applying the arm’s length principle underlying article 9 and article 7(2).10

Conflicts of classification are in reality a question of the impact of domestic law on the interpretation of tax treaties.11 In this regard, article 3(2) of the OECD Model deals with the interpretation or application of the Convention and the elimination of double taxation in cases not otherwise provided for under the Convention. Accordingly, the other contracting state must follow the domestic definition of the state applying the treaty, and grants relief under either article 23A or article 23B.

However, in transfer pricing cases (under article 7 and article 9 of the OECD Model) both contracting states apply their domestic transfer pricing legislation, and there is no obligation under the treaty that the other contracting state follow the domestic definition of the state applying the treaty, as both countries may rely on their domestic law definition. It has been argued that a treaty is “applied” only in the contracting state that makes the primary adjustment under article 9(1). Under this view, the other contracting state that makes a corresponding adjustment under article 9(2) is therefore bound by the classification made by the first contracting state under article 9(1).

The author believes that this argument cannot be accepted. First, a domestic law interpretation of article 9 must in any...
case be made on the basis of the law of the state applying the treaty (lex fori). Second, a treaty is “applied” when making a corresponding adjustment under article 9(2), also in the narrow sense that has been argued in support of classification under the domestic law of the source state under article 3(2). Thus, through a corresponding adjustment, the treaty restricts taxation under domestic law. Third, it is clear from the Commentary on Article 9 of the OECD Model that the contracting states are not bound by each other’s classifications.12

With regard to economic double taxation, the situation would sometimes be different from juridical double taxation, as both contracting states tax the same income more than once in the hands of two different taxpayers. Therefore, international transfer pricing conflicts between two competent authorities arising from different interpretations of facts of individual cases should be resolved under article 25(3) of the OECD Model, and issues related to the interpretation of transfer pricing cases would be decided in light of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) within the scope of a MAP.

A good example of conflict of classifying and evaluating the facts of individual cases in transfer pricing is the allocation of functions and risks amongst the related parties. As seen most of the time in practice, disputes between two contracting states may also arise by determining whether the parties in an individual case are “related” for purposes of article 9 of the OECD Model. For instance, in the United States the notion of “control” is defined very broadly so as to include any kind of control (whether direct or indirect) and no specific definition of related parties is available. On the other hand, “related parties” are defined under Chinese domestic law less broadly, as a 25% direct or indirect shareholding is required in order for a party to be regarded as “related”. In recent years, an important conflict related to classifying and evaluating the facts of permanent establishment (PE) cases concerns the notion of “significant people functions”, which determine the allocation of profit between a headquarters and its PE. The significant people functions relevant to the assumption of risk and the economic ownership of assets will vary from business sector to business sector (e.g. such functions are unlikely to be the same for an oil extraction company and a bank) and from enterprise to enterprise within sectors (e.g. not all oil extraction companies or all banks are the same). A particular enterprise may have one or more significant people functions relevant to the assumption of risk and to the economic ownership of assets, each of which must be taken into account in the analysis.13

2.1.3. Application of different transfer pricing methods and selection of comparables

One of the particular areas where transfer pricing MAP cases arise involves disagreement on the selection of the appropriate transfer pricing method to be applied to the related-party transactions. One particularly critical dispute arises also where one party (taxpayer or tax administration) advocates the use of a one-sided method (e.g. cost-plus method, resale price method or transactional net margin method), while the other (tax administration or taxpayer) advocates the selection of a profit split method. In profitable situations, the conflict is about the attribution of the residual profit, and is often linked to the identification of “local intangibles” arguably attributable to a subsidiary and to which residual return should be allocated.14

Disputes as to the selection of the transfer pricing method are often essentially related to the functional analysis and the comparability analysis. As has been experienced in many MAP cases, another source of the debate concerning the application of the most appropriate transfer pricing method is the selection of the tested party. Most countries tend to select their own taxpayers as the tested party, although in many cases this is not the right approach to testing the arm’s length principle. Also, in respect of the selection of the most appropriate transfer pricing method (mainly the transactional net margin method), the selection of the appropriate profit level indicator for a specific transaction is determinative for a tax dispute.

