Release of BEPS discussion draft: Make Dispute Resolution Mechanisms More Effective

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In brief

On December 18, 2014, the Organisation for Economic Co-operation and Development (OECD) released its work on Base Erosion and Profit Shifting (BEPS) Action 14: Make Dispute Resolution Mechanisms More Effective (the “Discussion Draft” or “Draft”). During the last decade, the OECD has issued guidance to improve dispute resolution mechanisms, including the Manual on Effective Mutual Agreement Procedures (MEMAP) in 2007. Today’s global tax controversy environment, however, calls for a more focused effort to improve the effectiveness of the Mutual Agreement Procedures (MAP) in resolving treaty-related disputes. The Draft acknowledges that it does not present a consensus view of the Committee on Fiscal Affairs and the discussion only provides proposals and options to arrive at measures that will constitute a minimum standard to which participating countries will commit. Further, the Draft acknowledges that a universal adoption of mandatory binding arbitration would be difficult, if not impossible, in the immediate term to achieve, and therefore suggests the need for complementary solutions that are practical and impactful. The Discussion Draft specifically focuses on obstacles that prevent resolving disputes and identifies corresponding measures and options to address such obstacles. Taking a holistic view, the Draft should be read in the context of a three-pronged approach that would improve resolution of disputes through MAP. This three-pronged approach would: (i) consist of political commitments to effectively eliminate taxation not in accordance with the tax convention; (ii) provide new measures to improve access to MAP and improved procedures; and (iii) establish a monitoring mechanism to check the proper implementation of the political commitment.

The political commitment and the measures to improve MAP are grounded in four principles that form the basis of the OECD’s recommendations. These four principles are the framework of the Discussion Draft:

1. Ensuring that treaty obligations related to MAP are fully implemented in good faith
2. Ensuring that administrative processes promote the prevention and resolution of treaty-related disputes
3. Ensuring that taxpayers can access MAP when eligible
4. Ensuring that cases are resolved once they are in MAP
Specific measures that will implement the political commitment will be determined as part of future work on Action 14. Such measures will likely be supplemented by a monitoring process that will evaluate the functionality of MAP and include an overall assessment as to the commitment made by individual countries. This monitoring process, while not described in the Discussion Draft, is expected to be performed by a select forum of competent authorities.

In detail

The OECD’s Action Plan set forth Action 14 to make dispute resolution mechanisms more effective. Recognizing that actions to counter BEPS need to be complemented by improvements to the effectiveness of MAP, the Action Plan made a commitment to examine and address obstacles that preclude countries from resolving treaty-related disputes. This effort included consideration as to the absence of mandatory and binding arbitration provisions in the majority of treaties.

The Discussion Draft is the OECD’s effort to overcome traditional obstacles to MAP by recommending options to improve dispute resolution mechanisms. The Draft accomplishes this objective by setting forth four principles that build the foundation of the paper. First, the Discussion Draft identifies the obstacles that prevent the principle from being implemented, and secondly, it recommends options as to how such obstacles could be addressed or eliminated.

Ensuring that treaty obligations related to MAP are fully implemented in good faith

The absence of an obligation to resolve MAP in Article 25 of the OECD Model Treaty may, in itself, preclude full implementation of treaty-related disputes, and accordingly, the Discussion Draft proposes that Commentary to Article 25 should emphasize that MAP is an important obligation and is actually an extension of a relevant tax treaty. Further, participating countries are encouraged to include paragraph 2 of Article 9 in tax treaties – and utilize the multilateral instrument in Article 15 – to avoid economic double taxation that would otherwise result in the absence of the Article. These two solutions, according to the Draft, would aim to remove obstacles that prevent the full implementation of Article 25 in good faith.

Comment: The additional Commentary to Article 25 would help clarify that the term “shall endeavour” to resolve MAP actually equates to an explicit obligation on the part of competent authorities to seek to resolve cases in a “principled, fair, and objective manner, on its merits” and in accordance with applicable international tax principles. This clarifying language is an important step towards making it clear that competent authorities have an affirmative obligation to ensure that MAP is fully implemented in good faith.

