

# The Evolving World of Global Tax Planning: Part II

**The authors continue their analysis of the evolving world of global tax planning, with a particular focus here on means of resolving cross-border tax disputes.**

## 1. Introduction

Part I of this three-part series addressed one of the considerations that MNEs may want to take into account when adapting their effective tax rate strategies (ETR strategies) in the evolving world of global tax planning.<sup>1</sup> The current global tax environment, foundations of the existing tax framework, base erosion and profit shifting (BEPS), country-by-country reporting and whether the goals of the OECD BEPS Project have been achieved, were also addressed.

This Part II addresses the anticipated tsunami of cross-border tax disputes commonly thought to be on the horizon. Such a threat is an important element of the framework for developing an effective strategy to take advantage of the planning opportunities that exist during this time of transition (which will be addressed in Part III of this series). This article will also address steps being taken to develop means of efficiently resolving international tax dispute dockets at all levels. Stagnant and growing dockets serve the interests of neither government nor MNEs.

This article will also refer to the discussion in Part I where appropriate, including use of the same defined terms.

## 2. Globalism vs. Populism in the International Tax World

Part I ended by noting that the goal of the OECD BEPS Project to facilitate cooperation among countries to prevent base erosion, does not seem to have been achieved.<sup>2</sup> There appears to be little indication that countries will consistently adopt the overall design, as opposed to utilizing those elements consistent with their respective self-interests. The assumption that such consistency can be achieved was also the fundamental mistake made by the League of Nations in 1926 when the current tax treaty and transfer pricing framework was established.<sup>3</sup>

Tax authorities and the OECD often seem to overlook – or conveniently ignore – that MNE strategies are largely

a function of the rules established by countries to develop their own tax base (at the expense of other countries). In other words, countries, in their respective self-interests, grant incentives of various sorts to encourage economic investment (referred to here as available regimes). MNEs take advantage of these incentives to minimize their tax liabilities, which the BEPS project views as, somehow, inappropriate behaviour of MNEs denuding the tax base of other countries.

Like water going downhill, MNE planning strategies will utilize the most efficient path to achieve desired objectives. Indeed, this is a fiduciary duty to shareholders. Tax expense is a major expense of all MNEs which needs to be managed as effectively as possible in a competitive world. For example, if Country A offers an incentive such that MNE 1 makes an investment in Country A, as opposed to Country B which offers no such incentive, the net result is that jobs and economic activity are created in Country A and not in Country B. Country B may perceive that its tax base has been eroded. But who has done this? Country A via its incentive? Or MNE 1?

International tax disputes arise when Country B challenges the activity of MNE 1 by asserting that it should have been paying tax in Country B. If there is a treaty between Countries A and B, there could be a mutual agreement (MAP) or competent authority proceeding. If that proceeding stalls for whatever reason, all parties would benefit from processes that would lead to reasonably efficient resolution.

The transparency demanded by country-by-country reports<sup>4</sup> and related matters evolving on a unilateral country basis (seeking, once again, to attract tax base away from other countries) will create new opportunities and paradigms for MNE ETR strategies. It may be that these evolutions will drive planning and acquisition strategies toward treaty or non-treaty protected corporate structures designed, for example, to (i) take advantage of new opportunities created by the new regimes and (ii) minimize transfer pricing exposures, imposition of exit or other taxes on the movement of intangibles or other assets. Such a process will be developed in Part III of this series.

These developments in the international tax world reflect, not surprisingly, what is evolving in the global political world. The popular press regularly addresses what is often described as *globalism vs. populism*, which reflects an apparent trend of voters and governments to focus less on the global good and more on local needs. The same

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1. M. Herrington & C. Lowell, *The Evolving World of Global Tax Planning: Part I*, 24 Intl. Transfer Pricing J. 1 (2017), Journals IBFD.  
2. Herrington & Lowell, *supra* n. 1, section 6.  
3. Herrington & Lowell, *supra* n. 1, section 6.4.

4. Herrington & Lowell, *supra* n. 1, section 5.2.

phenomenon appears to be developing in the world of cross-border taxation, which may be evolving as it did in 1926: idealistic visions of a globalized tax order (BEPS Project) vs. realism-populism on a country-by-country basis. Countries seem to be reacting to the former (BEPS) as they did to the League of Nations in 1926. As noted, the League assumed there would be consistent adoption of tax policy throughout the world, but countries pursued agendas to achieve their respective objectives.

In contrast to the policies incorporated in the Final Reports under the BEPS Project, countries seem to be pursuing their own policies. Several countries have adopted, or are considering, an incremental tax on what are deemed excessive profits in other countries (the diverted profits tax or its equivalents in the United Kingdom and France, for example), declaring that taxes so collected are not subject to treaty relief (it is up to other countries to provide relief from double taxation).<sup>5</sup> In the Trump administration era in the United States, there may be serious consideration of addressing border adjustability, territorial and related elements,<sup>6</sup> as the EU is evolving toward the formulary allocation mechanism (the CCCTB).<sup>7</sup>

In short, the global tax world is plainly in a state of transition. The ultimate reality may be far different than was anticipated by the BEPS Project. It is this seemingly ever-expanding populism in the efforts of countries to protect and enhance their own tax bases that is commonly viewed to indicate the level of cross-border tax disputes on the horizon.

### 3. Dispute Dockets

An increasingly difficult issue relating to competent authority processes throughout the world is the amount of time required for resolution (and the costs of such lengthy periods) and the ever-expanding inventory of cases, again, on a global basis. In the aggregate, these elements indicate that the processes are not working in an efficient manner.

There are a variety of reasons contributing to the time required to resolve these matters, including inadequacy of case development, complexity of fact patterns, infrequency of face-to-face government contacts, workload and related matters. OECD and individual country tax officials have indicated the need to streamline the competent authority process, including simplification of the pertinent transfer pricing rules.