International transfer pricing disputes are largely related to the proposed comparables. Tax authorities in many cases either conduct their own comparable search or deny certain comparables offered by the taxpayer. As more commonly seen in practice, the vast majority of disputes may not reach an agreement due to the selection of different comparables by two competent authorities. Sometimes, in addition to the comparables issue, the appropriate point in the arm’s length range can give rise to disputes, as depending on the domestic transfer pricing rules – countries may have a particular approach concerning the arm’s length range despite the fact that competent authorities would agree on the comparables.

Another related issue is the use of databases. Many tax authorities throughout the world prefer, as a default, local comparables, while others have a more global approach, such as pan-European comparables recognized by the European competent authorities together with local comparables. Another issue closely related to comparables concerns the comparability adjustment. Whether comparability adjustments should be performed (and if so, what sort of adjustments should be performed) in a particular case is a matter of judgment.15

14. C. Silberztein, Transfer Pricing Disputes and Their Causes, 16 Asia-Pac. Tax Bull. 6 (2010), at 439, 441, Journals IBFD.
15. Para. 3.47, 3rd sentence, OECD Guidelines.
2.2. MAPs under article 25 of the OECD Model

2.2.1. Generally
The MAP under the OECD Model is divided into two stages. The first is conducted in the state of residence, i.e. from the submission of an objection up to the decision by the competent authority of the residence state. Any objection must be presented within three years of the first notification of the action that gives rise to taxation. Different time limits are, however, specified in some tax treaties. The second stage is conducted between the contracting states, and consists of resolving the dispute on an amicable basis, i.e. by agreement between the competent authorities. The two main characteristics of this procedure are as follows. First, it is not mandatory for the contracting states to reach an agreement to eliminate double taxation. The states are required only to negotiate. Second, there are time limits for each stage of the procedure, including the three-year period in which a request for a MAP must be submitted. Besides, as discussed in the following section, article 25 of the OECD Model includes an arbitration process as a supplementary mechanism serving to enhance the effectiveness of the MAP.

2.2.2. Introduction of article 25(5) of the OECD Model and its effects on mutual agreement procedures
The introduction of article 25(5) of the OECD Model has been one of the most significant changes in the Model since it was first released in 1963. The possibility of using arbitration in transfer pricing cases had been on the agenda of Working Party 6 of the OECD Committee on Fiscal Affairs since the early 1990s, but that work was not actively pursued until the creation, in 2003, of a joint working group of Working Party 6 and Working Party 1 delegates. In January 2007, the Committee on Fiscal Affairs approved the final report of the joint working group, "Improving the Resolution of Tax Treaty Disputes", which included the final version of the arbitration provision and the Commentary thereon. These changes to the OECD Model were finally included in the 2008 Update of the OECD Model which was approved by the OECD Council on 17 July 2008. Article 25(5) provides that, in cases where the competent authorities are unable to reach an agreement under paragraph 2 within two years, the unresolved issues will, at the request of the person who presented the case, be resolved through an arbitration process.

The effects of article 25(5) of the OECD Model on MAPs have been quite critical, even though the purpose of article 25(5) is not to replace the MAP with a new mechanism. It functions, in reality, as a supplementary procedure to the MAP in cases where the competent authorities are not able to achieve an appropriate solution or where both competent authorities disagree on the interpretation of a treaty provision. In terms of transfer pricing cases, more fundamentally, the introduction of an arbitration clause similar to that found in article 25(5) to resolve issues after two years should considerably reduce the risk of lengthy mutual agreement procedures. As mentioned by many tax authorities, the most important effect of the arbitration process has been the acceleration of MAPs rather than resolving disputes during the arbitration itself.

