

## **Treaty Dispute Final Arbitration**

The fifth protocol to the Canada-US treaty contains a mandatory arbitration provision whose mere existence is expected to alter the behaviour of the competent authorities and thus reduce the need for the provision's actual operation. The mandatory arbitration provision's expected impact on administrative practice rests on two factors: (1) the administrators cannot opt out of the process, and (2) the arbitration board must choose between the last best offer of each side rather than settle on a compromise solution.

The protocol amends treaty article XXVI, altering the mutual agreement procedure (MAP) and adding the mandatory arbitration provision. Currently, under a MAP a Canadian or US resident who is concerned about the implementation of treaty provisions can take the matter to its own country's competent authority, which will attempt to resolve the matter with its counterpart in the other country. Michael Mundaca, Treasury Deputy Assistant Secretary for International Tax Affairs, noted in his July 10, 2008 testimony before the US Senate Committee on Foreign Relations on Pending Income Tax Treaties that even in cooperative bilateral relationships, the competent authorities cannot always reach a timely and satisfactory resolution. The mandatory arbitration provision provides competent authority with an additional tool--a final step--for dispute resolution.

Under amended article XXVI(6), if the competent authorities cannot completely agree on a case, it "shall" be resolved through arbitration if certain conditions are met. The word "shall" is the significant change, replacing the voluntary with a mandatory arbitration procedure. The conditions that trigger the mandatory arbitration are threefold: (1) tax returns are filed with the United States and/or Canada for the taxable years in issue; (2) the taxpayer who presented the case to the competent authority and any other taxpayer whose tax liability will be directly affected by the resolution (concerned persons) agree to arbitration; and (3) the issue arises under a treaty provision that is subject to arbitration. A diplomatic note entitled "Annex A to the Convention" (the arbitration note) is an agreement between the two countries, annexed to the treaty and an integral part thereof, that has the same entry-into-force date as the protocol. The arbitration note provides that the arbitration provision applies to articles IV (residence, as it relates to a natural person), V (permanent establishment), VII (business profits), IX (related person), and XII (royalties, allocation of exempt and non-exempt portions of royalties, and transactions involving related persons), unless the competent authorities agree before the date on which an arbitration proceeding would otherwise begin that the particular case is not suitable for determination by arbitration. The mandatory arbitration provision is thus of limited but significant scope.

New paragraph 7 provides key rules and definitions for implementing the arbitration procedures, particularly timing requirements and opting-out provisions for concerned persons. Paragraph 6 establishes a threshold requirement for arbitration; all concerned persons must agree to arbitration in accordance with paragraph 7. Before arbitration proceedings begin, concerned persons must agree not to disclose to any other person any information received during the course of the proceedings from the United States, Canada, or the arbitration board, except for the board's determination. Furthermore, if a concerned person does not accept an arbitration board's determination, the determination does not constitute a resolution under MAP and is not binding with respect to that case. The diplomatic arbitration note provides that a concerned person may terminate the arbitration proceeding at any time. The competent authorities have no unilateral right to opt out, however, and thus arbitration is expected to be used rarely; the competent authorities may reach a mutual agreement to resolve a case and terminate the proceeding. The arbitration note addresses additional technical and procedural aspects of the arbitration procedure.

The timing requirements are intended to bring about more timely resolution of disputes. Paragraph 7 states that arbitration proceedings "shall begin" on the later of (1) two years after a case commences (unless both competent authorities have previously agreed to a different date) and (2) the earliest date upon which the concerned persons' agreement to proceed with arbitration is received by both competent authorities. The arbitration board must deliver a determination within six months of the board chair's appointment, and the determination must be the proposed resolution submitted by either the United States or Canada. Each competent authority may propose only one amount for arbitration. In testimony before the Senate Committee on Foreign Relations, Deputy Chief of Staff of the Joint Committee on Taxation Emily McMahon explained, "The last best offer approach is intended to induce the competent authorities to moderate their positions, including before arbitration proceedings would commence, and thus to increase the possibility of a negotiated settlement."

The paragraph 6 changes and new paragraph 7 apply to cases under consideration by the competent authorities on the date when the protocol enters into force and to cases subsequently coming under consideration. The US Treasury's technical explanation to the protocol notes the potential for a large number of MAP cases becoming subject to arbitration immediately upon the expiration of two years from the protocol's entry into force; to avoid the bottleneck, the competent authorities are encouraged to develop and implement procedures for arbitration by January 1, 2009 and to begin scheduling in that two-year period for the arbitration of appropriate cases in inventory.

The arbitration note states that in making its determination, the board shall apply, as necessary, (1) the treaty provisions; (2) any agreed commentaries or explanations concerning the treaty; (3) US and Canadian laws to the extent that they are not inconsistent with each other; and (4) any OECD commentary, guidelines, and reports regarding relevant, analogous provisions of the OECD model treaty. The protocol's technical explanation should constitute an agreed commentary for this purpose: it is an official US guide to the protocol whose content Canada has reviewed and subscribes to. The technical explanation's introduction says that both governments view it as an accurate reflection of the policies behind the particular protocol provisions and the understanding reached with respect to the treaty's and the protocol's application and interpretation. The arbitration note also says that an arbitration determination has no precedential value and that the board shall not provide a rationale for its determination.

Mandatory arbitration raises questions of sovereignty. The US model treaty does not include a mandatory arbitration provision, but in 2007 the US Senate ratified a treaty protocol with Germany and a treaty with Belgium, both of which include such arbitration provisions. On July 17, 2008, the OECD Council approved changes to the OECD model treaty and commentary (the 2008 model treaty update) that incorporate a mandatory and binding arbitration procedure. The OECD model treaty does not require the choice of a last best offer; a footnote to the suggested text acknowledges that countries are not bound to pursue arbitration if doing so is not consistent with domestic policy. Additional concerns expressed at Senate hearings include the lack of input directly from the taxpayer (a concerned person), the selection of arbitrators, and the precedential value of arbitration decisions. However, as noted by Mr. Mundaca, the new arbitration provisions reflect an international business need: "Tax treaties cannot facilitate cross-border investment and provide a more stable investment environment unless the treaty is effectively implemented by the tax administrations of the two countries."

US tax administrators are also looking at the initial stages of tax administration. In a July 10, 2008 speech, IRS Chief Counsel Donald Korb described international taxation as the "new frontier" and said that the IRS anticipates conducting joint exams of multinational taxpayers with foreign countries. Possible joint audits raise a variety of issues, but at least in some cases may produce the most effective resolution of potential international tax disputes.

*Alice A. Joseffer*  
Hodgson Russ LLP, Buffalo