The Case for Mandatory Binding Arbitration in International Tax

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Introduction

International tax disputes are more prevalent today than ever before. As countries seek to defend their tax bases with increased vigour during the implementation of the OECD’s base erosion and profit shifting (BEPS) proposals, the number of disputes is likely only to increase. By adopting mandatory binding arbitration (MBA), the inefficient and ineffective mutual agreement procedure (MAP) can be transformed into a robust, “well-oiled” tax dispute resolution mechanism.

The 2016 US Model Income Tax Convention (“the US Model”) contains a prototype MAP that incorporates MBA. This prototype should inform the development of MBA under the BEPS Action 15 multilateral instrument.
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Existing MAP Framework

The existing OECD MAP framework under Article 25 of the Model Tax Convention (“the OECD Model”) is undermined by the absence of an obligation on the contracting parties to resolve the dispute. Instead, contracting states are merely required to “endeavour” to resolve disputes. This “quasi-duty” is triggered only if the contracting state believes the claim to be justified and if it cannot otherwise resolve the taxpayer’s complaint. Furthermore, when contracting states agree to commence the MAP, there is no time limit imposed on negotiations.

International tax disputes often remain outstanding and unresolved indefinitely under MAP, particularly where the views of the contracting states are diametrically opposed. In such circumstances, the taxpayer is invidiously “left in the dark” and may continue to suffer double taxation with no avenue for redress unless and until the respective contracting states resolve the matter.

Paragraph 5 of Article 25 of the OECD Model provides for mandatory arbitration where MAP fails to resolve a dispute within two years. However, the incorporation of arbitration into double taxation treaties (DTTs) under the OECD Model is discretionary. As a result, in practice, arbitration is not commonly incorporated into DTTs internationally, largely due to the general perception that it involves ceding fiscal sovereignty.

BEPs Action 14: Making Dispute Resolution Mechanisms More Effective

The primary objective of the OECD’s BEPS Action 14 final report (“the Report”) is to make tax-treaty related dispute resolution mechanisms more effective. The fulfilment of this objective will be crucial to the overall success of the BEPS project.

The concerns raised by the business community about the potential for double taxation arising from the implementation of the BEPS proposals were generally met with assurances that the Action 14 proposals would be sufficiently adept to deal with any such instances should they arise. Although the Report does not adopt MBA as a minimum standard in dispute resolution due to the lack of consensus on the issue, the work on Action 14 has generated an international appetite for its adoption, which may lead to its becoming the norm in international tax disputes. The 20 OECD Member States, including Ireland, that have committed to developing a mechanism for MBA were involved in 90% of the MAP cases outstanding at the end of 2013.

US Experience

Like many countries, the US was traditionally reluctant to incorporate binding arbitration into its DTTs. However, in more recent years, the concept has been viewed increasingly as “an effective and appropriate tool to facilitate mutual agreement under US tax treaties”. MBA is currently available under a number of key US DTTs, including Canada and Germany. Empirical evidence suggests that MBA has improved tax dispute resolution in practice under these DTTs by significantly enhancing efficiency and certainty for taxpayers.

Support for MBA in the US continues to grow. The recent publication of the US Model adopts a practical MBA framework, the most significant features of which are:

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1 In 2014, the OECD reported that the total number of open MAP cases was 5,423. This figure represents an increase of 130.57% from the 2,352 open cases reported at the end of 2006. During this period, the average time for completing MAP cases rose from 22.1 months in 2006 to 23.79 months in 2014. Ireland has experienced an even starker increase in open MAP cases during this period. In 2014, Ireland had 25 open MAP cases compared to 4 at the end of 2006, an increase of 525%. (source: http://www.oecd.org/ctp/dispute/map-statistics-2014.htm)


5 The Report describes the commitment by the OECD sub-group as “a major step forward” and notes, in its final paragraph, that “a mandatory binding MAP arbitration provision will be developed as part of the negotiation of the multilateral instrument envisaged by Action 15”.


9 In a speech to the OECD on 10 June 2015, Robert Stack, US Treasury Deputy Assistant, highlighted the need for MBA after BEPS, noting that “we need to advance the ball for mandatory binding arbitration – work about which I’m fairly optimistic, in fact”, cited in Sapirie, “The Hesitation in Adopting Mandatory Binding Arbitration”, 17.
Mandatory: Disputes that are not resolved within two years of commencing the MAP, or at a later date as agreed between the contracting states, shall be submitted to arbitration.

