

MUTUAL AGREEMENT PROCEDURE – GUIDE TO THE PERPLEXED

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A. INTRODUCTION

Commencing from 1.1.2003 the State of Israel began applying a personal tax system and in effect for the first time regulated in an individual manner taxation of the international activity of Israeli resident entrepreneurs and investors.

The international taxation field is one of the complex and fascinating topics in the taxation fields, and it appears that also five years after the coming into force of Amendment 132 of the Ordinance, it is still in its infancy and the disputes, the issues and the ambiguity are still numerous in this field. Thus for example, only in recent days we received word that procedures, instructions and forms on the subject of the reports related to trust taxation were published.

In light of that stated, in the coming years we will see many more disputes in the field of tax issues involved in international activity.

Therefore according to our approach, the significance of the mutual agreement procedure included in the tax conventions to which Israel is a party rises, and we will see that in the coming years this procedure will be applied with greater vigor.

We chose in this article to again detail the substance of the procedure, the procedures entailed therewith and additional relevant issues.

B. MUTUAL AGREEMENT PROCEDURE – SUBSTANCE OF THE PROCEDURE

Article 25 of the Model Convention of the Organization for Economic Cooperation and Development (the – OECD) (hereinafter – “**the Model Convention**”), defines the mutual agreement procedure recommended by the Organization. Most of the tax conventions to which Israel is a party, include an article similar to the version proposed by the Model Convention. Hereinafter is an example of the mutual agreement procedure article in the convention between Israel and Holland¹.

“Article 28: Mutual Agreement Procedure –

1. Where a person believes that the actions of one of the contracting states, or both, cause or will cause him a tax liability that is not in accordance with the provisions of this convention, he is entitled, notwithstanding the remedies provided him pursuant to the internal laws of these states, to bring his matter before the competent authority of the contracting state wherein is his place of residence.

¹ A treaty between the government of the State of Israel and the Kingdom of Holland from regarding avoidance of double taxation and avoidance of tax evasion with respect to taxes on income and on capital.

2. The competent authority, if the objection appears justified to it, and if it cannot reach an adequate resolution alone, the competent authority will endeavor to resolve the matter by mutual agreement with the competent authority of the other contracting state, with the aim of preventing a tax liability that is not in accordance with this convention.
3. The competent authorities of the contracting state will endeavor to resolve by mutual agreement any difficulty or doubt with respect to interpretation of the convention or the application thereof. They are also entitled to consult together in order to avoid double taxation in cases regarding which there are no provisions in this convention.
4. The competent authorities of the contracting states are entitled to communicate with each other directly, including through a joint committee composed of themselves or of their representatives, in order to reach an agreement as construed in the preceding sub-articles.”

Article 25 of the Model Convention of the OECD constitutes a basic example of the procedure called mutual agreement procedure. The State of Israel, within the framework of the tax conventions to which it is a signatory, over the course of the years customarily includes this article of mutual agreement procedure in a format similar to Article 25 of the Model Convention.

Nonetheless, there are a number of conventions to which Israel is a signatory where the mutual agreement procedure included therein is not identical to the article in the Model Convention. Thus for example, Article 25(4) of the convention between Israel and Belgium² prescribes that the competent authorities of the contracting states must reach an agreement in relation to the administrative means required to carry out the provisions of the convention, and in particular with respect to the evidence that residents of one of the contracting states must present, in order that in the other contracting state they will benefit from the exemption or from the deductions for tax purposes specified in the convention.

As a rule, the main objective of the mutual agreement procedure included in the tax conventions is to resolve disputes concerning the application of the tax convention and/or to enable proper interpretation of any of the provisions thereof.

It is accepted that the mutual agreement procedure constitutes a unique procedure, extraneous to the internal law, which was designed to enable resolution of the disputes on the basis of cooperation and mutual agreement between the relevant countries.

Within the framework of the tax conventions to which Israel is a signatory the Minister of Finance or the authorized representative thereof is defined (see for example Article 2 of

² A treaty between the government of the State of Israel and the Kingdom of Belgium from 1972 regarding avoidance of double taxation and avoidance of tax evasion with respect to taxes on income and on capital.

the convention between Israel and the United States wherein the competent authority is defined) as the competent authority for the purpose of the mutual agreement procedure.

