Kluwer International Tax Blog

The effectiveness of the Mutual Agreement Procedure and the global tax controversy landscape: some critical observations on current pressure areas and suggestions to improve the framework

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Introduction

On 22 May we delivered an opening address on the current practical challenges of dispute prevention and resolution at the International Tax Dispute Day organized in Singapore by the Tax Policy Center of the University of Lausanne and the Singapore Tax Academy.

While acknowledging the progress made since the adoption of BEPS Action 14 in relation to the mutual agreement procedure ("**MAP**") of tax treaties, we observed (at least based on our practice) that problematic positions remain in place in some States. These positions which include for example MAP *"dodging"* (for instance by labelling differently what is *de facto* a transfer pricing adjustment) or the *ab initio* refusal to deviate from a unilateral position in case of audit settlement or adjustment based on an anti-avoidance rule, may lead to an improper denial of access to or operation of the MAP. These approaches, which undermine the effectiveness of the MAP, all have in common that treaty law is not interpreted in good faith pursuant to arts. 26 and 31 of the Vienna Convention on the Law of Treaties ("**VCLT**"). Moreover, there is a growing tendency (at least in some states) to invoke domestic law obstacles (or limitations) not to fully implement treaty obligations. This is in clear contradiction with art. 27 VCLT which states that: *"a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty"**[1]***. Finally, some of these practices may be at odds with general principles of law (for example due process or proportionality at the MAP access level) which are also applicable to the interpretation of tax treaties pursuant to the principle of systemic integration (art. 31(3)(c) VCLT) [2]. We believe that tackling these issues is important (and practically realistic) as part of the tax certainty agenda at a time at which tax controversies continue to be on the rise. Of course, there would in principle be no need to further clarify in the commentaries to art. 25 OECD MC what already flows from a proper interpretation of treaty law and from BEPS Action 14. However, such clarification could further constrain states to observe their treaty obligations.

Finally, there is in our view room for improvement of the MAP framework in two areas. First, it would be appropriate to develop a framework akin to the Bilateral Advance Pricing Arrangement

(**"BAPA**") for non-transfer pricing cases. Second, there is a need to extend international tax dispute settlement to indirect taxes which are outside the MAP.

Taking advantage of the flight back to Switzerland, we have thus prepared this blog which further elaborates on these questions.

Some pressure areas relating to MAP access

Cases of improper denial of access to MAP

It is uncontroversial that art. 25(1) OECD MC provides taxpayers with a right to access the MAP that is rooted in treaty law. BEPS Action 14 and the OECD commentaries make it clear that such access must be granted in good faith. Moreover, access to MAP must also comply with general principles of law, notably the principle of proportionality[3]. Therefore, the practice of some competent tax authorities consisting in hindering access to MAP by imposing conditions or requiring information going beyond what is necessary (or suitable) represents in our view an improper denial of access to MAP.

Equally problematic is the position of states refusing to grant access to MAP where, for example, an adjustment is based on a general or specific domestic anti-abuse rule. Such position is undoubtedly in breach of art. 27 VCLT, the interpretation conveyed by BEPS Action 14 and the OECD commentaries[4]. Moreover, the question of whether the relevant anti-abuse rule complies with the threshold of the Principal Purpose Test[5] or the guiding principle[6] is by essence a bilateral issue which needs to be settled through the MAP[7].

MAP "dodging"

A practice that may also be encountered is what we describe as "*MAP dodging":* a state makes an adjustment (for example the denial of deductibility of fees for services) which produces *de facto* an outcome identical to a transfer pricing adjustment but such adjustment is formally not based on transfer pricing legislation. This state then claims that such adjustment is outside art. 25(1) OECD MC. That position is unsustainable. First, for purposes of art. 9 OECD MC as a distributive rule, the basis of an adjustment under domestic law is irrelevant. Further, as BEPS Action 14 makes clear the failure to provide MAP access with respect to a treaty partner's transfer pricing adjustment may frustrate a primary objective of tax treaties.[8] In this regard, it is quite clear that the object and purpose of both art. 9 and 25 OECD MC would be defeated if the latter were to only apply to "*formal"* transfer pricing adjustments. For this reason, this practice is incompatible with the principle of good faith, amounts to tax treaty dodging in that it renders the MAP inoperative. Finally, following this position, this would mean that *de facto* transfer pricing adjustments would be classified "*as cases not provided for in the Convention"* within the meaning of art. 25(3) OECD MC. There is obviously no support for such an interpretation in the genesis and commentaries to art. 25(3) OECD MC. A proper delineation between paragraphs 3 and 1 of art. 25 OECD MC thus also leads to the conclusion that such adjustments are covered by art. 25(1) OECD MC. The OECD commentaries should therefore make it clear that such type of MAP "*dodging"* is incompatible with a good faith interpretation of art. 25(1) OECD MC.

