



In Committee

BIAC Discussion Draft on

Mutual Agreement Procedure in Transfer Pricing: Practical Experiences of Multinational Enterprises

October 31, 2003

(Replaces earlier Discussion Draft Dated February 18, 2003)

Summary:

This Discussion Draft is to serve as a basis for dialogue between BIAC and the OECD CFA Joint Working Group on Dispute Resolution for Working Party No. 1 and Working Party No. 6. The paper provides business perspectives on use of the Mutual Agreement Procedure (MAP) in the transfer pricing context.

MNEs seek a practical, fair and reliable procedure to solve transfer pricing disputes. This Discussion Draft presents what BIAC members have identified as the principal weaknesses of the existing MAP, and suggests a number of improvements, including the use of arbitration as an alternative, when the MAP deadlocks.

1. MAP: Expectations of MNEs

International transfer pricing (TP) is an issue of **strategic importance** for many MNEs with a multitude of complex inter-company transactions. TP examinations usually cover a number of business years and may lead to unilateral tax adjustments that can be very large. To avoid double taxation in such cases, the tax authorities of the other State must agree to make a corresponding adjustment.

It is well known that TP is not an exact science. Despite the fact that MNEs carefully choose reasonable TP methods and make great efforts to document TP, there is a risk that a tax inspector does not agree with the resulting profits. Since TP conflicts may lead to **substantial double taxation** for the group as a whole, it is crucial that reliable procedures exist which allow both the MNEs and the tax authorities to find **satisfactory solutions** for such conflicts.

The MNE has an interest in ensuring that a solution can be found within a **reasonable period of time**. An unresolved transfer pricing case is a financial burden and creates uncertainty for an enterprise. When the assessment becomes final, the enterprise has to pay the tax, although the adjustment may not be justified. The enterprise may also be confronted with penalty charges or interest charges for late payment. Besides these financial factors, an unresolved transfer pricing dispute has other negative effects for the business of the enterprise: it creates uncertainty for the

tax years that have not been audited yet, it can have a negative impact on pending investment decisions. In addition, the conflict may become a matter of public knowledge, which in turn can have adverse effects on the reputation of the company or group, etc.

2. Choices for a MNE in case of TP conflicts

An enterprise that is confronted with TP adjustments in a country has **several choices**: it can accept the adjustments, it can discuss the result with the tax authority, it can object to the final assessment before the local tax courts, it can request that a MAP is introduced based on a tax treaty or, within Europe, it can proceed under the European Arbitration Convention.

The reasons for choosing one of the options mentioned above will depend on a number of factors. Many of them are **company specific**: e.g. are the transactions well documented, is the TP method reasonable, are there comparable cases, are the arguments of the tax authorities and the results acceptable, can the company afford the burden of a prolonged TP conflict, etc.

Other factors are **country specific** and can hardly be influenced by the taxpayer: e.g. the transfer pricing policy of the country making the assessment, willingness to listen to arguments of the taxpayer, chances to have an adjustment modified by the tax inspector or his superior body, experiences with local tax courts, existence of a tax treaty that provides for MAP to resolve the transfer pricing conflict, willingness of a competent authority to enter into a MAP and to modify an assessment, etc. As a MAP involves at least two tax authorities, the latter point is also of importance regarding the treaty partner.

3. Why is MAP not used more often?

MAPs should be and frequently are the **procedure of choice** when there is a tax treaty that provides for a MAP to resolve a transfer pricing conflict. Many MNEs rely on MAPs to resolve transfer pricing conflicts. A recent favourable innovation in the MAP process has been the use of MAPs in connection with **advance pricing agreements** and other procedures that MNEs can utilize to resolve transfer pricing matters before disputes arise. A general examination of those MAP programs that MNEs have found to be successful and are regularly using to resolve transfer pricing disputes, could help to identify the aspects of those MAP programs that cause them to be successful.

While MNEs have used MAPs to successfully resolve transfer pricing disputes, only a **limited number of TP conflicts** are dealt with in a MAP compared with the multitude of inter-company transactions worldwide. Therefore, in the absence of an effective MAP process, most cases are being settled between the taxpayer and the taxing authority on the basis of the assessment by the taxing authority, and in these cases the likely result is double taxation. It is important to find out why this is so.

BIAC members suggest a **number of reasons** why the MAP is not used more often in practice. One obvious reason is the inapplicability of a treaty with a MAP provision. Other reasons relate to dissatisfaction with the MAP: time-factor, cost-factor, lack of involvement of the taxpayer, and uncertainty about the results. A more detailed analysis gives, however, more insight into the real problems and may help to find improvements or alternatives to the MAP.

