Resolving Multilateral Tax Treaty Disputes: (In)competent Authority in the 21st Century

I. Introduction

In today's world, taxing authorities of many industrialized and semi-industrialized nations rely on a network of treaties they have negotiated with other countries' taxing authorities to resolve the issues arising from the specter of double taxation. Double taxation can arise in situations where both jurisdictions are "high tax," such as the United States and the United Kingdom. While there is not much opportunity for the taxpayer to save tax dollars, each jurisdiction is generally reluctant to relinquish jurisdiction to tax the income, due to fears that its tax base is being eroded. Without little incentive to agree, double taxation is a real possibility. Conversely, in a situation where a taxpayer shifts much of its income from a high tax to a low tax jurisdiction, there are significant tax savings to be enjoyed. In this situation, the high tax jurisdiction will be very aggressive with its transfer pricing analysis, in order to ensure that its tax base is not being eroded. Double taxation is likely to arise because the low tax jurisdiction will have already taxed the profits located there, and then any subsequent adjustment in the high tax jurisdiction will lead to some of those same profits being subjected to a second round of taxation.[1]

How these disputes are resolved often involves a carefully orchestrated dance, in which the relevant information is exchanged, and each country negotiates for what it perceives to be its rightful income tax base. But what happens when these negotiations

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[1] *See* Femia, Rocco & Alexander Zakupowsky, Jr., *Japan Tax Association*, May. 24, 2005 (on file with the author). For an example of when double taxation can arise due to source versus residence disputes, see note 39, *infra*.

break down? What if a country staunchly refuses to alter its position? Is there a better way to negotiate the outcome of the dispute, such that each party can walk away feeling as if it has lost nothing? Or does the nature of the dispute (one authority will essentially cede the jurisdiction to tax business profits in question) guarantee that harmonious resolution is unlikely?

Why do we care about how such disputes are resolved? Because the breakdown of negotiations can lead to costly litigation for the taxpayer in both jurisdictions. Further, it is likely that the taxpayer will have lower after-tax profits than it should, either by paying extra tax or by incurring significant and unnecessary expenses. While no one is arguing that most important business decisions are driven solely by tax considerations, the breakdown in the amicable resolution of a tax dispute can have significant impact on the bottom line. Such negative implications will lead a business to consider seriously where it carries out overseas functions; if those functions are mobile, those decisions will often be tax-driven. If a country becomes known as one that historically has refused to compromise in tax dispute negotiations, even the hint that a multinational corporation ("MNC") will lose any of the tax benefits of doing business in that country may lead it to conduct its business elsewhere. Conversely, those countries known to act more reasonably in negotiations may be able to attract more business, ultimately mitigating any tax base erosion they may encounter by capitulating in individual cases.

This paper examines the shortcomings of the competent authority[2] process and examines whether alternative dispute resolution – specifically, mandatory, binding arbitration – would more efficiently resolve the types of disputes that commonly arise

[2] Throughout this paper, the terms "competent authority" and "mutual agreement procedure" will be used interchangeably.

between taxing authorities when double taxation appears to be imminent. The paper will begin with a basic fact pattern to give context to the issue. Next, it will examine bilateral advanced pricing agreements as a means of prospective dispute resolution, and suggest that while effective, they are an impracticable solution. The paper will go on to analyze the shortcomings of the competent authority process currently incorporated into most bilateral treaties, and examine the role of arbitration in resolving disputes arising under tax treaties. For competent authority proceedings and the arbitration process, the paper examines recent OECD proposals to modify both regimes, as well as the European Union's Arbitration Convention, and proposals of the Joint Transfer Pricing Forum to modify the mutual agreement process/advisory commission procedures contained therein. This paper will address the shortcomings of the Arbitration Convention's processes, but conclude that it represents the most complete model of a method for resolving double taxation disputes, as it appropriately accommodates the goals of efficiency, transparency and certainty in any resolution of tax disputes. Finally, this paper will address critiques of mandatory, binding arbitration as a dispute resolution tool in international tax, rejecting the contention that relinquishment of fiscal sovereignty is a valid justification for refusing to implement arbitration processes.

II. Base Case: GlaxoSmithKline

A case that is currently on the docket in the United States Tax Court, GlaxoSmithKline & Subsidiaries v. Commissioner[3], provides a perfect example of how competent authority process can disintegrate, leading to lengthy, costly and difficult

[3] Tax Court Docket Nos. 005750-04, 006959-05 (the amount in controversy, including interest, is roughly $10 billion, the largest ever litigated in the United States).

litigation.[4] GlaxoSmithKline ("GSK") is a pharmaceutical holding company with offices in North Carolina and Philadelphia. Its parent is located in the United Kingdom. GSK was formed subsequent to a merger between US-based Glaxo Wellcome and UK-based SmithKline Beecham.

The IRS proposed deficiencies under § 482[5] arise from Glaxo Wellcome's sales and licenses for the heartburn medication Zantac. Interestingly enough, after the merger, Glaxo Wellcome discovered that SmithKline Beecham had received much more favorable treatment from the IRS on its transfer pricing issues relating to its sales and licenses of Tagamet, a heartburn medication which was a direct competitor with Zantac[6]

As evidenced in a hearing on a procedural matter before the Tax Court in 2001, GSK initially sought to "resolve their differences through the Advance Pricing Agreement

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[4] According to its website, GlaxoSmithKline received two notices of deficiency. For tax years of 1989 to 1996, the IRS assessed a deficiency of $2.7 billion, and GSK estimated the amount of interest on that deficiency to be $2.5 billion. See Press Release, January 4, 2004, *available at* http://www.gsk.com/ControllerServlet?appId=4&pageId=402&newsid=121. For tax years 1997 to 2000, the IRS assessed another deficiency of $1.9 billion, and the interest on that deficiency was estimated to be around $700 million. *See* Press Release, January 26, 2005, *available at* http://www.gsk.com/ControllerServlet?appId=4&pageId=402&newsid=412. The case is tentatively scheduled to go to trial in October 2006. *Id.*

[5] Unless otherwise specified herein, all section references are to the Internal Revenue Code of 1986 and the regulations promulgated thereunder.

[6] *See* Moskal, Jerry, *IRS Locked in a Hard Battle Over GSK's Tax Bill*, TRIANGLE BUSINESS JOURNAL, April 23, 2004, *available at* *http://www.bizjournals.com/triangle/stories/2004/04/26/story6.html*

Program."[7] Later, GSK sought redress through the mutual agreement procedure[8] as outlined in the US-UK Tax Treaty.[9]

Under Article 25 of the treaty, in the event that the possibility of double taxation arises, the taxpayer may present his case to the taxing authorities in the state in which he is resident or a national.[10] Then,

> the competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at an appropriate solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of [double] taxation. Where an agreement has been reached, a refund as appropriate shall be made to give effect to the agreement.[11]

The treaty mandates that the contracting parties make an effort to resolve "any difficulties or doubts arising as to the interpretation or application" of the treaty, including issues relating to source, character and allocation of income, deductions, credits or allowances.[12] Finally, the treaty allows for direct communication between competent authorities to foment reaching an agreement. [13] However, the treaty contains no directives to make this process public, or to at least share the process with the taxpayer who is seeking relief.

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[7] *See GlaxoSmithKline Holdings (Americas), Inc. v. Commissioner*, 117 T.C. 1, 2 (2001).
[8] *Id.* (noting that both parties were committed to the competent authority process and neither expected the IRS to issue a notice of deficiency for 1989 through 1997).
[9] *Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, T.I.A.S. No. 9682, 31 U.S.T. 5668, 5680 (1980) (hereinafter "US-UK treaty").
[10] *Id.* at Art. 25(1).
[11] *Id.* at Art. 25(2).
[12] *Id.* at Art. 25(3).
[13] *Id.* at Art. 25(4).

Accordingly, it is impossible to know precisely how and why the negotiations in GSK's case broke down. The only publicly available information is the trial date.[14]

What alternatives to the APA system and competent authority could have led to a better outcome for GSK?

III. Prospective Dispute Resolution: Bilateral Advanced Pricing Agreements

The advance pricing agreement program ("APA") is a relatively recent system, introduced by the Internal Revenue Service ("IRS" or "Service") during the 1990s. The program was designed primarily to address the inefficiencies of administering the United States' transfer pricing rules.[15] The Service is of the opinion that the problems arising from these inefficiencies result in less taxable income being subject to U.S. jurisdiction.[16] These issues arise from the general maxim underlying all transfer pricing issues: When there are related parties engaging in multi-jurisdictional transactions, it behooves the group to allocate profits and losses on a tax-benefited basis. The parties' relationship presents ample opportunities for structuring transactions to minimize the overall effective tax rate of the controlled group.

In the United States, the "right" transfer price is defined as the arm's length price. In other words, the proper price charged between related parties is the same price that

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[14] *See GlaxoSmithKline Holdings (Americas), Inc. v. Comm'r, supra* note 7, at 2 (remarking that GSK and the IRS initially had high hopes for the successful resolution of the dispute through competent authority).; *see* also note 4, *supra* and accompanying text.