As noted by the scholar Dr. M. Bricker in his article³, the mutual agreement procedure has three primary objectives –

- a. Specific Case Mutual Agreement – resolution of disputes in concrete cases, in which an assessee claims that he is liable for tax in a manner that is inconsistent with the provisions of the Convention. This objective is detailed within the framework of Article 25(1) of the Model Convention of the OECD organization, which prescribes –

"Where a person considers that the actions of one or both of the contracting states result or will result for him in taxation not in accordance with the provisions of this convention, he may, irrespective of the remedies provided by the domestic law of those state, present his case to the competent authority of the contracting state of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the contracting state of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with provisions of the convention"

And it is stressed, it is certainly possible that the mutual agreement which the tax authorities reached in a specific case, of a specific assessee, will be of an interpretive nature that will have implications beyond the limits of that same concrete case.

- b. Interpretive Mutual Agreement – resolution of general disputes usually with respect to the manner of interpretation of the Convention or the application thereof, without reference to a specific assessee. See for example the beginning of Article 25(3) of the Model Convention of the OECD, which prescribes:

"The competent authorities of the contracting states shall endeavour to resolve by mutual agreement any difficulties or doubts arising

³ M. Bricker "Mutual Agreement Procedure and the Arbitration Clause in Tax Conventions" Taxes 15/2 (April 2001) on page 21.

as to the interpretation or application of the convention..."

- c. Legislative Mutual Agreement Procedure – avoidance of double taxation in relation to instances regarding which the convention is silent (see for example Article 25(3) of the OECD Convention, which prescribes:

"... They may also consult together for the elimination of double taxation in cases not provided for in the convention"

Within the framework of the explanations to the Model Convention of the OECD (in paragraph 12 of Article 25), it was determined that an assessee does not have to wait until the tax liability which is not compatible with the tax convention, is actually imposed on him, but rather it is sufficient for him to prove that such a liability is within the realm of an "imminent possibility".

There is no dispute that "double taxation" with respect to the mutual agreement procedure intrinsically includes the inclusion of the same income in the tax base by more than one tax authority, concerning the same tax period when referring to the same assessee.

However, it appears that the mutual agreement procedure offers a solution also for cases in which the tax authorities wish to impose on the same income – taxes, which are similar in nature (if not identical), in different countries with respect to an identical tax period (thus for example with respect to transfer pricing).

Furthermore, it appears that the mutual agreement procedure can be applied also in cases wherein "double taxation" is not involved, this in particular where imposition of tax contrary to the convention is involved. The explanations to the Model Convention of the OECD⁴ specify a number of examples of situations of this type, such as where one of the contracting states wishes to collect tax, where the tax convention gives the taxation right exclusively to the other contracting state, which does not collect tax on the assessee's income at all in the specific case.

In other words, a request to instigate a mutual agreement procedure is also possible in order to obtain a tax exemption in both the contracting states, since the contracting states are bound to the agreements and the determinations which they placed on themselves within the framework of the convention, even if these determinations lead to undesirable tax consequences from their perspectives. This is also the approach of the scholar Prof. Vogel as follows⁵:

⁴ Article 25 paragraph 11 of the explanations to the Model Convention of the OECD.

⁵ Klaus Vogel, **On Double Taxation Conventions** (3rd Ed. Kluwer, 1996), p. 1353 (hereinafter – "**Vogel**").

"A request to set in motion a mutual agreement procedure may even be presented in order to achieve exemption in both contracting states. while it is true that DTCs are designed to eliminate no more than double taxation and that a result providing double exemption is undesirable, double exemption resulting from a correct application of DTC rules must nevertheless be allowed to stand, because the two states continue to be bound by the rules they made, even if such rules lead to undesirable results."

In order for an assessee to be entitled "to benefit" from the protection of the provisions of the convention and including of the mutual agreement procedure provisions, all he has to do is to show that actions, of one or both of the contracting states, caused or are liable to cause him to be liable for tax contrary to the provisions of the convention. In most of the states, the assessee is not even required to prove his claim that he is taxed or is going to be taxed contrary to the provisions of the convention⁶.

As a rule, when a competent authority in a contracting state receives an application from an assessee who is a resident of that same contracting state, it must investigate the dispute in light of the state tax laws in both the contracting states and in light of the provisions of the relevant convention.

The scholar Y. Sherman in his article⁷ claims that should it become clear that the tax authorities in the other state indeed took an action which imposes a tax liability not according to the provisions of the convention, they have a duty to initiate a procedure of mutual agreement. This duty was explicitly prescribed in the tax conventions to which Israel is a signatory, which adopt the provisions of the Model Convention of the OECD organization⁸:

"If, however, it appears to the competent authority that the taxation complained of is due wholly or in part to a measure taken in the other state, it will be incumbent on it, indeed it will be its duty to set in motions clearly appears by the terms of paragraph 2"

⁶ Vogel on page 1353.

⁷ Y. S. Sherman "Dispute Resolution Techniques between Contracting States in Tax Conventions (Mutual Agreement or International Arbitration)", Taxes 8/2 (April 1994), on page 5.