3.1 MAP is time-consuming

One element that is very often mentioned is the **time factor**. For the reasons mentioned above a MNE has an interest that a TP dispute is resolved quickly. A MAP is a **bilateral procedure**. This means that the competent tax authorities of both countries must be convinced that a MAP is available and appropriate. They will then normally exchange letters and, where unable to resolve the matter at that stage, will try to find a date for a consultation. In a next step both parties have to

prepare the case, which normally requires extensive consultations with the taxpayers. In complex cases more than one round of talks will often be necessary. The fact that there are often few TP specialists in a tax administration is another factor that may prolong MAPs. As a result, a MAP can last for several years – which is a very long period of time in today’s business environment.

Many enterprises cannot live with a long period of uncertainty on important issues. They therefore might come to the conclusion that it is better to find a solution unilaterally and to accept the resulting double taxation. This is **highly unsatisfactory** for a number of reasons: disregard of the TP Guidelines, disregard of treaty obligations, negative financial effects for the enterprises involved, and possible consequential reduction of relevant cross-border trading activity.

BIAC conclusions: It is important that one or the other competent tax authority does not unduly prolong a MAP. The MAP must come to a resolution within a **fixed period of time** (e.g. 18 months, or 2 years, as under the EU arbitration convention). It would be important in such case to clearly define the moment when the time period begins and ends. BIAC strongly recommends that OECD members make a commitment of resources, including personnel, to allow processing of cases within the shortest period of time possible.

Requirements that the competent tax authorities of both countries must exchange position papers and commence negotiations **within certain time periods** after the MAP is requested would be extremely helpful in this respect. They would make sure that both authorities are obliged to cooperate in an efficient way. Competent tax authorities that consistently fail to meet these deadlines should be encouraged to commit the necessary **additional resources** to be able to meet these deadlines.

3.2 MAP is costly and resource-consuming

A bilateral MAP means that two tax authorities have to become familiar with the general and local business strategy of an enterprise. They have to understand the details of complex business transactions, they must consult extensive TP documentation and have to review, select or reject potential comparable transactions. As the taxpayers are not allowed to be present at the MAP itself, MNEs have to provide documentation and prepare the tax authorities so that the competent authorities can discuss the case and appropriately represent the interests of the parties involved. For the MNE, this is a **costly, burdensome and resource-consuming process**.

BIAC conclusions: Competent tax authorities should allow MNEs to **present their position and analysis simultaneously** to both of the competent tax authorities that are evaluating the transfer pricing conflict. The competent tax authorities should also be **flexible about the documentation requirements** for seeking a MAP. Instead of detailed descriptions of both the relevant transactions and the MNE’s analyses of those transactions, the competent tax authorities should be willing to accept oral presentations that are combined with slides, outlines, or other forms of documentation.

3.3 MAP is not an open procedure

Most taxpayers that are prepared to go for a MAP have **confidence** that the tax authorities will try to solve the case based on the TP Guidelines and in the interest of the taxpayers. But since the representatives of the enterprise are not present at the table, there is a latent fear that the case was not properly dealt with in the MAP. The tax authorities may **lack a full understanding** of the business each of the affiliated entities is conducting and the complex business transactions that are the focus of the transfer pricing adjustments. There may also be the worry that a solution has been agreed upon that is not in line with the **TP Guidelines** or that some kind of **“horse trading”** was involved in order come to an understanding. A further weakness in the process is that, even in

those cases where double taxation is eliminated, the authorities may be unwilling to provide guidance – to the extent the process permits – for later years to prevent transfer pricing conflicts in those later years. MNEs may also be concerned that the **control** over the resolution of the transfer pricing conflict of other offices within the tax authority is greater than the control of the persons assigned to execute the MAP. For companies that usually are not willing to ask for a MAP these concerns seem to be of great importance.

BIAC conclusions: There are strong arguments for why the taxpayers should be **present at the discussions**. It would then be clear that the results were achieved based on a full understanding of the issues and the intentions of the taxpayers and that the TP Guidelines were respected in a case-by-case discussion. Under such conditions it would also be easier for the enterprises to accept a result which is perhaps less favourable than expected. Experience with advance pricing agreements indicates that allowing more active involvement and participation by MNEs with the competent tax authorities in analysing a transfer pricing dispute can assist the competent tax authorities in understanding and resolving the transfer pricing dispute.

At a minimum, the taxpayer should be allowed to be **present during the fact finding phase** (presentation of the case, explanation of why double taxation has arisen, demonstration of what the taxpayer believes arm's length pricing to be, remedy that the taxpayer would propose, etc.). In all cases the competent tax authorities should be required to provide an **explanation of the methodology** on which they relied to reach the agreement to eliminate the TP conflict. In addition, competent tax authorities should be encouraged to grant to persons charged with executing the MAPs **authority and discretion to reach an agreement** to eliminate the TP conflict on a basis that is consistent with the OECD TP Guidelines. The persons and office in the competent tax authority that initiated the transfer pricing adjustment should not exercise any oversight over the decision by the persons charged with executing the MAPs.

