Summary Brief

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What Have We Learned About International Tax Disputes?

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This Briefing summarises ICTD Working Paper 55, which examines the Mutual Agreement Procedure (MAP) for tax authorities to resolve their differences over the interpretation of tax treaties. It surveys available evidence on reasons for the increase in such conflicts, and analyses proposals for improving the MAP, especially mandatory binding arbitration. Despite the shift to arbitration in the past decade among Organisation for Economic Cooperation and Development (OECD) states, there has been a continued rise in conflicts and in the time taken to resolve them. It seems inappropriate, especially for developing countries, to deal with these important issues through international procedures cloaked in total secrecy. A better approach would be to aim to minimise conflicts by developing clear and simple rules for apportioning the income of integrated transnational corporations (TNCs), and agreeing interpretations of tax treaty provisions that can be made public. Greater transparency is the best way to provide the clarity and predictability that business needs, and to reassure the public that decisions on international taxation are fair.

Enforcing tax treaties

Tax treaties allocate rights to tax between states, but their provisions also generally apply automatically in national law.
This gives directly enforceable rights to taxpayers – mainly TNCs – to bring actions in national courts against any tax measure that may be contrary to a treaty. Treaties also generally include a procedure for a taxpayer to complain to the competent authority in the tax administration against a tax measure that may be contrary to the treaty. If the competent authority considers the complaint admissible it may resolve the issue itself, but otherwise must consult

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with the competent authority of the other treaty partner.

Thus, not only can taxpayers directly enforce tax treaty provisions that benefit them, which is unusual in international law, but they can also take advantage of two parallel procedures – one legal and one administrative.

Under the tax treaty's MAP, the two competent authorities must endeavour to eliminate any taxation not in accordance with the treaty – but they are not obliged to do so. The MAP is an administrative procedure, conducted in total secrecy, and even the existence of a claim is not made public – so it tends to be preferred by corporate tax advisers to court cases, which generally are public. However, TNCs frequently complain that the MAP takes too long, and does not guarantee an outcome. The solution they have long pressed for is to oblige authorities to refer unresolved disputes to binding third party arbitration.

The BEPS project and dispute resolution

This was regarded as a key issue during consultations on the G20/OECD project on base erosion and profit shifting (BEPS), especially by tax advisers for TNCs. The BEPS project's main proposals would strengthen the power of tax authorities to combat the tax avoidance techniques that have become increasingly prevalent among TNCs. Although these measures will be coordinated to some extent, their implementation in national law and by national officials will inevitably leave much scope for divergent interpretations.

The risk of such divergence is especially high since many of these provisions are complex, and fail to provide clear rules – especially for the allocation of profits between the different affiliates of a TNC. In particular, the rules on transfer pricing allow a range of methods, and require tax officials to analyse each TNC's

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business model and to identify the functions performed, assets deployed and risks assumed by the TNC's various component subsidiaries and branches. This requires specialist knowledge of a wide range of business sectors, and involves discretionary and subjective judgements. Hence, there is justifiable concern about the likely increase in conflicts due to inconsistent evaluations by different tax authorities.

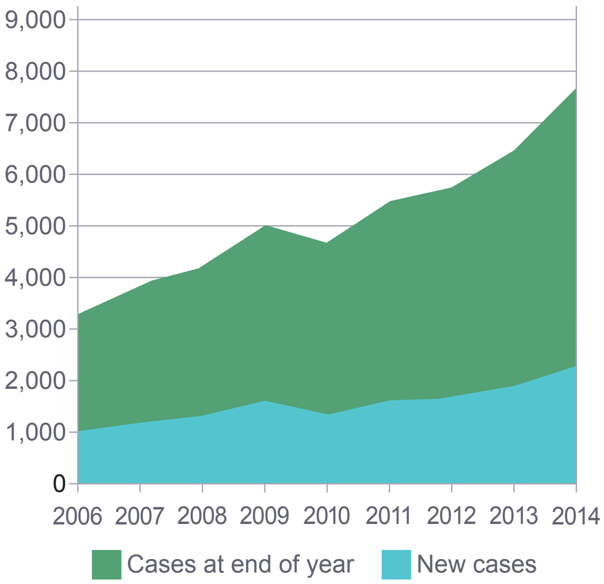
Consequently, the BEPS outputs also provide measures to strengthen dispute resolution. They aim to put pressure on states to ensure that all conflicts are resolved within a strict timetable. Some states have also committed to accepting mandatory binding arbitration, and there may be pressure on others to do so. However, the procedures will remain totally secret.