⁸ *Ibid*, in clause 2.3.

According to our approach, the articles of the mutual agreement are lacking. While they constitute a dispute resolution mechanism between the relevant states, this solution does not mandate the reaching of an agreement and the attainment of a solution, but only requires of the states to make a good faith effort in an attempt to bring about the resolution of the disputes.

Therefore, in all those same cases wherein the competent authorities do not succeed in bridging the gaps, the objective of the convention may be frustrated and the degree of certainty that is supposed to be given to the assesseees will be harmed. There are those who in such situations call for the adoption of an arbitration procedure (including inclusion of provisions in this spirit in the tax conventions to which Israel is a signatory, similar to the convention between Germany and the United States (Article 25(5))⁹, however this does not concern this article.

The OECD organization published 3 models of conventions for avoidance of double taxation. These models from the years 1963, 1977, 1992, served in the past and continue to serve also today as a foundation for a considerable portion of the tax conventions in the world in general, and among them the tax conventions to which Israel is a signatory.

As the scholar Dr. M. Bricker maintains in his article¹⁰ -

“The first objective of the mutual agreement procedure is application of specific cases wherein the assessee claims that he is liable for tax in a manner which is not consistent with the provisions of the tax convention, in other words taxation which stands in contradiction to the provisions of the convention”

It is clear that taxation of the income, by more than one tax authority – will constitute “double taxation”. Furthermore, according to our approach, there may be cases of double taxation also where a certain authority exempts that same income from tax (pursuant to the internal law existing in that same state), while the other authority seeks to subject this income to tax. Thus for example, the convention between Israel and Belgium exempts capital gain generated in Israel from tax where the seller is a resident of Belgium.

However, it is possible that in Belgium the seller will be exempt from capital gains tax by virtue of the provisions of the internal law and including the provisions of the participation exemption commonly used in Belgium. In this case, should Israel seek to subject the seller (the Belgian) to capital gains tax in Israel, then according to our approach there is room for the allegation that this involves double taxation. Furthermore, it is clear that this involves taxation contrary to the provisions of the convention between Israel and Belgium in a manner which mandates application of the provisions of the mutual agreement procedure.

The scholar Mr. Bricker in his article claims that¹¹ -

⁹ See: Y. Sherman, **Ibid** on page 6.

¹⁰ See: M. Bricker “**Mutual Agreement Procedure and the Arbitration Clause in Tax Conventions**” Taxes 15/2 (April 2001) 15.

“The most important basis of the mutual agreement procedure is prevention of double taxation of the assessee... Double taxation with regard to application of a mutual agreement procedure includes... the inclusion of the same income in the tax base by more than one authority concerning identical tax periods when from a legal perspective the income belongs to the same assessee”.

And adds: **“it is appropriate to note that the mutual agreement procedure may be applicable even in situations which are not necessarily connected with double taxation contrary to the convention, and this where imposition of the tax under discussion is in clear contradiction to the rule found in the convention”.**

As a rule, in order to apply the mutual agreement procedure, it is sufficient for the assessee to show a probability that the consequence of some action on the part of one of the contracting states will be tax liability contrary to the provisions of the tax convention. According to our approach, the mutual agreement procedure can and should be applied also independently by the competent authority, without the need to rely on an earlier application of the injured or liable to be injured assessee. Since indeed this is the duty of the authority as an administrative authority.

According to our approach, whereas the role and the purpose of the tax conventions is to benefit and to provide certainty for investors in different states, it appears that the provisions of the mutual agreement article should be interpreted broadly, and the application thereof should be liberally allowed, in any case of doubt. Since indeed, the rule and purpose thereof is to serve the injured assessee as an additional remedy and protection from a non-proportional and/or improper injury by one or more of the contracting states and/or an injury in a manner contrary to the provisions of the convention and/or the interpretation thereof. Restriction of the application article will necessarily result in more cases where the objective of the convention and the intention of the parties will be frustrated, and thus will result in harm to the assessee public confidence in the tax convention institution. Such harm will first and foremost harm the contracting states (which wish to attract to themselves additional investors).

According to our approach, it is advisable that the contracting states stand on “their hind legs” and unequivocally fight against decisions and/or attempts of the other authority to subject the assessee to tax in a manner which is inconsistent with the provisions of the convention and/or the purpose thereof.

C. WHO IS THE INITIATOR OF THE APPLICATION

1. As a rule, the initial application to instigate a mutual agreement procedure will be submitted by the assessee¹². After submission of the application, the competent authority will examine whether there is an internal solution

¹¹ **Ibid**, **Ibid**.

¹² **Ibid**, on page 23.

which would avoid “double taxation” on the assessee, and so far as no such solution exists, the competent authority will have to institute a mutual agreement procedure with the second contracting state.