Another key impact of the arbitration process on MAPs is related to the success of MAPs, as the controversy will ultimately be resolved through either the MAP or the arbitration process. The arbitration process in this manner also gives the competent authorities an opportunity to produce a different resolution than the decision of the arbitration panel during a 6-month period, following the communicating of the arbitration decision. Thereby, the competent authorities do not have to follow the decision taken by the arbitration panel and may still come to a common agreement on the existing dispute.

2.3. Mutual agreement procedure and the Arbitration Convention

2.3.1. Key features
The EU Arbitration Convention (90/436) is based on two distinct processes: the MAP and mandatory arbitration. It provides for a MAP (similar to the OECD MAP) wherein a taxpayer considers that double taxation has not been eliminated as provided for under the Convention, and the competent authorities of the Member States concerned must then endeavour to resolve the case by mutual agreement. The Convention provides for mandatory arbitration, which constitutes an integral part of the MAP if the competent authorities in a MAP are unable to reach agreement within two years. The relevant treaty states (EU Member States) are then obliged to establish an advisory committee. The Convention covers both economic and juridical double taxation.

The material scope of the Arbitration Convention (90/436) is limited to transactions between enterprises of Member States. Therefore, the Convention is not applicable to enterprises established in non-EU countries. Although the Convention does not apply to PEs of non-EU enterprises, it covers transactions between subsidiaries of a non-EU enterprise located in Member States.

2.3.2. Application of the Arbitration Convention (90/436) in settling transfer pricing disputes
The application of the Arbitration Convention (90/436) varies among the contracting states. Although different practices can be observed, the general principles of the
Convention are based on the arm’s length principle. As is closely analysed, this could be clearly seen in the wording of article 4(1) of the Convention, which literally borrows from article 9 of the OECD Model. Similarly, the separate entity approach of the OECD (article 7.2 of the OECD Model) is reflected in article 4 of the Convention for the profit allocation between a head office and its PE under the distinct and separate enterprise principle.

The application of the Arbitration Convention (90/436) in settling transfer pricing disputes follows a two-step approach. In the first stage, a typical MAP (as in the case of an OECD MAP) is carried out. This situation is reflected in article 6 of the Convention. As typically happened under tax treaties, the Convention first requires that transfer pricing controversies among the Member States be resolved by a MAP, but the competent authorities may endeavour to resolve the case with a view of elimination of the economic double taxation within the scope of the MAP. The arbitration process that is the second step of the MAP must be initiated if the competent authorities have been unable to agree on the elimination of the economic double taxation in a transfer pricing case. In contrast to a MAP, the arbitration procedure guarantees the elimination of the economic double taxation under the Convention.

In cases where the competent authorities fail to reach an agreement within the two-year period of the MAP, they will first set up an advisory committee. The advisory committee consists of a chairman, two representatives from each competent authority and an even number of “independent persons of standing,” who are drawn from a list of names of several individuals nominated by each Member State. The arbitration committee must issue an expert opinion as to whether the adjustment of profits required or rejected by a tax administration is compatible with the arm’s length principle under article 4 of the Arbitration Convention (90/436). Surprisingly, it is not the arbitration committee that adopts a final decision on the transfer pricing dispute, but rather the competent authorities.

Under article 12 of the Arbitration Convention (90/436), the competent authorities have a second chance to agree on the resolution of a transfer pricing dispute within a six-month term after the advisory committee has made its recommendation. If they fail to reach a mutual agreement within six months, the decision of the arbitration committee becomes binding on the tax administrations. The taxpayer is not allowed to reject the outcome if the request was based on the Arbitration Convention (90/436) and the outcome is the result of the establishment of an advisory committee. In such cases, the resolution agreed by the competent authorities is binding, both on the relevant competent authorities and on the taxpayer.