In 2009, the OECD began accumulating competent authority statistics for 2006 and 2007.<sup>8</sup> These statistics indicated an increase in the overall docket of 13% from

5. C. Lowell, M. Martin & M. Levey, *International Transfer Pricing: OECD Guidelines* para. 14.64(1)(d) (Thomson Reuters 2016).
6. M. Feldstein, *The House GOP's Good Tax Trade-Off*, *The Wall Street J.*, at A13 (6 Jan. 2016).
7. J. Kirwin, *EU Unveils Action Plan to Overhaul Corporate Tax Law. Transfer Pricing Rules to Ensure Profits Taxed Where Earned*, 24 *Tax Mgmt. Transfer Pricing Rep.* 179 (25 June 2015).
8. *OECD Issues Statistics from 30 Nations on Mutual Agreement Procedure Cases*, *BNA Daily Tax Rep.* (30 Sept. 2009), at I-5. The statistics are available on the OECD website. See also, *Competent Authorities' Inventories Growing Despite Completing Cases, APAs, Officials Say*, *BNA Daily Tax Rep.*, at I-4 (11 Dec. 2009).

2006 to 2007 (with the results broken down by country). In OECD countries, the average time for completion in 2007 was 18.9 months, a 14% decrease as compared with 2006. By 2011, OECD competent authority dockets had generally increased in every intervening year, with the increase in processing time averaging around 25% in 2011 and 2012.<sup>9</sup>

The OECD's mutual agreement procedure statistics for 2013 reveal the number of cases initiated by OECD member countries for each year from 2006 through 2013.<sup>10</sup> In this period, the inventory grew by almost 85% (to 1,910 cases filed, from 1,036).<sup>11</sup> Data for the number of pending cases at the end of the reporting periods reflect a growing inventory, with aggregate cases expanding by almost 100% (to 4,566, from 2,352). The average time for resolution expanded to 23.57 months in 2013 (from 22.10 months in 2006), which, at least, reflects a process that has remained reasonably stable. The same trend continued in 2015,<sup>12</sup> reflecting the common perception that the post-BEPS world will generate significant additional disputes needing resolution.

The OECD statistics do not include inventory of non-member countries, which the authors know from experience and anecdotal evidence is significant, at least in certain countries. In addition, the European Union has a mandatory arbitration process, although it is unclear whether this involves a material volume of cases.<sup>13</sup> Finally, the OECD statistics do not reflect the percentage of full relief that is provided in competent authority proceedings.<sup>14</sup>

Criticisms of the deliberate pace of case resolution and ever-expanding inventories is fair enough, although it is not apparent that the process is any slower than administrative appeals or judicial resolution of cases of comparable complexity in most countries. There is also no real alternative for treaty-country disputes.

9. *MAP Inventory Increased 15 Percent for OECD Members Between 2010, 2011*, 21 *Tax Mgmt. Transfer Pricing Rep.* 1192 (18 Apr. 2013); *MAP Inventory Rose Nearly 6 Percent for OECD Members Between 2011, 2012*, *BNA Daily Tax Rep.*, at I-1 (4 Sept. 2013).
10. OECD, *Mutual Agreement Procedure Statistics for 2013*, <http://oecd.org/ctp/dispute/map-statistics-2013.htm>. See generally M. Herzfeld, *MAP Statistics Tell a Sorry Tale*, *Tax Notes* 236-4 (9 Dec. 2014).
11. The largest filings in 2013 occurred in the United States (403), Germany (267), and France (216).
12. OECD, *OECD Releases Mutual Agreement Procedure (MAP) Statistics for 2015* (12 May 2016), <http://www.oecd.org/tax/oecd-releases-mutual-agreement-procedure-map-statistics-for-2015.htm> (an average cycle time decreased to 20.47 months). See generally M. Herzfeld, *Mutual Agreement Procedure Stats: The BEPS Effect*, *Worldwide Tax Daily* 240-1 (14 Dec. 2016).
13. See section 11.1.1.
14. In contrast, US statistics reflect that complete relief was provided in 86% of US-initiated adjustments and 46% of foreign initiated matters. *U.S. Competent Authority Statistics Covering 15 Months Ended 12/31/13*, reprinted in 23 *Tax Mgmt. Transfer Pricing Rep.* (29 May 2014). See also C. Lowell & M. Martin, *U.S. International Taxation: Practice & Procedure* section 9.06(4)(n). The US statistics are also noteworthy in reporting that 94% of pending cases were foreign-initiated. The average processing time was also approximately 18 to 20 months.

#### 4. Coming Reality of Dispute Resolution

Predictability is an essential element of encouraging cross-border trade, foreign direct investment and economic growth (the economic foundation). The business community is confronted today with a seemingly ever-expanding spectre of double or multiple taxation. This is starkly reflected in the continually mounting inventory of competent authority cases, as noted above.

The reasons for such growth can be boiled down to competition between countries for tax base. Whether this is characterized as *residence* versus *source*, transfer pricing or otherwise, the simple reality is that the risks of double taxation and prolonged tax controversies are increasing, which negatively impacts all parties to the process, as well as the economic foundation. This reality is underscored by epochal substantive and transfer pricing changes on the near horizon from the BEPS Project. The central focus of the BEPS Project is the ETR strategies of MNEs, as noted above. The current EU State aid process stands as mute testimony to the multilateral nature of the underlying issues: countries and MNEs each compete – in their own self-interest – for tax base. Tax is, after all, revenue on one side (countries) and expense on the other (MNEs).<sup>15</sup>

The net effect of the BEPS Project is likely to be as follows:

- countries: devotion of additional resources to tax base protection; and
- MNEs: focus on effective tax rate planning to take maximum advantage of available regimes to minimize taxation and risks of double taxation (the nature of the BEPS Project, involving a loss of predictability, provides stark encouragement for MNEs to take the most aggressive possible approaches using the available regimes, then seeing what happens in other countries and ultimately the availability of dispute resolution processes – the absence of effective processes will be a factor in developing ETR Strategies).

