# New remedies

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*Peter Steeds* and *Paul Fields* examine BEPS Action 14, which seeks to improve dispute resolution mechanisms for relieving double taxation

## Key Points

### What is the issue?

BEPS Action 14 seeks to improve dispute resolution mechanisms for relieving double taxation. Multiple announcements from the OECD, the European Commission and HMRC are changing the landscape for dispute resolution.

### What does it mean to me?

The BEPS project is expected to substantially increase the number of cross-border tax disputes as tax authorities are likely to interpret the BEPS changes differently. Multinational taxpayers and their advisers need to understand the remedies available to them, and how those remedies are changing.

### What can I take away?

Although Action 14 has not delivered universal binding arbitration, significant progress has been made towards making dispute resolution more effective. Binding arbitration is also becoming more widely available, and as a result tax treaty mutual agreement procedures are expected to be an increasingly popular option for taxpayers facing double taxation.

When the OECD’s Base Erosion and Profit-Shifting (BEPS) action plan was announced, Action 14 (making dispute resolution mechanisms more effective) was considered to be a key counterbalance to the radical modernisation of the international tax rules, which would help taxpayers by delivering an effective mechanism to relieve double taxation. Sadly, it was the one of the slowest actions to make progress, and expectations of an agreement to binding mandatory arbitration by all participating countries proved unrealistic.

However, there has been positive progress on many fronts, including a commitment to binding arbitration clauses by 20 key countries. The European Commission (EC) has also made significant progress in this area.

This article explores the recent announcements from the OECD, the EC and HMRC, and considers how they might impact taxpayers.

## Background

There has been a steep increase in transfer pricing and other cross-border tax disputes in recent years which will only accelerate as BEPS actions are implemented. Double taxation risk continues to be a significant concern for multinational enterprises. Groups frequently live with unrelieved double taxation because the potential remedies in place are limited in scope, inconsistently applied, and burdensome in operation, in terms of time, cost and management resource required to pursue them.

When faced with double taxation, a multinational’s first recourse will generally be through a double taxation convention (DTC) between the relevant countries. In most cases, a DTC will include a mutual agreement procedure (MAP) based on Article 25 of the OECD Model Tax Convention (MTC), requiring the competent authorities of the respective countries to endeavour to eliminate double taxation, but not usually compelling them to do so.

Whilst the MAP process works well in some jurisdictions, its effectiveness varies significantly, and it is often a costly and protracted process, hence deterring taxpayers from using it. Also, certain tax authorities have routinely found technical reasons not to accept applications.

In 2008, a clause was added to the MTC allowing for binding arbitration where the competent authorities could not reach agreement. However, many pre-2008 DTCs continue in operation and many recent DTCs have been concluded without including a binding arbitration clause.

## The OECD perspective

BEPS Action 14 called for effective dispute resolution mechanisms to resolve DTC-related disputes, and address obstacles to resolving disputes, such as the frequent absence of arbitration provisions and denial of access to MAP in certain situations. Given the major BEPS changes and their increasingly subjective interpretation, effective dispute resolution will be more critical for taxpayers than ever.

### Minimum standards, best practice and monitoring processes to improve dispute resolution

Although the use of MAP in DTCs is long-established, the process is often slow, inefficient, and sometimes difficult for taxpayers to access. The October 2015 BEPS report on Action 14 outlined minimum standards and best practices for resolving treaty-related disputes under MAP, whilst noting that there was no overall consensus on binding arbitration.

The key mechanism through which the OECD proposes to deliver change is a programme of peer reviews that will monitor how tax administrations operate MAP. In October 2016, the OECD released an assessment methodology for this peer review and monitoring process; a MAP statistics reporting framework for competent authorities; and guidance on documentation to be submitted with MAP requests.

The Stage 1 peer reviews are being conducted in batches. The first batch, which commenced in December 2016, included Belgium, Canada, the Netherlands, Switzerland, the UK and the US. The OECD is currently gathering input for reviews of Austria, France, Germany, Italy, Liechtenstein, Luxembourg, and Sweden, with more planned over the next two years. Stage 2 will involve monitoring of improvements.

## Introduction of mandatory binding arbitration for unresolved disputes

For DTCs with a binding arbitration clause, the number of resolved MAP cases tends to increase, as tax authorities are more inclined to reach negotiated settlements rather than go to arbitration. Although there remains no consensus on the adoption of binding arbitration among all OECD and G20 countries, 20 countries, including the UK, have committed to implement it.