In our opinion, a correct interpretation of the provisions of the conventions for avoidance of double taxation, will be that which imposes a duty on the authority to initiate and to begin a procedure for mutual agreement, where it appears to it that if it does not do so, the assessee is liable to find himself liable for tax contrary to the provisions of the relevant convention.

2. An assessee who applied to the competent authority, his aforesaid application actually requires the competent authority to examine whether his claims are appropriate. Should it be found that the request of the assessee to institute the mutual agreement procedure is appropriate, then the competent authority will attempt to reach an agreement with the competent authority in the second contracting state, in order to resolve the matter in a manner that will avoid imposition of tax contrary to the provisions of the convention¹³.
3. In those same cases, the competent authorities of both the contracting states must sit amongst themselves and agree on a manner wherein the assessee will not be charged with tax in a manner which is inconsistent with the provisions of the convention. As a rule, the approach that the contracting states are not required to find a solution to the concrete problem is accepted, however they are required to invest maximum efforts in good faith for the sake of resolving the dispute. According to our approach, the absence of finding a solution contradicts the intention at the foundation of the arrangement (the convention). In this regard paragraph 25(2) of the Model Convention of the OECD prescribes as follows –

"The competent authority shall Endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other contracting state, with a view to the avoidance of taxation which is not accordance with the convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the contracting state"

¹³ See also: Dr. Gideon Klugman, Adv. and Meir Kaputa, Adv. “The Convention for Avoidance of Double Taxation between Israel and the United States”, on page 355.

In light of the aforesaid, we are of the approach that cases where the matter will not be resolved by mutual agreement by virtue of the provisions of the Convention, will cause harm to the assessee public confidence (particularly those having international investments/activities) in everything related to prima facie certainty that the Tax Convention intends to provide. Therefore, according to our approach, the contracting parties would do well to let go where they did not find a solution by agreement, also at the price of loss of tax income.

4. Loss of the assessee public confidence in the taxation system of a certain state, and especially the absence of its uncompromising support of the tax conventions to which it is a signatory, will severely harm the attraction of that same state in everything concerning the lure of foreign capital to that same state, and especially the luring of cross-boarder entrepreneurs, which will avoid investing therein/by means thereof.
5. According to our approach, one of the primary and important objectives of the tax conventions is the lure of foreign capital and entrepreneurs into the territories of the contracting state, inter alia due to providing certainty with respect to the tax consequences of those same investors/entrepreneurs.

D. 3 CATEGORIES OF THE MUTUAL AGREEMENT PROCEDURE¹⁴

It is accepted to divide the mutual agreement procedure into 3 primary categories, as follows –

- (1) The mutual agreement procedure in the narrower sense – this category was intended to avoid, in specific cases, taxation contrary to the provisions of the convention. The state of residence of the assessee, can solve such a specific problem which arose without involving the second contracting state. In this category, in any case where an assessee believes that he is taxed contrary to the provisions of a convention, he is entitled to demand application of the procedure. It will be clarified that within the framework of this category, the mutual agreement procedure will be broadened eventually into a general discussion regarding the legal problems which were discovered within the framework of the specific case. Moreover, the contracting states may include, within the framework of the issues raised in the specific case, issues regarding double taxation which are not provided for in the convention and to merge between both procedures (the specific and the general)¹⁵.

¹⁴ Vogel on page 1345.

¹⁵ Vogel on page 1368.

"A mutual agreement procedure in the narrower sense will, in principle, deal with a particular case... it will, however, inevitably extend to a general discussion of the legal problems revealed by the particular case or doubts arising when interpreting or applying the convention. Moreover, the competent authorities may at any time include, among the questions discussed, those of double taxation not dealt with the convention. In that event, a consultation procedure as envisaged by Art. 25(3) will be held side – by side with a mutual agreement procedure as envisaged by Art 25(1). In other words, the two procedures will merge."

- (2) The consultation procedure for removing difficulties - was intended to avoid restrictions or doubts arising due to interpretation of the convention, generally or specifically.

"As envisaged by the first sentence of Art 25(3), is designed to eliminate impediments or doubts arising as to the interpretation or application of the convention, in particular or in general"

- (3) The consultation procedure for filling in gaps (lacunas) in treaty coverage – this category enables both the contracting states to consult amongst themselves in order to avoid situations wherein double taxation is liable to be generated in cases where the Convention does not provide a solution to the aforesaid problem.

