

RECENT DEVELOPMENTS IN DISPUTE RESOLUTION UNDER TAX TREATIES

**DECEMBER 2, 2006
ROBERT H. GREEN
CAPLIN & DRYSDALE, CHARTERED
WASHINGTON, DC**

BACKGROUND

- **HEIGHTENED NEED FOR ROBUST DISPUTE RESOLUTION TECHNIQUES**
- **MULTINATIONAL COMPANIES (MNCS) ARE INCREASINGLY GLOBALIZING THEIR BUSINESS OPERATIONS**
- ➤ **GLOBALIZATION FOR MNCS TYPICALLY MEANS THE CENTRALIZATION OF CERTAIN FUNCTIONS AND THE ASSUMPTION OF RISKS IN LOW-COST AND FREQUENTLY LOW-TAX JURISDICTIONS.**
- ➤ **OBJECTIVE IS TO REDUCE THE COMPANY'S COST STRUCTURE AND, IF POSSIBLE, TO LOWER THE GLOBAL EFFECTIVE TAX RATE**
- ➤ **ALTHOUGH MANY, IF NOT MOST OF THESE CONSOLIDATIONS OF FUNCTIONS IN A LOW-COST, LOW-TAX JURISDICTION ARISE FROM LEGITIMATE BUSINESS RESTRUCTURINGS, THERE ARE FREQUENTLY TAX SAVINGS INVOLVED AND ALWAYS TAX ISSUES.**

TAX ISSUES

- ➤ **TAX ISSUES ARISE ON MAJOR CORPORATE RESTRUCTURINGS IN THE VARIOUS COUNTRIES WHICH SUFFER THE LOSS OF THE ACTIVITIES AND FUNCTIONS IN THEIR JURISDICTIONS AND COMMONLY EXPERIENCE A SHARP DECLINE IN CORPORATE TAX REVENUES.**

- ➤ **AMONG THE ISSUES THAT ARISE AS A RESULT OF THE NEW BUSINESS ARRANGEMENT ARE THE FOLLOWING:**
- ◆ **IMPOSITION OF A POTENTIAL GOODWILL/EXIT TAX UPON THE TRANSFER OF FUNCTIONS FROM HIGH-TAX COUNTRIES;**
- ◆ **WHETHER THE PRINCIPAL HAS A PERMANENT ESTABLISHMENT IN ONE OR MORE OF THE AFFILIATE JURISDICTIONS;**
- ◆ **AMOUNT OF PROFITS TO BE ATTRIBUTED TO THE PE;**
- ◆ **THE APPROPRIATE MARKUPS TO BE APPLIED TO VARIOUS SERVICES PERFORMED ON A CROSS-BORDER BASIS;**
- ◆ **WHETHER INTANGIBLES ARE DEVELOPED LOCALLY IN ANY OF THE AFFILIATE JURISDICTIONS; AND**
- ◆ **THE EXTENT TO WHICH THE ECONOMIC BEHAVIOR OF THE PARTIES IS CONSISTENT WITH THE UNDERLYING DOCUMENTATION CONCERNING THE FUNCTIONS AND RISKS INVOLVED.**

OTHER ISSUES

- ➤ **DOES THE PERFORMANCE OF INTERCOMPANY SERVICES INCLUDE EMBEDDED INTANGIBLES THAT REQUIRE COMPENSATION?**
- ➤ **HOW SHOULD THE SAVINGS DERIVED FROM THE PERFORMANCE OF MANUFACTURING AND OTHER FUNCTIONS IN LOW-COST LOCATIONS BE APPORTIONED BETWEEN THE AFFECTED JURISDICTIONS — .E.G. — SO-CALLED ISSUE OF COST LOCATION SAVINGS?**