Some pressure areas relating to MAP operation

Pursuant to BEPS Action 14, the commentaries to art. 25 OECD MC state that the operation of the MAP must be performed in good faith and "*in a fair and objective manner, on its merits, in*

*accordance with the terms of the Convention and applicable principles of international law on the interpretation of treaties**[9]***. Yet, in practice cases of improper operation of the MAP still subsist.

The refusal to "deviate" in case of audit settlements or the application of anti-avoidance rules.

A first well-known example involves audit settlements: a taxpayer may be inclined to settle a case (also to avoid criminal law ramifications as the case may be). While this may not preclude access to MAP, some competent tax authorities may still refuse to deviate from the position taken in the audit settlement with, therefore, possible double taxation if the other contracting state does not provide relief. A similar situation may arise in instances involving the application of domestic anti-avoidance rules.

We submit that the foregoing outcomes are not in accordance with an interpretation of treaty law in good faith. When addressing audit settlements[10] and anti-avoidance rules, the commentaries to art. 25 OECD MC essentially focus on MAP access[11]. We believe however that the emphasis should also be placed on the requirement to properly operate the MAP in these instances. This is clearly not the case where a competent tax authority refuses *ab initio* to deviate. Moreover, pursuant to art. 27 VCLT, a domestic law limitation is here not a valid justification.

Suggestions to improve the MAP framework

Dispute prevention: building a BAPA like framework for non-transfer pricing disputes

A key practical aspect of the MAP is of course it's dispute prevention component. As is well known, the Bilateral Advanced Pricing Agreement (BAPA) framework is based on art. 25(3) first sentence OECD MC[12]. While we appreciate that for many MNEs disputes mainly concern transfer pricing, there is at the same time little doubt that (at least in certain regions) non-transfer pricing cases are on the rise. These may involve characterization issues (for example business profits versus (embedded) royalties), jurisdictional questions (for example treaty residence or permanent establishment issues), beneficial ownership, the PPT, etc.

We thus submit that it would be desirable to develop a comparable framework with best practices for such non-transfer pricing disputes. There is indeed no reason why dispute prevention under art. 25(3) first sentence OECD MC should be limited to transfer pricing. Much like the best practice n°1 of the BAPA manual this new framework would in particular state that treaty disputes are to be resolved through a principled based approach with reference to the principles of international law and the commentaries to the MCs.

The case of indirect taxes

Finally, and leaving aside the global minimum tax for which an *ad hoc* dispute resolution system is necessary, a dispute settlement mechanism which would apply to indirect taxes is in our view also desirable. Cross-border disputes involving indirect taxes are indeed practically a live question at least in certain regions. However, these latter disputes do not fall within the MAP. Therefore, a framework would need to be developed. It is beyond the scope of this blog to discuss the various possible options, but we believe that solutions do exist.

[1] We are of course well aware that the practice of treaty override is permissible in some states. The legality of such practice under municipal law has however no bearing under international law. Further, for purposes of compliance with the minimum standard of BEPS Action

14 and the peer review related thereto, compliance with treaty obligations and art. 27 VCLT is by essence the only benchmark.

[2] Art. 31(3)(c) VCLT refers to *«any relevant rules of international law applicable in the relations between the parties »*. It is settled that these rules are the sources of international law (notably general principles of law) set out in art. 38(1) ICJ Statute

[3] Art. 31(3)(c) VCLT

[4] 2017 OECD Commentary, para. 26 ad art. 25

[5] Art. 29(9) OECD MC

[6] 2017 OECD Commentary, para. 61 ad art. 1

[7] BEPS Action 14, final Report, N 13 et seq; 2017 OECD Commentaries, para. 26 ad art. 25

[8] BEPS Action 14, final Report, N 11

[9] 2017 OECD Commentary, para. 5.1 ad art. 25

[10] 2017 OECD Commentary, para. 45.1 ad art. 25

[11] 2017 OECD Commentaries, para. 26 ad art. 25

[12] See OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris (https://doi.org/10.1787/0e655865-en), para. 4.134 et seq; OECD (2022), Bilateral Advance Pricing Arrangement Manual (https://www.oecd.org/en/publications/bilateral-advance-pricing-arrangement-manual_4aa570e1-en.html)

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