3. Shortcomings of Mutual Agreement Procedures in Resolving International Transfer Pricing Disputes

3.1. Key issues arising from shortcomings of mutual agreement procedures

3.1.1. Ineffective process and persisting double taxation

The weaknesses of the MAP under income tax treaties are well known: the taxpayer has no right to participate, the procedure is time consuming and it is uncertain whether a satisfactory outcome will be achieved.26 The main shortcoming of the MAP is that it is not a binding process. As the process is initiated by the competent authorities, it often takes a long time and in some cases (e.g. complex transfer pricing cases) the process fails without a real resolution or only limited elimination of double taxation.

In certain countries, the MAP process is not initiated by the competent authority unless double taxation has actually occurred. However, this produces an ineffective process, as the taxpayer loses time because it most likely does not have enough capability to understand that potential double taxation would arise. The key is that the potential taxation contrary to the Convention must not be merely a hypothetical possibility, but a “practical probability.”27 In this context, in the author’s opinion, the best option – for practical reasons – is that the auditor highlight the potential double taxation contrary to the Convention in his or her audit report in order to provide timely warning to the taxpayer.

Further, some competent authorities have had a tendency not to discuss a case in a MAP where an adjustment is based on anti-avoidance provisions of their country’s domestic law. This means, generally, that if a competent authority were to consider a request for assistance in such a case, it would limit itself to forwarding the case to the other competent authority for any relief that the foreign competent authority may provide at the latter’s discretion. It may be helpful to generally review whether domestic “anti-avoidance” laws conflict with a country’s obligations under the provisions of a tax treaty. Of course this issue is very specific to the domestic law of each country and any one particular tax treaty.28

Moreover, some states take the view that a MAP may not be initiated by a taxpayer unless and until payment of all of a specified portion of the tax amount in dispute has been made. They consider that the requirement for payment of outstanding taxes, subject to repayment in whole or in part (depending on the outcome of the procedure), is an essentially procedural matter not governed by article 25 of the OECD Model, and is therefore consistent with it. A contrary view, held by many states, is that article 25 indi-

25. Sec. 6 Decree on Mutual Agreement Procedures IFZ2008/248M.
28. OECD Ctr. for Tax Policy and Admin., Manual on Effective Mutual Agreement Procedures (MEMAP), sec. 3 How MAP works, para. 3.2.3 (OECD 2007), International Organizations’ Documentation IBFD.
icates all that a taxpayer must do before the procedure is initiated, and that it imposes no such requirement. Those states find support for their view in the fact that the procedure may be implemented even before the taxpayer has been charged to tax or notified of a liability, and in the acceptance that there is clearly no such requirement for a procedure initiated by a competent authority under paragraph 3.29

Whether the competent authority process is ineffective is a matter that is also observed during the arbitration procedure, as it is a part of the MAP – including EU cases where the arbitration process is also dependent on the MAP. A case is sent to arbitration if the competent authorities do not resolve the matter themselves within two years, and the arbitrators are required to decide the case before them within six months. If the arbitrators do not decide the case within the six-month time limit, the parties may extend the time limit for another six months or replace the arbitrators. These time limits are realistic in some cases, but are unrealistic for complex transfer pricing cases.30 Furthermore, the arbitration provisions usually do not contain rules regarding the composition of the arbitration committee. Thus, it rests entirely with the tax authorities to decide how to set up the arbitration committee, if domestic law does not provide otherwise. Therefore, it is doubtful whether the arbitration commission may act completely independently of the tax administrations.31

3.1.2. Interaction between recourse to mutual agreement procedures and domestic law; recommendations of the OECD MEMAP

3.1.2.1. Generally

MAPs are unique procedures which fall outside the domestic law of a contracting state, as they are regarded as a part of international obligations of the country concerned which should be accomplished without any restrictions under domestic law. The relationship between MAPs and domestic law is a complex issue, but it is a crucial aspect of the practical application of the MAP. This issue may arise when a MAP is initiated, when it is under way or after a decision has been reached and the mutual agreement remains to be implemented.32