Dealing with divergence

Divergent interpretations may result either in double taxation or in double non-taxation – that is, tax avoidance. Exploiting loopholes due to such divergence is central to the techniques developed by tax advisers to reduce TNC tax payments. One way to block such loopholes is for tax authorities to harmonise their interpretations through the MAP – unfortunately it has rarely been used for this purpose. The MAP is almost always initiated by a taxpayer, usually a TNC, complaining about possible double taxation.

Due to the secrecy that surrounds these conflicts, there is little hard information about their nature or causes. However, data on the number of MAP cases has been collected and published for the past ten years by the OECD, and more recently by the European Commission (see the Appendices of the research paper). The OECD data reveals both a significant growth in cases initiated, and a sharper rise in pending cases each year (Figure 1). Even before the BEPS project, OECD countries experienced a continuing increase in conflicting interpretations of tax treaties, and a larger rise in the time taken to resolve them.

Figure 1 Growth of MAP cases between OECD countries



Indirect evidence suggests that a large majority of conflicts deal with allocation of profits of TNCs (transfer pricing).

The bulk of MAP cases have occurred among the main OECD countries, and so far little use has been made of the procedure in developing countries. A significant exception is India, which introduced transfer pricing regulations based on the OECD Guidelines in 2001. Their enforcement led to a rapid rise in cases, and by 2012 there was an estimated backlog of over 3,000 cases in the tax tribunals. It is not possible to compare the number of court cases with MAP complaints, as India does not publish this data. However, a conflict about the backlog of MAP cases between the US and Indian competent authorities became public, leading to the replacement of the Indian official in July 2013. In January 2015 a press release announced that they had signed a Framework Agreement under the MAP procedure, which aimed to facilitate resolution of some 200 conflicts; a year later it was reported that about half had been resolved, though no details are public.

In contrast, Brazil, which applies a system of fixed margins for transfer pricing considered unorthodox by the OECD, has experienced relatively little litigation, and few or no MAP claims. China has seen an increase to 55 MAP cases in 2014, according to data reported to the OECD. Most developing countries have no formal arrangements in place for the MAP. However, cases are beginning to emerge – for example, it is known that two MAP claims have been made in the Netherlands and in South Africa as a result of tax assessments by the Uganda Revenue Authority involving telecommunications companies.

Such claims may increase further, especially if countries adopt interpretations that could be considered unorthodox.

The introduction of arbitration

The growth in cases among OECD countries has continued, despite reforms they have introduced to the MAP in the past decade – including a shift to arbitration.

An arbitration procedure has been in place between EU states for transfer pricing cases since 1995. Under the EU Arbitration Convention, if such a conflict has not been resolved within two years it must be referred to a Commission consisting of an even number of independent experts, as well as representatives of each tax authority. The Commission must produce a reasoned opinion: the decision can only be published by agreement of the parties, and this has never occurred. The competent authorities must then resolve the conflict within six months, either by accepting the decision or agreeing an alternative solution. In practice, it seems less than half a dozen cases have been referred to a Commission.

Ten years ago, the US introduced a different form of arbitration in its treaties with Canada and Germany, also for disputes unresolved within two years. This 'baseball' or 'short-form' arbitration requires the arbitrators not to give their own independent opinion, but to choose between the last best offers tabled by the state parties. The decisions are also prohibited from being published, or being used as precedents in later cases. Informed commentators suggest that ten or a dozen arbitrations have taken place in the nine years since the procedures have been in effect, mostly between the US and Canada, and that so far the US has won all of them.

Arbitration provisions have been included in the OECD model convention (2007) and that of the United Nations (2011, as an alternative). Various versions of these have been included in over 200 actual treaties, including some with developing countries (Table 1). A key issue is who has the right to trigger arbitration: four of these developing country treaties give the taxpayer this right, in line with the OECD model; the others require either one or both competent authorities to agree to refer.

