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SECRETARIAT DISCUSSION PAPER ON ALTERNATIVE DISPUTE AVOIDANCE AND RESOLUTION PROCEDURES

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Working document

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1. Introduction and context

1.1. Background

1. Adjusting the results of transactions of an enterprise with an associated enterprise in another state to an arm's length result may lead to double taxation unless a corresponding adjustment is made to the taxable profits of the other enterprise. This will usually involve discussions with the tax administration in the other state. But, even if single taxation is achieved, the costs involved for the enterprises and the tax administrations can be substantial.
2. An unresolved transfer pricing dispute can have other adverse effects for an enterprise. For example, it can create uncertainty for pending investment decisions.
3. An enterprise that is confronted with transfer pricing adjustments in a country as the result of an audit by a tax administration can accept the adjustments or object to the final assessment before the local tax courts. When the assessment has been confirmed, if the enterprise believes there has been double taxation, it can request a Mutual Agreement Procedure (MAP) based on a double tax treaty or, within the EU, it can proceed under the Arbitration Convention.¹ In some Member States, it is possible to request an MAP before an assessment has been confirmed.
4. A recent innovation in the MAP process have been Advance Pricing Agreements (APAs) and other procedures that MNEs can utilize to resolve transfer pricing matters before disputes arise. Such alternative dispute avoidance and resolution procedures may reduce the likelihood of costly, time consuming and possibly conflicting MAPs and domestic judicial proceedings.

1.2. Scope of this paper

5. So far, the JTPF has looked at ways for speedier and more streamlined dispute resolution procedures in the framework of mutual agreement procedures and arbitration, i.e. after double taxation has occurred. Considering, however, that the overall objective should be the prevention of double taxation and the reduction of the compliance cost, the JTPF in its work programme 2005-2006 (see doc. JTPF/008/REV4/2004/EN of 1st December 2004), agreed to examine also possible preventive measures to avoid double taxation.
6. This paper examines alternative procedures to avoid double taxation and thus reduce the number of dispute resolution and appeals procedures. The paper also examines supplementary dispute resolution techniques outside the framework of mutual agreement procedures and arbitration.
7. The promotion of administrative co-operation between national tax authorities can also help to resolve transfer pricing disputes.

¹ Some double tax treaties also provide for an arbitration procedure if no mutual agreement is reached between the competent authorities, but they do not provide for mandatory arbitration.

1.3. OECD – Joint Working Group on Dispute Resolution

8. To take forward work on improving dispute resolution, the OECD has created a working group of delegates from OECD Member States' tax administrations. The OECD on 27 July 2004 released for public comment a progress report on "Improving the Process for Resolving International Tax Disputes" . The report describes different kinds of proposals covering both operational and substantive issues for improving dispute resolution. The report states that the mutual agreement procedure can sometimes take a long time and use a considerable amount of taxpayer and tax administration resources. As such results are unsatisfactory to all concerned, a number of Supplementary Dispute Resolution ("SDR") techniques are, therefore, being considered in the report to deal with such situations, ranging from an advisory opinion to a more formal arbitration process.

1.4. PATA – Guidance on Mutual Agreement Procedures and Bilateral Advance Pricing Arrangements

9. The Pacific Association of Tax Administrators (PATA) on 25 June 2004 issued internal operational guidance covering mutual agreement procedures (MAPs) and bilateral advance pricing arrangements (BAPAs) amongst its member countries.
10. The guidance was issued in two documents. The first document is entitled "MAP Operational Guidance for Member Countries of the Pacific Association of Tax Administrators" and is intended to facilitate and support resolution of MAP cases amongst PATA member countries as well as to ensure consistent and timely treatment of such cases. The second document is entitled "BAPA Operational Guidance for Member Countries of the Pacific Association of Tax Administrators" and is intended to establish a common approach for treating taxpayers in a fair and consistent manner when seeking BAPAs, provide a working framework that enables the smooth and timely completion of BAPAs and encourage and facilitate the use of BAPAs amongst PATA member countries. The purpose of releasing these internal working documents is to increase the level of transparency in the MAP and BAPA processes within PATA member countries.
11. The main objectives of the PATA Guidance are:
 - to establish a common approach for treating taxpayers in a fair and consistent manner when seeking a bilateral or multilateral APA;
 - to provide a working framework that enables the smooth and timely completion of APAs; and
 - to encourage and facilitate the use of APAs among PATA Members.