In short, predictability of tax base results is a serious issue for countries and MNEs alike. The only realistic antidote would be to make dependable and independent treaty-based mandatory dispute resolution a cornerstone of the BEPS Project. At present, the OECD anti-BEPS efforts are focused on the use of a mechanism (mandatory binding arbitration) that is anathema to many countries, as will be discussed below.

#### 5. Existing Dispute Resolution Systems Are Not Consistently Functional

The reality of the international tax world is that (i) unilateral actions by tax authorities pose serious double taxation problems when viewed from an overall MNE and other country tax base perspective (i.e. when one country seeks to tax income reported in another country), (ii) domestic resolution processes in virtually all countries are inefficient and expensive, and do not resolve bilateral or double taxation matters and (iii) treaty-related procedures work efficiently between only a few countries.

15. Lowell, Martin & Levey, *supra* n. 5, para. 2.06(4)(b).

Regarding competent authority processes, there are numerous reasons why they are not functioning efficiently or successfully in many situations, including:

- the treaty in question may not have a MAP article, so there is no competent authority process framework for disputes between countries;
- many countries have little or no experience with such processes;
- MNEs have no right to initiate the MAP process, as opposed to requesting it, which is left to the discretion of the competent authorities;
- MNEs have no right to be heard in the process, nor to be informed about the proceedings (although, as a practical matter, this is customary);
- the competent authorities are under no obligation to ultimately reach an agreement;
- MNEs have no legal remedy, other than the national courts, to enforce resolutions where one country refuses to be bound or otherwise declines implementation; and
- there are typically no staged levels of potential resolution involving alternative dispute resolution (ADR) techniques, which have been successful in other areas.

#### 6. Means of Addressing the Need for Functionality

In the hope of addressing these concerns about dispute resolution efficiency, a variety of approaches have been taken by some countries or considered by others in recent years.

##### 6.1. Arbitration

A solution often suggested as a means of resolving concerns about competent authority procedures is arbitration. An arbitration arrangement would presumably involve reference of a competent authority case to an arbitrator or arbitrators for purposes of rendering a binding determination. The necessity of such a mechanism reflects the reality that such processes do break down or become stalemated.

The possibility of using arbitration in tax disputes has been recognized for some time in the work on the OECD Model Convention. In 1977, the Commentary on Article 25 mentioned the possibility of “independent arbitrators” who could be asked to give “advisory opinions”, and a later version of the Commentary on Article 25 also referred to the possible “solution” of arbitration.<sup>16</sup> Proposed updates were made in 1984.<sup>17</sup> In the interim, a number of changes

16. See former para. 4.170 *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

17. The 1984 OECD report contained a discussion of the use of arbitration procedures to ensure that corresponding adjustments would be made consistently. OECD, Committee on Fiscal Affairs, *Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure; The Taxation of Multinational Banking Enterprises; The Allocation of Central Management and Service Costs* (OECD 1984) (the 1984 Report). After discussing some of the advantages and disadvantages of arbitration, the 1984 Report concluded that “for the time being” it was not appropriate to recommend an arbitration procedure.

took place, including the EU Arbitration Convention (discussed below), trade agreement dispute resolution procedures, bilateral tax treaty provisions and the dramatic increase of interest in transfer pricing questions, with their attendant potential for tax controversy. In light of these developments, it was concluded that it seemed appropriate to analyse again and in more detail whether the introduction of a tax arbitration procedure would be an appropriate addition to international tax relations.

In August 2004, the OECD issued a draft competent authority procedure report<sup>18</sup> urging improvements in mutual agreement procedures under the OECD Model, including the potential use of arbitration.

In the 2008 update of the OECD Model, an arbitration provision was included via the addition of a new paragraph 5 to article 25. It requires arbitration if the competent authorities cannot reach agreement after two years; then, at the insistence of the taxpayer, mandatory binding arbitration may be instituted on issues preventing agreement and the competent authorities will be bound by the arbitral decision. The case would remain within the MAP provisions of the applicable treaty. In other words, the arbitration mechanism is a means of breaking a deadlock between the competent authorities, while resolution remains a state-to-state matter.

An arbitration decision is binding on both contracting states, with paragraph 5 providing that the decision “shall be implemented” notwithstanding any domestic statute of limitations unless the taxpayer “does not accept the mutual agreement that implements the arbitration decision”.

Tax treaties based on the OECD Model, of course, may or may not include an arbitration provision, and the contracting states also may choose to deviate from the Model language regarding the terms of the arbitration.

The UN adopted generally similar procedures. Its Model is administered within the UN Committee of Experts on International Cooperation in Tax Matters. With respect to arbitration,<sup>19</sup> article 25 of the UN Model<sup>20</sup> reflects differences of opinion with respect to the benefits of arbitration via two alternative articles, one without arbitration (article 25A) and one with (Article 25B). Article 25A is the same as the previous version of article 25, while article 25B is similar to article 25 of the OECD Model except that the MAP must have been unresolved for three (as compared to two) years since initial presentation of the case by the taxpayer and:

- a competent authority, not a taxpayer, submits the matter to arbitration; and

- when an arbitral decision has been reached, the two competent authorities may still agree not to implement the decision.

While arbitration processes are included in the OECD and UN Models, and several countries have arbitration clauses in certain of their treaties,<sup>21</sup> such provisions have been made operational in only a limited range of situations. Even where an arbitration clause exists, disputes rarely get to arbitration – suggesting that the principal impact appears to be encouragement of the competent authorities to reach agreement before their cases become eligible for arbitration.