[15] For a historical description of the evolution of the transfer pricing rules, including the promulgation of regulations under § 482, see Ring, Diane M., *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross-Border Taxation*, 21 MICH. J. INT'L L. 143, 150-58 (2000).

[16] IRS Report on Application and Administration of I.R.C. § 482 (Pub. 3218), 1999 Daily Tax Report 108 at L-3.

unrelated parties, acting at arm's length, would charge each other.[17] While the rule sounds simple, it is deceptively so. Taxpayers are required to use the "best" of several specified transfer pricing methods to determine what the proper arm's length price would be. By the 1970s and 1980s it was becoming increasingly clear that the arm's length standard was difficult to apply without serious disagreement between the taxpayer and the government as to which transfer pricing method should have been used to derive an arm's length price.[18] The APA program serves as a means of prospectively agreeing on a company's transfer pricing method on a going forward basis for the next three years.

One aspect of the APA program is the bilateral APA ("BAPA") system, which allows for the taxpayer, the taxpayer's home country, and a second country in which the taxpayer earns income to agree to the transfer pricing methods the taxpayer will use, thereby avoiding conflict down the road. The BAPA system is advantageous where the taxpayer and the competent authorities can all agree in advance as to the prices that will be charged between the taxpayer and its related parties. The BAPA approach is not unique to the United States; many other countries have since instituted advanced pricing agreement systems, and the OECD has issued its own guidance on the subject.[19]

The BAPA program can be generally described as a prospective version of the mutual assistance procedures outlined in most bilateral treaties against double taxation. In general, under the BAPA system, the taxpayer will approach the tax authorities and ask

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[17] Treas. Reg. § 1.482-1 (2005).
[18] *See* generally Avi-Yonah, Reuven S., *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 95 (1995); Notice 88-23, 1988-2 C.B. 458 (hereinafter "the White Paper").
[19] *See* OECD Transfer Pricing Guidelines at

each to agree on an appropriate transfer pricing method before the transaction begins.[20] In return, the taxpayer is expected to provide full and complete information to the authorities, ensuring that they can efficiently deduce the best transfer pricing method.[21] The information shared is extensive, and includes "business activities, plans, competitors, market conditions, and prior tax circumstances."[22] Most importantly, the taxpayer presents his own explanation of the planned pricing method, and why it is appropriate given the circumstances.

The unique aspects of the BAPA system include the fact that the taxpayer and the governments discuss the proper transfer pricing method in advance of the transaction's consummation. Furthermore, it is a voluntary program; the taxpayer seeks the governments out to discuss the parameters of its business and the possible transfer pricing methods, perhaps divulging even more information than would have been available during audit. While there are other ways to obtain prospective determinations from the Service (namely in the form of private letter rulings), the BAPA program is different, largely due to the fact that it involves another government's taxing authority and because the agreement is confidential.[23]

Prior to 1996, if the taxpayer sought a BAPA, it would proceed as if it were seeking a unilateral APA: It approached the IRS, they discussed pertinent facts and conducted an economic analysis, and ultimately reached an agreement. They signed a memorandum of

[20] *See* De Waegenaere, Anja, et al., *Using Bilateral Advance Pricing Agreements to Resolve Tax Transfer Pricing Disputes*, at 3, Tuck School of Business Working Paper No. 2005-24, Social Science Research Network Electronic Paper Database, *available at* http://ssrn.com/abstract=766044.
[21] *Id.*
[22] Ring, *supra* note 15, at 147.
[23] *See id.* at 159.

understanding, and then the competent authority would conduct negotiations with the foreign taxing authority. This was changed largely due to the fact that many countries felt they were being handed a "done-deal," and it was difficult to encourage voluntary compliance in that kind of situation. Now, the foreign competent authority is involved in the process before the taxpayer and the Service have reached any sort of agreement.[24]

To be sure, while the procedures for obtaining a BAPA seem straightforward, the practicality of the program as it relates to transfer pricing certainly has its critics. Most commentators recognize that while obtaining a BAPA prior to entering into a cross-border transaction is ideal, it is far from practicable. For one thing, some have noted that the BAPA procedures inhibit cooperation between tax authorities when the two countries have differing transfer pricing regimes and one stands to lose a significant amount of money by agreeing on methods not recognized within its own regime.[25]

Further, an economic analysis of taxpayers seeking to obtain a BAPA shows that the more of the taxpayer's income that is potentially subject to double taxation that is at stake, the less likely the taxing authorities are to reach an agreement as to which transfer pricing method to use. This conclusion comes from an analysis of what the costs will be to each authority to undertake an audit. Naturally, while the auditing costs will rise with the scale of the audit to be undertaken (larger transactions require more resources for the audit, which results in higher auditing costs), at some point the potential tax revenue from a transfer pricing adjustment will outweigh any administrative costs the taxing authority

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[24] Ring, *supra* note 15, at n. 104.
[25] *See* De Waegenaere, *supra* note 20, at 16. This argument is closely related to that of the "feasibility" of a BAPA, discussed *infra*.

will incur to determine the appropriate transfer price.[26] Thus, the *desirability* of a BAPA depends on the costs of obtaining one versus the costs of conducting an audit in the absence of a BAPA. However, the *feasibility* of a BAPA is often determined by the amount of income subject to double taxation. Thus, one commentator has articulated the maxim that "all feasible BAPAs are desirable," while noting that the inverse is not true.[27]

Finally, when the tax rates of the two countries are similar and the auditing costs are rather expensive, there is speculation that a BAPA is less desirable. This conclusion assumes that when audit costs are high, neither country is likely to audit: The low tax country will not because it is too expensive, and the high tax country will not because there is little incentive for the taxpayer to shift income to a country where the tax rate is the same. Accordingly, when the two countries have the same tax rates, a BAPA will only be negotiated when the cost of doing so is very low, because neither country is likely to incur audit costs where the taxpayer has not obtained a BAPA.[28]

Other commentators cite the positive aspects of the BAPA program in general, arguing that taxpayers already experiencing troubles with an audit may find the program attractive because of the potential to avoid further penalties, interest, and dispute costs, as well as the possibility that the agreement terms can be applied to prior open years ("rollback").[29] Other important benefits of obtaining a BAPA include the ability to use a transfer pricing method that comports with the taxpayer's unique facts, even when such a method would have been otherwise untenable under U.S. law, and the ability to reach

[26] *See id*. at 11.
[27] *Id.* at 16.
[28] *Id.* at 16-17.
[29] *See* Ring, *supra* note 15, at 166.

agreement on method when treaty partners might not generally accept methods rooted entirely in U.S. law.[30]

Of course, the significance of the certainty that double taxation will be avoided in at least two different jurisdictions cannot be overlooked. In fact, the OECD supports BAPAs, and cites several positive aspects of the process, including that it "facilitate[s] principled, practical and co-operative negotiations," and "use[s] the resources of the taxpayer and the tax administration more efficiently."[31] That certainty, however, cannot compensate for the BAPA process's shortcomings. The process represents a significant burden to the taxpayer, who is expected to come forward and present the Service with all of the requisite facts it needs to undertake its analysis. Moreover, the process takes a significant amount of time to complete. This process may be unpalatable to the taxpayer who, for valid business reasons, declines to pursue a BAPA.[32] Also, the taxpayer may not be at liberty to wait until the process is complete before beginning the transaction in question. Thus, while attractive in certain circumstances, the limited situations in which a BAPA's benefits will outweigh its costs results in an ineffective tool for the bulk of double taxation disputes. Interestingly enough, recognizing that the BAPA process often involves the competent authorities of the respective tax administrations, the OECD, in its

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[30] *See* Ackerman, Robert E., *Will U.S. Standardization Erode Key Flexibility in APAs?*, 12 J. INT'L TAX'N 12, 15 (2001).

[31] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Annex at AN-22 (1999). The OECD also emphasizes the cooperative spirit required to actually reach an agreement, and encourages the process to be conducted in a "neutral manner," with respect to, *inter alia*, the taxpayer's residence and the jurisdiction in which the BAPA request was initiated. *Id.* at AN-22-23.