## Multilateral Instrument

In November 2016, the OECD published the Multilateral Instrument (MLI) which is intended to help governments swiftly implement the BEPS tax-treaty related actions without renegotiating individual treaties. The MLI includes certain minimum standards for improving dispute resolution which will apply automatically to all covered DTCs.

A binding MAP arbitration provision was developed for inclusion in the MLI, using so-called ‘baseball arbitration’ as the default approach, which countries may elect to apply to DTCs where both parties to a treaty have exercised this option.

## Baseball arbitration in tax treaties

In ‘final offer’, or baseball arbitration, the two parties state their assessment of the correct allocation of profit, and the arbitrator has to choose one of these positions, rather than conducting the traditional negotiation to reach a compromise. Most experience of this approach is between the US and Canada where it generally works well.

The advantage of this approach is that it discourages tax authorities from taking unreasonable negotiating stances, since this would increase the risk of the arbitrator accepting the other party’s position. Also, because the parties only have one chance to put forward a reasonable offer, it tends to be a quicker, more cost effective process.

## The EU perspective

The European Arbitration Convention (EAC) established a binding mechanism for ensuring the elimination of double taxation in disputes between EU member states.

The EAC acts as an incentive for competent authorities to reach agreement more consistently, since they prefer to reach a negotiated settlement which they have control of, rather than moving to a costly arbitration process with an uncertain outcome.

The existing EAC is limited in terms of scope and accessibility. It applies only to transfer pricing and permanent establishment (PE) profit attribution cases, but not disputes regarding the existence of a PE or, generally, thin capitalisation disputes, recharacterisation-related issues or secondary adjustments.

Historically, some tax authorities have obstructed access to the EAC, by interpreting it in a limited manner, or through use of the ‘serious penalty’ exclusion. In early 2016, the EC opened a consultation on improving double taxation dispute resolution mechanisms, and in October 2016 issued a draft Directive which would widen the scope of the EAC to cover all double taxation disputes between member states, and give taxpayers greater access whilst preventing obstructive practices.

## The UK perspective

In the UK, the introduction of the Diverted Profits Tax (DPT) has added to the general uncertainty for taxpayers arising out of the BEPS action plan. Brexit only adds another layer of complexity. It is expected that the EAC will no longer apply to the UK following Brexit – for new cases at least – and it remains to be seen whether the Article 50 negotiations will see UK resident companies retaining some form of access to arbitration with member states.

Meanwhile, HMRC’s revised Statement of Practice on Advance Pricing Agreements (APAs) has stricter acceptance criteria. It also confirms that the programme cannot be used to agree a DPT position, but an early discussion of DPT will be required before the submission of an application. HMRC also recently published guidance preventing any transfer pricing discussions with taxpayers outside the formal APA or enquiry process.

However, there are some positive signs. In addition to the MLI, several recently updated DTCs with key trading partners have binding arbitration clauses and, with many jurisdictions, HMRC’s MAP programme continues to deliver effective agreements.

## Conclusion

It is essential that taxpayers have access to an efficient, wide-ranging and enforceable process for eliminating double taxation. Binding mandatory arbitration is undoubtedly the most effective mechanism to achieve this. Considering the number of countries participating in Action 14, reaching a unanimous consensus on binding arbitration was inevitably mission impossible. But that is not to say that Action 14 has been a failure. The overarching goal was to make dispute resolution mechanisms more effective, and there has clearly been significant progress towards that.

The OECD has set minimum standards and best practices for tax authorities in administering MAP, and provided a peer monitoring system to ensure compliance. In addition, the use of more innovative approaches to arbitration, should encourage tax authorities to take a more reasonable stance, and reduce the length and cost of negotiations. Meanwhile, 20 countries have committed to implement binding arbitration through the MLI and hopefully this will encourage others to do the same.

Within the EU, there are welcome proposals to strengthen the EAC, broaden its scope and improve access and enforceability through the proposed EU Directive.

The effectiveness of the new dispute resolution measures will be truly tested with the inevitable increase in disputes after the first Country-by-Country reports are submitted this year and the new transfer pricing rules start to bite. To succeed it will be necessary for tax administrations to respond positively to the proposals by committing sufficient resources to their competent authority teams and creating a culture where delivering effective dispute resolution is deeply embedded in the organisation.

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