There are three basic forms of tax arbitration:

- *independent opinion*: independent arbitrators decide the merits of the case;
- *last best offer* (commonly referred to as so-called baseball arbitration, as such an approach has been used for disputes in US Major League Baseball): each competent authority offers a possible solution and the arbitrators choose one or the other, rather than making their own decision. Such an approach is often believed to encourage presentation of more reasonable proposals, as extreme positions are more likely to be rejected by the arbitrators; and
- *institutional*: sometimes referred to as “institutional”, this form of arbitration could be implemented via an international organization with established procedures (there are several, including the International Chamber of Commerce). This type of process would rely on pre-established institutional procedures, which would ensure the arbitration proceedings begin and move along in a timely manner. In this regard, the institution could provide guidance on all elements of the process (frankly, addressing the objections noted below). The institution should have its own rules, but others – devised by the parties or such organizations as the UN Commission on International Trade Law (UNCITRAL) – could be used. The institution could also provide draft clauses and lists of qualified arbitrators.

While institutional arbitration has potential, there is limited experience in the context of country-to-country proceedings. On the other hand, tax issues have arisen in investor-state and commercial arbitrations handled via institutional processes under certain bilateral investment agreements and other treaties.

There is experience with arbitration in the international taxation arena that provides a base for optimism that global processes can be developed.

18. OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishment – Part 1 (General Considerations)* (OECD 2 Aug. 2004).

19. UN, Committee of Experts on International Cooperation in Tax Matters, *Resolving Issues That Prevent a Mutual Agreement: Supplementary Mechanisms for Dispute Resolution – Subcommittee on Dispute Resolution: Background Note* (2008), available at [http://www.un.org/esa/ffd/wp-content/uploads/2014/10/4STM\\_EC18\\_2008\\_CRP6.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/4STM_EC18_2008_CRP6.pdf).

20. *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2011), Models IBFD.

21. Only approximately 5% of treaties in place contain an arbitration mechanism as of 2014. W.F.G. Wijnens & J.J.P. de Goede, *UN Model in Practice 1997-2014*, 68 Bull. Intl Taxn. 3, at 118 (2014), Journals IBFD. See generally J. Kollman, P. Koch, A. Majdanska & L. Turcan, *Arbitration in International Tax Matters*, 77 Tax Notes Intl. 13, at 1189 (30 Mar. 2015) (summarizing a January 2015 conference on this subject at Global Tax Policy Center at the Vienna University of Economics and Business).

### 6.1.1. Arbitration Convention: An arbitration procedure is included in the European Union

The Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (the Arbitration Convention) was ratified in 1994.<sup>22</sup> It went into effect on 1 January 1995, to be effective for five years, but has been extended.<sup>23</sup>

Arbitration under the Convention is used when the competent authorities cannot agree on a transfer price that eliminates double taxation. If the competent authorities do not reach an agreement eliminating double taxation in two years, an advisory commission will be set up to decide the issue. The commission must express an opinion within six months. The competent authorities then must act within six months to eliminate double taxation; if they do not, the decision of the commission will take effect.<sup>24</sup>

The Arbitration Convention does not apply if either of the taxpayers is subject to a serious penalty resulting from the adjustment, and each EU country has stated (as an attachment to the Convention) exactly what it considers a serious penalty. The serious-penalty provision apparently means that taxpayers must have clean hands to merit arbitration.

Experience with the Arbitration Convention has provided a laboratory or model for tax arbitration within the competent authority process. As of 2015, there have been hundreds of cases docketed, but only a few have produced actual arbitrations.

In January 2015, the EU Commission established a group of transfer pricing experts, the EU Joint Transfer Pricing Forum (the Forum). Its purpose is to assist and advise the Commission in finding solutions to achieve uniform application of transfer pricing rules within the European Union. It will also monitor the functioning of the EU Arbitration Convention.<sup>25</sup>

### 6.1.2. US and Canadian experience

The United States and Canada amended their tax treaty in 2007 to provide for mandatory binding arbitration in cases where the competent authorities are unable for two years or more from the commencement date (when necessary information was available) to resolve the issue under normal MAP procedures (taking effect on 15 December 2008, so that cases first became eligible for arbitration on 15 December 2010).<sup>26</sup>

The arbitration board consists of three arbitrators. Each competent authority selects one arbitrator within 60 days, and together they choose a third, who will be the chair of the arbitration board, from an approved list within 60 days. The proceedings are confidential, with non-disclosure all around. There are specific submission rules, including a resolution paper not to exceed five pages (with a supporting paper of no more than 30 pages plus annexes already a part of the competent authority process). It should be written in the form of a mutual agreement, including all issues to be resolved.

The decisional process is the last-best-offer approach (i.e. baseball arbitration). Thus, the arbitration board chooses between the two submitted resolution papers. If there are multiple issues, the board may choose between the papers for each respective issue. A determination is based on a majority vote, which will constitute a resolution by mutual agreement. The written determination does not include any findings or rationale, and so cannot serve as precedent for the future.

Experience here probably reflects the largest body of arbitral experience in transfer pricing cases. A variety of conclusions can be distilled from this experience:

- the last-best-offer approach streamlines the process, as does the limitation on submissions;
- the absence of any public resolution facilitates the process;
- like the situation under the EU Arbitration Convention, there have been relatively few cases handled through this arbitration procedure in comparison with the overall Canada-United States docket, meaning that the threat of arbitration likely facilitates resolution;
- the presence of arbitration after the two-year period inevitably facilitates the analysis, evaluation, movement and resolution of cases, as well as the resolution of internal bureaucratic issues on both sides; and
- the process provides a ready means of resolution when impasse occurs.<sup>27</sup>

22. The Arbitration Convention has been extended from 2000 through 2005. K. van Raad, *EC Arbitration Convention Extended Beyond Year 2000*, 16 Tax Notes Intl. 21 (21 May 1998). See also European Commission, *Transfer Pricing and the Arbitration Convention* (2015), [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/transfer\\_pricing/arbitration\\_convention/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/arbitration_convention/index_en.htm).

23. In March 2007, the EU Member States ratified the EU Convention extending the Arbitration Convention to new member states. 18 Member States Ratify EU Convention Extending Arbitration Convention to New Member States, *Worldwide Tax Daily* 62-1 (30 Mar. 2007). The EU Council approved a revised Code of Conduct for implementation of the convention for transfer pricing disputes in December 2009. *EU Approves Revised Arbitration Convention Code of Conduct; VAT Package to Enter into Force*, 2009 *Worldwide Tax Daily* 246-1 (28 Dec. 2009).