A second issue involves the relationship between existing domestic legal remedies and arbitration where the taxpayer has not undertaken (or has not exhausted) these legal remedies.33 Where a mutual agreement is reached before domestic legal remedies have been exhausted, it is normal for competent authorities to require, as a condition for the application of the agreement, that the persons affected renounce recourse to domestic legal remedies that may still exist as regards the issues covered by the agreement. Without such renunciation, a subsequent court decision could indeed prevent the competent authorities from applying the agreement.34

3.1.2.2. Recommendations of the OECD MEMAP

First, the OECD MEMAP points out that with respect to adjustments or actions by a tax administration, it is advisable that taxpayers protect, for greater certainty, their rights of domestic appeal or redress, and that they take note of the domestic processes for doing so. As mentioned above, in the practices of certain OECD countries, the OECD MEMAP acknowledges that the competent authorities prefer to deal with transfer pricing cases via either MAPs or domestic remedies, and do not allow the taxpayer recourse to both remedies at the same time, even though certain countries accept a simultaneous MAP and domestic remedy.

As noted above, the tax authorities may limit further recourse to domestic remedies pending the audit stage. This is realized by achieving an audit settlement which includes an agreement that the taxpayer not pursue a MAP. However, such an approach is quite risky, especially for transfer pricing cases, as transfer pricing practices of tax authorities are highly debatable. To this end, the author believes that taxpayers should refrain from early audit settlements, as the remaining dispute may not be resolved with the competent authority of the other contracting state at a later time because the corresponding adjustment would not be possible under the domestic law of the other contracting state.

Furthermore, the MEMAP notes that a taxpayer may suffer from the economic equivalent of double taxation – even where underlying double taxation is eliminated through a MAP agreement – if there is considerable asymmetry between two countries’ treatment of interest that may accrue on tax liabilities and refunds. This, for example, could also be seen in a transfer pricing dispute. Assume that State A reassesses the transfer prices of Company X and adjusts the price of 100 downward to 80 by charging 5 of interest on the tax deficiency. The other contracting state, State B, agrees to this adjustment and grants relief to Company Y, a related party of Company X, under the State A-State B tax treaty. However, there is no refund of the interest on taxes paid in State B. Thus, the effectiveness of the MAP is diminished to the extent of the partially continuing double taxation.

3.1.3. Time limitations under domestic law

Time limits are also associated with transfer pricing issues. Relief under article 9(2) of the OECD Model may be unavailable if the time limit provided by a treaty or domestic law for making corresponding adjustments has expired. Article 9(2) does not specify whether there should be a time limit after which corresponding adjustments may not be made. Thus, relief may depend on whether the appli-
cable treaty overrides domestic time limitations, establishes other time limits or has no effect on domestic time limits. In a transfer pricing case, a country may be legally unable to make a corresponding adjustment if the time has expired for finalizing the tax liability of the relevant associated enterprise.

In this context, the MEMAP recommends that tax authorities notify the taxpayer in the shortest possible time, especially when the other contracting state has a domestic rule deviating from the OECD Model and restricting the corresponding adjustment. This is critical for transfer pricing cases because, alternatively, transfer pricing audits would be lengthy processes and the taxpayer may lose the MAP opportunity. The time limit issue might also be addressed through rules governing primary adjustments rather than corresponding adjustments. The problem of time limits on corresponding adjustments is at times due to the fact that the initial assessments for primary adjustments for a taxable year are not made until many years later. This critical point can be much better understood with the following example.

Assume that tax authorities of State A examine the restructuring transactions of the related parties where Company X, a full-fledged manufacturer, is converted into a contract manufacturer. The auditor concludes the audit of the restructuring transactions in Year 3, which is the last year for the statute of limitations in State A, and the audit is finalized with reassessment, as it is claimed that Company X transferred its intangibles to Company Y, a principal in State B. State B has a four-year statute of limitations and the treaty between State A and State B deviates from the OECD Model. In such a case, there is no possibility to make a secondary adjustment, although State A initiates a MAP upon the request of Company X, as State B will refuse the MAP after the review of the MAP case. The reason for continued double taxation in this case is based on the disparity in the domestic law of both countries.

