Analysis

BEPS and the future for cross-border dispute resolution

Speed read

Implementation of the OECD's BEPS recommendations will result in an increase in disputes in relation to international tax. Current procedures are cumbersome and do not always result in the dispute being resolved. G20 and OECD countries will agree minimum standards for dispute resolution which will include more widespread adoption and use of an improved OECD mutual agreement procedure (MAP). Twenty countries have gone further and agreed to submit to binding arbitration where a dispute cannot be resolved by agreement. The proposals are a step in the right direction but do not go far enough. Much can be learned from the use of arbitration in Bilateral Investment Treaties.

Jason Collins

Pinsent Masons

Jason Collins is head of the tax group and also head of client relationships for the financial services sector at Pinsent Masons. He specialises in the resolution of complex disputes with HMRC in all aspects of direct tax and VAT. Email: jason.collins@pinsentmasons.com; tel: 020 7054 2727.

Almost an afterthought in the OECD's action plan for preventing base erosion and profit shifting (BEPS) is Action 14 – making dispute resolution mechanisms more effective. Yet with countries being urged to make radical changes to their tax laws which will, on the OECD's estimate, result in the collection of an extra $240bn a year in tax, the instances of double taxation and the scope for tax disputes is likely to increase substantially. Even in the unlikely event of every country fully adopting all the BEPS recommendations, disputes about interpretation will arise, not least because not all countries will implement the proposals in exactly the same way. To add fuel to the fire, country by country reporting will lead to greater scrutiny of where a multinational corporation is paying tax.

The mechanisms for resolving international tax disputes are therefore likely to become ever more important in the future. Counter-intuitive as it may seem, having a demonstrably fair and transparent dispute resolution procedure – even though it may lead a country to forgo tax otherwise due under its domestic law – ultimately leads to greater investment by giving multinationals greater confidence to do business in that country. The generally weak or wishy-washy recommendations under Action 14 feel a little like an opportunity missed.

The current regime

Article 25 of the OECD Model Tax Convention sets out the 'mutual agreement procedure' (MAP) for resolving treaty disputes. Not all treaties have incorporated Article 25 but, where it applies, a taxpayer can approach the 'competent authority' of the state in which they are resident in order to try to activate the MAP.

MAP requires the competent authorities of the two tax treaty partners to engage with each other when a taxpayer claims that it is being taxed otherwise than in accordance with the treaty as a result of the actions of one or both of the relevant tax authorities. The taxpayer is not a formal party to the engagement but, depending on the jurisdictions concerned, may be invited to participate informally.

Although Article 25 contains provision for the ultimate resolution of the dispute through arbitration, very few treaties incorporate this measure, meaning that the contracting states are only required to 'endeavour' to resolve the dispute. The best case scenario is that one jurisdiction decides to grant unilateral relief. The worst case scenario is that the two competent authorities cannot agree and the taxpayer has to live with double taxation. Even if the contracting states do ultimately reach agreement, the process is cumbersome and it generally takes a long time for the issue to be resolved.

Within the European Union, in transfer pricing-based disputes taxpayers can also request MAP assistance under the European Arbitration Convention. This MAP procedure provides for binding arbitration. However, even amongst member states there remains a reticence to activate arbitration, with only three out of 182 cases which remained unresolved after two years being sent for arbitration (as at the end of December 2013).

The three core proposals

In its final report on Article 14 the OECD sets out three core proposals. The first proposal, to be adopted by all, is that countries should commit to minimum standards on the resolution of international tax disputes, consisting of the removal of obstacles to an effective and efficient MAP. Countries will also agree to a 'robust peer-based monitoring mechanism' in relation to their compliance with the standards.

The second proposal is that the standards will be supported by a suite of 'best practices', which are voluntary.

The third proposal is that 20 countries will commit to adopting a form of binding arbitration (as yet not agreed upon) in situations where it is not possible to resolve the dispute by agreement.

Minimum standards

The minimum standards comprise three general objectives, each of which has a number of specific elements containing greater detail. The general objectives are:

1. Countries should ensure that treaty obligations related to MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
2. Countries should ensure that administrative processes promote the prevention and timely resolution of treaty-related disputes; and
3. Countries should ensure that taxpayers that meet the requirements of paragraph 1 of Article 25 can access the MAP.

Standards 1 and 2

At its most basic, the detailed elements of standard 1 require countries to incorporate in all their treaties paragraphs 1 to 3 of Article 25 of the OECD model article on MAP (as varied by standards 3.1 and 3.3 – see below) and to ensure that the MAP procedure is available in relation to disputes surrounding transfer pricing (1.1) and anti-treaty abuse provisions (1.2).