"As envisaged by the second sentence of Art. 25(3), allows consultation between the two tax authorities for the elimination of double taxation in cases not provided for in the convention"

AS A RULE, THERE ARE 3 PRIMARY REASONS FOR TAXATION CONTRARY TO THE PROVISIONS OF THE CONVENTION:¹⁶

- (1) Faulty interpretation of the provisions of the convention.
- (2) Faulty interpretation of the provisions of the internal law.
- (3) Faulty interpretation of the facts laid at the basis of the case.

Each one of the three alternatives above may constitute the reason for instituting a mutual agreement procedure. There is an approach according to which, abuse of the provisions of the convention by the assessee, is liable to deny him the possibility of protection which the convention may make available to him. We believe that the proper handling of Treaty Shopping is by means of the allegation (which the relevant authority is required to prove) that the convention does not apply to a specific assessee, and this pursuant to the provisions of the convention itself. However, a conclusion should not be reached that a prima facie attempt to benefit from the provisions of the convention, denies certain rights in accordance thereto so long as this is not prescribed explicitly in the relevant convention. According to our approach, the provisions of the convention will apply fully and verbatim, also in the case where a certain assessee prima facie attempts to benefit from the benefiting provisions of a certain convention unless the provisions of the convention themselves allow one of the contracting states not to apply to that same assessee the benefits which the convention provides, for instance where there is a limitation of benefits article in the convention itself, in a manner which allows the application thereof to that same assessee.

Taxation contrary to the provisions of the Convention must be based on some action of one of the contracting states or both. Some action in this regard can constitute an action or omission as a result of which the applicant was subject to tax contrary to the provisions of the convention.

H. THE TIME ALLOTTED IN THE CONVENTION FOR INSTITUTING THE MUTUAL AGREEMENT PROCEDURE (LIMITATION)

Article 25(1) of the Model Convention of the OECD prescribes that as a rule, the time frame for submission of the application for instituting the mutual agreement procedure is three (3) years. This period is measured from the day when the applicant is given notice of the specific action which causes or is liable to cause, allegedly, double taxation and/or taxation contrary to the provisions of the convention¹⁷.

Nonetheless there are tax conventions which limit the aforesaid time frame to two years (thus for example was prescribed in the convention for avoidance of double taxation

¹⁶ Vogel on page 1354.

¹⁷ See for example Article 25(1) of the convention between Ireland and the State of Israel regarding double taxation and avoidance of tax evasion with respect to taxes on income.

between Israel and Belgium and, in the conventions between Israel and Italy, Ethiopia, the Philippines, Canada and Romania).

In each case where a date is not prescribed in the convention, the date for submission of an application will be within a reasonable time from the date when the applicant initially became aware of the action which causes or is liable to cause his liability for tax not in accordance with the provisions of the convention.

F. MANNER OF IMPLEMENTING THE PROCEDURE BETWEEN THE CONTRACTING STATES

1. Article 25(4) of the Model Convention of the OECD explicitly prescribes that the preferred manner of communication between the contracting states is direct communication. The communication does not have to be accomplished by diplomatic means. The communication can be in writing, verbal, by fax or by any other means of communication. The contracting states can establish committees on their behalf in order to examine the means available to them for agreement and finding resolutions for those same cases requiring such a resolution. Representatives of the committees will be predominantly senior tax people who are familiar with and proficient in the relevant topic on the agenda¹⁸.

"This paragraph determines how the competent authorities may consult together for the resolution by mutual agreement, either of an individual case coming under the procedure defined in paragraph 1 and 2 or of general problems relating in particular to the interpretation or application of the convention, and which are referred to in paragraph 3. It provides first that competent authorities may communicate with each other directly. It would therefore not be necessary to go through diplomatic channels. The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meeting, or any other convenient means. They may, if they wish, formally establish a joint commission for this purpose"

¹⁸ The explanations to the Model Convention of the OECD, paragraph 4.

2. The opinion that the contracting states are not bound to reach any agreement in the course of the mutual agreement procedure is accepted. In any case where the contracting states had some obligation to reach an agreement within the framework of the procedure, representatives of the states would have been denied the discretion that is granted to them within the framework of the procedure. In addition, representatives of the committees cannot be compelled to act and/or compromise contrary to their internal law¹⁹. In Israel Article 196 of the Income Tax Ordinance prescribes that the provisions of the convention prevail over the internal law. Therefore it appears that it cannot be argued that the resolution proposed in the convention is contrary to the internal law and therefore is not possible.

Nonetheless it is clarified that in any case where there are a number of interpretations for the manner of taxation and/or the internal law, the contracting states must accept the interpretation that enables them to reach mutual agreement. And as the scholar Prof. Vogel maintains in this regard²⁰-

"If tax law or domestic law allow more than one interpretation, the one to be given preference should be that which makes mutual agreement possible"

In other words, also Prof. Vogel is of the approach that where there are a number of possible interpretations, the approach that is consistent with the provisions of the convention should be adopted.