3.1.4. Impact of mutual agreement procedures on domestic litigation

Taxpayers may initiate a case against a reassessment by the tax authorities or have recourse to administrative proceedings before litigation. However, it is difficult for a taxpayer to decide which option, namely either domestic litigation or requesting a MAP, is more appropriate for a cross-border dispute. Some taxpayers may prefer the MAP, but most taxpayers, in practice, initiate a legal action against the reassessment of the tax authorities.

Countries, however, hold two opposing views on the effect of mutual agreements in internal tax law. The first view maintains that, as the Commentary on the OECD Model points out, the courts have the final say in questions of interpretation, and the country is therefore not bound by the mutual agreement on interpretation. The second view holds that the mutual agreement procedure amounts to a valid delegation to the competent authorities to come to an agreement on interpretation, which is accordingly binding on the courts. From this background, it is clear that there is no consensus as to whether a mutual agreement on interpretation is binding on the courts, as this depends on each country’s domestic law and completely opposing views are held by different countries.

The Commentary on Article 25 of the OECD Model, on the other hand, recognizes the two approaches and recommends separate solutions for each approach. It is aware of no possibility to commence a MAP in certain countries where the MAP decision is not binding on the local court because of constitutional or domestic law provisions or decisions. However, paragraph 27 of the Commentary on Article 25 of the OECD Model also mentions that the recognized general principle under tax and other treaties is that domestic law – even domestic constitutional law – does not justify a failure to meet treaty obligations. Accordingly, the Commentary advises that tax authorities permit taxpayers to initiate simultaneously a MAP and domestic litigation.

The author shares the OECD view on this approach, and if a MAP is concluded at an earlier time than the domestic litigation, the competent authorities may suspend their agreement and apply the more favorable solution (either a MAP agreement or the court decision) after a final judgment is rendered. Nevertheless, in above-mentioned countries, domestic litigation and requesting a MAP simultaneously are not possible to effect in practice. For this reason, the MAP cannot be effectively pursued, as the decision of the court is binding on the competent authority in those countries.

On the other hand, the approach of the OECD Commentary to arbitration and domestic litigation is straightforward. Paragraph 76 of the Commentary on Article 25 of the OECD Model states that for the arbitration process to be effective and to avoid the risk of conflicting decisions, a person should not be allowed to pursue the arbitration process if the issues submitted to arbitration have already been resolved through the domestic litigation process of either state (which means that any court or administrative tribunal of one of the contracting states has already rendered a decision which deals with these issues and which applies to that person).

The Arbitration Convention (90/436) also has a similar approach concerning recourse to a MAP and/or domestic litigation. As a general principle, the Arbitration Convention recognizes the means of simultaneous recourse and states in article 7(1) that enterprises may have recourse to the remedies available to them under the domestic law of the contracting states concerned alongside the MAP. The OECD Commentary is aware of the different implementations in OECD member countries. In the same way, the Arbitration Convention also states that the MAP may not

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35. Para. 4.43 OECD Guidelines.
36. Para. 4.44 OECD Guidelines.
37. OECD Ctr. for Tax Policy and Admin. supra n. 28, at Sec. 3. How MAP works, para. 3.2.2
38. Para. 4.47 OECD Guidelines.
be initiated by EU Member States where the domestic law of a contracting state does not permit the competent authority of that State to derogate from the decisions of its judicial bodies. 40

The author suggests that a taxpayer first bring its case before the court in those countries where domestic law does not allow its competent authority to deviate from a court decision, and then request a MAP, as both the OECD Model and the Arbitration Convention (90/436) acknowledge that the three-year period for initiation of a MAP commences when the final judicial decision is rendered. Therefore, an immediate request for a MAP is not suggested if the taxpayer has strong evidence showing that the reassessment is incorrectly determined by the tax authorities. On the other hand, a direct MAP request is more beneficial for a taxpayer where it is obvious that there have been many leading cases adjudicated by the court on the topic.