KEY PROBLEM

- **CONTROVERSIES BETWEEN TAX AUTHORITIES ON THESE ISSUES COMMONLY INVOLVE SUBSTANTIAL ADJUSTMENTS, WHICH ALWAYS COMPLICATE THE RESOLUTION OF TAX DISPUTES.**
- **IN LIGHT OF THE NUMBER OF SUCH CASES AND THE SUBSTANTIAL AMOUNTS IN CONTROVERSY, THE NEED FOR ROBUST DISPUTE RESOLUTION TECHNIQUES IS HEIGHTENED.**

RECENT DEVELOPMENTS

- **EXPANDED USE OF APAS IN LESS CONVENTIONAL SITUATIONS**
- **◆ TRADITIONALLY, APAS HAVE BEEN USED TO REACH AGREEMENTS IN ADVANCE ON TRANSFER PRICING AND RELATED ISSUES BETWEEN HIGH-TAX COUNTRIES.**
- **◆ APAS HAVE ALSO BEEN USED BY TAXPAYERS TO RESOLVE EXISTING TAX CONTROVERSIES FOR OPEN TAXABLE YEARS, BUT TYPICALLY THE FOCUS HAS BEEN ON DISPUTES BETWEEN HIGH-TAX JURISDICTIONS.**
- **➤ A RECENT DEVELOPMENT THAT HAS EMERGED IN THE US APA PROGRAM INVOLVES THE ACCEPTANCE OF BILATERAL APA PROGRAMS BETWEEN THE US AND LOW-TAX COUNTRIES.**
- **➤ ACCORDINGLY, IT IS POSSIBLE THAT THE USE OF AN APA COULD BE EMPLOYED INVOLVING TAX DISPUTES ARISING FROM TRANSFERS OF FUNCTIONS/RISKS FROM HIGH-TAX TO LOW-TAX JURISDICTIONS.**
- **◆ CONCERNS/LOW-TAX COUNTRY HAS ONLY MODEST TAX REVENUE TO DEFEND, ALTHOUGH IT MAY AGGRESSIVELY DEFEND THE INCENTIVES THAT ATTRACTED THE TAXPAYER.**

EVALUATION OF MUTUAL AGREEMENT PROCEDURES (MAP)

- **OVERALL, THE USE OF MAP AS A DISPUTE RESOLUTION TOOL HAS BEEN REASONABLY EFFECTIVE.**
- **CRITICISMS DIRECTED AT MAP INCLUDE:**
 - **➤ DELAYS IN CASE RESOLUTION;**
 - **➤ DELAYS MAY ARISE FOR A MYRIAD OF REASONS: SUBSTANTIVE DIFFERENCES, SUBSTANTIAL AMOUNT INVOLVED, DELAYS IN PREPARING POSITION PAPERS, ETC.**
 - **➤ DOUBLE TAXATION CAUSED BY INABILITY TO CLAIM CORRELATIVE RELIEF DUE TO EXPIRATION OF STATUTE OF LIMITATIONS;**

EMERGING INTERNATIONAL CONSENSUS SURROUNDING THE USE OF MANDATORY ARBITRATION AS A DISPUTE RESOLUTION – VEHICLE

- **HISTORICALLY, ONLY COUNTRIES IN THE EUROPEAN UNION (EU) EXPRESSED SUPPORT FOR THE USE OF MANDATORY OR BINDING ARBITRATION TO RESOLVE BILATERAL TAX DISPUTES.**
- **ON JULY 23, 1990, MEMBERS OF THE EUROPEAN UNION SIGNED THE EUROPEAN ARBITRATION CONVENTION PROVIDING ARBITRATION PROCEDURES TO BE USED IN RESOLVING TRANSFER PRICING DISPUTES BETWEEN THE SIGNATORY STATES.**
- ➤ **ADDITIONAL RENEWALS OF THE EU ARBITRATION CONVENTION HAVE BEEN APPROVED FOR FIVE YEARS IN 1995 AND AGAIN IN 2004.**

RECENT DEVELOPMENTS HAVE ACTED AS A CATALYST TO GALVANIZE SUPPORT FOR BINDING ARBITRATION INTERNATIONALLY AS A DISPUTE RESOLUTION TOOL