G. OBJECTIVE OF THE PROCEDURE

Prof. Vogel in his book notes that the objective of the mutual agreement procedure must be aimed at avoiding taxation contrary to the provisions of the convention²¹, and in the language of Prof. Vogel:

"The endeavour must be direct towards avoiding taxation contrary to the convention. Avoiding in this connection not be taken literally. i.e., mean taking a preventive measure. Preventive measures will be the

¹⁹ Vogel on page 1368.

²⁰ Vogel on page 1378.

²¹ Vogel on page 1368.

exception, in most cases a mutual agreement procedure will serve to eliminate such taxation contrary to the convention as already been imposed (see in Art. 25(1) '... result or will result... in taxation...'. "

In other words, the objective is avoidance of any consequence “causing or liable to cause...” taxation in a manner contrary to the provisions of the relevant tax convention.

H. THE PLACE OF THE ASSESSEE IN THE MUTUAL AGREEMENT PROCEDURE²²

Within the framework of the mutual agreement procedure, the assessee has the right to present his objection. Beyond this, the assessee does not constitute a party to the mutual agreement procedure proceeding. The contracting states give the assessee certain essential guarantees. Representation of the assessee within the framework of the proceeding can be verbal or in writing and/or through a representative on his behalf.

Certainly the correct and proper approach will be to allow the assessee to present the facts on his behalf, to present the relevant information with respect to him – to allow him the right to be heard prior to making a decision in his matter that may harm him. As is well known, the right to be heard is a basic right due to an assessee in every proceeding that is conducted with respect to him (whether criminal and whether civil), and which is liable to determine his fate. This is so also with regard to the mutual agreement procedure.

It will further be noted that the tax authorities in Israel routinely require a power of attorney from the applying assessee, with the institution of the procedure in his matter, in a manner according to which they will represent him in the procedure. According to our approach, giving such a power of attorney to the Israeli tax authority is problematic in the sense that the assessee is liable in certain cases to find himself bound to a decision, without the ability to object. And it is stressed, in the usual situation, where the states do not represent the specific assessee, the possibility is open to him to submit his objection before the relevant legal courts, in each one of the states.

It is possible that this manner of objection will be blocked before the assessee, where he authorizes a certain authority to represent him in the procedure (through a power of attorney on his behalf), and therefore, our recommendation is to avoid this. According to our approach, the authority cannot require such an authorization, as a fundamental condition to opening the mutual agreement procedure.

²² Vogel on page 1370.

Parenthetically it is said that according to our approach the tax authorities in Israel impose heavy requirements on an assessee requesting to consider the institution of a mutual agreement procedure (beyond the accepted), and therefore, our recommendation is to consider in appropriate cases to institute the mutual agreement procedure in the other relevant state, to the extent possible.

I. AGREEMENT OF THE CONTRACTING STATES

After the contracting states agreed amongst themselves, their agreement is subject to the agreement of the relevant assessee and to abatement of the pending portion of the legal proceeding, with respect to which the agreements were achieved between the contracting states²³.

So far as the agreement is not acceptable to the assessee, he will be entitled to continue to realize all his rights pursuant to any law, whether by way of legal proceeding against one authority, and whether against the second authority (and/or against both concurrently), and the mutual agreement procedure cannot impair any one of the aforesaid proceedings.

"The rules laid down in paragraph 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of the objections by the taxation authorities. When taxation not in accordance with the convention arises from an incorrect application of the convention in both states, taxpayers are then obliged to litigate in each state, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an amicable basis, i.e. by agreement between competent authorities, the first stage being conducted exclusively in the state of residence... from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter."

²³ The explanations to the Model Convention of the OECD, paragraph 1-2.

Therefore, the mutual agreement procedure does not preclude an assessee from conducting an ordinary proceeding within the framework of the internal law.

J. INCOME TAX IMPLEMENTATION ORDER

On 5.12.2001 the Israel Tax Authority published Implementation Order No. 23/2001 (hereinafter – “**the circular**” and/or “**the order**”)²⁴ which concerns the institution of a mutual agreement procedure. The objective of the circular is to specify the procedure involved in the institution of a mutual agreement procedure, by the Israel Tax Authority. The circular also specifies the position of the Israel Tax Authority with respect to a number of more fundamental issues involved in the mutual agreement procedure.

Thus for example the Implementation Order prescribes that the objective of the mutual agreement procedure prescribed in the tax conventions to which Israel is a party, is **avoidance of tax liability contrary to the provisions of the convention**²⁵. In other words, not avoidance of double taxation, not avoidance of international tax planning – treaty shopping, but rather avoidance of tax liability contrary to the convention, is the primary objective of the mutual agreement procedure, also according to the approach of the Tax Authority.

