

BIAC Comment on OECD Discussion Draft:

**Proposals for Improving Mechanisms for the
Resolution of Tax Treaty Disputes (the “Discussion Draft”)**

5 May 2006

BIAC wishes to wholeheartedly commend the OECD for its work on Mutual Agreement Procedure (MAP) arbitration. We believe that it is very important that countries adopt and implement a mandatory arbitration mechanism for resolving tax treaty disputes. We believe that the adoption of such an arbitration mechanism as a supplement to the MAP process would have the effect of making the MAP more reliable and more efficient. If properly implemented, arbitration would have the effect of assuring taxpayers from the outset that the MAP process will lead to an effective resolution of double taxation controversies in a manner that avoids double taxation.

In our opinion, the general approach reflected in the Discussion Draft sets out a pragmatic framework for the implementation of such a mandatory arbitration process. It takes account of the fact that the step from MAP to a mandatory arbitration procedure is politically sensitive. On the other hand, from the perspective of the taxpayer, mandatory arbitration is a guarantee to make sure that both contracting States fulfil the engagements they have entered into when concluding a tax treaty.

We therefore consider the proposed modification of Article 25 of the OECD Model and the amendments of the Commentaries as an important step to further improve dispute resolution under bilateral tax treaties.

The degree of flexibility accorded to countries to implement the process is commendable. It is, under the given circumstances, the key for success. We especially commend the recognition that countries can implement an arbitration mechanism by mutual agreement under existing treaties, subject to local legal and political constraints. We recognize that many of the countries involved in developing these proposals have legitimate concerns about one or another aspect of compulsory arbitration. We commend the OECD for advancing this project notwithstanding those concerns and believe that, for many years to come, the international tax system will reap the rewards of the compromises and accommodations that have been made by individual countries in bringing this proposal forward.

The comments below are consistent with a number of the discussion points raised at the public consultation on the Discussion Draft on March 13, 2006 in Tokyo. They reflect also the comments BIAC received from its members and insights gained at the joint ICC-IFA

conference on the use of arbitration for the resolution of tax disputes, which was held on 3 May 2006 in Paris.

These comments should be read as requests for clarifications in the proposed draft amendments to the Model Treaty and Commentary contained in the Discussion Draft. On the other hand, the international business community thinks that all efforts should be made, at the present stage already, to strengthen the competences of the arbitrators in order to provide for a procedure which effectively helps to resolve those cases where no agreement was achievable under in the MAP, and which offers taxpayers a fair and balanced treatment.

We would like to see of course some more fundamental changes in the proposals, in order to shift the balance from the tax authorities to independent arbitrators and to make sure that double taxation is eliminated in all cases in accordance with the rules of the treaty. If this is not realistic given the sensitive nature of the proposed steps and the danger that the project could be opposed by some Member States, a compromise should be found between what would be necessary to have as an arbitration procedure that would fulfil the expectations of business, and the political realities where tax authorities would like to have the maximum control over the new, mandatory arbitration procedure.

For countries that would be prepared to accept the first mentioned alternative, we would recommend that the pros and cons of the different possible ways to set up the arbitration panel and the procedural rules would be shown in the new commentaries, together with alternative solutions that could also be envisaged.

One could also go a step back and provide for an intermediate solution where the arbitration tribunal would try to explore with all the three parties concerned (CAs and the taxpayer) -- at a given stage of the procedure and based on preliminary findings of the arbitration tribunal – whether a solution could be found by mutual agreement, before a formal decision is taken and has to be fully motivated and published. Such a possibility could be mentioned to show how flexibly the instrument can be used, e.g. in politically sensitive cases.

