

2016 MODEL TREATY – MANDATORY ARBITRATION

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In the newly released U.S. Model Income Tax Convention (“2016 Model Treaty”), a provision was made for “mandatory arbitration” to resolve disputes. The mandatory arbitration provision is designated in Article 25 (Mutual Agreement Procedure).

IN GENERAL

In general, competent authority provisions in most U.S. tax treaties require that parties attempt to resolve treaty disputes between themselves, but generally, they do not mandate an agreement. The 2016 Model Treaty, along with several newly-signed U.S. tax treaties, includes a mandatory arbitration provision. However, most existing treaties contain arbitration provisions that are non-binding.

The U.S. believes that a mandatory arbitration provision will incentivize parties to resolve their disputes before the actual arbitration proceeding. Based on results from the U.S.-Canada Income Tax Treaty, the I.R.S. estimates that 80% of the cases that were scheduled for arbitration were settled in advance due to that treaty’s mandatory arbitration provision. The U.S. estimates that mandatory arbitration will resolve disputes in six to nine months, a timeframe which is considerably faster than current alternative treaty dispute resolution options.

2016 MODEL TREATY HIGHLIGHTS

Local Law

The 2016 Model Treaty contains language that supersedes procedural limitations in domestic law. Additionally, collection procedures are suspended during the arbitration period.¹

Mandatory Arbitration Process

The arbitration board is comprised of three members who may only consider resolutions presented by the parties. The board may not provide its own resolution to the dispute.

In order to submit a case to arbitration, the following conditions must be satisfied:

- Tax returns have been filed for the years in question with one of the treaty countries.
- Two years have passed since the commencement date of the case, unless

¹ U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 25(2).

the competent authorities agree to a different date.

- The taxpayer has submitted a written request to proceed to binding arbitration.
- A decision on the matter has not already been made by a tribunal or a court.²

Appeal Process

Should the taxpayer disagree with the arbitration panel's decision, the taxpayer will have 45 days to appeal the ruling.³ The taxpayer may then proceed with other alternative dispute resolution procedures, such as court litigation or voluntary amnesty programs.

COMPARISON TO OTHER U.S. TAX TREATIES

Canada

The U.S.-Canada Income Tax Treaty contains many of the same elements of the 2016 Model Treaty, with some significant differences. First, both Canada and the U.S. must agree that the subject matter is suitable for arbitration. Subject matter suitable for arbitration is explicitly enumerated in the 2010 memorandum of understanding between the two countries.⁴ Secondly, rules concerning the appeals process are not explicit in the U.S.-Canada treaty or its protocols, contrary to the 2016 Model Treaty, which specifically describes these matters.

Germany

The U.S.-Germany Income Tax Treaty has an arbitration clause similar to the one established in the Canadian treaty. However, the U.S.-German arbitration process is much more detailed than the one established under the Canadian treaty. While the German treaty provides for the composition of the arbitration board in a manner similar to the 2016 Model Treaty, it does not mention the appeals process in the same detailed manner.⁵

O.E.C.D. Model Treaty

The O.E.C.D. includes a mandatory arbitration article in its 2014 O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty").⁶ Under the O.E.C.D. Model Treaty, a party is able to apply for mandatory arbitration if an issue has not been resolved within two years from the presentation of the matter



² *Id.*, art. 25(7).

³ *Id.*, art. 25(9)(k).

⁴ Memorandum of Understanding Between the Competent Authorities of Canada and the United States of America, art. 26(6)(b), Nov. 8, 2010.

⁵ U.S. Department of the Treasury, Technical Explanation of the Convention and Protocol Between the United States of America 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, (1989), art. 25.

⁶ O.E.C.D., Model Tax Convention on Income and on Capital: Condensed Version 2014, (Paris: O.E.C.D. Publishing, 2014), art. 25(5).

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to the competent authority. Similar to the new U.S. provisions, the O.E.C.D. Model Treaty states that mandatory arbitration cannot occur if the matter is resolved by a court or tribunal in advance of arbitration. The decision is binding on both parties, notwithstanding procedural time limits in the domestic country of either state.

A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board. While these matters are explicitly described in the 2016 Model Treaty, the O.E.C.D. Model Treaty allots the actual process and structure to the competent authorities of each treaty country.

B.E.P.S. CONCERNS REGARDING MANDATORY ARBITRATION

Action 14 of the O.E.C.D.’s B.E.P.S. Action Plan acknowledges several concerns with regard to mandatory arbitration clauses. Firstly, mandatory arbitration removes national sovereignty through the superseding effect of treaties over domestic procedural limitations. Secondly, the power of mandatory arbitration boards may be too broad and some countries may wish to constrain an arbitrator’s power over certain issues. Practitioners should note that the U.S. has demonstrated a similar concern, as evidenced by this exact limitation in the arbitration clause of the U.S.-Canada treaty.

CONCLUSION

Based on recently signed U.S. tax treaties, the mandatory arbitration clause will be an essential part of U.S. tax treaties going forward. Practitioners should focus on details relating to the composition of the arbitration panel and the appeals process. These two provisions often result in the biggest divergence between the 2016 Model Treaty and an actual effective treaty when signed.