Beslechting van transfer pricing geschillen

Djebali, N.

SUMMARY

RESOLUTION OF TRANSFER PRICING DISPUTES

1. Introduction of the research project

The research focuses on the various procedures for transfer pricing dispute resolution existing at an international level between states and taxpayers. These procedures, successively, are the advance pricing agreement procedure (hereafter also referred to as: APA procedure), the mutual agreement procedure and the arbitration procedure (hereafter referred to as: the transfer pricing procedures). The list ought to be nuanced in the sense that the first procedure is not so much concerned with the resolution of these disputes as with the prevention of them. Nevertheless, this study also analyses the advance pricing agreement, as this procedure is nationally and internationally considered to be an important factor for dispute resolution in the transfer pricing area.

The objective of the research is to determine to what extent the current transfer pricing procedures provide a fair and also sufficiently efficient and effective framework for the resolution of cross-border transfer pricing disputes. The answer to the central question will be based on an evaluation of the dispute resolution framework against the higher national and international standards of fair trial and on stocktaking research (i) into the results acquired with the procedures at national and international level, (ii) into the present national and international legal basis for its implementation, and (iii) into the changes in the procedures that were over the years introduced. Next, the study identifies the main issues in the dispute resolution framework paying equal attention to each of the transfer pricing procedures. Finally, the study offers, for the purpose of a continuing and positive development of the transfer pricing procedures, recommendations that can solve the identified issues and that can, in particular, create a framework for the resolving cross-border transfer pricing disputes that responds better to the criteria of fairness, efficiency and effectiveness.

2. Description of the research project

The study is organized into three parts that reflect the various stages of the research together with the corresponding research objectives and methods:

Part I	The current transfer pricing procedures
Part II	In-depth analysis of the dispute resolution framework
Part III	Recommendations and an alternative dispute resolution framework

The objective of part I (chapters 2 to 4) is to provide a clear insight into the backgrounds, the design and the Dutch practice of the transfer pricing procedures

by means of research in the areas of legal history and positive law. Each of these chapters concludes with stocktaking quantitative research into the results acquired with the various procedures at national and international level and the national and international legal basis for the execution of the procedures (appendices 1 to 7). For the purpose of comparison with the Dutch practice, the practices of three important trade partners of the Netherlands that are also representatives of three prominent 'transfer pricing continents', *viz*. Germany, Japan and the United States of America, are also considered (extern comparative law research).

Part II (chapters 5 and 6) examines the mutual consultation model, which underlies the APA procedure as well as the mutual agreement procedure, and international arbitration. Notwithstanding the fact that the mutual agreement procedure and the arbitration procedure are not included in the traditional judicial system, on account of their key position – *viz.* final resolution in cross-border transfer pricing disputes (as for this kind of disputes there are neither national nor international alternatives available) –, the study gives an in-depth analysis of them on the basis of the principles of a fair trial as enshrined in article 6 ECHR and as developed in ECHR case law (see in detail chapter 5, section 5.1 and chapter 6, section 6.1). For the evaluation of the arbitration procedure the study also considers so-called legal cornerstones of arbitration, which are normally taken as a starting point in international commercial situations. The analysis follows the ideal image of the transfer pricing procedures as set out in the introductory chapter in which they qualify as fair, and also as efficient and effective methods of dispute resolution, and that are in due compliance with the aforementioned principles. Not only for reasons of legal protection is this evaluation against higher principles indicated – *viz.* has the taxpayer with the development of the procedures been given an effective instrument for the resolution of cross-border transfer pricing disputes?–, also legal equality, legal certainty and the development of the law are guaranteed by these common standards. For the evaluation the author has chosen the following criteria: fair access to the procedure, impartial and independent adjudication, the principle of a fair hearing and adjudication within a reasonable period of time. Ultimately, the objective of part II is to identify the main issues in the current dispute resolution framework by means of stocktaking qualitative research consisting of an evaluation of the changes that were over the years introduced by the national and supranational institutes concerned (the Dutch Ministry of Finance, the EU and the OECD).

Finally, part III (chapter 7) answers the central research question namely to what extent the current transfer pricing procedures provide a fair and sufficiently efficient and effective framework for the resolution of cross-border transfer pricing disputes. This part of the study also sheds a light on the national and international basis for the execution of the procedures and the expected developments. Further, part III forges together the results of the first and second part of this study, which leads to a proposal to improve the current dispute resolution framework (design-based research). This proposal has a twofold scope: to provide (i) recommendations to improve the various transfer pricing procedures, and (ii) an alternative

scheme to improve the general framework, in particular the transitional stage from the mutual agreement procedure to the arbitration procedure. For the purpose of the design of this alternative scheme, there will be an excursion into the arbitration rules of the United Nations Commission on International Trade Law (hereafter referred to as: UNCITRAL) and of the International Chamber of Commerce (hereafter referred to as: ICC) (internal comparative law research). The valuable elements of these rules are incorporated into the design of the new scheme.