24. See generally Schwartz, *The European Union Arbitration Convention: Perspective on an Alternative for Double Tax Relief*, 11 Tax Mgmt. Transfer Pricing Rep. 409 (4 Sept. 2002); J.H. Guttentag & A.E. Misback, *Resolving Tax Treaty Issues: A Novel Solution*, 40 Bull. Intl. Fiscal Doc. 8/9, at 350 (1986).

25. S.-O. Lodin, *The Arbitration Convention in Practice*, 42 Intertax 3, at 173 (2014); C.J.E.A. Sporken, *Facilitating Dispute Resolution: Efforts by the EU, the OECD and Netherlands*, 24 Tax Mgmt. Transfer Pricing Rep. 1782 (28 Apr. 2015); I. Verlinden & M. Haupt, *The EU JTPF Shifts Gears on Dispute Resolution*, 22 Intl. Transfer Pricing J. 5, at 275 (2015), *Journals IBFD*.

26. Operating guidelines were released in 2010. CA: Revenue Agency, *Arbitration Board Operating Guidelines*, <http://www.cra-arc.gc.ca/tx/nnrds/2010brtrtrnbrdgdlns-eng.html>.

27. There have been arbitrations in the US Tax Court. The first case was in 1993 utilizing the so-called baseball rules, in which the tax authorities prevailed. P.J. Bergquist & E.D. Ryan, *Losing the Battle, but Winning the War: Reflections on the Apple Computer Inc. § 482 Arbitration*, 2 Tax Mgmt. Transfer Pricing Rep. 12, at 337 (20 Oct. 1993). Arbitration procedures have also been agreed on in cases that have adopted procedures other than the baseball rules *Tax Court Approves Contingent Stipulation Allowing Fujitsu to Go to Negotiations*, 1 Tax Mgmt. Trans-

**6.1.3. BEPS Action 14 Final Report**

In December 2015, the BEPS Action 14 Final Report was released on dispute resolution. In 50 pages, it declares the overriding need in the following words: “the introduction of measures developed to address [BEPS] should not lead to unnecessary uncertainty for compliant taxpayers and to unintended double taxation. Improving dispute resolution mechanisms is therefore an integral component of the work on BEPS issues”.<sup>28</sup>

This is to be accomplished by developing minimum standards with respect to treaty-related dispute resolution, rapid implementation of the standards and establishment of a robust peer-based monitoring mechanism through the OECD Committee on Fiscal Affairs to the G20. The minimum standard will:

- ensure that treaty obligations related to the MAP are fully implemented in good faith and MAP cases are resolved in a timely manner;
- ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
- ensure that taxpayers can access the MAP when eligible.<sup>29</sup>

The minimum standard will be complemented by a set of best practices. In addition, some 20 countries have agreed to mandatory binding MAP arbitration in their bilateral tax treaties (said to represent 90% of outstanding MAP cases at the end of 2013, although this figure relates to OECD cases).<sup>30</sup>

**6.1.4. Multilateral instrument**

The so-called multilateral instrument was released in late November 2016 as a cornerstone of the BEPS Project.<sup>31</sup> It is an ambitious effort of the OECD to impose its will on as many countries as possible. The explanation comprises 85 single-spaced pages, and 359 paragraphs. The multilateral instrument draft itself is 48 similar pages. The purpose of the multilateral instrument is to transpose several of the BEPS Action items, noted below, without having to go through the tedious process of amending some 2,000 to 3,000 existing treaties.

The multilateral instrument is not intended to replace existing tax treaties. Rather, it is meant to be applied alongside existing tax treaties to modify their application in a manner that implements various BEPS measures. The treaty related measures from the BEPS Project include those which provide for minimal standards, which are:

- Action 2 (hybrid mismatches);
- Action 6 (prevention of treaty abuse);

- Action 7 (avoidance of permanent establishment status); and
- Action 14 (dispute resolution, specifying binding mandatory arbitration).

Signatories of the multilateral instrument must agree to adopt the various minimum standards under the BEPS Project, subject to flexibility in the multilateral instrument regarding the approach that a jurisdiction may follow. A signing ceremony for the multilateral instrument will be held in June 2017 in Paris.

The multilateral instrument will be applicable only if both treaty partners adopt the instrument, and only to the extent that specific provisions have not been reserved or opted-out of by either party (as discussed below). Prior to ratification, the OECD will provide an opportunity for treaty partners to engage in a, hopefully, efficient process to make these determinations. There may also be necessity for individual countries to undertake parliamentary or legislative processes to approve the ratification process.<sup>32</sup>

In other words, while consistency is obviously an intended result, the multilateral instrument recognizes the reality that many countries will not agree to all of the provisions. Accordingly, countries are allowed to sign the agreement, but then opt out of specific provisions or make appropriate reservations with respect to specific treaties. This process is to be undertaken via notification of the “depository” (the OECD). Accordingly, countries will be able to make individual decisions on whether to update a particular treaty using the multilateral instrument.

Accordingly, there are a variety of initial questions to be addressed by each country, including:

- Does it intend to sign the multilateral instrument?
- Which of its treaties will be covered?
- Will its treaty partners agree?
- What provisions will be included, reserve upon or opted-out of? If there is an opt-out, the country is supposed to advise the depository of how this impacts each of its treaties. This will be a time-consuming process.
- How will it negotiate with specific treaty partners with respect to the various technical provisions of the multilateral instrument?

Regardless of whether a material number of developed or developing countries will sign the multilateral instrument,<sup>33</sup> it seems apparent that the net result will be a period of chaos in treaty relationships, as there will inevitably be, for example, (i) signers and non-signers, (ii) reservations and (iii) opt-outs.

fer Pricing Rep. 135 (7 July 1993) (arbitration proceedings activated if competent authority discussions are not successful).