3.1.5. Limited taxpayer participation

The competent authorities do not have an obligation to include the taxpayer as a party to the MAP negotiations. Therefore, the taxpayer may partially contribute to the process, but has no authority to examine the files related to the case. The participation of the taxpayer is generally limited to written or oral presentations, in person or through a representative. The MAP, by its nature, is not transparent, as many contracting states regard MAP consultations as a confidential, government-to-government process in which taxpayer participation would be barred or otherwise inappropriate. 41 While the taxpayer is encouraged to provide whatever further information the tax authorities think might be helpful, the taxpayer often feels that the MAP process is remote and takes place in a something of a black box. 42 Moreover, there is no obligation to disclose the agreement. This absence of mandatory dispute resolution is the most significant disadvantage of the procedure. 43

Due to the limited taxpayer input, it is recommended that the taxpayer provide the required information in a timely manner and keep the competent authorities updated as to any changes which would critically affect the result of the MAP. In transfer pricing cases, the other related party would be involved in the case, and it is also advisable that the related party in the other contracting state provide directly the same information to the competent authority of the other contracting state so as to prevent further conflict between the two states. On the other hand, the taxpayer may be invited to make a presentation before the competent authorities, where appropriate, to ensure a common understanding of the facts of the particular case. It is generally desirable for taxpayers to be given every reasonable opportunity to present the relevant facts and arguments to the competent authorities, both in writing and orally. 44 This point is quite important for complex transfer pricing cases. Although the competent authorities may access the details of related parties, it could be very difficult for the competent authorities to understand the underlying reasons for the transactions. A noteworthy example is business restructuring. The competent authorities in this regard may not grasp the business reasons for the restructuring transactions and may make an incorrect determination regarding the dispute which could be a reason not to reach an agreement.

None of the treaty provisions, identically, grants the individual taxpayer influence over the arbitrator. Most of arbitration clauses do not provide for the taxpayer participation in the procedure before the arbitration committee. Some provisions grant the taxpayer the right to be represented or present its views before the committee. The arbitration procedures must be established in the notes to be exchanged by the national administrations, and it is up to administrative bodies to decide which procedural rights must be afforded to taxpayers. 45 Thus, taxpayer participation is also limited in the arbitration process. The taxpayer will, of course, be informed of the positions of the competent authorities and – especially in transfer pricing cases – will be requested by the arbitrators to present their position. But the arbitration process will continue to be a state-to-state process.

Limited participation by the taxpayer in a MAP is one of the most significant shortcomings of the procedure. Many commentators criticize this situation within the scope of a MAP, as, in some instances, it would result in package deals where mutual compromises are made between the competent authorities and the taxpayer may suffer from those bargains.

3.1.6. Triangular cases and collateral effects of MAPs on third states

In a triangular transfer pricing case, a double taxation issue would turn into a very difficult matter for which to find a solution. This situation can be illustrated by the following transfer pricing example. See Figure 1.

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41. Para. 155 of the UN Guide to the MAP.
44. OECD Ctr. for Tax Policy and Admin. supra n. 28, sec. 3 How MAP works, para. 3.3.2.
45. Züger, supra n. 31, at 223.
Company R, a manufacturer in State R, carries on business in State PE through a PE, a regional hub of Company R. The PE holds 100% of the shares of Company S, a distributor company in State S. Company R ships its products and the PE holds those products in its warehouse. The PE resells the products upon the order to Company S. The tax authorities of State S carry out an audit and increase the profit of Company S by adjusting the transfer price in the transaction between the PE and Company S. As a result of transfer pricing adjustment in State S, double taxation arises. Assuming that there are tax treaties between all countries, double taxation can be eliminated only if State R and State PE both agree to provide relief from double taxation. The tax treaty between State S and State PE, however, does not apply, as there is no resident recipient in State PE owing to the fact that the PE is not a separate entity under the tax treaty between State S and State PE. In this case, relief from the double taxation in State PE is possible only under unilateral relief in accordance with the domestic law of State PE or the non-discrimination clause (article 24) of the tax treaty between State S and State PE.

