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Treaty Arbitration: Where Art Thou?

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In a commentary for *TMIJ* dated August 12, 2011,[1] I wrote about the ''shifting paradigm'' in international tax enforcement — a movement away from confrontation to increased cooperation through the adoption and implementation by tax authorities worldwide of new strategies, structures, processes, and tools to reduce both the number of cross-border disputes and the cost and time required to resolve such disputes. As noted in that commentary, one principal area of focus for tax authorities has been the increased acceptance of alternative dispute resolution mechanisms, such as advance pricing agreements (APAs), which are designed to avoid transfer pricing disputes on a prospective basis, and mandatory treaty arbitration, which is intended to force settlement of prolonged Competent Authority disputes without double taxation. While acceptance of the APA process led to enthusiastic implementation, the same has not been true for mandatory arbitration, notwithstanding the obvious need for and stated commitment to its use. If tax authorities are serious about improving the process for resolving international tax disputes, they need to begin using mandatory arbitration as the general rule, rather than the rare exception.

EU Arbitration Convention

The European Union (EU) has had an Arbitration Convention applicable to transfer pricing since the early '90s.[2] To date, however, there have been only two reported completed arbitrations under the Convention. Neither was efficient or effective. The first EU arbitration was concluded in 2003 between France and Italy and involved Electrolux affiliates. Apparently, the two tax authorities took 18 months just to select the arbitration panel (compared to the prescribed six months to complete the entire process), the process was dominated by issues of logistics and related procedural issues, and the case cost more than the amount at issue.[3] The second EU arbitration was described by taxpayer's outside counsel as taking more than three years, was beset by significant procedural delays, and was eventually resolved in 2009 through the Mutual Agreement Procedure (MAP), rather than by arbitration.[4] No other arbitrations under the EU Convention have been reported, although Sweden appears to have referred a case to an advisory commission (i.e., an arbitration panel) in 2009,[5] and it is rumored that Germany referred another case to a

[1] Sharon, ''The Shifting Paradigm in International Transfer Pricing Enforcement: Key IRS Implementation Challenges,'' 40 *Tax Mgmt. Int'l J.* 475 (8/12/11).

[2] Convention on the Elimination of Double Taxation in Connection with the Adjustments of Profits of Associated Enterprises (1990) (90/436/EED), signed on July 23, 1990.

[3] *See* D'Alessandro, ''Improving the Resolution of International Tax Disputes,'' *Tax Notes Int'l* (9/28/09), at p. 1160, and Moses, ''Practitioner Describes Three-Year Arbitration Over Change of Method under EU Convention,'' 19 *Transfer Pricing Rpt.* 653 (10/7/10).

[4] See ''Practitioner Describes Three-Year Arbitration Over Change of Method under EU Convention,'' 19 *Transfer Pricing Rpt.* 653 (9/7/10).

[5] EU Joint Transfer Pricing Forum, ''2009 Update on the Number of Open Cases under the Arbitration Convention'' (2/10/11),

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commission in 2010. Over the many years, the actual use of arbitration by EU countries has been disappointing, to say the least.

OECD Model Treaty

After an extended study process that began in 2003, the Organization for Economic Cooperation and Development (OECD) adopted in 2008 new paragraph 5 of Article 25 of the OECD Model Treaty, which provides for mandatory binding arbitration of Competent Authority cases that remain unresolved for more than two years (the same length of time required under the EU Arbitration Convention). Notwithstanding this ''international consensus'' on the efficacy of mandatory arbitration, only a handful of countries have been incorporating mandatory arbitration into their treaties, and even then only on an *ad hoc* basis.[6] In the three years since the OECD adopted new paragraph 5, there have been no reported completed arbitrations and only a few rumored cases.

U.S. Tax Treaties

The United States has accepted treaty arbitration for more than two decades. Indeed, the first U.S. tax treaty that allowed arbitration was signed in 1989, with Germany. However, that treaty, along with subsequent U.S. treaties with several other countries, including Canada, Mexico, Ireland, Switzerland, and the Netherlands, provided for voluntary arbitration only.[7] None of these voluntary provisions has ever been invoked.[8]

Over the past five years, the United States has incorporated mandatory arbitration into four new treaties (i.e., Germany, Belgium, France, and Canada), with a fifth treaty currently awaiting approval in the U.S. Senate (i.e., Switzerland). During this same period, Treasury has negotiated a number of other, admittedly less important, treaties without mandatory arbitration (e.g., Iceland, Bulgaria, and Hungary).[9] The current U.S. Model Income Tax Treaty (2006) does not include a mandatory arbitration provision, but that is expected to change in the next update.