28. OECD, *Executive Summaries: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, at 41 (OECD 2015).

29. OECD, *Executive Summaries*, supra n. 28, at 41-42.

30. See also Bennett, *Twenty Nations Back Binding Arbitration to Settle Tax Disputes*, 24 Tax Mgmt. Transfer Pricing Rep., at 754 (15 Oct. 2015).

31. J.P. Finet, *OECD Adopts Multilateral Instrument*, Tax Notes 229-3 (29 Nov. 2016).

32. See generally Lewis, *Multilateral Instrument Faces Challenges on Way to Success*, *OECD Official Says*, 2016 Worldwide Tax Daily 232-4 (2 Dec. 2016).

33. E.g. Bell, *U.S. Unlikely to Sign Multilateral Tax Treaty*, *Daily Tax Rep.*, at I-3 (1 Dec. 2016).

In short, the formal position of the OECD with respect to cross-border dispute resolution is that the norm should be binding mandatory arbitration.

## 7. Alternative Dispute Resolution Procedures

While there is support for binding mandatory arbitration of cross-border tax disputes within the MAP process, many countries have objected to such mandatory processes. In view of such resistance, there have also been efforts to develop alternative dispute resolution (ADR) procedures that could be steps in MAP dispute resolution short of such arbitration.

### 7.1. Objections to arbitration

Several countries have raised concerns with regard to mandatory binding arbitration for international taxation disputes, including:

- the perception of a loss of sovereignty (i.e. the ability of a tax authority to say “no” to a proposed resolution);
- the expectation that independent arbitrators, perceived by all countries as being truly expert and independent, may be difficult to identify;
- possible high and unforeseen costs;
- loss of control to participate in crafting solutions for cases deemed important to specific countries;
- additional time for cases to achieve resolution;
- expansion of the scope of the issues before the arbitral panel (so-called scope creep);
- confidentiality of the results of the process;
- enforceability of an award against reluctant countries; and
- scepticism about the viability of the process absent a broad embrace of such procedures.

This list is intended to be merely illustrative. Many of these objections have been raised by developing countries, often reflecting experience in the resolution of international tax issues via investment agreement arbitrations.<sup>34</sup> Such obstacles have existed in all non-tax contexts in which effective, and broadly embraced ADR (including mandatory arbitration), has been developed. There is no apparent substantive reason why this cannot also be done in the area of international taxation, as discussed below.

If these obstacles are to be overcome, there needs to be a frank recognition of their nature, followed by a process of identifying ways to alleviate the underlying anxieties. For example the most common objection to arbitration is the loss of “sovereignty” by the country in question. This term can have different connotations, although in the present context it most likely means that a country would surren-

34. M. Herzfeld, *Looking Beyond Tax Treaties to Address Cross-Border Tax Issues*, 79 *Tax Notes Intl.* 642 (Aug. 245, 2016); P.K. Sidhu, *Is the Mutual Agreement Procedure Past Its ‘Best-Before Date’ and Does the Future of Tax Dispute Resolution Lie in Mediation and Arbitration?*, 68 *Bulletin Intl. Taxn.* 11, at 590, sec. 4 (2014), *Journals IBFD*; *Tax Disputes Out of Investment Pacts*, *Business Standard* (15 Jan. 2016). See also P. Sukhraj, *Cairn in Arbitration with India to Settle \$ 1 Billion Tax Dispute*, 25 *Tax Mgmt. Transfer Pricing Rep.* 338 (July 14, 2016) (the investment arbitration claim being handled by the Permanent Court of Arbitration at The Hague in the Netherlands).

der its ability to say “no” to a potential resolution deemed not in its best interests.

### 7.2. UN Secretariat focus on alternative dispute resolution

These dispute resolution issues were addressed by the Secretariat of the UN Committee of Experts on International Cooperation in Tax Matters (Committee of Experts) in a paper on dispute resolution presented at the annual meeting in Geneva, Switzerland during the week of 19 October 2015. In 188 paragraphs spread over 55 single-spaced pages, the Secretariat framed a way forward to develop a functioning, globally embraced dispute resolution process.<sup>35</sup>

This UN Paper contains a detailed background discussion of the need for international tax dispute resolution processes, as well as the pros and cons of existing models used in tax and non-tax dispute resolution – including a matrix of alternatives, such as expert determination, mediation/conciliation (which forms of ADR are discussed below); institutional, independent or last-best-offer or baseball arbitration; traditional MAP; and litigation).

The Committee of Experts approved the formation of a subcommittee to consider and report back to the Committee on a variety of issues, including:

- options for ensuring the MAP procedure under article 25 (in either of its alternatives in the UN Model) functions as effectively and efficiently as possible;
- other possible options for improving or supplementing the MAP procedure, including the use of non-binding forms of dispute resolution (such as mediation);
- the exploration of issues associated with agreeing to arbitration clauses between developed and developing countries; and
- the need or otherwise for any updates or improvements to the Guide to the MAP under tax treaties.

The subcommittee was composed of 30 members, from both developed and developing countries, global finance organizations, academics, civil society, international organizations and the OECD. Its report to the Committee was presented at the October 2016 session (the 2016 Report), which reflected:

- growing political and economic uncertainties, including the anticipated growth of tax controversies in all countries as the need for tax base protection and expansion continues to grow;
- uncertainty concerning domestic implementation of the BEPS Actions by countries;
- the expected increase in availability of information on the transfer pricing practices of MNEs (due to

35. See generally T. Welty, L.L. Gavioli, M.P. Thomas & C.H. Lowell, *Preparing for a Tsunami of International Tax Disputes*, 80 *Tax Notes Intl.* 12, at 1047 (21 Dec. 2015); D. Spencer, *The U.N. Tax Committee, Developing Countries, and Civil Society Organizations* (Parts 1 and 2), 26 *J. Intl. Taxn.* 42 (Dec. 2015), 27 *J. Intl. Taxn.* 44 (Jan. 2016) (providing a detailed explanation of the evolving role of civil society organizations or NGOs).