- ➤ **WHILE VOLUNTARY ARBITRATION PROVISIONS EXIST IN SEVERAL US TREATIES, *E.G.*, NETHERLANDS, CANADA, GERMANY, ETC. THERE WERE NO US BILATERAL TAX TREATIES CONTAINING BINDING ARBITRATION UNTIL THIS YEAR.**
- ➤ **NEW PROTOCOL TO US-GERMANY TAX TREATY CONTAINS FIRST MANDATORY ARBITRATION CLAUSE IN A US TAX TREATY.**

KEY FEATURES

- **◆ APPLIES TO WIDE RANGE OF ISSUES, INCLUDING TRANSFER PRICING, PE, BUSINESS PROFITS, RESIDENCE, AND ROYALTIES.**
- **◆ COMPETENT AUTHORITIES (CAS) MAY AGREE TO HAVE ARBITRATION APPLY TO ANY OTHER MATTER SUBJECT TO THE MAP ARTICLE.**
- **◆ CAS MAY ALSO REJECT THE CASE ON ARBITRATION ON GROUNDS THAT IT IS NOT “SUITABLE.”**

OPERATIONAL DETAILS

- ➤ **ARBITRATION MAY BE ACTIVATED UPON THE LATER OF TWO YEARS FROM THE COMMENCEMENT OF THE CASE OR**
- ➤ **RECEIPT OF A NONDISCLOSURE FORM FROM TAXPAYER.**
- **ARBITRATION PANEL IS COMPRISED OF THREE MEMBERS:**
- ➤ **EACH COUNTRY SELECTS ONE ARBITRATOR (60 DAYS)**
- ➤ **TWO ARBITRATORS CHOOSE THE THIRD ARBITRATOR (60 DAYS LATER) WHO WILL BE CHAIR**
- **DEFAULT: OECD SELECTS A PERSON FROM LIST AS THIRD ARBITRATOR WHO IS NOT A RESIDENT OF EITHER COUNTRY.**

PROCEDURE

- **WITHIN 90 DAYS OF APPOINTMENT OF CHAIR, EACH CONTRACTING STATE MAY:**
 - ➤ **PROPOSE A RESOLUTION OF THE CASE TO THE BOARD**
 - ➤ **ATTACH A POSITION PAPER**
 - ➤ **REPLY SUBMISSION PAPER MAY BE PROVIDED WITHIN 180-DAYS OF CHAIR'S APPOINTMENT**

FORM OF DECISION

- **ARBITRATION BOARD WILL DELIVER ITS DECISION WITHIN SIX MONTHS OF THE CHAIR'S APPOINTMENT.**
- **➤ BASEBALL ARBITRATION WILL BE EMPLOYED: DETERMINATION WILL BE ONE OF TWO PROPOSED RESOLUTIONS.**
- **➤ BASEBALL ARBITRATION SHOULD HAVE A MODERATING EFFECT ON CAS AND ALSO WITH RESPECT TO THE AUDIT PRACTICES OF IES.**
- **IT HAS BEEN WIDELY REPORTED THAT THE PROTOCOL TO THE US-CANADA DOUBLE TAX TREATY THAT IS CURRENTLY BEING NEGOTIATED WILL INCLUDE A BINDING ARBITRATION PROVISION SIMILAR TO THE APPROACH IN THE US-GERMANY TREATY.**

OTHER KEY DEVELOPMENTS ENHANCING SUPPORT INTERNATIONALLY FOR BINDING ARBITRATION TO RESOLVE TAX DISPUTES.