Binding: A determination of the arbitration panel that is accepted by the taxpayer is binding on the contracting parties.

Format: The US Model adopts a “final-offer” or “baseball-style” format whereby the arbitration panel determines the dispute by selecting the position put forward by one of the contracting states. “Baseball-style” MBA is pragmatic and particularly useful in transfer pricing disputes, the most common double taxation disputes in practice, where there are often numerous justifiable positions that may be adopted by the parties. The precedential value to be derived from previous determinations of such disputes is questionable in light of the fact-specific nature of the subject matter.

Participation: The taxpayer is entitled to submit a paper detailing the taxpayer’s analysis and views on the case before the contracting states submit their respective position papers to the panel. Taxpayers are obviously uniquely positioned to explain processes and operations in their businesses. Denying a taxpayer the right to participate in MBA would therefore be counterintuitive.

Procedure: The procedures and timelines for each arbitration are determined in advance by the contracting states by mutual agreement.

Panel: The contracting states each appoint one representative to the arbitration panel. The two representatives jointly appoint an independent chair.

Conclusive: If a determination of the arbitration panel is not accepted by a taxpayer, the case is ineligible for any further negotiation between the contracting states.

The publication of the US Model is timely and should provide a paradigm for the development of MBA at OECD level.

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Tax Arbitration in Ireland and the EU

Provisions for binding arbitration are contained in four of Ireland’s 72 operating DTTs (Canada, Israel, Mexico and the US). The arbitration provisions are not mandatory, however, and apply only if both contracting states and the taxpayer agree to submit to arbitration. As a result, the Irish DTT arbitration provisions are seldom, if ever, triggered in practice. International experience suggests that the inclusion of voluntary arbitration provisions in DTTs is ultimately futile. The only recourse to MBA currently available to Irish taxpayers is through the EU Arbitration Convention (“the EU Convention”), although Revenue notes that none of the Irish cases submitted for resolution under the EU Convention have progressed to arbitration.

The EU Convention provides that Member States have two years to resolve transfer pricing disputes by MAP, failing which an advisory commission must be established to resolve the dispute by arbitration. However, arbitration under the EU Convention has rarely been invoked in practice despite the fact that many disputes remain outstanding after the two-year MAP period has lapsed. It has been suggested that the experience to date

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10 “Baseball-style” arbitration is so called due to its procedural similarity with salary arbitration in major league baseball.

11 See Farah, “Mandatory Arbitration of International Tax Disputes”, 742, where the author suggests that voluntary arbitration provisions in US tax treaties have never been used in practice.

12 Revenue, The Role of the Competent Authority, 18.


14 Only three of the 983 open cases awaiting resolution under the EU Convention at year-end 2013 had progressed to arbitration. Of the 432 cases pending resolution after two years of commencement, a settlement was agreed in principle in only 38. See http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2014/jtpf_008_2014_en.pdf.

indicates that taxpayers have some reservations regarding arbitration under the EU Convention.\footnote{16}

**Comment**

Many observers, including the OECD, suggest that the principal impact of MBA on tax disputes is that it incentivises early resolution by contracting states seeking to avoid outsourcing decision making and that it can therefore be highly effective in practice, even if rarely invoked.\footnote{16} This appears to be consistent with the US experience to date.

Although the commitment to MBA at OECD level is a positive development, the success of OECD MBA as a tool to resolve international tax disputes will ultimately be determined by the form it adopts. The US Model proposes a pragmatic format, which should be followed. The conclusive nature of “baseball-style” MBA focuses the contracting parties on resolution from commencement and therefore encourages the parties to adopt a more practical approach in disputes while preserving the inherent flexibility of the MAP. This format should also be more politically acceptable to states that view MBA with suspicion.

MBA is inherently decisive and provides for the efficient determination of disputes in an impartial, practical and structured way. The certainty and efficiency achievable through MBA are vital to protect enterprises with cross-border operations from double taxation and to promote confidence and engagement among the business community in the evolving international tax landscape. The structure and format of OECD MBA should become more apparent over the coming months.

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16 OECD, Improving the Resolution of Tax Treaty Disputes (2007), 4; Sapirie, “The Hesitation in Adopting Mandatory Binding Arbitration”, 15; Farah, “Mandatory Arbitration of International Tax Disputes”, 750. Farah suggests that the imposition of MBA could encourage contracting states to adopt a “blocking method” whereby MAP would be declined to avoid or block recourse to MBA. It is submitted, however, that the minimum standards proposed in the Report, if implemented correctly, should provide adequate protection against such action.