Ensuring that administrative procedures promote the prevention and resolution of treaty-related disputes

Appropriate tax administrative processes are imperative to ensuring competent authority mandates are executed in an effective and efficient manner. The Discussion Draft identifies a number of administrative obstacles that may impede the resolution of MAP cases and correspondingly suggest certain best practices. This includes, but is not limited to, ensuring competent authority is autonomous from the audit and exam function (and thereby objective), engaging sufficient resources, and eliminating performance indicators that are based on sustained audit adjustments or tax revenues collected.

Moreover, to ensure that audit settlements do not block access to MAP, the Discussion Draft encourages participating countries to discontinue the practices that would preclude taxpayers from invoking MAP where an audit settlement has been concluded, or alternatively, create notification procedures which would require the taxpayer to notify the competent authorities of the Contracting States to the treaty at hand.

The Discussion Draft also recognizes that bilateral Advance Pricing Agreements (APA) are an important alternative dispute resolution option to increase certainty, decrease the risk of double taxation, and proactively prevent transfer pricing disputes. Hence, participating countries are encouraged to implement bilateral APA programs that are inclusive of procedures that would permit a taxpayer to request assistance for multiple-year issues (including a roll-back of agreed approaches to prior APA periods), which would allow for more efficient use of competent authority resources and preclude duplicative MAP requests.

Comment: The Discussion Draft’s focus on administrative processes that improve the prevention and resolution of disputes is a work stream being performed in tandem with the Forum on Tax Administration (FTA) as part of its Multilateral Strategic Plan on
Mutual Agreement Procedures: A Vision for Continuous MAP Improvement (the Strategic Plan). One point of focus, by both Action 14 and the Strategic Plan, is determining best practices that will ensure there is global awareness of the impact of certain audit functions with respect to international matters. This commitment is an important effort at improving processes throughout the entire tax controversy and dispute resolution life cycle.

Further, in addition to the APA alternative, countries should consider developing and improving other dispute resolution options, such as administrative appeals, domestic mediation, and domestic arbitration to potentially resolve more disputes before they proceed on to MAP.

**Ensuring that taxpayers can access MAP when eligible**

Many of the primary obstacles to the resolution of treaty-related disputes are corollary to the treaty obligations that provide access to MAP. According to the Discussion Draft, it is foreseeable these obstacles will be significantly compounded by the BEPS work and the forthcoming guidance that will promulgate more stringent international tax standards potentially altering the global tax system and may result in incongruent interpretation and application of the standards by local jurisdictions.

The key obstacles to MAP access and the options proposed by the Discussion Draft, include but are not limited to, improving the simplicity of access to and use of MAP, developing guidance on the content of requests for MAP assistance to avoid excessive or onerous requests, clarifying the availability of access to MAP in situations where an anti-abuse provision is applied, clarifying the relationship between MAP and domestic law remedies, providing guidelines on time limits to access MAP, and clarifying issues related to self-initiated foreign adjustments and MAP.

**Comment:** The effort to address obstacles to MAP access is an important initiative as auditors in certain countries are increasingly raising serious roadblocks where a taxpayer indicates a desire to pursue MAP. The parallel work of Action 14 and the Strategic Plan will cohesively address practical and legal impediments to MAP access – the result of which should have a measurable impact. This is particularly important in light of the BEPS work and the impact that domestic law remedies may have on the use of MAP.

**Ensuring that cases are resolved once they are in MAP**

Procedural – as opposed to substantive – issues are often the main obstacles that impede resolution of MAP cases. The work on BEPS is expected to add significantly more burden to MAP processes – placing a serious strain on the system as inventories are expected to rise dramatically.

Accordingly, the Discussion Draft proposes a number of recommendations to improve MAP processes. This includes employing a principled approach to resolving MAP cases as well as improving cooperation, transparency, and the working relationship of competent authorities.

The Discussion Draft also discusses the merits of mandatory binding arbitration in an environment where policy constraints or other reasons prevent a global consensus. Since the inclusion of paragraph 5 to Article 25 of the OECD Model Treaty in 2008, mandatory binding arbitration in bilateral treaties has gradually been recognized as an important tool to incentivize resolution of MAP cases in certain countries. The Discussion Draft on Action 14, however, explicitly recognizes that MAP arbitration procedures have not been widely adopted, and in some cases, may be denied even if arbitration procedures are available.