- 1. Overriding Objective of Finality:** We believe that the most important feature of a mandatory arbitration proposal is that it lead efficiently to a binding and enforceable final resolution of the double tax issues that may arise in any particular case. If the proposals are seen by affected taxpayers as providing governments with the ability to “agree to disagree” or to subvert the arbitration process by obstructing agreement on technical or procedural matters relating to the arbitration, they will not have the desired effect of increasing taxpayer confidence in the MAP. We understand that it is important to the drafters that the arbitration mechanism operate within and as a supplement to the MAP, rather than as an alternative quasi-judicial mechanism for solving disputes. We do not believe that a process which operates within and as a supplement to the MAP process need be inconsistent with the objective of final resolution of double taxation cases. The following comments are intended to suggest ways in which the Discussion Draft can be clarified to enhance the objectives of finality and the complete elimination of double taxation.
- 2. Terms of Reference:** The Discussion Draft suggests that the scope of a particular arbitration be determined by the agreement of the competent authorities through the mechanism of agreed terms of reference. On this point, we note that this is highly

unusual in the other forms of arbitration where it is the task of the independent arbitration body to decide not only on procedural matters, but also on the jurisdiction (what issues shall be solved).

Based upon the discussions at the March 13, 2006 public consultation, we understand the drafters to intend that the terms of reference will provide in every case for resolution of the specific issues preventing a MAP resolution that eliminates double taxation. We are concerned, however, that without further clarification of this point in the Discussion Draft, taxpayers may interpret the process as one in which governments intend to retain the flexibility to prevent an arbitral decision that eliminates double taxation by overly narrow drafting of the terms of reference or by a failure to agree on the terms of reference. We therefore suggest that the Discussion Draft state unequivocally that the terms of reference should be drafted in such a way that the arbitral decision will have the effect of leading directly to a final resolution of the case that eliminates double taxation. We further suggest that the Discussion Draft be revised to provide – at least -- that if the competent authorities are unable to agree on the terms of reference within the stated time limits, the case be forwarded to the arbitrators with a mandate to issue a final binding decision resolving all outstanding issues so as to eliminate double taxation in a manner consistent with the treaty.

- 3. Definition of an Unagreed Case:** The conversations at the public consultation revealed a lack of clarity regarding the definition of an unagreed case. In particular, it appeared that at least as to certain matters, the drafters wished to have competent authorities retain the ability to agree that two inconsistent interpretations of the treaty which lead to effective double taxation are nevertheless each acceptable interpretations. In effect, there appears to be a desire to permit competent authorities to “agree to disagree” in at least some set of cases. We believe this approach is inconsistent with the objectives of a tax treaty and with the fundamental policy objectives underlying the arbitration procedure.

If this reservation of authority to avoid the obligation to eliminate double taxation is a necessary condition of moving forward, we strongly suggest that the Discussion Draft be clarified to reflect the specific cases in which this ability to disagree is intended to be retained and to limit the scope of potential disagreement to the fullest possible extent. In particular, we urge that the drafters state unequivocally, in the proposed new treaty commentary, that their intention is that this reservation of a right to disagree not apply to (i) transfer pricing cases; and (ii) to cases involving disputes over the existence of a permanent establishment. We understood from the public consultation that the intention of the drafters was that the arbitration process should lead to an effective guarantee of complete relief from double taxation in at least these two important categories of cases and strongly urge that this intention be clarified in the Discussion Draft and the accompanying Model Treaty commentary.

- 4. Taxpayer Waiver of Judicial Recourse:** The Discussion Draft requires taxpayers to waive the right to local country judicial remedies as a condition of initiating arbitration. We urge that further consideration be given to the timing and scope of such a required waiver. It seems appropriate for the governments to require a commitment on the part of the taxpayer to accept an arbitral decision that fully

eliminates double taxation as a condition for initiating the process. However, it would be inappropriate to demand such a waiver if the terms of reference are drafted in such a way that the taxpayer does not believe the process will lead to final resolution of the case that eliminates double taxation. We suggest that the Discussion Draft be clarified by stating that the taxpayer need provide the waiver only upon his review and acceptance of the terms of reference, or at a minimum, that the taxpayer have the right to revoke the waiver upon review of the terms of reference if such terms of reference are not acceptable to the taxpayer. We further believe that the Discussion Draft should be clarified to indicate that the taxpayer's waiver will automatically be revoked if, after initiating arbitration, the competent authorities resolve the case on an agreed basis either prior to or in a manner inconsistent with the decision of the arbitrators.