- country-by-country reporting and increased use of exchange of information provisions);
- the reality that developing countries are increasingly putting in place sophisticated transfer pricing legislation and are creating large business units within tax administrations for tax base protection; and
  - many countries have limited or no experience with MAP processes. This may mean that such countries are potentially losing tax revenue by not entering into a bilateral or multilateral tax dispute resolution framework.<sup>36</sup>

Accordingly, the 2016 Report suggested there is a need to return to basics and define the meaning of each dispute resolution mechanism in order to ensure that every party to a dispute understands what is meant when talking about ADR, MAP, mediation, arbitration and expert evaluation/determination, which could become an update of the UN Guide to the Mutual Agreement under Tax Treaties<sup>37</sup> with a more case study-oriented approach, including examples of all documents to be prepared during a MAP for illustration purposes. It could also lead to a UN handbook on dispute resolution.

### 7.3. Forms of alternative dispute resolution

In situations where the parties to a MAP procedure have unequal experience in competent authority matters, struggle to reach harmonious agreement, or otherwise could benefit from having procedural steps available prior to a binding arbitration process, there are a variety of processes that could be developed for utilization (by the UN or the OECD, or in specific bilateral contexts). In this regard, it may be that guidance for transfer pricing or other cross-border tax issues could be found in ADR procedures developed in non-tax areas.<sup>38</sup> Specifically, such ADR processes could provide non-binding advice on a resolution that is consistent with the treaties involved and pertinent taxation principles.

The views of tax administration officials, predictably, vary from country to country. In some countries, tax officials have expressed significant interest in such processes.

In any event, it certainly seems that the increasing level of cross-border tax controversy should lead, eventually, either to streamlined competent authority procedures that can resolve disputes between tax administrations in a timely and efficient manner or to some type of tax ADR procedure.

36. UN, Committee of Experts on International Cooperation in Tax Matters, *Coordinator's Report on Work of the Subcommittee on the Mutual Agreement Procedure – Dispute Avoidance and Resolution* (Twelfth Session, Geneva, 11-14 Oct. 2016).

37. UN, Committee of Experts on International Cooperation in Tax Matters, *Guide to Mutual Agreement Procedure under Tax Treaties* (Oct. 2012).

38. D. Ernick, *BEPS, Broken Promises, and What the OECD Can Learn from the WTO About Dispute Settlement Procedures*, 43 *Tax Mgmt. Intl. J.* 624 (9 Oct. 2014) (reviewing the processes used by the World Trade Organization to resolve trade disputes).

In this regard, there are a variety of ADR processes that are commonly utilized in non-tax contexts.<sup>39</sup>

#### 7.3.1. Expert determination

An expert determination could occur when a tax authority concludes that its position in a potential transfer pricing or other matter would benefit from review by an independent person. This could take place before or during a competent authority proceeding. If a competent authority process is pending, such consultation could also involve one or both tax authorities on a non-binding basis. A possible situation is presented in Example 1.

##### Example 1

GasCo is based in Country A and has operations in many countries, including Country B through a wholly-owned subsidiary (FCo). The business conducted by GasCo and FCo produced a combined income of EUR 100 in Year 1, of which EUR 5 is reported in Country B and EUR 95 in Country A for corporate income tax purposes. The transfer pricing results in both countries are reflected in appropriate transfer pricing documentation, in both cases using a one-sided TNMM methodology.

The Country B tax authorities examine FCo and, after reviewing the combined income information, believe that the FCo income should be EUR 50. Those tax authorities have discussed this position informally with FCo, which has presented the report of an expert confirming the FCo documentation supporting the as-reported result of EUR 5.<sup>40</sup>

In such a situation, the Country B tax authorities may decide that they would benefit from an independent analysis of its position and that of FCo. Accordingly, it could engage an expert for this purpose. The engagement could be limited to factual or legal matters, or both (and would presumably not address procedural matters). The expert could be engaged to review documents only, or meetings could be scheduled. It could also result in an oral or written report, as may be appropriate to the Country B tax authorities. In such an informal process, the expert advice should be delivered in an efficient, timely manner. Costs would be those of the tax authorities.

From Country B's perspective, such a process provides an external check on its internal determination. The external analysis could also be helpful in any future discussions with the taxpayer; a domestic appeals or litigation process; or a competent authority proceeding.

The same type of expert determination process could be undertaken on a collegial basis between the Country B tax authorities and FCo. If a competent authority proceeding were commenced, such a process could also be followed by both tax authorities. In such a situation, the determination could be binding or advisory. Costs could be borne as determined by the parties.

Such a process is used in some countries. For example in the United Kingdom, the competent authority (HMRC) allows an ADR process in which a specialist is brought

39. T. Welty, L.L. Gavioli, M.P. Thomas & C.H. Lowell, *Lessons from U.S. Dispute Resolution Processes*, 82 *Tax Notes Intl.* 1039 (21 Mar. 2016).

40. Lowell, Martin & Levey, *supra* n. 5, para. 12.05(6)(d)(i).

into the proceedings to facilitate the negotiations.<sup>41</sup> The specialist is not necessarily an expert in taxation, but in ADR. The competent authority maintains responsibility for resolution (sovereignty) as negotiations proceed with the independent party. The proceedings may also be more efficient and, consequently, less costly. Further, the taxpayer's right to appeal is maintained. According to HMRC, the benefits of such ADR include:

- the impetus towards resolution via a fresh approach;
- issues can be “unpacked” and alternatives explored on a confidential basis, with a potential lasting benefit beyond the discussions on the dispute itself; and
- even if the dispute is not resolved, respective positions can be sharpened and, possibly, prepared more effectively for litigation.

HMRC reports that most such ADR events have been concluded in one day, and the average elapsed time from application to resolution was 24 weeks in large or complex cases and 61 days in small and medium-sized enterprise cases. This is a significant contrast with the multi-day hearings and 70-week average of the process of appeal for such cases.<sup>42</sup>

In short, an expert determination process can be flexible, efficient and timely. As compared with arbitration, there is little chance of “jurisdictional creep” (i.e. the expansion of the scope beyond the initial issues). It could also be a useful first step in a process that might otherwise become more formal and confrontational.