The Discussion Draft outlines three main policy concerns that appear to prevent the use of mandatory binding arbitration: (i) the position that mandatory binding arbitration infringes on national sovereignty; (ii) the concern that access to arbitration may be restricted or limited in scope; and (iii) the risk of conflict between arbitration and domestic legal remedies.

To address these concerns, the Discussion Draft outlines a number of options, including but not limited to, increasing the transparency of arbitration, tailoring the scope of arbitration, facilitating adoption of arbitration, and clarifying coordination with domestic legal remedies.

The Discussion Draft also outlines options to address practical issues, such as the appointment of arbitrators, conditions under which deferral to arbitration is appropriate, the confidential nature of arbitration, the use of evidence in arbitration, and the form in which the final arbitration decision should be made.

Importantly, the Discussion Draft does address the two principal approaches to decision-making in arbitration – the “independent opinion” and the “final offer.” The independent opinion is the more conventional, traditional approach whereby the parties present the facts and the arguments to the arbitration panel, and the panel makes an independent decision based on the applicable law. In the final offer
approach (informally referred to as “baseball arbitration”), the competent authorities present their respective proposed resolution to an arbitration panel and the panel adopts one of the proposed resolutions.

The Discussion Draft concludes that reaching global consensus on the use of mandatory arbitration may be difficult. The Discussion Draft does recommend, however, that participating countries develop guidance on the use of different arbitration mechanisms as default approaches, including the advantages and disadvantages of an independent opinion or a final offer. The Discussion Draft also explicitly invites commentators to suggest additional measures that would facilitate the resolution of MAP cases, particularly in situations where the competent authorities are unable to conclude a MAP case within two years.

Comment: The OECD’s MAP statistics for the 2013 reporting period provide quantitative evidence of the dramatic surge in tax audits and disputes among OECD member countries. At the end of reporting period 2013 the total number of open MAP cases was 4,566, representing a 94 percent increase as compared to 2006, and is the largest number of pending MAP cases in history.

Looking forward, the BEPS reform is likely to lead to more disputes, which in turn, will create significant tax compliance uncertainty for multinationals and put extreme pressure on the MAP process.

In this environment, it is disappointing to learn that the OECD has been unable to reach broad consensus on the need for mandatory binding arbitration, an alternative that has to date produced very positive results in getting MAP cases resolved in a timely fashion. However, it is encouraging that participating countries are being asked to develop guidance on the use of different arbitration mechanisms as default approaches. The bottom line is that there is an acute need for arbitration mechanisms – binding, or other forms – to ensure that all MAP cases will be resolved within a very reasonable timeframe.

**The takeaway**

There are a number of emerging trends that are shaping today’s global tax environment and influencing the actions of stakeholders around the world.

Tax administrations continue to scrutinize cross-border transactions as a means to grow revenue and build infrastructures. Moreover, there is the risk that growing differences will emerge between residence and source based countries, which may lead to a divergence of views on basic taxing rights and fundamental principles. These differences – along with the BEPS reform and unilateral measures by certain countries – will inevitably lead to more cross-border tax disputes and the risk of double taxation.

Today’s platform for resolving international tax disputes is already under tremendous strain and specific measures are required to ensure MAP is more effective and efficient. Indeed, it is critical to improve dispute resolution procedures at this time.

The Discussion Draft is a very important first step by the OECD in identifying key obstacles that are limiting taxpayer access to the MAP process and preventing countries from resolving MAP cases as well as the OECD’s commitment to implement key changes to address such obstacles. Even though the Discussion Draft is preliminary in nature, and further work on Action 14 is expected to result in specific measures that are intended to constitute a minimum standard, we hope that as many countries as possible will commit investments and resources to adopt the forthcoming measures. We also hope that countries will expend effort to continuously and cohesively build upon this minimum standard to collectively drive other MAP access and process improvements as the BEPS movement unfolds.
Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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