2. Possible forms of alternative dispute avoidance and resolution procedures

2.1. Advance Pricing Agreements (APAs)

a) Definition and Functioning of APAs

12. An advantage of an APA is to overcome uncertainty of transfer pricing both for business and national tax administrations. A disadvantage is that it may involve a lengthy and costly procedure, both for enterprises and tax administrations. However, such disadvantage must be compared to the length and the cost of an audit and an MAP and/or litigation.
13. An APA is an agreement between an enterprise and its tax administration that determines, generally in advance of controlled transactions, an appropriate methodology (including comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the arm's length result of those transactions over a fixed period of time, i.e. generally between 3 and 5 years. Some countries agree to rollbacks to prior not yet audited years.
14. An APA is initiated by a taxpayer and requires discussions between one or more associated enterprises, and one or more tax administrations.
15. APAs can be unilateral (an agreement between an enterprise and one tax administration), bilateral (an agreement involving an enterprise and two countries where it operates) or multilateral (where more than two tax jurisdictions are involved).² Agreements involving more than one country are usually covered under the MAP of the countries involved. In some countries, domestic provisions do not permit the tax administrations to enter into binding agreements directly with the taxpayers, so that APAs can be concluded with the competent authority of a treaty partner only under the mutual agreement procedure.
16. Some countries allow unilateral agreements without the involvement of other interested tax administrations. The results of transactions covered by a unilateral APA may affect the tax liability of associated enterprises in other tax jurisdictions. Where appropriate, the competent authorities of other interested jurisdictions should, therefore, be informed about the procedure as early as possible to determine whether they are willing and able to consider a bilateral agreement.
17. Because of concerns over double taxation, most countries prefer bilateral or multilateral APAs. Some countries will not grant a unilateral APA. However, in many countries unilateral APAs are more numerous than bilateral/multilateral APAs, not least because unilateral APAs can be concluded faster and with lower costs. The bilateral (or multilateral) approach is more likely to reduce the risk of double taxation, to be equitable to all tax administrations and enterprises involved, and to provide greater certainty.

² In 2004, the first three multilateral APAs were concluded within the EU. On 8 April 2004, a multilateral APA was signed by Airbus Industries and the tax administrations of France, Germany, the United Kingdom and Spain. Euronext and Cleartnet concluded multilateral APA with the tax administrations of Belgium, France and The Netherlands. The agreements were signed on 19 April 2004.

18. APAs, including unilateral ones, differ in some ways from private rulings that some tax administrations issue to taxpayers. An APA generally deals with methodology, whereas private rulings tend to be limited to addressing questions of a legal nature based on the facts presented by a taxpayer. An APA usually covers several transactions, several types of transactions on a continuing basis, or all of a taxpayer's cross-border controlled transactions for a given period of time. In contrast, a private ruling request usually is binding only for a particular transaction.
19. An APA may cover all of the transfer pricing issues of a taxpayer (as is preferred by some countries) or may be limited to specified transactions. An APA can provide an opportunity to apply the agreed transfer pricing methodology to resolve similar transfer pricing issues in open prior years. However, this application would require the agreement of the tax administration, the taxpayer, and, where appropriate, the treaty partner.

b) Advantages of APAs

20. An APA can assist enterprises by addressing uncertainty. When the term of an APA expires, the opportunity may also exist for the relevant tax administrations and enterprises to renegotiate the agreement. Because of the certainty provided by an APA, an enterprise may be in a better position to predict its tax liabilities, with the governments providing a tax environment that is favourable for investment.
21. Typically, associated enterprises are allowed to participate in the process of obtaining an APA, by presenting the case to and negotiating with the tax administrations concerned, providing necessary information, and reaching agreement on the transfer pricing issues. From the associated enterprises' perspective, this ability to participate is an advantage over the conventional mutual agreement procedure.
22. Due to the taxpayer participation, APAs can provide an opportunity for both tax administrations and taxpayers to consult and cooperate in a non-adversarial spirit and environment. The opportunity to discuss complex tax issues in a less confrontational atmosphere than in a transfer pricing examination can stimulate a free flow of information among all parties not least because in an APA discussion no irreversible actions have been taken. The APA process leaves, therefore, more flexibility than a MAP process. The non-adversarial environment may also result in a more objective review of the submitted data and information than may occur in a more adversarial context (e.g. litigation). The close consultation and cooperation required between the tax administrations in an APA program may also lead to closer relations with treaty partners on transfer pricing issues.
23. An APA may prevent costly and time-consuming examinations and litigation of major transfer pricing issues for taxpayers and tax administrations and thus reduce the exposure to interest payments and penalties. Once an APA has been agreed, fewer resources may be needed for subsequent examination of the taxpayer's return. It may still be difficult, however, to monitor the application of the agreement. The APA process itself may also present time savings for both enterprises and tax administrations over the time that would be spent in a conventional tax examination.