Nevertheless, the dispute is not over yet at this level because State PE, after executing the corresponding adjustment, will likely adjust the profit of the PE. Therefore, double taxation arises one more time and a MAP between State R and State PE is required to eliminate it. In this way, a carousel of MAPs in transfer pricing cases comes into the picture. An alternative solution would be simultaneous MAPs between (i) State S and State PE and (ii) State R and State PE. A last option which is debatable could be employed by initiating a direct MAP between State S and State R. However, the competent authority of State R may claim there is no transaction between State R and State S, and deny the MAP request of State S. In practice, countries standing in the middle (in this case, State PE) prefer to resolve the dispute with the source country (in this case, State S) and then initiate a new MAP with the state of the parent company (in this case, State R). However, the best solution for double taxation arising from triangular transfer pricing cases is that the competent authorities of three countries (in this case State R, State PE, and State S) commence a single MAP to resolve the controversy in a more effective manner. Moreover, the nightmare would be worse if there were no arbitration clause in the tax treaties of the states concerned.

4. Conclusion

From the author’s perspective, it is apparent that MAPs will continue to be the basic mechanisms for the resolution of international tax disputes. However, MAPs are not utilized to come to an accurate solution among the competent authorities because the competent authorities are not obliged to achieve a resolution to eliminate double taxation (provided that the tax treaty in question does not contain an obligatory arbitration clause). The weaknesses of MAPs originate from the lack of a right to taxpayer participation, the time-consuming nature of the procedure and uncertainty as regards a satisfactory outcome. In certain countries, a MAP is not initiated by the competent authority unless double taxation has occurred. However, this produces an ineffective process, as the taxpayer cannot take action for the timely elimination of double taxation. Thus, the existence of such time limits and the fact that they vary from country to country should be taken into account in order to minimize double taxation.

In terms of international transfer pricing disputes, there is no clear determination as to which remedy is to be sought first under both tax treaties and domestic law. Thus, taxpayers can – in theory – initiate a MAP while pursuing domestic law remedies. Practices of MAPs vary and, in particular, some countries require the taxpayer to waive its right to a domestic remedy before the commencement of a MAP. Others countries make the implementation of a mutual agreement dependent on the taxpayer’s acceptance and waiver of domestic remedies. Identically, in most transfer pricing cases, the competent authorities will not be willing to initiate discussions with another contracting state as long as domestic remedies are pursued by the taxpayer.

Therefore, in practice it is still not possible to simultaneously both pursue domestic litigation and request a MAP. For this reason, a MAP cannot be effectively pursued, as the court’s decision will be binding on the competent authorities in those countries. In such situations, the Commentary on the OECD Model suggests that the best option is for the related party in the other contracting state to initiate a MAP where both remedies are simultaneously available. Conversely, in countries where the competent authorities of the relevant countries are not bound by the court decision, the taxpayer should opt to pursue a MAP instead of bringing a case before the court. The ineffectiveness of the process is also observed during the arbitration procedure. In some states, unresolved issues between the competent authorities may be submitted to arbitration only if domestic legal remedies are no longer available.

The existence of an arbitration procedure in a tax treaty, contrary to what is believed, is not always helpful to resolving international transfer pricing disputes because the arbitration procedure is one-sided, secretive, expensive for the governments and an intrusion on national sovereignty. For these reasons, most governments have avoided arbitration. In addition, the competent authorities do not have an obligation to include the taxpayer as a party to the MAP negotiations. The author does not find reasonable the claims of the states that confidentiality of government–government communications is a very sensitive issue between two states and therefore taxpayers should not be involved in the actual MAP negotiations. However, the involvement of taxpayers or their representatives in the actual MAP negotiations would contribute to the MAP’s being concluded in a reliable manner.