Table 1 Tax treaties with developing countries containing arbitration provisions

Developing country	Partner	Year	How triggered	Taxpayer opt-in before?	Taxpayer opt-in after?	Competent authorities bound by the result?	Time delay	Court case in parallel?	Taxpayer represented?
South Africa	Canada	1995	Both states	N	N	Y	NA	Y	N
Egypt	Netherlands	1999	Either state	Y	N	Y	5	Y	N
Uganda	Italy	2000	Both states	Y	N	N	NA	N	Y
Congo	Italy	2003	Both states	Y	N	N	NA	N	Y
Uganda	Netherlands	2004	Either state	Y	N	Y	2	Y	N
Ghana	Italy	2004	Both states	Y	N	Y	NA	Y	N
South Africa	Netherlands	2005	Either state	Y	N	Y	2	Y	N
South Africa	Switzerland	2007	Either state	Y	N	Y	3	Y	N
OECD model		2007	Taxpayer	Y	Y	Y	2	Y	N
Ghana	Netherlands	2008	Either state	N	Y	Y	2	Y	N
Namibia	Canada	2010*	Both states	Y	Y	Y	NA	Y	N
UN model		2011	Either state	N	Y	N	3	Y	N
Ethiopia	Netherlands	2012	Taxpayer	Y	N	Y	2	Y	N
Malawi	Netherlands	2015*	Taxpayer	Y	Y	Y	3	Y	N
Kenya	Netherlands	2015*	Taxpayer	Y	N	Y	2	Y	N
Rwanda	Jersey	2015**	Either state	N	Y	N	3	Y	N
Algeria	UK	2015*	Taxpayer	Y	Y	Y	2	Y	N
Zambia	Netherlands	2015	Either state	N	N	N	2	N	N

*OECD type clause **UN type clause

Source: Hearson (2015) The tax treaty arbitrators cometh, https://martinhearson.wordpress.com/2015/09/21/the-tax-treaty-arbitrators-cometh

The tiny number of cases actually sent to arbitration shows that its main effect is to put pressure on the competent authorities to resolve cases. Yet there has been a continued rise in the time they take. The main success in reducing a large backlog quickly seems to have resulted from the Framework Agreement between the US and India.

Tax issues in trade or investment arbitration

Aside from the MAP, a number of tax-related disputes have been referred to arbitration under international investment or trade agreements, which allow investors to bring complaints against unfair or discriminatory treatment of any kind. On this basis, a number of arbitrations have been initiated under such treaties relating to tax matters, including claims by Heritage Oil against Uganda, and both Vodafone and Cairns Energy against India. Some such treaties now have filters to try to exclude tax treaty interpretation issues from such arbitration. The experience of arbitration or adjudication in these related fields may have suggested to some that a similar procedure could also be suitable for tax.

However, investment arbitration has been described as being in crisis, and developing countries in particular have moved to denounce or renegotiate treaties with arbitration provisions. Criticisms have concerned the undemocratic nature of giving TNCs the right to challenge national regulation through a private international arbitration. They have also focused especially on the illegitimacy of arbitrators chosen ad hoc, sometimes having conflicts of interest, adjudicating on public policy issues affecting substantial public revenue, often under a cloak of secrecy. International tax arbitration is even less formalised and much more opaque, so is vulnerable to the same criticisms.

The MAP and national sovereignty

Developing countries have generally opposed arbitration, often citing concern about national sovereignty. This is not just an abstract issue. Tax treaties allocate rights to tax, and leave it to each state to decide how to exercise those rights. Since treaties generally have direct effect in law, each country's courts must apply their provisions; tax authorities are also subject to the law as interpreted by the courts. It is contrary to principles of the rule of law to give administrative authorities wide discretion in applying rules, especially if their decisions are subject to confidentiality and have little or no accountability. Hence, the MAP as an administrative procedure can be said to lack legitimacy if it usurps the role of the courts.

Arbitration goes further, and entails accepting a supranational decision as binding. It can easily be understood why this is difficult for both governments and wider public opinion to accept. This is especially so as the procedure operates in total secret, and deals with matters that have aroused widespread concern, often involving hundreds of millions of dollars of government revenue.