3.4 MAP does not oblige tax authorities to come to a solution

From the point of view of the MNEs this seems to be the **predominant weakness** of the MAP. Many enterprises are not willing to run the risks and costs of a MAP if they are not sure that at the end of the MAP double taxation will be eliminated. Although a partial elimination of double taxation may in exceptional circumstances be acceptable for the taxpayers and the tax authority of each state, a situation where no conclusion can be found between the competent authorities is highly unsatisfactory for taxpayers and authorities. Taxpayers that are asking for a MAP are ready to lay the facts on the table and to discuss their business strategies and transactions in detail. They are willing to do so only if they see a strong likelihood that the MAP will come to a fair and satisfactory result. As long as this is not guaranteed they have to think twice before they go for the MAP.

BIAC conclusions: One of the most important weaknesses of the MAP is the fact that it does not have to come to a conclusion that fully eliminates the double taxation. The agreement must not only cover past business years, but can also give guidance to the enterprise for the following years (e.g. regarding the TP method). In all cases where double taxation would exist in the absence of an agreed resolution to the transfer pricing conflict, an agreement must be found. If this is not possible within a given time period under the MAP, **another mechanism** must come into play to force a resolution.

3.5 Other weaknesses of the existing MAP

The following list contains a number of **other reasons** why MNEs do not make use of the MAP in practice:

- Countries that will simply not engage – lack of mechanism to oblige them to do so.
- Countries that fail to properly publicise how to get into the process (deliberately or otherwise).
- Countries that do not follow the letter or the spirit of OECD TP Guidelines.
- Insistence of countries that tax in dispute must be paid before, or guaranteed before, the process can be accessed.
- Countries that effectively give companies a choice between domestic procedure or the MAP will not agree to make adjustments under MAP once the position has been determined domestically.
- Problems with domestic time limits.
- Prejudice for other transactions or for the following years.
- Lack of justification of the results of the MAP – lack of transparency.
- No guidance on the acceptable TP methods (e.g. for following years).
- Little likelihood that national tax authorities will correct the assessment of the local authorities.
- Adjustments made in an audit must be accepted to avoid penalties and interest.
- “Horse trading” / “trade offs” when a number of cases are discussed.
- Costs of prolonged MAP, especially travel costs for long distances (e.g. PMEs).
- Lack of confidence in own tax authorities (fear of retaliation).
- Existing conflicts with own tax authorities on other issues.
- Lack of time / personnel of own tax authorities.
- Lack of experience, understanding of complex transactions by tax authorities.
- Image of “good” taxpayer could be damaged (locally / internationally).
- Risk of triggering a multilateral MAP.
- Fear that business secrets are not fully respected.
- Lack of confidentiality on the conflict (intentional leakages to press).
- Publication of name and results of MAP (prejudice for cases with other countries).

BIAC conclusion: The reasons mentioned above indicate that the existing MAP is not always **implemented** in a proper way and that procedure itself has serious **weaknesses** in the sense that aim of the procedure – reliable and timely elimination of double taxation based on the rules of the tax treaty – is not regularly achieved.

4. Double taxation must be fully eliminated, if necessary through arbitration

The objective of tax treaties is the **avoidance of double taxation**. Taxpayers have an obligation to contribute to such a result by being cooperative and giving the necessary information. On the other hand, they have a right to expect, where a double taxation convention is in force, that double taxation will be fully eliminated in (bona fide) situations. The result must be based on the rules of the treaty, which means – in the case of transfer pricing – the respect of the arm’s length principle.

It is understood that tax authorities may have had reservations in the past about the introduction of **binding arbitration**, but BIAC believes that now is an appropriate point at which to re-examine the issue. The steady growth of international trade by MNEs inevitably leads to more risk of double taxation. The comfort afforded by arbitration processes would help ensure that such risk does not inhibit that growth. It is now some years since the **EU Arbitration Convention** first entered into force. Whilst there have been frustrations in areas of ratification and interpretation, MNEs have had positive experience with the existence of the convention. This has not been in the sense that cases have been arbitrated, but in our experience rather that the convention has encouraged timely settlement and elimination of double taxation by the authorities. We believe it should be possible to build, now, on that experience. An improved MAP would firmly remain the mainstay of the process of eliminating double taxation, but access to **arbitration as a fall-back** in defined circumstances could then become a vital support for the process.

BIAC conclusions: In cases where the tax authorities are not in a position to come to an agreement within a give time period, or to come to an agreement that the MNE asserts is consistent with the tax treaty, the taxpayers should have the right to **ask for an arbitration** procedure.

The international business community proposed compulsory and binding arbitration and a model arbitration clause for tax treaties in two **Statements of the International Chamber of Commerce (ICC)** of 3 May 2000 and 6 February 2002, which are attached.

BIAC is of course highly interested and would appreciate to discuss these issues mentioned above with the OECD bodies in more detail and to **participate in the process of improving the procedures for the elimination of international taxation conflicts.**

Attachments