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Global Tax Alert

Mandatory Binding Treaty Arbitration under OECD's Multilateral Instrument

Executive summary

On 24 November 2016, the Organisation for Economic Co-operation and Development (OECD) released the text of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) under BEPS Action 15 (the multilateral instrument or MLI). Approximately 100 countries formally adopted the text and the related explanatory statement at a ceremony hosted by the OECD following the conclusion of the negotiations during the week of 21 November 2016. The text of the multilateral instrument and the explanatory statement are available on the OECD website.[1] Part VI of the MLI enables countries to include mandatory binding treaty arbitration (MBTA) in their double tax treaties (DTTs) in accordance with the special procedures provided by the MLI. Unlike the other Articles of the MLI, Part VI applies only between countries that expressly choose to apply Part VI with respect to their DTTs. Currently, 20 countries have committed to adopt and implement MBTA in their bilateral tax treaties.

The MBTA provision will apply to all cases of taxation contrary to the relevant tax treaty, unless a country has made a reservation specifying a more limited scope. The MLI provides flexibility for countries to bilaterally agree on the mode of application of the MBTA, including the form of arbitration. However, the default rules defined in the MLI will apply if countries do not reach such an agreement before a case materializes that is eligible for arbitration. For those countries that choose to implement MBTA through the MLI, the MLI provisions

would apply to all DTTs that do not have such a provision, or instead of existing provisions that provide for MBTA. Nevertheless, countries may reserve the right not to apply the MBTA provision of the MLI to some or all of its DTTs that already have a MBTA provision.

Detailed discussion

Background

Over the past years, the inventory of unresolved mutual agreement procedure (MAP) cases has increased significantly. This is partly due to the fact that the MAP process does not always function properly and does not provide for enforcement mechanisms. It is expected that as a result of the implementation of the BEPS recommendations, the number of MAP cases will increase even more in the future. In its final report on BEPS Action 14, *Making Dispute Resolution Mechanisms More Effective*, released in October 2015, the OECD acknowledged this issue and discussed the use of MBTA and as a way to solve the gridlock, and announced that, as part of the MLI, MBTA provisions would be developed. MBTA was, however, not elevated to a minimum standard.[2] The MBTA rules are, therefore, meant to apply only if both countries that are signatories to the MLI notify the OECD of their willingness to subscribe to the rules. Currently, 20 countries have committed to adopt and implement MBTA in their bilateral tax treaties and 27 countries have participated in the sub-group on arbitration that has drafted the MBTA provision.[3]

The MBTA rules, once adopted, will provide taxpayers with much needed certainty that a case once submitted to MAP will be resolved.

Timing and scope of the arbitration procedure

The MBTA rules allow a person to request arbitration if the competent authorities were not able to reach an agreement under a MAP within two years. The competent authorities may agree on a shorter or longer period to resolve a particular case through a MAP provided they notify the affected person before the expiration of the two-year period. In addition, countries that have subscribed to MBTA rules can make a reservation and substitute the two year period with a three-year period in all their DTTs.

Unless a country makes a specific reservation with respect to the scope of the cases eligible for arbitration, all treaty related disputes that could not be resolved through MAP could be subject to arbitration.

Rules of the arbitration procedure

The competent authorities of countries that have implemented MBTA in their DTTs should agree on its mode of application, including the minimum information necessary for accepting a case for substantive consideration, before the date on which unresolved issues under MAP become eligible for arbitration. Such agreement may include certain default rules provided by the MLI itself, such as on the appointment of arbitrators. Furthermore, the OECD is expected to release a model competent authority agreement that can serve as the basis for the procedural arbitration rules. The default rules are solely meant to ensure that the absence of such rules does not delay the arbitration process for cases that would be eligible for arbitration. The competent authorities can, therefore, deviate from the default rules if they so choose.

The MLI sets out default rules for the composition of an arbitration panel and the appointment and qualifications of arbitrators. Under those rules, the arbitration panel is composed of three independent individual members. One member is to be appointed by each competent authority and those two members must then appoint a third member who is not a national or resident of either country to serve as Chair of the arbitration panel.

Under the MLI provisions, countries will bear the cost incurred in connection with the arbitration proceedings. The MLI also contains rules to ensure that any information shared with the arbitration panel and their staff remains confidential. Also, the competent authorities may require that each taxpayer, and their advisers, agree in writing that none of the information received from the competent authorities or the arbitration panel during the arbitration proceedings is made public.