3. Summary of the conclusions

The analysis of the transfer pricing procedures in the first and second part of this study has shown important issues that preclude a positive answer to the central research question. This does not mean, however, that the procedures, or more generally spoken, the current dispute resolution framework, after having undergone some adjustments, could not fulfill the ideal image of fairness, efficiency and effectiveness or could better comply with these criteria. The research has demonstrated that the procedures could very well develop into more practical and effective instruments with which the taxpayer has recourse to decisive legal remedies and which provide him with a strong legal position. Below, the author will summarize her conclusions with regard to the transfer pricing procedures and their main underlying models, *viz*. the mutual consultation model and international arbitration (see for a complete account chapter 5, section 5.6, chapter 6, section 6.6, and chapter 7).

The APA procedure is for the time being the one that is used most frequently out of the three transfer pricing procedures. In that sense, it can be considered as the most effective one. By concluding APAs with tax administrations on a national or international basis, taxpayers enjoy many advantages. By means of APAs, companies obtain certainty on the way transfer prices within the business group are applied for the upcoming years and on the degree of acceptability. This certainty means that important risks are avoided like conflicts with the tax administration leading to transfer pricing adjustments and, in the worst case, double taxation. An APA also creates internationally a more certain playing field which improves the company's position. It may be added that, once the transfer pricing policy of a company has been approved of by the tax administration, it establishes a precedent, so that renewal of the agreement could be a simplified process requiring relatively little documentation to be submitted. The APA procedure thus brings about significant benefits and therefore it is applied by a large group of companies, including Dutch multinationals. The requests are in particular concerned with the acquirement of bilateral APAs, as they regard cross-border transactions and, consequently, generate the greatest certainty. Smaller companies usually apply for unilateral APAs given the costs of procedures involving international consultation. This APA that is acquired via a purely national procedure provides, however, interesting advantages like certainty within its own state and a better starting position in the case of an international conflict as the tax authority of the state of residence has already approved of the taxpayer's transfer pricing policy. In other words, the unilateral APA can also be considered a potentially effective and therefore attractive instrument. This type of APA falls, however, outside the scope

of this research, that is concerned with dispute resolution between states (see chapter 1, section 1.5). Only the request of a bilateral or a multilateral APA will offer a suitable solution for future conflicts at an international level (and in so far as there exist old conflicts, the APA can be granted rollback). An APA procedure could, however, also be started immediately after the successful ending of a mutual agreement procedure in order to prevent future problems between the states involved. Because as a part of the preceding consultations, exchange of information and international discussions have already taken place, the APA procedure is likely to proceed well. Such a combination of procedures will further improve their efficiency and effectiveness.

In summary, it can be concluded that the bilateral and the multilateral APA – although the latter type of APA is used far less frequently as for the time being it has not a sufficient national and international basis – are effective instruments for the resolution, or rather, the prevention of cross-border transfer pricing disputes. Commercial results show that the APA procedure is positively developing as far as the national part of the procedure is concerned, and that this part may, therefore, qualify as efficient (in which statistics moreover no distinction is made as for the various APAs, see appendix 5). The lack of distinction between the types of APAs and their corresponding chances of success impede the insight into the degree of success of the bilateral and multilateral APA. The picture is less positive with regard to the international part of the procedure. The consultation between the states often is a long-lasting process of several years, also depending on the state to be consulted and the tax treaty that constitutes the basis for the consultation.

Further, the examination of the mutual agreement procedure in the light of the principles of a fair trial has given the impression of a procedure that is potentially promising, but that needs to be strengthened. In its present shape it still has too many discrepancies with respect to the procedural standards developed by the ECHR. The question arises, however, to what extent compliance with those standards should be the result. Realistically, the mutual agreement procedure will never be in full compliance with them, given the evident character of a government process. These standards can, however, be used as a basis for the evaluation of, in particular, the fair character of the procedure and the resulting options for improvement, as is also argued in the introductory chapter, section 1.3 and 1.4 and in chapter 5, section 5.1. This is particularly necessary as the procedure bears important features of a judicial trial and, for the time being, no other legal remedies are available for the resolution of cross-border transfer pricing disputes (like an international judicial procedure, see chapter 7, section 7.3). For the improvement of the procedure a balance has to be found between the ECHR standards and the starting points for a government process, which process has also clear mainly pragmatic advantages.