[32] For example, if the corporation is under continuous audit, as are many large corporations in the United States, providing the Service with more information than that which it would normally have might impact other areas of the corporation's transfer pricing policies, and increase its chances of having an allocation made in other transactions.

nomenclature for BAPAs ("MAP-APAs"), likens the process to competent authority dispute resolution.[33]

IV. Retrospective Dispute Resolution: Competent Authority Process

a. General Discussion

The competent authority process is designed to allow authorities from each country to consult and hopefully, to reach a resolution of double taxation issues. Generally, these disputes arise out of one or more different scenarios: the taxation in dispute is not in accordance with treaty methods, there are doubts or difficulties surrounding the proper way to interpret the treaty, or an instance of double taxation not contemplated by the parties to the treaty has arisen.[34]

An interesting aspect of the process is that it allows a taxpayer to request the competent authority of its state of residence to contact the other state and initiate proceedings, regardless of the remedy afforded by applicable domestic law.[35] As many commentators have noted, this unique characteristic of the process often leads to tension between the taxpayer and the resident state, because their individual interests are often inconsistent with each other.[36]

Further tensions arise between sovereign states, as the disputes revolve around aspects of each country's internal taxation regimes. By their very nature, double taxation treaties impose certain obligations on the member states, and only these member states

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[33] *Id.* at AN-21.
[34] *See* Anton, Fernando Serrano, *Settlement of Disputes in Spanish Tax Treaty Law*, *in* SETTLEMENT OF DISPUTES IN TAX TREATY LAW, 427, 429-30 (Michael Lang & Mario Züger, eds. 2002).
[35] *See* Rooney, Paul C. & Nelson Suit, *Competent Authority*, 49 TAX LAWYER 675 (1996).
[36] *See id.* at 675-76.

can demand that the other not tax the taxpayer, grant the taxpayer a credit, or take any other action that will result in non-discrimination to the taxpayer.[37] The types of conflicts that arise between member states that are parties to a double taxation treaty can arise in fact or in law, or they can arise out of the states' differing interpretations of specific treaty language.[38] For example, a factual dispute could arise out of the states' different qualifying times for what constitutes a permanent establishment, while interpretative conflicts might arise out of the states' differing positions on sourcing rules.[39]

In the transfer pricing context, mixed factual and legal disputes generally arise out of the taxpayer's chosen transfer pricing method; while it is a question of law which transfer pricing method is best, the taxpayer's decision to use a particular transfer pricing method in the first instance is a highly fact intensive determination.[40] In fact, this is exactly the type of dispute that arose in the base case of GSK: The IRS questioned GlaxoWellcome's transfer pricing methods relating to its distribution of Zantac, and an adjustment under § 482 was proposed.

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[37] *See* Züger, Mario, *Settlement of Disputes in Tax Treaty Law – General Report*, *in* SETTLEMENT OF DISPUTES IN TAX TREATY LAW, 15, 17 (Michael Lang & Mario Züger, eds. 2002) [hereinafter *Settlement of Disputes*].

[38] *See id.*

[39] For example, suppose taxpayer conducts business in both State A and State B for the taxable year at issue. The taxpayer has a customer service and sales office in State A, which considers proceeds from Internet sales passing through a server there to be sourced to State A. Conversely, the taxpayer may have a business office in State B, and because that office conducts all accounting functions, as well as the packaging and shipping of items sold on the Internet, State B considers the sales proceeds to be sourced to it. In such a situation, taxpayer potentially would be subjected to tax in both states. *Cf.* Züger, *supra* note 16, at 18.

[40] *Cf. Settlement of Disputes*, *supra* note 37, at 17.

In theory, the competent authority process is not a difficult undertaking, at least logistically speaking. Under the OECD's model treaty[41] (which most bilateral double taxation treaties mirror), the mutual agreement procedure has several general rules by which the member states are expected to abide. Beyond that, there is little direction as to how the negotiations are to be undertaken, what information is to be disseminated to the taxpayer, and there is not a mandate that the competent authorities ultimately reach a conclusion.

Specifically, the OECD model treaty states:

> 1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
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> 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
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> 3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
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> 4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

[41] OECD Model Tax Convention, Art. 25, Mutual Agreement Procedure (2003).

As noted earlier, there is no requirement that the mutual agreement procedure process include the taxpayer as a party to the negotiations, which means that the taxpayer may be caught in a situation in which it has neither the ability to participate in proceedings, nor the opportunity to inspect case files.[42] While the OECD model does allow for taxpayers to present written or oral arguments in person or through a representative, the reality is that the competent authorities complete the process through written correspondence or in person, usually with no input from the taxpayer.[43] Because the nature of the process is not completely transparent, and because the tax authorities can condition their participation in the negotiations upon the guarantee of certain concessions or deny that a dispute exists at all, many critics complain about "package deals" being awarded in the mutual agreement procedure context. In other words, despite the OECD's caution that each mutual agreement procedure case be viewed individually, because the road leading to the negotiating table can be long and difficult, tax authorities have an incentive to settle as many of the same "types" of disputes as they can in one fell swoop.[44]

Other drawbacks include the fact that the model treaty provides no timeline for the resolution of the dispute, and the fact that neither state is bound to reach some type of resolution of the dispute.[45] Indeed, the OECD considers the absence of a requirement of a

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[42] *See Settlement of Disputes*, *supra* note 37, at 21-24; *see also* Züger, Mario, ARBITRATION UNDER TAX TREATIES: IMPROVING LEGAL PROTECTION IN INTERNATIONAL LAW, 13-14 (2001) (quoting Article 25(45) of the OECD Commentary) [hereinafter ARBITRATION UNDER TAX TREATIES].
[43] *See* ARBITRATION UNDER TAX TREATIES, *supra* note 42, at 14.
[44] *See id.* at 14-15.
[45] *See Settlement in Disputes*, *supra* note 37, at 22.

resolution to be the "fundamental deficiency" of the entire process.[46] Further, assuming an agreement is reached, the decisions are normally not published, so the taxpayer (and those coming afterward) have no idea why the case was resolved the way it was.[47] Recognizing the many shortcomings of the mutual agreement procedure, the OECD recently has undertaken the daunting task of proposing methods of refining the system.

b. OECD Proposals

In March of 2006, the OECD convened a group in Tokyo, Japan, to discuss ways to better effectuate resolution of tax disputes within the rubric of the mutual agreement procedure outlined in its Model Tax Convention. As early as 2004, the OECD recognized a need for change, issued its proposals for improving tax treaty disputes, and invited public commentary.[48] Those proposals,[49] along with its draft Manual on Effective Mutual Agreement Procedures ("MEMAP"),[50] were discussed in more detail in the March 2006 meeting.

The OECD described the problem with the current implementation of mutual agreement procedures as one that arises not due to the inherent nature of the process, but

[46] *See* ARBITRATION UNDER TAX TREATIES, *supra* note 42, at 13.
[47] *See Settlement of Disputes, supra* note 37, at 22-23.
[48] *See* OECD, Centre for Tax Policy and Administration, *Improving the Process for Resolving International Tax Disputes*, July 2004, *available at* www.oecd.org/dataoecd/44/6/33629447.pdf.
[49] *See* OECD, Centre for Tax Policy and Administration, *Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes (Public Discussion Draft),* Feb. 2006, *available at* http://www.oecd.org/document/31/0,2340,en_2649_34897_29601439_1_1_1_1,00.html [hereinafter "*Proposals*"].
[50] *See Proposals*, *supra* note 49, Section C at 35. The MEMAP will be located on an OECD website, and it is geared to taxpayers and tax administrations alike. Still in the development stages, the MEMAP will "explain the various stages of the [MAP], discuss various issues related to that procedure and, where appropriate, describe best practices." *Id.* The MEMAP is available at http://www.oecd.org/document/45/0,2340,en_2649_34897_36156141_1_1_1_1,00.html.

because of the increasing number and complexity of tax treaty disputes. Accordingly, the proposals are broken down into two large groups. The first, and some would say, “groundbreaking” set of proposals suggest incorporating a section on alternative dispute resolution into the OECD’s Model Tax Convention.[51] The second set of proposals address general problems identified with the current MAP process, and suggest solutions to be included in the commentary on the Model Tax Convention. It is the second set of proposals that will be addressed in this section.[52]

i. Time Limitations

Noting Art. 25(1)’s three–year time limitation on the taxpayer’s ability to seek MAP assistance, the working group recognized the need for clarity as to the time when the period begins to run. Specific topics for clarification included, inter alia, upon what specific event should the time period generally be considered to begin running, and whether the time limits for MAP proceedings should run concurrently with any domestic proceeding (such as audit or litigation) the taxpayer pursues.[53]

Moreover, with respect to the coordination of domestic remedies with those of the MAP, the OECD suggests two possible remedies. One, the taxpayer may required to initiate the MAP, “with no suspension [of] domestic proceedings, but with the competent authorities not entering into talks in earnest until the domestic law action is finally determined….” The alternative is that the “competent authorities enter into talks, but

[51] *See generally*, *Proposals*, *supra* note 49, Section A.
[52] *See generally*, *Proposals*, *supra* note 49, Section B. The alternative dispute resolution mechanisms discussed in Section A of the Proposals are discussed in Section VI.C, *infra*.
[53] *See Proposals*, *supra* note 49, at ¶ 17.

without finally settling an agreement unless and until the taxpayer agrees to withdraw domestic law actions."[54]

Note that there is no clear settlement of which remedy is to be sought first. The proposals suggest that the taxpayer can initiate the MAP process while continuing to pursue domestic law remedies, but that the competent authorities will not begin discussions "in earnest" until the domestic remedies have been "determined." Not only does this course of action not foment efficiency, it also calls into question the certainty of the final action. What does "determined" mean? Final resolution? An unfavorable result to the taxpayer? Surely the OECD does not suggest that the taxpayer will be able to wend its way through its domestic legal system, obtain a result, and then – if that result proves unsatisfactory – seek resolution under the MAP process. The alternative to this suggestion, that the MAP process not be initiated until the taxpayer agrees to abandon domestic law remedies eradicates the possibility of two outcomes, and ensures that the agreement reached between the competent authorities will be the only one binding the taxpayer.

ii. Transparency

In the 2006 proposals, the OECD acknowledged earlier work in 2004, which recognized that the lack of transparency in the MAP process is a problem. To that end, the 2004 proposals suggested that OECD member countries disseminate "information concerning the organization of competent authority functions and the procedures to be followed in mutual agreement cases."[55] Accordingly, there is now information of the OECD website for both member and non-member countries concerning the process. The

[54] *Id.* at ¶¶ 20-23.
[55] *Id.* at ¶ 2.

proposals are important not only because of what they say, but also because they highlight the insufficiencies of the current process. The current state does not lend itself to the lengthy resolution of a dispute; indeed, there is some uncertainty as to when and how the MAP process is initiated.

