Will binding arbitration improve cross-border dispute resolution

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Analysis

Will binding arbitration improve cross-border dispute resolution?

Speed read

When the OECD published its final package of measures with regard to its BEPS project, Action 14 was focused on making dispute resolution mechanisms more effective by strengthening the mutual agreement procedure (MAP) and minimising the potential risk of double taxation. The minimum standards proposed by the OECD will be complemented by a set of best practices. Without a mandatory binding arbitration provision, most tax treaties simply provide that the competent authorities must 'endeavour' to resolve the position by mutual agreement. However, HMRC has already taken steps to improve dispute resolution by introducing alternative dispute resolution (ADR); and the UK has started updating its double tax treaties with regard to arbitration.

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The Leaders' Declaration issued following the June 2015 G7 summit stated: 'we will strive to improve existing international information networks and cross-border cooperation on tax matters, *including through a commitment to establish binding mandatory arbitration*' (emphasis added).

Action 14 of BEPS expresses the widely-held view that the best way to ensure that cross-border transfer pricing disputes are effectively resolved is through mandatory binding arbitration. Without it, an increase in such disputes is inevitable.

The MAP

On 1 February 2018, HMRC published revised guidance and a new Statement of Practice SP 1/2018, summarising the UK's practice in relation to methods for reducing or preventing double taxation. The new guidance is consistent with the OECD recommendations on Action 14.

In the new statement of practice, HMRC defines MAP as: 'a process which enables competent authorities of treaty partners to interact with the intention to resolve international tax disputes. The competent authorities are obliged to use their best endeavours to reach an agreement with a view to the avoidance of taxation which is not in accordance with the MAP article in the relevant tax treaty.'

Resolving transfer pricing disputes is a key focus for tax administrations. Recently released figures from HMRC show that whilst the average time to resolve MAP cases increased marginally from 23 months in 2011/12 to 24.4 months in 2016/17, the increase from 18.5 months in 2015/16 to 24.4 months in 2016/17 was more significant. In the 2011/12 to 2016/17 period, the number of cases admitted increased by almost 50% (45 to 80); during that same period, the number of cases resolved decreased from 46 to 36 (bit.ly/2jmz8Nw).

One of the key determining factors on timing is the extent to which HMRC is required to collaborate with tax administrations in other countries.

Action 14 introduces a commitment to minimum standards and a peer monitoring process to ensure that agreed best practice recommendations are honoured. Critically, one of the minimum standards introduced by Action 14 is a requirement that countries include and interpret article 25 paras 1 to 3 in their tax treaties (calling upon contracting states to resolve any difficulties by mutual agreement), in line with the OECD model and commentary. In doing so, Action 14 gives confidence to taxpayers suffering economic double taxation that they will be able to access MAP and to expect that countries will implement resulting mutual agreements.

In summary, the minimum standards proposed by the OECD will be complemented by a set of best practices. Together they aim to ensure that:

- treaty obligations relating to the MAP are fully implemented in good faith and that cases are resolved in a timely manner;
- administrative processes are implemented to prevent treaty-related disputes and help to resolve those that arise; and
- eligible taxpayers can access the MAP.

Mandatory binding arbitration

Without a mandatory binding arbitration provision, most tax treaties simply provide that the competent authorities must 'endeavour' to resolve the position by mutual agreement. There may be no further provisions in the treaty setting out the procedure to be followed in the event that they are unable to agree.

This 'endeavour' obligation is a relatively low standard and imposes no binding duty on the competent authorities to resolve the dispute, leading to delays in many MAP cases. The need for a strict two-year deadline before arbitration commences was a key issue for commentators on the OECD's 2014 discussion paper on MAP.

There is some history to arbitration in the context of double tax agreements. The International Chamber of Commerce first promoted arbitration as a means of resolving international tax matters back in 1995. In 2008, the OECD adopted a new paragraph (para 5 of article 25) of its model convention which dealt with arbitration, and this has subsequently been adopted by many countries, although the notes to the model convention envisage that constitutional law or policy may prohibit the inclusion of such a provision for some states.

With the publication of the report on Action 14, it became clear that a group of countries considered that mandatory binding arbitration was the way to ensure the resolution of double tax treaty disputes. These countries included Australia, France, Germany, Japan, New Zealand, the United Kingdom and the United States. It is clearly significant that these countries are committed to arbitration.

For policy reasons, there has historically been resistance to the inclusion of mandatory binding arbitration provisions in tax treaties, primarily because these provisions were perceived as removing control from the competent authorities, but these recent commitments to MAP arbitration show that this perception is changing. An undoubtedly significant factor in this regard is the fact that the OECD model convention provision operates on the basis that only specific issues on which the competent authorities are unable to reach a decision may be submitted to arbitration. The procedure cannot be used to challenge decisions made by mutual agreement of the authorities.

It is envisaged that a mandatory MAP arbitration provision will be developed and the countries referred to above will consider how their various views on the provision can be reconciled.