### 7.3.2. Mediation

Mediation is typically appropriate when controversy has been joined.<sup>43</sup> It could be at an examination stage between tax authorities and an MNE (as in Example 1), although it is more likely to be used once a domestic appeal or bilateral competent authority process is engaged.

Mediation normally involves a trained mediator, and is intended to facilitate negotiation and a more objective self-analysis from the parties. In this regard, the mediator is regarded as helping the parties reach agreement, as opposed to having the authority or responsibility to make binding decisions.

Mediators often engage in a form of shuttle diplomacy between parties, helping them evaluate the strengths and weaknesses of their respective cases without the other party's presence. The mediator's role is often to broaden dispute resolution options, allowing the parties to craft a

solution to amicably resolve the matter in question. The advantages of mediation are that the parties may not have to meet; outside advisors can be present or not; and the process may be resolved efficiently and at reasonable cost.

The mediator can be an individual respected by all parties, but not a member of either the tax administration, the taxpayer or the taxpayer's advisors. The role of the mediator is to evaluate the submissions and communications between the parties and recommend an appropriate non-binding resolution, including an explanation of the bases of such proposal. The parties can then use the recommendation as a basis for seeking a final binding resolution. Presumably, the mediator's recommendation would be private (as an element of the competent authority process protected by treaty secrecy).

While there would be an inevitable range of issues that would need to be addressed with respect to such a process,<sup>44</sup> it, again, provides a potentially useful intermediary step between the normal MAP process and binding arbitration.

### 7.4. There is room for optimism

While there is anxiety in all quarters of the international tax world concerning the development of efficient dispute resolution procedures, it is encouraging that there is focus among tax authorities and MNEs alike to develop such processes. In this regard, many other groups are also focused, including the UN, World Bank, International Monetary Fund, civil society, OECD and International Chamber of Commerce.

## 8. Relevance of Dispute Resolution to ETR Strategic Planning

In a world in which the list of countries zealously seeking to protect their tax bases, making proposals to increase domestic tax revenues (e.g. following the BEPS Project or their own unique base protection measures) continually expands, it seems apparent that in evolving their ETR strategies, MNEs will need to take into account the potential cross-border disputes that may evolve from any changes in overall structuring (which will be addressed in Part III of this series).

Consider the situation in Example 2:

### Example 2

DomCo is based in Country X. Its international operations are conducted through a wholly-owned subsidiary based in Country Y (HoldCo), which provides a regime that enables material amounts of the global income (outside Country X) to be taxed at low effective tax rates. In order to take advantage of this regime, HoldCo utilizes a range of royalty, interest and hybrid structures. In addition, local country activities are conducted by affiliates pursuant to one-sided transfer pricing arrangements resulting in residual profits inuring to the benefit of HoldCo, and subject to its planning structures.

In recent years, the local country affiliates have encountered significant transfer pricing challenges from local country tax authorities, asserting a variety of permanent establishment, profit

41. UK: HM Revenue and Customs, *Tax Disputes: Alternative Dispute Resolution* (2014), <http://www.gov.uk/tax-disputes-alternative-dispute-resolution-adr>.

42. Lloyd & Dennis, Tax Journal “Q&A: How Is ADR Working for Large Businesses?” (5 Feb. 2015).

43. There are various versions of mediation that could be useful in certain circumstances. So-called early neutral evaluation is similar to mediation, but is undertaken with maximum informality early in a dispute resolution process. It could be useful to establish parameters for eventual resolution. Specifically, it could facilitate the parties' taking realistic appraisals of their respective positions. Such a process should be speedy and relatively inexpensive. “Conciliation” involves a conciliator playing a more direct role in resolving the dispute, including making proposals for resolution.

44. Lowell, Martin & Levey, *supra* n. 5, para. 12.05(6)(d)(ii).

sharing, general anti-avoidance and related theories. Country Y has also indicated that its regimes providing benefits to HoldCo will be revised to better coordinate with global tax policy developments. Finally, there has been a change in political leadership in Country X that is expected to result in a material evaluation of applicable Country X tax policies.

In such a situation, it is to be anticipated that DomCo and HoldCo will be undertaking appropriate consideration of whether their ETR strategies need to evolve. In this regard, they may be considering a variety of potential planning approaches, including:

- replacement of the Country X planning to take advantage of new opportunities in the Country X tax reform, and to avoid incremental limitations;
- evolution of the Country Y structure of HoldCo, replacing it with an alternative structure – perhaps a low ETR option, such as a patent box (which could be in Country X);
- such planning steps may be accompanied by:
  - migration of “mind and management”;
  - contribution of IP rights to a new entity (and consequent removal from other entities or countries); and/or
  - increasing the substance of certain operations in specific countries, such as HoldCo in Country Y; and
- similar considerations may apply with respect to finance, IP ownership and other elements of the prior DomCo ETR strategy.

In each such situation, the ETR strategic team will need to address multiple considerations in relation to structuring, ETR, legal mechanics, risk profile (in all countries, including transfer pricing, exit taxes and intangible transfers), and the inevitable list of considerations, which will be addressed in Part III of this series.

As such elements are addressed, a normal step in the process will be to address appropriate opinions (internal or external) concerning the respective tax exposures, as well as considerations relating to the country-by-country and other forms of documentation that any such restructuring will require. It may also be appropriate to take the analysis one step further to address likely challenges from the various tax authorities, including how such potential controversies can be handled through a dispute resolution process. Such challenges may be asserted on principles that may be plainly inconsistent with OECD, UN or home country guidelines. Appropriate considerations could include the efficiency of treaty or non-treaty processes in the countries in question.

### *Part III of this series*

Part III of this series will address the opportunities offered by the epochal change occurring in the international tax world.