Even with the proposals' strides toward certainty under the MAP process, the steps undertaken to increase transparency leave much to be desired. While general information about the competent authority process is helpful, taxpayers still are not privy to information regarding their own disputes. They do not participate in the negotiations themselves, nor do they have access to any kind of written opinion discussing the reasoning of the competent authorities in reaching an agreement. Thus, rather than a primer on how the competent authority process functions, taxpayers would benefit more from the availability of reliable information that may help them weigh the likelihood of success if they choose to seek relief through the MAP process. Furthermore, there is still no guarantee that the MAP process will result in an agreement; accordingly, binding arbitration as a means of settling double taxation issues seems like a more palatable approach, when taking into account the desire to have a dispute resolution process that is efficient and transparent, lends itself to certainty, and whose results can be relied upon – or at least consulted for guidance – in future cases.

V. Arbitration as a Means of Resolving Disputes: Moving Forward

a. General Discussion

In the arena of international law, arbitration has long been a successful tool in the dispute resolution process. Several forms of arbitration exist, and it is up to the parties to the dispute to decide which method will result in a resolution being efficiently reached.

The common feature of all forms of arbitration is that they are a means of reaching a binding decision under international law, and that they are legal in nature, as compared to mediation, conciliation, and other forms of dispute resolution that are described as "diplomatic means" of dispute settlement. Another common aspect amongst the different types of arbitration is that the parties are left to decide between themselves "the machinery" for settling the dispute.[56] The types of arbitration most relevant in the context of resolving double taxation issues are those that deal specifically with states as parties, or public international arbitration. Regardless of the specific method chosen, arbitration usually leads to a resolution of the issues in a manner agreeable to all parties to the dispute.

The first type of arbitration involves states designating a tribunal to resolve either disputes that may arise in the future, or one that has already developed. For example, commissions with equal numbers of arbitrators from each state can be designated as the final arbiters of any disputes between states. In the event that the members of the commission are unable to reach an agreement, the commission could also include a neutral member not from either state, who would serve as an "umpire," resolving the issue for once and for all.[57] Another type of arbitration does away with the idea of a commission, and instead allows the disputing parties to refer all matters to a foreign head of state or government. This type of arbitration is not as common today, but some relatively recent examples of its implementation do exist.[58]

[56] *See* Merrills, J.G., INTERNATIONAL DISPUTE SETTLEMENT, 88 (3d ed. 1998)
[57] One of the earliest examples of this type of arbitration is the Treaty of Ghent between the United States and the United Kingdom, which was signed in 1814. *Id.* at 89.
[58] *See, e.g., Argentine-Chile Frontier Case*, 38 I.L.R. 10 (1966); *Beagle Channel Arbitration (Argentina v. Chile)*, 52 I.L.R. 93 (1977).

Rather than refer the dispute to a foreign head of state or government, another option involves referring the matter to a qualified individual arbitrator. One of the attractive advantages of this type of arbitration is that the matter can often be resolved quickly and inexpensively, as compared to employing an entire commission of arbitrators. By the same token, large or very complex cases might not be appropriate for referral to an individual arbitrator, as the workload can be exhausting. Traditionally, individual arbitrators have also been jurists, although in rare circumstances, someone else may be chosen.[59]

Today, the most common form of arbitration involves a body of an odd number of arbitrators who have the power to decide the issue by majority vote. Importantly, this type of arbitration is used most often in the context of disputes arising under treaties, exactly the same types of disputes the mutual agreement process seeks to remedy. The arbitrators on this type of body, often referred to as a "collegiate tribunal," typically consist of one arbitrator from each state that is a party to the dispute, and a few neutral arbitrators agreed upon by both states.[60]

b. United States – Germany Double Taxation Convention: A Workable Example of an Arbitration Clause?

In the context of tax treaties, arbitration is a useful tool for settling disputes arising from double taxation. Especially given the fact that tax authorities are not bound to reach an agreement under the mutual assistance procedures, a binding opinion of the collegiate tribunal provides a means of reaching an agreement even when the parties have no

[59] *See* Merrills, *supra* note 56, at 90-91. For example, France and New Zealand settled the dispute in the *Rainbow Warrior Case* with the Secretary General of the United Nations as the arbitrator.
[60] *Id.* at 91-92.

incentive to do so on their own. Recognizing the fact that arbitration can be effective in dispute settlement, many countries have incorporated arbitration clauses into the tax treaties they have negotiated. For example, the United States has arbitration clauses in its tax treaties with Germany, Canada, France, Ireland, Italy, Kazakhstan, Mexico, and Switzerland, but notes as to the specifics of the arbitration process have been exchanged only in the United States-Germany treaty.[61] The arbitration clause in the United States – Germany treaty reads as follows:

> Disagreements between the Contracting States regarding the interpretation or application of this Convention shall, as far as possible, be settled by the competent authorities. If a disagreement cannot be resolved by the competent authorities it may, if both competent authorities agree, be submitted for arbitration. The procedures shall be agreed upon and shall be established between the Contracting States by notes to be exchanged through diplomatic channels.[62]

While seemingly a step in the right direction, the notes discussing the mechanics of the arbitration process severely limit the situations in which each state might invoke arbitration. As an initial matter, each state must consent before referring the dispute to arbitration. First, arbitration may only be invoked if the parties have exhausted all of the mutual assistance procedures outlined in Art. 25(1)-(4), and only if the dispute does not concern the tax policy or domestic tax laws of either state.[63] The Notes allow that the arbitration panes shall have no fewer than three members, and each state shall choose the

[61] *See* ARBITRATION IN TAX TREATIES, *supra* note 42, at 19.
[62] *Convention Between the United States of America and the Federal Republic of Germany for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital and to certain other taxes, with a related protocol, exchanges of notes and memorandum of understanding*, Art. 25(5), 1708 U.N.T.S. 3 (1991) [hereinafter "*the Convention*"].
[63] *See id.* at *Note* (Aug. 29, 1989), at ¶ 1.

same number of arbitrators, with the remaining members from either the United States, Germany or other OECD member countries.[64]

The Notes also have restrictive rules affecting the transparency of the arbitration panel: The members of the panel must agree to the competent authorities' confidentiality procedures, and the most restrictive procedure will trump.[65] However, taxpayers will be afforded the opportunity to present their views to the arbitration panel.[66] Keeping with the shroud of secrecy in which the mutual agreement procedures are undertaken, the Notes allow that the arbitration panel is to provide an explanation of its decision to the competent authorities of each state, but makes no mention of providing the same to the taxpayer. The arbitrators are to apply the law of the tax treaty, while taking into account each state's domestic law, as well as international law principles. As usual, the arbitration will be binding on both states and on the taxpayer, but the Notes mandate that the decisions have no precedential value, perhaps to combat the widely perceived notion that decisions reached under the mutual agreement procedure are akin to "horse trading." However, while on one hand stating that the arbitration panel's decisions will not have any precedential value, the language strongly suggests that subsequent cases turning on "substantially similar" issues and facts should be decided in the same fashion, even when different taxpayers are involved.[67]

Thus, while the inclusion of Article 25(5) in the United States-Germany tax treaty seems promising, the terms of the arbitration are so restrictive that they closely resemble the mutual agreement procedure – and all of its limitations. That the competent

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[64] *See id.* at ¶ 2(a).
[65] *See id.*
[66] *See id.* at ¶ 4.
[67] *See id.* at ¶ 5.

authorities even contemplated arbitration as a means of dispute resolution is promising. But the fact that each state must consent before the matter is referred to arbitration is perhaps indicative of an underlying reluctance to relinquish decision-making authority to a disinterested third party, and it seems unlikely that this remedy will be available often.. Perhaps recognizing the shortcomings of the arbitration clauses as they currently stand – whether in force or not – the OECD recently issued recommendations modifying the treatment of arbitration in its Model Tax Convention.

c. OECD Proposals: Inclusion of Arbitration in the Mutual Assistance Procedure Process

The OECD states that the "MAP process can…be improved by supplementing it with …dispute resolution techniques which can help to ensure that international tax disputes will to the greatest extent possible be resolved in a final, principled, fair and objective manner for both the countries and the taxpayers concerned."[68] However, not wanting to undermine its own MAP procedure – which the OECD acknowledges as being insufficient, as it does not require competent authorities to reach an agreement – the proposals warn that competent authorities should first attempt to resolve disputes under a MAP process that integrates these alternative dispute resolution techniques, and not use them as an "alternative route" to deciding the issues.[69] To that end, the proposals suggest requiring the *mandatory* resolution of unresolved MAP cases, and propose the inclusion in the Model Tax Convention of a paragraph similar to that of Art. 25(5) in the United States – Germany convention.[70]

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[68] *See Proposals*, *supra* note 49, Section A at ¶ 10; *see also id.* at ¶ 45.
[69] *See id*. at ¶¶ 8-10.
[70] *See id.* at ¶ 13.