- 5. Selection of the Arbitrators:** We believe officials from the governments involved in a competent authority negotiation should not be appointed as arbitrators. The perceived lack of fairness and objectivity arising from such an appointment would, in our judgment, outweigh any perceived efficiency benefit in virtually every case. Such a solution would lead to a situation where the chairman of the tribunal would have to decide alone and then find the support of at least one of the other arbitrators, which is far from the ideal of an arbitration tribunal that should find the best solution as a group of independent persons.

Regarding the situation where the two arbitrators fail to agree on the person of the third arbitrator within the proposed time-limit, the question comes up who shall be the appointing authority. The proposal to refer it to the Director of the CTPA met a lot of criticism, and we therefore strongly recommend to confer this task to the ICC court of Arbitration (which has broad experience and acceptance by OECD and non-OECD countries) or to the Permanent Court of Arbitration in the Hague (which would decide on an appropriate body). It seems to us very important (in particular if the tribunal would be composed as proposed in the OECD draft) to find a chairman who can act in total neutrality and independence and such a person must not necessarily be a tax specialist (a list of possible chairs could be kept at the ICC Court of Arbitration).

- 6. Denial of Arbitration When Local Law Penalties Have Been Asserted:** The Discussion Draft suggests that the competent authorities should have the ability to deny arbitration to certain classes of taxpayers that are deemed to have acted in bad faith. We disagree with this suggestion for several reasons. First, we see no reason to apply a higher or different standard to access to the arbitration process than applies to access to the MAP process in the first instance. If access to treaty relief procedures is to be conditioned on some standard of good faith dealing, that determination should be made at the commencement of the MAP process and should not be revisited two years later at the commencement of arbitration. A different approach would create too strong a temptation on the part of governments to arbitrarily avoid their obligation to resolve double tax issues by making non-justiciable assertions of bad faith dealing. Second, if a good faith dealing standard is to be enshrined, it should be made absolutely clear that the mere assertion of a penalty by field agents under local law is not sufficient cause to prevent access to either MAP or arbitration procedures. The proliferation of harsh penalty regimes around the world permits audit level officials to assert applicability of penalties in

many transfer pricing cases. Early initiation of the MAP process in such cases is highly desirable, and if the mere assertion of penalties for lack of adequate documentation or other reasons can block access to the process, MAP procedures would soon become largely irrelevant to the resolution of tax disputes. Local tax inspectors should clearly not be given the ability to arbitrarily subvert treaties by blocking access to MAP merely by asserting that penalties should be imposed. Third, in many transfer pricing disputes between OECD countries, the income in question is appropriately taxed in one of two countries with relatively consistent tax rates. Taxpayers often are mere stakeholders in these disputes, and are largely indifferent to the outcome provided double taxation is relieved. Denial of MAP relief from double taxation in such situations because of the mere assertion of penalties or the assertion in one country of less than full cooperation seems particularly inappropriate. Accordingly, if a good faith dealing standard is retained at all, the Discussion Draft should be clear that access to MAP and / or arbitration on the basis of assertions of bad faith dealing by taxpayers should be the extremely rare exception to the general rule that MAP processes, including arbitration, should be widely available to provide for relief from double taxation.

- 7. Taxpayer Participation:** We commend the drafters for the clear recognition in the Discussion Draft that taxpayer participation in the arbitration process is essential to the success of that process. We believe that the Discussion Draft could be clarified to make this point yet more forcefully. In particular, we believe that the taxpayer should be accorded a role in the development of the terms of reference. At a minimum the taxpayer should be given the ability to review and approve the terms of reference as a condition of going forward with the arbitration. We also believe that the Discussion Draft should state that the taxpayer is to be a full participant in the arbitration proceeding, with the ability to make written and oral presentations to the arbitrators and, importantly, that taxpayers be given the ability to review submissions of the respective governments to the arbitrators and to provide the arbitrators with comments on those submissions.