- ➤ **ANNOUNCEMENT BY CANADA DURING OECD WORKING PARTY MEETING THAT IT WAS ABANDONING ITS PRIOR OPPOSITION TO MANDATORY ARBITRATION AND WOULD SUPPORT ARBITRATION IN SELECTED TREATY NEGOTIATIONS.**
- ◆ **IMPORTANCE OF MAJOR SOURCE-BASED COUNTRY, SUCH AS CANADA, EMBRACING BINDING ARBITRATION CANNOT BE OVERSTATED IN TERMS OF ITS IMPORTANCE IN BROADENING THE BASE OF SUPPORT FOR BINDING ARBITRATION IN THE INTERNATIONAL COMMUNITY.**

OECD REPORT

- **OECD RELEASED A DRAFT OF A PROPOSED EDITION TO ARTICLE 25 OF THE MODEL TAX TREATY WHICH CONTAINS A BINDING ARBITRATION FEATURE.**
- **THERE ARE SEVERAL OPERATIONAL DIFFERENCES BETWEEN THE BINDING ARBITRATION PROVISION IN THE OECD VERSION COMPARED WITH THE BINDING ARBITRATION PROVISION IN THE US-GERMANY PROTOCOL.**

OECD REPORT (CONTD.)

THESE INCLUDE:

- ➤ **SCOPE: US — TRANSFER PRICING, RESIDENCE, BUSINESS PROFITS, PE, AND ROYALTY ARTICLES WITH CAS GIVEN DISCRETION TO DENY ACCESS TO ARBITRATION;**
- **OECD: ARBITRATION MAY COVER ALL UNRESOLVED ISSUES;**
- ➤ **INITIATION OF PROCESS: US — AUTOMATIC REFERRAL AFTER TWO YEARS, DATE OF COMMENCEMENT OR FILING OF NONDISCLOSURE AGREEMENT;**
- **OECD: TAXPAYER MUST INITIATE THE PROCESS AFTER TWO YEARS FROM THE DATE THAT THE CASE WAS PRESENTED TO SECOND CA;**
- ➤ **SELECTION OF ARBITRATION PANEL: US — EACH COUNTRY SELECTS ONE MEMBER, AND THE TWO ARBITRATORS SELECT THE THIRD WHO IS CHAIR;**

OECD REPORT (CONTD.)

- **OECD: EACH CA APPOINTS ONE ARBITRATOR; TWO CAS AGREE ON THE THIRD FROM A LIST OF CANDIDATES. DEFAULT PROVISIONS APPLY IN BOTH CASES;**
- ➤ **BINDING/NOT BINDING: US — ARBITRATION IS TREATED AS AN EXTENSION OF THE MAP PROCESS, WHICH GRANTS THE TAXPAYER DISCRETION TO ACCEPT OR REJECT THE ARBITRATION DECISION;**
- **OECD: ARBITRATION DECISION IS BINDING ON THE CAS AND THE TAXPAYER;**
- ➤ **TAXPAYER INVOLVEMENT: US — NO TAXPAYER INVOLVEMENT;**
- **OECD: TAXPAYER MAY PRESENT HIS POSITION IN WRITING TO THE ARBITRATION BOARD AND MAKE A VERBAL PRESENTATION WITH THE PERMISSION OF THE BOARD.**
- ➤ **VOTING: US — SIMPLE MAJORITY;**
- **OECD: SIMPLY MAJORITY**
- ➤ **ANNOUNCEMENT OF DECISION: US — SIX MONTHS FROM THE APPOINTMENT OF THE CHAIR;**

OECD REPORT (CONTD.)

- **OECD: SIX MONTHS FROM APPOINTMENT OF LAST ARBITRATOR**
- ➤ **COSTS: US — EQUALLY SHARED BY THE CONTRACTING STATES;**
- **OECD: EACH STATE AND TAXPAYER COVERS COSTS ASSOCIATED WITH ITS PARTICIPATION**
- ➤ **PRECEDENTIAL VALUE: US — NO;**
- **OECD: NO**
- ➤ **DECISION FORM: US — BASEBALL ARBITRATION;**
- **OECD: QUASI-JUDICIAL APPROACH**
- ➤ **WHO INITIATES: US — PROCESS IS AUTOMATIC AFTER TWO YEARS;**
- **OECD: PROCESS MUST BE INITIATED BY THE TAXPAYER.**