The OECD arbitration clause differs in that it will not allow an unresolved matter to be referred to the arbitration panel as long as "any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide the same issues or if a decision on the same issues has already been rendered by such a court or administrative tribunal."[71] In clarifying the role of arbitration within the mutual agreement procedure, the OECD makes it clear that arbitration is only to be used where the competent authorities cannot agree; it is not to be used by the taxpayer as a recourse for what it perceives to be an undesirable disposition of the case by the competent authority of its resident country.[72]

Importantly, the proposed Commentary to Article 25 of the Model Tax Convention notes that even in the absence of an arbitration clause in a tax treaty, the states can still invoke the usage of the arbitration procedure by mutually agreeing to do so. Moreover, the proposed Commentary also suggests that in the absence of an arbitration clause, the states can also agree to refer the issue to an arbitration panel that will issue an independent, non-binding resolution of the case. Furthermore, not only may the states agree to use arbitration in the event of the inability to reach an agreement, the taxpayer may ask that any unresolved issues be referred to arbitration. Such request can be made anytime during the prescribed two-year period, or anytime thereafter, if the taxpayer wishes to give the competent authorities more time to resolve the matter.[73]

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[71] *Id.* at ¶ 14.
[72] *See id.* at ¶ 45 (offering new language for the Commentary on Article 25).
[73] *See id.* at ¶¶ 48-50; *cf.* ¶ 58 (allowing for the possibility that, some states may want to reach a different resolution than that provided in the arbitration panel's opinion, and so may opt for a six-month grace period after the arbitration opinion's issuance, during which they may reach an alternate agreement). If no such agreement is reached during the grace period, the arbitration panel's opinion becomes binding.

Regarding the taxpayer's exhaustion of domestic law remedies, the proposed Commentary clarifies that such is exhaustion is necessary so as to avoid conflicting opinions. The exhaustion requirement helps to ensure that the arbitration process is as effective as possible by negating the possibility that the panel's decision might later be litigated (and overturned) in court. Similarly, if the issue has already been decided by a court of law, arbitration will not be a means of recourse. Importantly, the proposed Commentary makes sure to note that the bar to arbitration will apply to all interested parties; thus, if the taxpayer seeking arbitration under the MAP process has a related party (member of its consolidated group) that is "directly affected by the case," and that related party still has available judicial recourse, arbitration is not an option.[74]

On unresolved issues directly related to the inability of competent authorities to agree on the proper arm's length price, the proposed Commentary directs the states to resolve the issues in accordance with the OECD's own Transfer Pricing Guidelines.[75] But this suggestion may not be as prejudicial as it sounds. The OECD's Guidelines have a clearly stated preference for transactional – as opposed to profits-based – transfer pricing methods.[76] In countries such as the United States, where there is no such preference for (or rather, stated abhorrence of) profits-based methods, it is easy to imagine the impasse

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[74] *See id.* at ¶¶ 53-54; *see* also *id.* at ¶ 62 (suggesting that arbitration requests be accompanied with declarations that all domestic law remedies have been exhausted, or if not, that the taxpayer agrees to "renounce irrevocably" those remedies).

[75] *See id.* at ¶ 89.

[76] Some commentators describe the OECD's justification for its preference for transactional methods as being twofold: (1) parties rarely determine prices based on profits, and (2) profit splits, and thus the transfer prices, can be affected by factors that have little to do with the determination of an appropriate price; *e.g.*, management problems. *See* European Union, Commission Staff Working Paper: Company Taxation in the Internal Market, COM(2001)582 final, *available at* http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf [hereinafter "Company Tax Study"].

between American competent authority and the competent authority in a state where the rules more closely align with the OECD's Guidelines. In an arbitration setting, however, the impasse could be resolved by the third (or fifth) member of the panel, who, having no preference for one or the other, could consider the domestic law of each state as well as the Guidelines to determine which method truly was the best for arriving at an arm's length price.

Thus, the OECD proposals can accurately be summed up as ones where the "mandatory resolution" of unresolved MAP cases is to be obtained through binding arbitration. The proposals, however, show a strong preference for the application of the MAP process first, and then referring the dispute to an arbitration panel should the competent authorities reach an impasse. As noted above, the MAP process in and of itself is objectionable because it does not lend itself to the timely resolution of double taxation issues, nor does it provide transparency. When there is an impasse under the MAP process, the taxpayer is unaware of the key issues between competent authorities and cannot even attempt to help the process along by agreeing to certain concessions that might be favorable to both sides and lead to the timely resolution of the issue. Because the OECD proposals are in favor of MAP process resolution first, they allow a two-year period for the competent authorities to reach an agreement, which is much more time than should reasonably be necessary for the competent authorities to either agree on how the issue will be resolved, or discover that no resolution will be forthcoming.[77]

[77] *See* Owens, Jeffrey, *The OECD's Work on Dispute Settlements in Tax Matters: A Progress Report*, 41 TAX NOTES INT'L 1057 (Mar. 27, 2006) (summarizing the OECD proposals, and noting that a realistic timeline for competent authorities to express their position on a particular issue to their counterparts is four to six months).

Moreover, the proposals give the parties a means of avoiding arbitration by ensuring that if any party "directly affected by the case" is entitled to resolution of the issue in administrative tribunals or courts, then the case my not be referred to an arbitration panel. This further reduces the likelihood of arbitration being implemented, as there will always be at least one "interested party" that would rather take their chances in court than leave the resolution up to an arbitration panel.

Procedurally, the competent authority process takes place before the taxpayer has decided whether or not to go to court. Glaxo is a prime example: once the United States and the United Kingdom could not agree to any corresponding adjustments that would relieve the taxpayer of double taxation, Glaxo elected to litigate the issue in Tax Court. While there will certainly be cases where both the taxpayer and the primary taxing authority would rather litigate the issue, it is rare that all *three* parties would rather litigate. The choice to go to court rather than send the issue to an arbitration panel calls into question several issues, not the least of which is what jurisdiction is the one to best decide the issue? How will the respective competent authorities decide in whose courts the outcome is the most favorable to all parties involved? Also, what mechanisms will be in place to require the jurisdiction in which the issue was not litigated to respect the decision and act accordingly? In the case where the issue is litigated in State A, and the courts decide in favor of State A – giving it the right to tax income – who is to say that State B won't ignore the decision and declare that it, too, has the right to tax the income in question, and thus refuses to make a downward corresponding adjustment. It is not hard to imagine this scenario, and in the case where this happens, the taxpayer will be in the same position it was in before the process began: Subjected to double taxation.

d. European Union Arbitration Proposals

i. Company Tax Study

Within the last five years, the European Union ("EU") has begun to address the issues surrounding double taxation that may arise when transfer prices are adjusted in transactions involving related parties in different member states. The EU Commission first came together in 2001 to identify the problems that generally plague corporate taxation that are unique to the EU, and the result of that meeting was a voluminous study.[78] While it may seem that the EU's transfer pricing woes have little to do with those of the rest of the world, in effect, the same problems plaguing the EU are the ones that plague tax authorities around the world. The Company Tax Study summed up the problem: "As economic integration in the Internal Market proceeded, the economic, technological and institutional barriers to cross-border trade continued to wane. At the same time, taxation systems adapted to this process only very gradually."[79] Replace "internal market" with "world," and instead of being applicable only to the EU, the issue is universal. Thus, some of the difficulties the Commission identified in the study are cogent to this discussion, as are some of their proposed solutions.[80]

The Company Tax Study specifically addressed transfer pricing, and identified several difficulties that it perceived resulted in a less efficient administration of the tax

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[78] *See* generally Company Tax Study, *supra* note 76, and accompanying text.
[79] *Id.* at 6.
[80] The International Chamber of Commerce has advocated mandatory, binding arbitration since 1984, and refers to the EU's Arbitration Convention as "an important precedent which merits consideration in framing the appropriate terms for international arbitration provisions in general." *See* International Chamber of Commerce, Commission on Taxation, *Policy Statement: Arbitration in International Tax Matters*, Doc. No. 180/438, May 3, 2000, *available at* http://www-old.iccwbo.org/home/statements_rules/statements/2000/arbitration_tax.asp.

laws. One of those areas was dispute resolution in instances in which double taxation between member states arose. As is the case worldwide, double taxation issues within the EU commonly arise because one member state may find an MNE's transfer price or transfer pricing method acceptable, while the other member state does not.[81] Thus, the question becomes how to resolve these disputes efficiently, in a manner that does not have a chilling effect on cross-border trade within the Internal Market. The study notes that while the OECD's Transfer Pricing Guidelines serve as the framework within which each member state's individual transfer pricing rules were crafted, the Guidelines themselves represent a compromise between OECD's own member countries. Thus, resolution of disputes even against a common backdrop is not easily attainable.[82] Moreover, some EU member states have not established their own transfer pricing guidelines or rules, and thus, the OECD's suggestions are of little consequence or influence when it comes to resolving disputes with these states.[83] Facing the difficulty of resolving these disputes, the Commission sought empirical evidence form the member states regarding the efficacy of both the MAP process and the EU Arbitration Convention[84] in resolving double taxation issues.