24. Bilateral and multilateral APAs substantially reduce the possibility of juridical or economic double or non-taxation where all the relevant countries participate. By contrast, unilateral APAs do not provide certainty in the reduction of double taxation because other tax administrations may consider that the methodology adopted does not give a result consistent with the arm's length principle. In addition, bilateral and multilateral APAs can enhance the mutual agreement procedure by significantly reducing the time needed to reach an agreement since competent authorities are dealing with current data as opposed to prior year data that may be difficult and time-consuming to produce.
25. The disclosure and information aspects of an APA as well as the cooperative attitude under which an APA can be negotiated may assist tax administrations in gaining insight into complex international transactions undertaken by MNEs. APAs can improve knowledge and understanding of highly technical and factual circumstances in areas such as global trading and the tax issues involved. The development of specialist skills that focus on particular industries or specific types of transactions will enable tax administrations to give better service to other taxpayers in similar circumstances. Through APAs tax administrations have access to useful industry data and analysis of pricing methodologies in a cooperative environment.

c) Disadvantages of APAs

(i) Unilateral vs. bilateral/multilateral APAs

26. Unilateral APAs may present significant problems for tax administrations and taxpayers alike. From the point of view of the associated enterprises involved, one problem is the possible effect on the behaviour of the associated enterprises. Unlike bilateral or multilateral APAs, a unilateral APAs gives only certainty for the taxpayer in one jurisdiction and may not in all cases lead to a reduction in economic or juridical double taxation for the MNE group. If the taxpayer accepts an arrangement that over-allocates income to the country making the APA in order to avoid lengthy and expensive transfer pricing enquiries or excessive penalties, the administrative burden shifts from the country providing the APA to other tax jurisdictions.
27. On the other hand, there are cases where unilateral APAs may be helpful or even the only possibility. For example, in countries where only unilateral APAs are available, or in cases where many countries are involved, a unilateral APA may be the only pragmatic solution. The same may be true for SMEs and in cases where only a small amount of tax is at stake or where the tax issue is not difficult and does not require the heavier process of a bilateral or multilateral APA. Care must be taken, however, that unilateral APAs are consistent with the arm's length principle in the same way as bilateral or multilateral APAs.

(ii) Specific disadvantages for tax administrations

28. An APA may initially place a strain on transfer pricing audit resources, as tax administrations will generally have to divert resources earmarked for other purposes (e.g. examination, advising, litigation, etc.). Demands may be made on the resources of a tax administration by taxpayers seeking the earliest possible conclusion to an APA request, keeping in mind their business objectives and time scales. These demands may not coincide with the resource planning of the tax administrations, thereby making it difficult to process efficiently both the APAs and other equally important work. Renewing an APA, however, is likely to be less time-consuming than the process of initiating an APA. The renewal process may focus on updating and adjusting facts, business and economic criteria, and computations. In the case of bilateral arrangements, the agreement of the competent authorities of both Contracting States is to be obtained on the renewal of an APA to avoid double taxation (or non-taxation).
29. Experience in some countries has shown that, most often, taxpayers which would be interested in APAs are very large corporations with a good voluntary compliance history which would be audited on a regular basis, with their pricing methodology then being examined in any event. There are some indications that taxpayers, having experienced difficulty with tax administrations on transfer pricing issues and not wishing these difficulties to continue, are often interested in applying for an APA. There is then a serious danger of audit resources and expertise being diverted to these taxpayers and away from the investigation of less compliant taxpayers, where these resources could be better deployed in reducing the risk of losing tax revenue. The balance of compliance resources may be particularly difficult to achieve since an APAs tend to require highly experienced and often specialised staff. Requests for APAs may be concentrated in particular areas or sectors, e.g. global trading, and this can overstretch the specialist resources already allocated to those areas by the authorities. Tax administrations require time to train experts in specialist fields in order to meet unforeseeable demands from taxpayers for APAs in those areas.