U.S. support for mandatory arbitration, at least on a selective basis with its major trading partners, is commendable — and also complementary to other recent IRS initiatives to improve the efficiency and effectiveness of international tax enforcement.[10] In reality, however, like other tax authorities, the IRS remains reluctant to actually use the mandatory process, especially outside of U.S.-Canada cases. I witnessed such reluctance firsthand as an observer and as a participant in various U.S. Competent Authority negotiations while serving as APA Director from April 2008 to February 2011. Since the first U.S. tax treaty with mandatory arbitration went into effect (with Germany on December 28, 2007), there have been no reported U.S. arbitrations. The ''scuttlebutt,'' however, is that two arbitrations were recently completed (with both panels adopting the U.S. position in baseball-style arbitration) and that a few other cases are pending, all involving Canada.[11] To my knowledge, none of these cases involves an APA.

Do the Numbers Matter?

The small number of arbitrations may not be surprising or problematic, given that one of the principal arguments in support of mandatory arbitration is that it will encourage tax authorities to resolve disputes before the required arbitration is triggered. According to the U.S. Treasury, arbitration will ''rarely be utilized'' because its ''presence will encourage the Competent Authorities to take approaches to their negotiations that result in mutually agreed conclusions in the first instance.''[12] At this point, we can only speculate about the effect of potential mandatory arbitration on the resolution of MAP disputes. The cases are too few, the public data is too limited,[13] and no ''baseline'' has been developed to isolate and measure the effect of arbitration on the process.[14] Although the initial IRS experience with Canada lends some support to the argu-

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item 11.

[6] A recent BNA survey of 24 countries found that only 11 out of the 24 were trying to incorporate mandatory arbitration into their treaties. ''BNA International Tax Forum Examines MAP and Arbitration Procedures,'' 20 *Transfer Pricing Rpt.* 400 (9/22/11).

[7] For additional background, see ''Testimony of Treasury Deputy Assistant Secretary for International Tax Affairs Michael F. Mundaca before the Senate Committee on Foreign Relations on Pending Income Tax Treaties'' (7/10/08).

[8] Harrington, ''No Dispute about the Increasing Importance of Arbitration in Tax Treaties,'' *Tax Notes Int'l* (9/6/10), at p. 753.

[9] In welcome news, Treasury announced on June 2, 2011, that it will begin negotiations with Japan on a new treaty that is expected to include mandatory arbitration. A new U.S. treaty with the United Kingdom that provides for mandatory arbitration is presumably not too far off.

[10] Other recent IRS initiatives include expansion of the compliance assurance process (CAP), adoption of the quality examination process (QEP), introduction of Schedule UTP, merging the IRS APA Program and the U.S. double-tax Competent Authority staff into a new Advance Pricing and Mutual Agreement (APMA) program, and initiation of a few joint audits (see article cited in note 1).

[11] Transfer Pricing Director Sam Maruca commented in Sept. 2011 that a ''couple'' of U.S. cases have been presented or were about to be presented to arbitration. Schuster, 20 *Transfer Pricing Rpt.* 407 (9/22/11).

[12] Mundaca testimony cited in note 7, at p. 6.

[13] For example, the OECD data provides annual breakdowns of MAP inventories by country (*see* note 16), but a further breakdown of each country's inventory by treaty is required to determine which cases (or percentage of cases) in a country's inventory are/were potentially eligible for arbitration.

[14] See Harrington article cited in note 8, at pp. 758–759, for a discussion about the complexities of establishing such a baseline.

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ment,[15] the broader data indicates that the mere threat of arbitration — as opposed to its actual use — will not be sufficient on its own to deal effectively with the growing volume of and increasing delays in international tax disputes.

According to OECD statistics, the inventory of pending MAP cases among OECD countries has grown 38.6% since 2006 — from 2,352 open cases at the end of 2006 to 3,261 open cases at the end of 2010.[16] At the same time, average case processing times have increased from 22.10 months in 2006 to 26.45 months in 2010. Even if the latter number is somewhat anomalous — average case processing times have been hovering at 22–23 months since 2006 — the fact that the *average* case in recent years has taken two or more years to complete suggests that a significant number of cases have been eligible for, but not gone to, arbitration.

The IRS has experienced similar trends in both MAP double-tax cases and APAs. According to IRS statistics, pending U.S. MAP cases (which include pending APAs (*see* note 14)) have grown from 430 in 2006[17] to 686 in 2011.[18] At the same time, average U.S. case processing times have increased from 22 months in 2006 to 28 months in 2011 — again, an *average* at or beyond the two-year arbitration trigger, meaning many U.S. cases have been eligible for, but not gone to, arbitration.[19] The trends specifically for double-tax transfer pricing cases[20] and bilateral APAs are similar,[21] but still no APA arbitrations to date.