In 2000, the Commission sent a questionnaire to the tax authorities of all member states, and 14 of 15 responded. The questionnaire asked the authorities to answer several

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[81] *See* Company Tax Study, *supra* note 76, at 260.
[82] *See id.* at 265.
[83] *See id.*
[84] CONVENTION ON THE ELIMINATION OF DOUBLE TAXATION IN CONNECTION WITH THE ADJUSTMENT OF PROFITS OF ASSOCIATED ENTERPRISES, July 23, 1990, O.J. (L 225) 10 (1990) [hereinafter "Arbitration Convention"], *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=41990A0436&model=guichett. For a discussion of the Arbitration Convention, *see infra* text at p. on page 32, *et seq*.

questions, including *inter alia*, the number of double taxation disputes resolved through the MAP process between 1995 and 1999, the most common difficulties encountered when engaging in the MAP process, why they felt the MAP process failed when an agreement was not reached, and what areas the authorities had the most difficulties with when trying to reach an agreement. The questionnaire then posed the same questions in the context of the Arbitration Convention, rather than the MAP process.[85] Of the cases accepted for resolution through the MAP process, 85% were successfully resolved, and the entire process lasted an average of 20 months.[86] As to resolution under the Arbitration Convention, 67% of cases were successfully resolved in 1995, and 48% were resolved in 1996 and 1997. Further, the evidence indicated that the member states consistently were not moving forward to the second phase, where advisory commissions are being set up. The data did not indicate, however, when the reasons for the lengthy process were attributable to businesses appealing the panel's decision to national courts.[87]

Regarding the other topics of the questionnaire, almost all member states indicated that they undertook almost no cooperative measures with other member states when double taxation issues arose. In other words, they did not conduct simultaneous audits of the taxpayer, nor did they exchange information with other tax authorities. The Commission noted that member states were "aware of the possibilities," but the actual level of cooperation was "modest," and gave no indication as what the barriers to cooperation might have been.[88]

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[85] *See* Company Tax Study, *supra* note 76, at 269.
[86] *Id.* at 269-70.
[87] *Id.* at 270.
[88] *Id.* at 273.

Returning to the issue of dispute resolution between member states, the Commission first identified several necessary characteristics of any dispute resolution process that might be implemented, including: Relief of double taxation should be achieved within a "reasonable time;" businesses should only have to employ modest resources to obtain relief; and the collection of the tax should be suspended pending the MAP process.[89] The Commission compared dispute resolution under both the MAP process and the Arbitration Convention, and despite the disappointing statistics outlined above, still concluded that arbitration was preferable.[90] While the Arbitration Convention and the MAP process are essentially the same instrument, the Convention is preferred because it guarantees relief from double taxation and is a relatively efficient procedure, in that there is a built-in 2-year deadline for negotiations between competent authorities.[91] The Commission did note, however, that the Arbitration Convention was not without its faults.

ii. EU Arbitration Convention

The Arbitration Convention was contemplated as early as 1976, and specifically addresses double taxation arising from transfer pricing adjustments made in member states.[92] The Arbitration Convention originally entered into force in 1995, and was to be

[89] *Id.* at 274.
[90] *Id.* at 275. The Commission also noted that litigation and APAs were methods of resolving disputes, but rejected them both as viable methods. First, litigation in national courts is not a viable method because it is expensive, time-consuming, and the result will be "one-sided" and not necessarily result in the elimination of double taxation. Regarding APAs, the Commission felt that because they are not well developed within the EU, they do not represent a realistic method of resolving double taxation. *Id.*
[91] *Id.* at 275-76.
[92] *See Transfer Pricing and the Arbitration Convention, Background, available at* http://europa.eu.int/comm/taxation_customs/taxation/company_tax/transfer_pricing/arbitration_convention/index_en.htm.

in force for five years. In 1999, a protocol was signed to automatically extend the Arbitration Convention's effective dates for another five years, from 2000 to 2005.[93] It is unique in that it calls for mandatory, binding arbitration in the event the MAP process proves ineffective in resolving double taxation issues arising from a taxpayer's operation of businesses in more than one member state.

Article 6 of the Arbitration Convention establishes a framework for settling double taxation disputes that largely mirrors the OECD's MAP process.[94] The process requires the taxpayer to initiate the process within 3 years' of first becoming aware that double taxation is imminent. The taxpayer first notifies its own competent authority, and the Arbitration Convention explicitly notes that the taxpayer may initiate the process regardless of the domestic remedies that may be available. If the taxpayer and its own competent authority are unable to resolve the matter, then the competent authorities are to

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[93] PROTOCOL OF 25 MAY 1999 AMENDING THE CONVENTION OF 23 JULY 1990 ON THE ELIMINATION OF DOUBLE TAXATION IN CONNECTION WITH THE ADJUSTMENT OF PROFITS OF ASSOCIATED ENTERPRISES, July 23, 1999, O.J. (C 202) 1, 1999 [hereinafter "PROTOCOL"]. While the latest extension expired four months ago, there is no indication from the website whether the Arbitration Convention will be in force for another five year period. Importantly, the Company Tax Study identified the requirement that the Arbitration Convention be ratified by all member states before it becomes effective as a major barrier to implementation. However, the lengthy nature of the ratification process – and thus, delays in the implementation of the Arbitration Convention – is beyond the scope of this paper. Instead, the substance of the Arbitration Convention is featured here as an example of a workable solution for the resolution of double taxation issues. The procedural drawbacks can be eradicated through a different form of implementation and they do not diminish the substantial benefits the process presents. *See* Communication to the Council, the European Parliament and the European Economic and Social Committee on the Work of the EU Joint Transfer Pricing Forum in the Field of Business Taxation from October 2002 to December 2003 and on a Proposal for a Code of Conduct for the Effective Implementation of the Arbitration Convention, COM(04)297 final at 5, *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2004/com2004_0297en01.pdf (suggesting that the ratification delays could be avoided if the Arbitration Convention was enacted under EC law, rather than by convention) [hereinafter "Code of Conduct"].

[94] *See* Arbitration Convention, *supra* note 84, at Art. 6

undertake negotiations in accordance with mutual agreement procedures.[95] These negotiations are not to exceed two years.[96]

After two years, if the MAP process has not yielded a result, the Arbitration Convention calls for the competent authorities to refer the matter to an advisory commission (arbitration panel), which will deliver its own opinion on how best to resolve the dispute.[97] The advisory commission consists of a chairman, two representatives from each competent authority, and an even number of "independent persons of standing," who are drawn from a list of names of several individuals nominated by each member state.[98] The taxpayer is allowed to provide any information, documentation, or other evidence that it feels may be of use to the advisory commission in reaching a conclusion. The competent authorities are generally expected to comply with the commission's requests for information, but they are not required to disclose any (1) information they cannot (under domestic or administrative law) obtain themselves or (2) "…trade, business, industrial or professional secret or trade process, or information the disclosure of which would be contrary to public policy."[99] Importantly, the taxpayer may request to appear or be represented at the commission's proceedings.[100]

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[95] *See id.*
[96] *See id.* at Art. 7(1). However, the taxpayer is not precluded from seeking a remedy under domestic administrative or tribunal laws; thus, when such recourse is sought, the two-year time period does not begin to toll until a final decision from an appellate court has been rendered. *Id.* Conversely, the taxpayer can agree to abandon all domestic and administrative tribunal remedies and seek a remedy only under the Arbitration Convention. *See id.* at Art. 7(3).
[97] *See id.*
[98] *See id.* at Art. 9(1)-(4).
[99] *See id.* at Art. 10(1).
[100] *See id.* at Art. 10(2).