The circular further specifies that the mutual agreement procedure is applied in three cases as follows –

- (1) **Individual Case Mutual Agreement Procedure**²⁶ – where an action of one of the states is liable to cause the tax liability of the assessee contrary to the provisions of the convention. The Tax Authority notes that an Israeli resident is entitled to apply to the competent authority of his state with a claim that an action of one of the states is liable to cause him tax liability not in accordance with the Convention. The above-mentioned rights are available to him in addition to remedies provided to the applicant pursuant to the internal law of the State of Israel, if it is so prescribed in the relevant convention. The Authority will only intervene if there is a conflict with a provision in the convention and not in issues connected with application of the internal law in the second state. The application will be submitted on the date prescribed in the relevant convention and if a date is not prescribed, then within a reasonable time from the day when the applicant became aware of his tax liability not in accordance with the convention²⁷. Submission of the application for conducting mutual agreement procedures will be submitted to the International Tax Division²⁸. The Authority will examine the degree of

²⁴ Income Tax Order 23/2001 “**Mutual Agreement Procedures in Conventions for the Avoidance of Double Taxation – Application Submission Procedure and the Handling Thereof**”.

²⁵ Clause 1 of the Implementation Order.

²⁶ Clause 3.1 of the Implementation Order.

²⁷ Clause 3 of the Implementation Order.

²⁸ Clause 4 of the Implementation Order.

justification in the application, in the case where it is not absolute, the Authority will notify of such in writing and will justify its decision. Should the application be justified it will approach the competent authority of the second contracting state and will attempt to resolve the matter by mutual agreement²⁹. The Authority will notify the applicant of the results of the mutual agreement procedure, also in the case of lack of cooperation and/or lack of agreement. According to its approach, the competent authority in Israel is not required to avoid double taxation unilaterally in the event that the proceedings ended without agreement.

Should an agreement be achieved in the mutual agreement procedures and the assessee did not oppose it, it is maintained in the circular that the agreement will be final, without a right to appeal or to object. The Authority in Israel is not responsible for the contracting state's application of the agreement. Submission of an application for conducting mutual agreement procedures does not stay the counting of the dates for submission of reports, objection and appeal. A decision regarding the freezing of dates in relation to a matter being heard before the court, will be made in coordination with the legal department at the Commission and at the Attorney's Office and will be subject to the approval of the court. Should the Authority decide to institute a mutual agreement procedure it is entitled to require guarantees from the applicant for payment of the tax, but assessment or collection proceedings with respect to the years in dispute will not be taken against the applicant. It is clarified that in any case where the Authority rejected the application for conducting mutual agreement procedures the applicant is not precluded from raising his issues in ordinary assessment proceedings³⁰.

- (2) **General case** the objective of which is to reach an agreement regarding interpretation of the provisions of the convention and the application thereof in general.
- (3) **Consultation procedure** intended to avoid double taxation with respect to cases not explicitly provided for in the convention.

The two last cases, are less relevant to our article, and we refer you to the provisions of the circular.

K. FREEZING OF THE LEGAL PROCEEDING FOLLOWING THE INSTITUTION OF A MUTUAL AGREEMENT PROCEDURE –

According to our approach, as was even adopted in the decisions of the Tel Aviv District Court, it is advisable to stay the legal proceeding in the matter of a certain assessee as long as the mutual agreement procedure is not exhausted between the relevant states,

²⁹ Clause 5 of the Implementation Order.

³⁰ Clause 6 of the Implementation Order.

otherwise the contracting states are liable to find themselves bound to decisions of the court in a certain state before the mutual agreement procedure is concluded.

Therefore, a motion to freeze a legal proceeding following an application for instituting a mutual agreement procedure to one of the competent authorities, should be submitted to the court within the framework of the preliminary proceedings and within the framework of the time allotted for such in the convention, and before commencement of the substantive legal proceeding.

Exhaustion of the mutual agreement procedure, first, is likely to make unnecessary the need to conduct the legal proceeding, and therefore, it would be appropriate to exhaust it prior to exhaustion of the legal proceeding. In this order of events, the assessee is liable to lose some of the defense pleas available to him, and therefore his defense proceeding is liable to be harmed.