So the available data indicates that, notwithstanding the threat of arbitration, the number of MAP cases becoming eligible for arbitration has been growing. Yet the number of cases being referred to arbitration remains tiny, and the number of completed arbitrations can be counted on one hand. In reality, tax authorities are treating ''mandatory'' arbitration as a voluntary process that requires the mutual consent of both authorities. For a variety of reasons, but mostly out of self-interest, they have been unwilling in individual cases to force an objecting tax authority into arbitration. In this environment, it is hard to believe that tax authorities perceive much risk from the threat of arbitration, other than possibly as a transitional matter (i.e., the U.S.-Canada experience).[22]

Conclusion

My point is not that the threat of arbitration has not led to any improvement in the number and timing of MAP disputes. Although it is impossible given the limited public data to be precise, the MAP inventory statistics would almost certainly be worse absent the possibility of arbitration. Still, it seems clear that significantly more arbitrations are needed to reduce, directly, the growing and aging MAP inventories, and, indirectly, to make the threat of arbitration more credible. For mandatory arbitration to become the rule, rather than the exception:

- The OECD and the EU need to reaffirm their respective commitments to mandatory arbitration;
- More countries need to accept mandatory arbitration as a matter of treaty policy, especially in Asia where acceptance of mandatory arbitration remains low;
- Taxpayers need to demand mandatory arbitration when eligible;
- Countries that have accepted mandatory arbitration must begin to use it, even when such use may not seem favorable in a particular case;

[15] The IRS and Canada apparently resolved 80% of the double-tax cases that would have been eligible for arbitration in the months leading up to the effective date of the new U.S.-Canada mandatory arbitration provision. See Moses, ''U.S., Canada See 80 Percent Reduction in Backlog of Cases Slated for Arbitration,'' 19 *Transfer Pricing Rpt.* 877 (12/16/10). As another benefit, the threat of arbitration has also apparently brought new discipline to the MAP process by forcing the IRS and Canada to be highly cognizant of the ticking, two-year clock. See Wright, ''Danilack Praises Early Arbitration Experience with Canada, Says Conclusions Premature,'' 19 *Transfer Pricing Rpt.* 1067 (2/24/11).

[16] OECD ''Country Mutual Agreement Procedure Statistics for 2010,'' released Dec. 8, 2011. The OECD has been releasing such statistics since 2006. The data is not perfect (e.g., it is not clear which countries have included APA inventories in their count (e.g., United States, yes; Japan, no)), but as long as the imperfections are consistent from year to year, the trends revealed by the year-to-year data changes should be reliable. Indeed, the OECD data is consistent with similar data for 2004–2009 published by the EU Joint Transfer Pricing Forum; *see, e.g.,* ''2009 Update of the Number of Open Cases under the Arbitration Convention,'' released Feb. 10, 2011.

[17] OECD ''Country Mutual Agreement Procedure Statistics for 2010.''

[18] ''U.S. Competent Authority Statistics for 2007–2011,'' released Dec. 16, 2011.

[19] Average case processing times may overstate the actual number of cases eligible for arbitration. For example, IRS case processing times start as of the date of a taxpayer's written MAP request — the earliest possible Commencement Date for double-tax cases under the arbitration rules — and end when both tax authorities have signed the formal agreement, which typically occurs months after the competent authorities have reached a ''handshake'' deal.

[20] ''U.S. Competent Authority Statistics for 2007–2011,'' released Dec. 16, 2011.

[21] *See* Announcement 2011-22, 2011-16 I.R.B. 672, ''Announcement and Report concerning Advance Pricing Agreements,'' at Tables 1–9.

[22] Canada has apparently begun rejecting APA requests involving more complex transactions because of fear that such cases will end up in arbitration. Such a policy would be unfortunate, given that the highest and best use of the APA process is to deal with novel and difficult cases.

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- More disclosure is needed about the availability of and actual use of arbitration to make the process more transparent.[23]

The good news is that the IRS, in particular, appears poised to expand its use of arbitration if for no other reason than to test the effectiveness of the process.[24] Other key countries (e.g., the United Kingdom, France, Germany, Canada, Australia, and Japan) need to get on board too. Systematic implementation will help accelerate the ongoing shift in international tax enforcement and surely help to relieve the growing pressures on global tax administration, to the benefit of taxpayers and tax authorities alike.

[23] The EU Joint Transfer Pricing Forum is studying a proposal to require additional disclosure about arbitration under the EU Arbitration Convention. Such disclosure might include, for example, more detailed information about MAP processing times, the age of inventories, why agreements could not be reached, and why cases have not been submitted to arbitration after two years. EU Joint Transfer Pricing Forum, ''Possible Additional Information on Pending Cases under the Arbitration Convention,'' released June 9, 2011. A small working group has been assigned to the topic and is expected to make a final recommendation in Mar. 2012.

[24] The Senate resolution approving the new U.S.-France Income Tax Treaty requires Treasury to submit a report to Congress after the tenth arbitration, detailing the U.S. experience with the process.

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