The advisory commission has six months to report its findings, and a simple majority will adopt its opinion. Once the advisory commission's opinion has been issued, the competent authorities are not bound to follow it. They have another six months within which to reach an agreement, and it is only if they cannot agree within those six months – ostensibly using the advisory commission's opinion as a guide – that the advisory commission opinion will become binding. The competent authorities may, but are not required to, agree to publish the advisory commission's opinion.[101] While it sounds promising – at the very least, a conclusion is guaranteed within three years if the competent authorities cannot agree and resolution is established through the advisory commission's opinion – the panel was of the opinion that the Arbitration Convention is not without its weaknesses.

The Company Tax Study addresses these shortcomings, and though significant, they do not detract from the overall strength of the process the Arbitration Convention establishes. Instead, the proposals are largely fiscal ones, and include suggestions that interest and penalties be waived pending the resolution of the dispute.[102] Moreover, the panel suggests that the collection of tax also be suspended pending resolution of the double taxation issues.[103] Another problem is that key terms, including "enterprise," "permanent establishment," and "associated [companies]" were not explicitly defined in the treaty, and these vague terms gave rise to different interpretations between member

[101] *See id.* at Arts. 11, 12.

[102] While these concerns are important, and the tolling of interest and penalties should be in effect pending the outcome, they do not add or detract from the underlying issues: whether the process is efficient and leads to a definite outcome that can be relied upon in future disputes. For a general discussion of the penalty and interest proposals, see Company Tax Study, *supra* note 76, at 279-80.

[103] *Id.* at 279. As will be discussed, *infra*, the suspension of collection of tax can lead to issues with forum shopping

states.[104] Furthermore, the Company Tax Study complains that the advisory commission stage (second phase) of the proceedings is poorly defined. Some of the complaints about the second phase were largely administrative (such as who is responsible for convening meetings). More serious deficiencies arise out of the Arbitration Convention's failure to establish penalties should the advisory commission not meet its six-month deadline, and out of its failure to require that the advisory commission's opinions be published, so that a body of work with precedential value can be established.[105]

Another serious deficiency of the Arbitration Convention is its failure to establish procedures for how to initiate the process when there is an undue delay on the part of the competent authorities; *e.g.*, when it takes an inordinate amount of time for the competent authorities to even decide whether the case is suitable for resolution under the Arbitration Convention.[106] Moreover, the panel notes that there is no automatic triggering of the second phase; when the MAP process has stalled, there is no mechanism for the automatic referral of the matter to the advisory commission.[107] Also, there is the issue of compliance with the Arbitration Convention: Where a member state's internal laws do not permit competent authorities to refer matters to an independent decision-making authority, the advisory commission will not be empanelled. Accordingly, the taxpayer will be required to abandon the possibility of an appeal before seeking an arbitration

[104] *Id.* at 281.
[105] *See id.* at 282.
[106] As noted above, one of the main critiques of the MAP process from the questionnaire was that the member states often took beyond two years to reply to the taxpayer's request for relief. *See* discussion, *supra* Section V.d.i., on page 29.
[107] *See* Company Tax Study, *supra* note 76, at 282-83.

opinion.[108] Solutions to these problems are proposed in the Joint Transfer Pricing Forum's Code of Conduct.

iii. Joint Transfer Pricing Forum Code of Conduct

Following the Company Tax Study, the Commission decided to form the Joint Transfer Pricing Forum ("JTPF"), whose members are comprised of tax authorities from each EU member state, as well as business leaders. Additionally, members of the OECD Secretariat are invited to attend JTPF meetings as observers. The JTPF's proposals are reached by consensus, and the group endeavors to propose "non-legislative solutions within the framework of the OECD Transfer Pricing Guidelines."[109]

Despite the rather daunting statistics noted above regarding the efficiency of the arbitration process, the JTPF continued the work initiated in the Company Tax Study and went on to suggest methods in which the arbitration process could be streamlined for a more efficient resolution of tax disputes. The resulting the Code of Conduct established clarifying rules for many of the procedural issues the Company Tax Study identified.[110] More importantly, the Code of Conduct established a framework for increasing the transparency of the MAP process, and requires that the competent authority with which the request was initiated keep the taxpayer abreast of "significant developments."[111] Also, the competent authorities are required to exchange position papers on the double

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[108] *Id.* at 282-83.

[109] European Commission, Transfer Pricing Forum Website, Background Information, *available at* http://europa.eu.int/comm/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm

[110] *See* generally Code of Conduct, *supra* note 93, at Annex II(1)-(2) (clarifying when the taxpayer's three-year period for seeking relief begins to toll, and detailing the beginning of the two-year period during which competent authorities may negotiate).

[111] *Id.* at Annex II(3.2)(b).

taxation issue within four months of the earlier of (1) the issuance of the notice of deficiency, or (2) the receipt of the taxpayer's request that the process be initiated. There are also included timelines for initial face-to-face meetings between competent authorities, and the Code of Conduct suggests that the taxing authorities should anticipate having in-person talks at least once a year.[112] Additionally, the Code of Conduct addresses the work of the advisory commission.

While establishing general procedural rules regarding the selection and remuneration of commission members, the Code of Conduct also offers specific guidance on the commission's opinion. Beyond the provision of general, factual information, the Code of Conduct requires the inclusion of "the arguments and methods on which the decision in the opinion is based."[113] The competent authorities must still agree to publish the decision, and if they do, the taxpayer must also give its consent. The Code of Conduct provides for the redaction of identifying information, and if the opinion is published, it will appear in the European Commission's Official Journal.[114]

It seems that the JTPF's work has filled many of the gaps left in the Arbitration Convention. In 2005, following the publication of the Code of Conduct, the Commission was noted that the "practical implementation [of the JTPF's conclusions and recommendations] could lead to important progress in achieving a proper tool to remedy double taxation," and suggested that in the future, it would explore "the need for proposing a Community instrument of law at a later stage."[115]

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[112] *See id.* at Annex II(3.3).
[113] *Id.* at Annex II(4.4).
[114] *See id.*
[115] *Id.* at Introduction(2)(12).

VI. Comparison/Contrast

The resolution of double taxation disputes should be efficient, transparent and lead to a guaranteed result, which – under ideal circumstances – could be relied upon in future disputes. The EU's approach has combined the popular MAP process with binding arbitration to guarantee a result for the taxpayer. Of the options currently available, the MAP/advisory commission process presents the best framework for resolving double taxation issues. While the MAP process alone certainly has its shortcomings – not the least of which is its failure to require competent authorities required to reach an agreement – the process is bolstered by the advisory commission's participation during the second phase. It is in that second phase that a result will be obtained, even if it becomes the default decision after the competent authorities still cannot reach an agreement. Thus, the certainty of an outcome is guaranteed. Moreover, the process provides for the possibility of publication of the advisory opinion in the Official Journal. Of course, publication should be required whenever the advisory commission's opinion is used to settle the dispute, as a way of further ensuring transparency of the entire process: If the opinions are known to be published, there is less likelihood that the advisory commission's opinion will be brief, with little or no analysis and a simple, conclusory statement regarding the outcome. Thus, with guaranteed publication, the likelihood that the opinion will meet the standards established in the Code of Conduct, which require an inclusion of arguments presented and analysis, is increased.

As for transparency, the EU approach allows for taxpayer participation, which is a drastic change from the secretive approach under the MAP process. Not only can taxpayers request to be present or have a representative present during the advisory commission's proceedings, they may present arguments and documentation supporting their position. Furthermore, the Code of Conduct requires that the taxpayer be kept abreast of "substantial developments" in the case. If kept abreast of the proceedings, the taxpayer can potentially defend its position by presenting additional arguments or evidence that might be persuasive.

Finally, the MAP/advisory commission approach requires that a decision be issued in a relatively timely fashion. While three years from inception to conclusion may seem like an inordinate amount of time, the reality is that the process requires communications between governments, as well as the creation of an advisory commission. When the current state is one in which cases referred to the MAP process alone can languish for years without resolution, three years is an attractive time period for an entire process. And at the end of this three-year period, the taxpayer will have a result. Accordingly, the main goals of efficiency, transparency and certainty are met under the EU dispute resolution mechanisms. There is, however, one problematic area the MAP/advisory commission process leaves open.

The drafters of the Company Tax Study rightfully point out that the taxpayer has a hard choice to make in cases where domestic law requires it to agree to abandon any appeal before seeking redress under the MAP process (and if necessary, the advisory panel).[116] The drafters, however, point to the OECD's recommendation that the collection of tax be suspended while the taxpayer pursues any domestic remedies available to it.[117] But this suggestion does not solve the problem: While suspending the collection of tax is important, it is more a fiscal concern than one relating to the end goal:

[116] *See* Company Tax Study, *supra* note 76, at 279.
[117] *See id.*

efficient and binding resolution of the dispute through a process that is transparent, in that it allows for taxpayer participation and dissemination of the final opinion. Even if the tax collection is suspended, the proposed remedy does nothing to prevent the taxpayer from engaging in a type of international forum shopping: If the result is unfavorable under the taxpayer's domestic law, it can seek a resolution through the MAP/advisory commission process, or it can choose to further litigate in its domestic courts after relinquishing its ability to seek recourse under the MAP/advisory commission process. This forum shopping will lead to disparate results, depending on whichever domestic law is applied; indeed, it is not hard to imagine the case where corporate taxpayers incorporate and conduct business in "havens" where either the domestic law generally is more favorable to a taxpayer's double taxation issues, or where the competent authorities are known to compromise during negotiations.[118]

This choice of which type of recourse highlights a bigger issue within the debate over whether to incorporate mandatory, binding arbitration into the MAP process: an inherent bias in favor of domestic dispute settlement procedures and against a neutral panel's resolution of the double taxation issues.