(iii) Specific disadvantages for taxpayers

30. Some businesses expressed concern that an APA may allow the tax administration to make a closer study of the transactions at issue than would occur in the context of a transfer pricing examination, depending on the facts and circumstances. The taxpayer must provide detailed information relating to its transfer pricing and satisfy any other requirements imposed for the verification of compliance with the terms and conditions of the APA. At the same time, the taxpayer is not sheltered from normal and routine examinations by the tax administration on other issues. An APA also does not shelter a taxpayer from examination of its transfer pricing activities. The taxpayer may still have to establish that it has complied in good faith with the terms and conditions of the APA, that the material representations in the APA remain valid, that the supporting data used in applying the methodology were correct, that the critical assumptions underlying the APA are still valid and are applied consistently, and that the methodology is applied consistently.

31. APAs cannot be used by all taxpayers because the procedure can be expensive and time-consuming and small taxpayers generally may not be able to afford it. This is especially true if independent experts are involved. APAs may therefore only assist in resolving mainly large transfer pricing cases. In addition, the resource implications of an APAs may limit the number of requests a tax administration can entertain. In evaluating APAs, tax administrations can alleviate these potential problems by ensuring that the level of inquiry is adjusted to the size and complexity of the international transactions involved.

d) The OECD Guidelines on APAs

32. In 1999 the OECD has issued Guidelines on the use of APAs within the framework of the mutual agreement procedure of the double tax treaties (see Annex). The OECD is trying actively to promote the use of APAs as a mechanism to reduce tax conflicts between tax administrations and taxpayers in the application of the arm's length principle.

e) EU-wide standardised APAs (pan-European APA model)

33. In recent years, several EU Member States have introduced specific regulations on APAs, for example Spain in 1996, France in 1999, the UK in 1999, the Netherlands in 2001 and Belgium in 2002. In France, the Finance Amendment Bill 2005 contains provisions instituting a formally legislated APA procedure to replace the current informal procedure.

34. Businesses claim that the different sets of rules governing the various APA procedures in Member States are time consuming and burdensome for businesses. Because bilateral and multilateral APAs require two or more tax administrations to agree on the transfer pricing methodology, it is much easier if the various jurisdictions use a similar approach. In the absence of a common approach, it can sometimes be difficult for the tax administrations to reach agreement. Differences in approach can sometimes lead to contentious negotiations that ultimately may fail to produce an APA and that may be costly for all involved and produce double taxation. Common guidelines providing clarity for both enterprises and tax administrations could be a remedy. When foreseeing common guidelines for APAs within the EU, these guidelines should mesh with the procedures in non-EU countries (e.g. US, Canada, Australia, Japan). These common guidelines and APA procedures should also be extended to branches.

35. In case the Forum wishes to deepen its analysis on APAs, the following issues may be worthwhile for further examination:

- Tax issues to be covered by an APA;
- Documentation to be submitted in the APA process;
- Critical assumptions and number of years to be covered by an APA;
- Transparency
- Co-operation of the taxpayer

- Procedures for possible prolongation;
- Application of APAs to open prior years, e.g. tax years not yet under examination/tax audit (so-called roll back);
- Binding effects on tax administrations and taxpayers;
- Fees; and
- Publication.

2.2. Facilitating access to APAs for SMEs ("Mini-APAs")

36. The complexity and cost of the APA procedure discourage many SMEs from using it. To alleviate this problem specific procedures for SMEs could be applied, such as:

- streamlining the requests made by the tax administration to assess the SME's transfer pricing policy by, for example, reducing the documentation requirements or the requests relating to comparables; and
- increased support from the tax administration in the creation and review of the APA application by the SME.

2.3. Simultaneous tax examinations

37. A simultaneous tax examination, as defined in Part A of the OECD Model Agreement for the Undertaking of Simultaneous Tax Examinations, means an "arrangement between two or more parties to examine simultaneously and independently, each on its own territory, the tax affairs of (a) taxpayer(s) in which they have a common or related interest with a view to exchanging any relevant information which they so obtain".