The final report highlights the two-stage approach to a request to access the MAP. Namely, the jurisdiction receiving a MAP request must determine whether the objection is justified; and, if so, it must decide whether it can resolve the issue by unilateral action. Only if a justified objection cannot be resolved unilaterally will the state in question move to the second, bilateral stage of the procedure.

Minimum standard 1 includes a commitment to 'seek to resolve' cases within an average timeframe of 24 months (1.3). Although it is not clear, presumably this timeframe starts to run from the beginning of stage 2 rather than stage 1.

The commitments under minimum standard 2 are woollier, such as ensuring that 'adequate resources are provided to the MAP function' (2.5) and publishing clear guidance easily accessible to the public (2.1).

Standard 3: removing key impediments

Minimum standard 3 addresses the issue that the current version of the MAP gives carte blanche to the state in which the taxpayer is resident to decide whether the claim is justified (as part of stage 1), and thus whether the case merits contact being made with the other state (i.e. stage 2). Standard 3.1 requires contracting states either:

- to use an amended version of Article 25 which allows the taxpayer to make its request to *either* contracting state; or
- to implement a bilateral notification or consultation process where the home jurisdiction does not consider the request to use MAP to be justified.

Crucially, standard 3.3 requires contracting states to avoid double taxation arising because of a mismatch in the time limits in one country for raising a tax assessment and the time limits in the other country for allowing a claim for relief from tax on those same profits – either by disapplying domestic time limits for recovery of tax, or to cap domestic time limits for assessing tax. The provisions would not apply in the cases of fraud, gross negligence or wilful neglect. As a stark example, HMRC can sometimes assess going back 20 years (failure to notify, e.g. a permanent establishment or UK tax resident non-UK incorporated company), but it is unlikely many countries would be happy to give back 20 years' worth of tax.

Best practices

Getting deeper into the woollier regions, Section B sets out the 'best practices'. These did not make the cut for minimum standards because they were not universally accepted. One in particular would have been welcomed by business if it had been elevated to a minimum standard; namely, suspending collection of any tax pending the outcome of the MAP procedure in order to avoid the cash flow disadvantages for the taxpayer of double taxation in the interim. It is hardly surprising that this is not a practice on which universal agreement could be reached.

Binding MAP arbitration

As noted, paragraph 5 of model Article 25 already provides for arbitration – although this provision is rarely incorporated by contracting states or made available in practice. The OECD says that, although the business community and a number of countries think that binding arbitration is the best way to resolve disputes, there is no consensus amongst all OECD and G20 countries. However, 20 countries, including the UK and the US have declared their commitment to provide for mandatory binding arbitration. The other countries are Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden and Switzerland.

The OECD notes that these countries are involved in 90% of outstanding MAP cases as at the end of 2013 – although it is not clear whether they mean that all of those cases are exclusively between the 20 countries, or merely involve one of the 20 countries (and a country outside this group). One must assume that it is the latter; otherwise, the OECD would be able to say that 90% of cases would be subject to binding arbitration if these proposals were already in place.

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Even amongst states that have committed in principle to arbitration, there seem to be differences of view, with some countries wanting arbitration for all disputes and others wanting arbitration limited to a subset of cases. The report itself does not mention this, but the arbitration could be on the basis that the arbitrator would be allowed only to choose between the 'last best offers' made by each country, and not to substitute an outcome of their own. The provision for arbitration will be developed as part of the negotiation of the proposed multilateral instrument (which will help countries to implement the BEPS proposals speedily and efficiently by removing the need to negotiate multiple new bilateral treaties with each other).

The future

Whilst a step in the right direction, the proposals clearly do not go far enough. It rather undermines the desire to reach international consensus on modernising international tax treaties if the countries concerned do not trust each other to agree to independent arbitration when they fall into dispute over the interpretation of those rules. As everyone who has played casual sport will know, the game quickly descends into acrimony and chaos in the absence of a referee!

A lot can be learned from the use of arbitration in Bilateral Investment Treaties. If a country is willing to submit to arbitration in disputes over the alleged illegal state appropriation of private assets, why would it not do so over taxation? Countries know they need investment treaties to attract foreign investment – so perhaps the international business community is not putting enough pressure on governments to recognise that investment is also harmed if double taxation cannot be readily avoided. However, this small step in the direction of arbitration does seem irreversible, and perhaps over time the arbitration of cross-border disputes will become commonplace. ■