VII. Theoretical Impediments to Adopting Arbitration

While mandatory, binding arbitration brings many of the desired aspects of dispute resolution to the fore in the context of double taxation disputes, there are many who decry its use. The main complaint is that its implementation will require governments to relinquish their taxing authority – indeed, their very sovereignty – to a disinterested arbitration panel. Indeed, while the OECD's recent efforts at updating its own Model

[118] *See also* discussion, *supra* Section V.c., on page 29.

Convention in favor of arbitration procedures might seem rather revolutionary, the body's views towards arbitration were not always so favorable. In a 1984 report on emerging issues in international taxation, OECD eschewed mandatory, binding arbitration as a dispute resolution tool because it required an "unacceptable surrender of fiscal sovereignty."[119] Once the argument is unpacked, however, it becomes clear that it is without merit.

When a situation like Glaxo arises, the taxpayer has sought redress from a process that has proven ineffective. In the MAP process context, the taxpayer and its competent authority are at odds: The taxpayer is in a position where its interests will not be fully represented. The domestic taxing authority is of the position that an allocation needs to be made, while the taxpayer most assuredly disagrees. Within the negotiations, the domestic competent authority is ostensibly invoking its "sovereignty" in that it is able to come to the table and confer with the other competent authority to reach an agreement regarding the proper allocation. On the other hand, if the domestic competent authority were to approach the MAP process with position that it would give up no "sovereignty" – in terms of which law to apply – the member states would never reach an agreement. So to whose sovereignty are we referring? The competent authority's right to decide under what circumstances and to what extent an allocation will be made? Or the sovereignty of domestic tax laws on a national level, meaning the law to be applied? Both inquiries reveal that there is no merit to the entire argument.

This concept that a domestic competent authority cannot give up its sovereignty to decide the allocation issue single-handedly is problematic on two levels. First, when the

[119] Organisation for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises – Three Taxation Issues*, (1984).

competent authority engages in the MAP process, it is already giving up a degree of its decision-making sovereignty, in that to reach an agreement, it must collaborate with another competent authority. Second, if the agreement is never reached, the domestic competent authority will be faced with the prospect of taking its argument to court, and facing the taxpayer on an individual basis. Again, the competent authority has lost its decision-making sovereignty to the extent that a court of law will apply domestic law to the matter, possibly reframing the entire issue, and reaching a result the domestic competent authority might never have contemplated.

In terms of domestic law sovereignty, the argument against arbitration is that it does not apply domestic law, and that resident countries are ceding their authority to interpret their own laws. This argument, however, reveals a reluctance to let the applicable law be tested on its merits. First, the MAP/arbitration commission procedures do not call for law that is necessary "foreign" to most seasoned international tax practitioners: The law under the applicable Convention will be applied first, with appropriate references to international law second, and domestic laws as a last resort. Thus, cautionary tales of the uninitiated tackling the Internal Revenue Code, for example, are most likely overblown. Finally, the procedures allow for the competent authority to present arguments to the commission, thereby giving each ample opportunity to present its interpretation of the issue. Even assuming that domestic laws will be referred to at some point during the arbitration process, those who make the national law sovereignty argument fail to acknowledge that the commission will consist of representatives of each member state's own choosing. Thus, those with expertise in the tax laws of each state will be present to analyze the issues and present respective arguments.

Once the arbitration procedures are examined in context, it becomes clear that the national law sovereignty argument is weak, as well. As noted, the arbitration commission will first apply the laws of the Convention applicable to the case. As with all diplomatic methods of rule-making, there is an element of compromise. Accordingly, to even reach the point of concluding a Convention on Double Taxation, countries have to be comfortable with the fact that the Convention really represents an amalgamation of tax principles from the member states. As with the MAP process, the willingness to come to the table and discuss creating an instrument of law that will bind both states requires a certain degree of relinquishment of "fiscal sovereignty."

Finally, those arguing against arbitration should consider what countries are willing to give up in favor of domestic law sovereignty. At its extreme, strict adherence to national law will likely result in a breakdown of the MAP process. Without arbitration as a second step, the taxpayer would likely seek redress in domestic courts, where domestic law will certainly be applied. In exchange for the reassurance associated with domestic jurists applying domestic law, states run the risk that they will lose everything. In other words, retaining domestic sovereignty is does not guarantee that the government's interpretation of its domestic laws will prevail. The taxpayer may prevail, and the domestic competent authority will be left in its original position; only this time, it will have a binding opinion detailing how the application of domestic law was not in the government's favor. Thus, rather than relying on the law as contained in an instrument of compromise to settle disputes, opponents of arbitration would allow an ethnocentric and myopic view of how best to resolve double taxation issues perhaps result in less income subject to a certain state's taxation.

Another issue some opponents may bring to the mandatory, binding arbitration debate is the fact that it is so transparent. In analogizing arbitration to other country-to-country arbitrations addressing public law matters, it is hard to cite a situation where those disputes are settled in the public arena. However, unlike a trade dispute, for example, tax arbitration cases have a discrete and identifiable third party whose interests are at stake as well. More importantly, transparency does not equate to a public proceeding *per se*; just as not all trials are open to the public, it would be acceptable to have the actual arbitration proceedings open only to interested parties. In this context, transparency refers to the taxpayer's opportunity to participate in the proceedings, as well as to the publication of well-reasoned opinions discussing the decision reached. Because the arbitration process replaces litigation of a double taxation dispute, the process by which it arrives at a binding decision should be no different than that leading to a binding result in a court of law. To that end, transparency is as necessary in arbitration as it is in the litigation context, because it serves as a monitor for the proper functioning of the system.

In a litigation context, safeguards such as transparency are there to ensure that those who have a stake in the proceedings will have a reasonable opportunity to be apprised of such. For example, in a civil court proceeding in the United States, if a person affected by the litigation has an interest in, but is not a party to, the litigation, he can interplead so that his claims may be heard. Even if he does not interplead, he will still be bound by the court's decision. Such a harsh result would be unfair were it not for the transparent nature of the litigation process. In the context of the MAP/arbitration commission process, the taxpayer is in the same position as if it were seeking interpleader: it has an interest in the outcome, and it will be bound by the decision. To not allow taxpayer participation is to assign the competent authority as the taxpayer's advocate. As noted earlier, however, the taxpayer and the competent authority are necessarily at odds, because they have different interpretations of the issue. That same tension carries over to the arbitration process: Neither the taxpayer nor the competent authority is likely to have changed its position. How to reconcile the outcome, which is again binding on the taxpayer, without allowing representation? There is no other way than to allow the taxpayer's participation.

The other aspect of transparency, the publication of opinions, is of a somewhat lesser degree of importance if the taxpayer's participation is allowed. That is not to say that a well-reasoned opinion need not be furnished to the taxpayer, but its dissemination to the public perhaps could be restricted without compromising the transparency goal. Those against publication could argue that the availability of arbitration decisions would induce other taxpayers to rely on the results, which are only binding on the governments and the taxpayer who are parties to the process. However, this argument against dissemination is weak when one considers that many bilateral tax treaty arbitration provisions suggest that arbitrators consider prior decisions when presented with similar issues of fact and law. Indeed, this actually makes for a stronger case in favor of publication.

Perhaps the biggest counterargument to any rejection of arbitration as a means of resolving double taxation disputes is that despite a historic reluctance, states are beginning to include not empty arbitration clauses, but concrete tools for arbitration's implementation, in bilateral tax treaties. Even the United States has exchanged notes for arbitration procedures under its tax treaty with Germany, and has at least contemplated doing the same in several others. And the recent studies and proposals promulgated by the OECD and EU illustrate that many other states are coming to view arbitration as a necessary supplement to the MAP process.

VIII. Conclusion

The MAP/advisory commission process represents the future of dispute resolution for double taxation issues. Under this process, the results are efficient and guaranteed, and ideally, both the taxpayer and the public are privy to the proceedings and the outcome. But the only way to increase the implementation of binding arbitration in the resolution of double taxation disputes is to actually use it. Fortunately, traditional arguments against arbitration based on “fiscal sovereignty” are beginning to lose their sway, as many have realized that the nature of the resolution of double taxation issues requires some compromise between states, and a concomitant relinquishment of some domestic sovereignty. The tax community should embrace arbitration as a means of settling these disputes, and any initiation of the MAP process worldwide should be interpreted as triggering phase one of a two-step process, under which a resolution will be obtained regardless of whether the competent authorities have reached an impasse.