The MAP and transfer pricing

The MAP was designed as an amicable procedure for administrative authorities to try, if possible, to coordinate their interpretation of tax treaties. Some divergence is inevitable, especially as regards the allocation of the income of TNCs or transfer pricing. Under the current dominant approach, TNCs are not treated as single firms: each country taxes the parts of the TNC within its jurisdiction, although it has the power to adjust the accounts of associated enterprises. Both tax advisers and the OECD have continued to insist that international tax rules must treat the affiliates within a TNC group as if they were independent entities dealing with each other at arm's length. Divergence on how to treat different affiliates may mean that the group as a whole is taxed on more than 100 per cent of its consolidated profits, but this constitutes economic and not juridical double taxation.

Since the methods for adjusting their accounts are based on subjective and discretionary judgements, it is not surprising that the number of these disputes has grown steadily – especially in the past decade as countries have applied these rules more rigorously. If countries could agree on a unitary approach to TNC taxation, based on clear criteria for allocating their total profits, there would be fewer conflicts and any disputes would be easier to resolve by transparent and principled decisions.

Effects of the reform proposals

The problems with the MAP are symptoms of a deeper malaise in the international tax system. Improvements may ameliorate some of the symptoms, but will worsen the disease. The lack of clear criteria for defining and allocating the tax base of TNCs has resulted not only in the growth of conflicts between tax authorities, but also a lack of public confidence in the legitimacy of the system.

The measures proposed in the BEPS report for reforming the MAP are aimed at solidifying the distinct international tax expert community. They call for the competent authority's officials who deal with the MAP to be separated from front-line tax examination staff, to encourage them to give autonomous decisions. The pressure to resolve cases quickly and by agreement will be increased, especially in countries accepting binding arbitration. Monitoring of the system through peer review aims to further strengthen

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acculturation to the norms of the specialist expert community. Yet the stress on the need for independence of the competent authority ignores concerns about the frequent rotation of roles between public officials and private tax advisers.

This will also place increasing strain on tax authorities that are already significantly under-resourced. International tax, and especially transfer pricing, demands highly trained staff who are scarce in any tax authority, but especially in developing countries. It is hard to justify the cost effectiveness of creating a separate competent authority with the skills to review their decisions.

International tax arbitration as currently practised does not aim to provide decisions based on reasoned application of principles that are published to ensure that like cases can be seen to be treated alike. Arbitrators will inevitably be drawn almost entirely from the members of the same club of specialists, dominated by developed countries, who have generally worked as both government officials and tax advisers. There must also be concern that the intention is to delegitimise methodologies and interpretations of tax norms that are regarded as unorthodox or unacceptable to those dominant in the international tax community. Cloaking the procedures in secrecy inevitably feeds suspicions that the intention is to exclude alternative approaches.

A better way forward

The primary aim should be to minimise conflicts by making international tax rules clearer and easier to apply. Greater use should be made of the MAP to reach agreed interpretations that can be published. The Framework Agreement between India and the US seems to have been successful, but would have had a greater impact if it had been published. Interpretive mutual agreements should include issues of double non-taxation, as well as possible double taxation. This is especially important in the current period of fluidity and change in international tax rules.

This applies in particular to transfer pricing rules – these seem to be the main source of disputes referred to the MAP, and the most intractable cases. Publication of the outcomes of MAP cases would help ensure that like cases are treated alike, provide guidance for other taxpayers, and help reassure public opinion that the system is working fairly. Reforms should aim to allocate the profits of TNC groups based on clear and quantifiable factors that reflect the actual economic activities and value created in each country. This would not only reduce the number of conflicts, but also ensure that the disputes that do occur can be adjudicated in a transparent, fair and consistent manner.

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Further reading

Picciotto, Sol, 2016, International Tax Disputes: Between Supranational Administration and Adjudication, ICTD Working Paper 55, IDS, Brighton (August)

Credits

This ICTD Summary Brief was written by **Sol Picciotto**. Sol Picciotto has taught at the universities of Dar es Salaam (1964–68), Warwick (1968-1992) and Lancaster (1992–2007), where he is now emeritus professor. He is the author of International Business Taxation (1992) and Regulating Global Corporate Capitalism (2011), several co-authored books, and numerous articles on international economic and business law and regulation, as well as state theory. He is coordinator of the BEPS Monitoring Group, and Chair of the Advisory Group of the ICTD, with which he has conducted research on international tax.

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