The Honorable Judge M. Altuvia maintained this in the Tel Aviv District Court in Income Tax Appeal 1255/02 **Jetek Technology v. Kfar Saba Assessing Officer**, Taxes 19/3 (June 2005) e-29 (hereinafter – “**Jetek Decision**”) as follows:

“The correct timing and order will be to exhaust the mutual agreement procedure prior to exhaustion of the appeal proceeding. A different order of events blocks the options of the appellant to exhaust the maximum from both such proceedings. Whereas the purpose of the convention is to avoid or at least to minimize the exposure of the appellant to payment of double taxation, choosing the aforesaid order is more compatible with this purpose and is in line with the ruling of the Supreme Court in the matter of Hatzor (Civil Appeal 165/85 Kibbutz Hatzor v. Rehovot Assessing Officer Israeli Decisions 39 (2) 70, pg. 1)”.

The Honorable Judge M. Altuvia adds in Civil Motion 5663/07 **Yanco Weiss Holdings (1996) Ltd. v. Holon Assessing Officer** and rules as follows –

“... An approach which fulfills the purpose of the convention and the explanations of the OECD organization will be to act notwithstanding the use of the counter planning instruments, to realize the non-exposure of the assessee to double taxation. One way to do so, in the absence of another provision in the convention, is to apply to the competent authority for the purpose of instituting a mutual agreement procedure. The one contracting state is likely to persuade the other contracting state that application of the convention is not at all appropriate and that the assessee must be liable to tax only in one place, by the state claiming abuse. However also other arrangements can be formulated between the competent authorities of the two convention states (see Income Tax Appeal 1255/02 **Jetek Technology v. Kfar Saba Assessing Officer, Taxes 19/3, e-196). Meaning, exposure of the assessee to both tax systems and conflicting claims of the convention states is**

not unique for use of the counter planning instruments and does not necessarily generate due to this use”

And it will be said that although we disagree with some of the statements of the Honorable Judge M. Altuvia in the above decision, we certainly join his words regarding the correct order of the proceedings.

For completion of the picture it is stressed that in Income Tax Appeal (Civil File) 1192/04 **Koltin Yigal and Sara v. Kfar Saba Assessing Officer**, the Honorable Judge M. Altuvia dismissed a motion to freeze the proceeding due to a mutual agreement procedure, however he did so since the appellant did not act with the required criterion of cooperation with the Authority, such as forwarding to the Authority the maximum information in order that the Authority could consider its position in the mutual agreement procedure. And it is noted, in the Koltin case the assessee applied to the Israel Tax Authority so that it would act in the mutual agreement procedure, however he had difficulties enduring the great burden which the Tax Authority imposed on him, similar to its position in the Implementation Order (as specified above – see clause J).

We have no choice but to join the words of the Honorable Judge Altuvia in the matter of Jetek, while adding a small amendment according to which the purpose of the convention is not only avoidance of double taxation, but there are numerous other reasons that states contract in tax conventions and including: attracting foreign capital, certainty for international investors and entrepreneurs and more.

Therefore, according to our approach the rationale laid at the foundation of instituting the mutual agreement procedure is first and foremost the attempt of the tax authority in one of the states to subject the assessee to tax in a manner that is allegedly inconsistent with the provisions of the relevant tax convention.

L. DOES AGREEMENT OF THE CONTRACTING STATES BIND THE ASSESSEE?

Within the framework of the explanations to the Model Convention of the OECD Article 25 (paragraph 31) it is noted that the assessee is not obliged to accept the agreement that was achieved between the contracting states. Such an agreement is subject to the approval of the assessee and he does not have to approve it or to accept it.

The assessee can accept the mutual agreement which was achieved on the one hand or reject it and thus return to the same stage he was at before the mutual agreement procedure was instituted between the contracting states.

It is stressed that the mutual agreement procedure is liable to last for a long period of time (sometimes a number of years). This is a consideration which must be taken into account prior to application for instituting such a procedure. Thus for example the

average period for completion of a mutual agreement procedure proceeding, where one of the member states is the United States is 600 days (approximately two years)³¹.

In our opinion, and in light of the fact that the mutual agreement procedure is a complex procedure, which requires, of the assessee and of the contracting states, to invest many resources, it is appropriate that the competent authority in Israel publish the agreements which were achieved with it within the framework of this procedure and to make them into public domain, similar to what was done concerning the pre rulings and the forfeit decisions.

As we saw above, instituting a mutual agreement procedure is a complex process, and it is advisable to do so with maximum caution and in a professional manner, since otherwise the assessee is liable to be harmed.

This document is only general and does not constitute giving advice and in any case no such use should be made of it without receiving an individual professional legal opinion and/or advice in accordance with the specific circumstances. In any case it is recommended in our opinion to examine ahead of time, all the legal ramifications prior to taking any action whatsoever.

³¹ See: Kathleen Matthews **ABA Tax Section U.S., Canadian and Mexican Competent Authorities Speak**, 14 Tax Notes Intl. 1997, Page 1734