Of course, support for a process will not always be translated immediately into results. One of the aims of Action 14 is that those that subscribe should seek to resolve MAP cases in an average of 21 months. HMRC's most recently released statistics above show that it is not meeting this target.

Peer reviews on the implementation of BEPS minimum standards have been published by OECD, with the first round (including the UK and the USA) having taken place on 26 September 2017, the second round on 15 December 2017 and the third round on 12 March 2018. Taxpayer review (stage 1) of the fourth round closed on 22 December 2017. The peer review process is currently behind schedule, with the third round originally scheduled for August 2017, and some peer reviews have been deferred until 2020.

Whilst there is a legitimate concern that the path from rhetoric to action is often a winding one, there is an increasing commitment to mandatory binding arbitration and, indeed, to alternative methods of dispute resolution.

In the EU, the Arbitration Convention can be invoked to resolve issues and, on 10 October 2017, the Council published the Directive on Tax Dispute Resolution Mechanisms, which further highlights the need for a dispute resolution mechanism to back up the MAP.

One of the issues with the MAP and any arbitration process is the involvement of taxpayers in the process. Given that the MAP comprises an agreement or dispute between countries, the lack of input from taxpayers has always been a concern. Many of the changes proposed by Action 14 emphasise increased transparency for taxpayers, which is one of the key aims of the wider BEPS project. For example, taxpayers should be able to easily access guidelines and procedures with respect to the MAP process; and, to enable this, MAP profiles should be published on a shared public platform. The need for transparency in any arbitration process is also recognised as important. In the preamble to the EU Directive referred to above, the need to provide a 'transparent framework for solving disputes' is key.

Whilst taxpayer involvement is important, equally, in order to resolve MAP cases in a timelier manner, the OECD has determined that it is not necessary for those in charge of such cases to obtain the approval of the individual(s) who made the initial adjustments prior to resolving cases, which could lead to delays in reaching a resolution.

Steps taken in the UK

HMRC has already taken steps to improve dispute resolution. In 2013, HMRC introduced alternative dispute resolution (ADR). This process involves a neutral (albeit HMRC) mediator in an attempt to bring the taxpayer and HMRC together. HMRC has itself observed that the use of ADR could be beneficial in double tax treaty disputes.

In addition, the UK has already started updating its double tax treaties with regard to arbitration. In general, the provisions provide that, should an agreement not have been reached within two years of submission, the taxpayer can request that the unresolved issues be subject to arbitration.

The 'last best offer' or 'baseball arbitration' method, touted as the default option in the OECD's multilateral instrument, can reduce both the time and costs of any arbitration. It applies a simplified arbitration process that comprises, in essence, simply picking between monetary values. This incentivises parties to provide 'middle ground' estimates. Baseball arbitration has been included in the UK's income tax treaty with Canada, and may be a valuable addition to other treaties going forward.

HMRC regards itself as already engaged in international arbitration. In the recent debates concerning FA 2018, Mel Stride, financial secretary to the Treasury, confirmed the importance of mandatory arbitration and described it as an extension of HMRC's current approach to international arbitration.

Of course, there are obstacles and the process is at an early stage. There are issues concerning timing and input from taxpayers and, quite simply, whether a treaty partner shares the same commitment to arbitration. In addition, many of the double tax agreements (such as those entered into by the UK with France and Spain) prevent unresolved issues from progressing to arbitration if a decision has already been made by a court or administrative tribunal of either state, or if the case has been presented to either competent authority under the European convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

Inevitably, the notion of the UK ceding decision making powers to a third party process raises the question of the impact of Brexit. At the least, the EU Arbitration Convention and the Directive on Tax Dispute Resolution Mechanisms might have limited application to the UK.

Perhaps the biggest issue therefore, still remains the underlying question of the extent to which countries are really prepared to reach agreement on international matters.

Conclusion

On 23 February 2016, the OECD announced that it would be opening membership of the Committee on Fiscal Affairs to any country which wanted to join as a BEPS associate. Whilst their membership would only be in relation to BEPS discussions, all countries will participate on the project on an equal footing. This is a positive step in achieving the consistent and successful implementation of the Actions and may lead to more effective dispute resolution under Action 14.

In reality, it will be difficult for us to determine the likelihood of the success of this Action without real market evidence, which will take time. However, there is likely to be an increase in disputes as a result of the BEPS project owing to the increase in the number of reporting jurisdictions, the changing rules and the focus of countries on international issues (as evidenced by the UK's position paper on the digital economy). We may therefore not have too long to wait before we see Action 14 in practice. ■

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- The new directive on tax dispute resolution mechanisms (Liesl Fichardt & Chintan Chandrachud, 26.10.17)
- Dispute resolution through mandatory binding arbitration (Ian Hyde & Robert Thomas, 21.7.16)
- BEPS Action 14: OECD detail on 'MAP' procedures (Rupert Shiers & Julian Brown, 3.11.16)