Types of arbitration process

The MLI provides for "final offer" arbitration (also known as "baseball arbitration") as the default type of arbitration process. Under final offer arbitration each competent authority will submit a proposed resolution addressing all issues under review. The proposed resolution should address each adjustment in the case that is brought to arbitration and should include allocation of monetary amounts (income or expenses) or a maximum tax rate to be charged under the DTT. The competent authorities would be allowed to propose alternative resolutions contingent upon resolutions on underlying questions, such as the existence of a permanent establishment or the determination of a taxpayer's residency under the DTT. Supporting position papers can be submitted,

as well as reply submissions to the proposed resolution of the other competent authority. Under the "final offer" proceedings the arbitration panel would select one of the proposed resolutions as its decision and is not required to provide any rationale for its decision.

Countries may make a reservation on the "final offer" type of arbitration proceedings and apply the "independent opinion" type of proceedings instead. Under this approach each competent authority should provide all necessary information to the arbitration panel. The arbitration panel will decide the case applying the provisions of the DTT and subject to relevant provisions of the domestic laws of the treaty partners. The decision should indicate the sources of law relied on and the reasoning applied.

Under both the "final offer" and "independent opinion" types of arbitration, the decision would be adopted with simple majority and would not have precedential value.

Countries are asked to make a reservation in relation to a specific form of arbitration if such form is unacceptable to them. A country that has not made a reservation for the type of arbitration can still reserve the right not to apply any of the options if a treaty partner has made such reservation. In that case, the arbitration article of the MLI would be considered not to apply until the competent authorities of both treaty partners reach an arrangement on the type of arbitration process. Furthermore, the competent authorities are always able to deviate from the above default rules, should they mutually agree on different rules.

Implementation of the arbitration decision

Once the arbitration decision is delivered, the competent authorities of the countries involved would enter into a mutual agreement that implements the arbitration decision.

The arbitration decision is final and binding, unless:

- The taxpayer directly affected by the decision doesn't accept the mutual agreement implementing the arbitration decision, or does not withdraw all issues related to the MAP from consideration of courts or administrative tribunals within 60 days from being notified.
- A court of one of the treaty countries issues a decision that the arbitration decision is invalid, however another request for arbitration can be made in that case.
- The taxpayer pursues litigation on issues that were resolved through a mutual agreement implementing the arbitration decision.

Countries may, however, notify that an arbitration decision is not binding on them and shall not be implemented if the competent authorities agree on a different resolution of all unresolved issues within three months after the arbitration decision has been delivered. They may choose that this option only applies to cases resolved through independent opinion arbitration process. This provision applies only where both tax countries have made a notification to this effect.

A country can reserve the right to exclude from arbitration issues that have been resolved through domestic litigation and to terminate the arbitration proceedings if a decision of a domestic court or tribunal is delivered prior to the conclusion of the arbitration proceedings.

The MAP or arbitration proceedings would terminate if within the time period between the filing of the arbitration request and the delivery of the arbitration decisions the competent authorities reach an agreement on the case. The same rule would apply if the taxpayer withdraws his request.

Application of the MBTA provision of the MLI

For those countries that choose to implement it, the MBTA provisions of the MLI would apply to all DTTs that do not have such a provision or instead of existing provisions that provide for MBTA. However, countries may reserve the right not to apply the MBTA provision of the MLI to some or all of its DTTs that already have an MBTA provision.

Implications

The MLI constitutes an unprecedented change in international taxation and it will have a significant impact on the taxation of multinational companies. If the proposed changes are adopted, taxpayers would have more certainty and predictability on the resolution of their double taxation disputes.

While it is not certain at this stage which countries will ratify the MLI and to which extent and when they will include the MBTA provisions, a broad range of multinational companies may be impacted by the proposal in the future. Global businesses may therefore wish to assess the impact on pending and expected disputes of the proposal and should monitor the implementation of this provision.

Endnotes

1. For the main features of the MLI, see EY Global Tax Alert, *OECD releases multilateral instrument to implement treaty related BEPS measures on hybrid mismatch arrangements, treaty abuse, permanent establishment status and dispute resolution*, dated 2 December 2016.
2. See EY Global Tax Alert, *OECD releases final report on improving the effectiveness of dispute resolution mechanisms under Action 14*, dated 8 October 2015.
3. The 20 countries that have committed to adopt mandatory arbitration are: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.

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