38. Cooperation and mutual assistance between tax administrations in the EU with regard to transfer pricing has been intensified in recent years. This enhanced cooperation has been made possible by means of different mechanisms such as, for example, the exchange of information and, to a lesser degree, simultaneous tax examinations and the visits of tax auditors of a Member State in another Member State. In this context it is worth mentioning, that EC Directive 77/799/EC on the exchange of information in direct and indirect taxes has recently been modified in order to implement a procedure for "simultaneous tax inspections" (Article 8.3 of Directive 2004/56/EC).

2.4. Voluntary or mandatory prior consultation

39. The European Commission working paper "Company taxation in the internal market" of 23 October 2001 suggests as a means to improve the practical application of the EU Arbitration

Convention, among other things, a framework for prior agreement or consultation before tax administrations make transfer pricing adjustments.

40. Paragraph 29 a) of the Commentary to Article 25 OECD Model Tax Convention provides that tax administrations should notify taxpayers as soon as possible of their intention to make a transfer pricing adjustment, since it is particularly useful to ensure as early and as full contacts as possible on all relevant tax matters between tax administrations and taxpayers within the same jurisdiction and, across national frontiers, between the associated enterprises and the other tax administrations concerned.

41. Similarly, Article 5 of the Arbitration Convention provides:

Where a Contracting State intends to adjust the profits of an enterprise in accordance with the principles set out in Article 4, it shall inform the enterprise of the intended action in due time and give it the opportunity to inform the other enterprise so as to give that other enterprise the opportunity to inform in turn the other Contracting State. However, the Contracting State providing such information shall not be prevented from making the proposed adjustment. If after such information has been given the two enterprises and the other Contracting State agree to the adjustment, Articles 6 and 7 shall not apply.

42. The Arbitration Convention (like bilateral double tax treaties) does, however, not oblige the tax administration of a Member State to agree in advance on an appropriate transfer price with the tax administration of the affiliated company before a transfer pricing adjustment is made. This procedure would solve most of the business concerns; i.e. the double taxation itself, the costs of temporarily having to finance the same tax burden twice, business costs of seeking double tax relief etc. However, tax administrations might argue that such a rule would increase their administrative burden, lead to more aggressive tax planning, and require substantial extension of the periods where tax returns are open etc. Since both concerns are valid, the basic idea of prior approval or the agreement on a less stringent and voluntary consultation procedure should therefore be considered in more detail.

43. Under such a prior consultation procedure, the tax administration of the country where the primary adjustment is to be made, would be required to consult the tax administrations of the other Member States concerned in advance regarding this adjustment. This process would give the various tax administrations the possibility of entering into discussions at an early stage and foster more cooperation between the tax administrations.

44. However, this procedure would not guarantee that the double taxation issue would be resolved in advance, because it only implies a consultation and not a prior approval of the tax administrations of the other Member States concerned. Introducing a prior consultation process in the auditing practice related to transfer pricing could, nevertheless, be a more pragmatic way to resolve, or rather avoid, double taxation resolution problems under the Arbitration Convention.

45. The current order of process being tax examination, reassessment and ultimately MAP (or appeals procedure) would be replaced with the following process: tax examination followed by a mutually agreed reassessment (corresponding to the result of the prior consultation or MAP). Such a process would lift the responsibility for settling transfer pricing disputes within the EU from the business level to the level where the claims are made, i.e. at the level of

Member States. As a result, the reassessment would be made at approximately the same time as the corresponding adjustment in the other Contracting State.

2.5. Expert opinion ("mediation")

46. Obtaining an expert opinion or mediation may be a further possible means for speedier and more streamlined dispute resolution procedures.
47. The current Commentary to Article 25 (paragraph 46) of the OECD Model Tax Convention on Income and on Capital discusses the possibility of competent authorities to obtain an “advisory opinion” from an impartial expert to help them reach a decision. In addition, the Commentary (paragraph 47) foresees the possibility of the parties obtaining an “opinion” on the “correct understanding” of a treaty provision from the OECD's Committee on Fiscal Affairs. Further, paragraph 4 of Article 25 of the OECD Model Tax Convention and paragraphs 4 and 41 of the Commentary on that Article foresee the possible formation of a “joint commission” to deal with some issues. Another possibility is to have a third party evaluate the strengths and weaknesses of positions taken by the competent authorities. These techniques are forms of “mediation” in which a third party assists the competent authorities in reaching a decision but generally does not have any independent decision making power.