The most important advantage and at the same time also the most important disadvantage of the mutual agreement procedure is its essence, *viz.* that problems are solved in an amicable consultation by the authorities of the states involved

without the participation of an independent third party. Besides, the taxpayer is left with too little legal protection. The 'principle of representation' according to which the taxpayers' state of residence stands in for him and as such protects his interests, does not function optimally, as there is a real risk that the interests of the states have priority in the search for a suitable solution (the so-called 'conflict of interests'). This basis of amicable consultation does not necessarily disqualify the procedure. The adverse aspects may be compensated, if:

(i) the internal design of the procedure qualifies as a fair trial with which taxpayers are given a real possibility to resolve their dispute and within which their legal position is sufficiently guaranteed, and
(ii) taxpayers have the possibility to bring their case before a higher, independent body that supervises the contents of the mutual agreements and, if required, reviews these agreements (see on this chapter 7, section 7.4.3, recommendation 11, and section 7.5.4 – the main procedure of international arbitration), in the light of the arm's length principle (and the related transfer pricing methods) as laid down in the applicable tax convention and the national regulations (see below the section on international arbitration).

From the in-depth analysis of the mutual consultation model in chapter 5 follows that the first condition is not yet fulfilled. Mutual consultation still has a too arbitrary character. The resolution of the dispute, its procedure, its progress and the position of the taxpayer herein depend too much on (i) the views and practical experience of the states involved, (ii) national substantive and procedural law, and (iii) the commitment and involvement of lower government agencies as for example the presence of subsidiary bodies of transfer pricing experts. The Netherlands has seen a positive development of all these aspects. Therefore, the problems will in particular arise in relationship to other states, for example problems that may arise in negotiations with less developed treaty partners, and divergence of views on the substantive interpretation or on the procedural aspects that may arise in negotiations with more equal partners.

For the sake of transparency, the author has distinguished two levels (see chapter 5, section 5.6), on which the arbitrary character of the mutual agreement procedure between states reveals itself. First the *'micro-level'* that has been discussed in the first part of the research, namely (i) the design of the transfer pricing procedures of which this mutual consultation is always a part either as preliminary procedure or as main procedure, (ii) the problems that arise in the separate procedures, and (iii) the adjustments that the various procedural stages accordingly need. At this level also the substantive difficulties of a more economic and technical nature appear, such as the divergence in transfer pricing methods and the different ways of their application by the states. Secondly a *'macro-level'* can be discerned. This level refers to the current dispute resolution framework and the position the mutual consultation model has in it. The examination of the mutual consultation model in chapter 5 has been done without taking into account the technical implementation difficulties, which enabled a view of the model from a wider perspective in order to get a good grip on its complexity. This perspective acquired

through an examination in the light of the principles of a fair trial has unveiled the essence of the mutual consultation model, which is at the core of the critiques made on this model, namely that, also given the historical design – states have strived for maintaining their sovereignty –, the model is susceptible to arbitrary decisions. Now, if the mutual consultation model needs to become ECHR-proof, the taxpayers' legal and procedural interests in particular ought to be protected more strongly. This can be achieved by strengthening the taxpayers' rights of defence and by countering, as far as possible, the difference in legal position between states and taxpayers during the proceedings. These adjustments should be made in combination with an appropriate opportunity for review afterwards.

With that, the author comes to her conclusions on international arbitration. The transition from the mutual agreement procedure to the arbitration procedure, the access to arbitration, the character and the scope of arbitration, the position of the arbitrators and the role of the taxpayer in the proceedings need to be improved for the arbitration procedure to qualify as a fair, efficient and effective procedure. In order to perform the role of supervisor for the mutual agreement procedure, the arbitration procedure should acquire a more independent and effective character and should not (partly) be left to the discretion of the states. Positive qualities, however, also deserve mentioning as international arbitration has over the years acquired a more refined format with the development of regulations at a European and at a more international level, on account of which states are found more and more inclined to delegate their sovereignty to an arbitration commission. This development is likely to continue depending, of course, on other more substantive developments in the transfer pricing practice (see in detail chapter 7, section 7.3). The use of the arbitration procedure is, however, for the time being a limited one as is clear from the available statistics (see appendix 5). In actual practice the procedure seems in particular to have the role of supervisor, as a result of which the mutual agreement procedure has increased in efficiency and effectiveness. It is preferable that the arbitration procedure not only has this important preventive effect, but also flourishes as an independent instrument itself. This is particularly necessary given the weaknesses of the mutual agreement procedure in its current form. An arbitration procedure that fulfills the ECHR-standards to a higher degree ensures that the whole dispute resolution framework will function better, the mutual agreement procedure can retain its informal and pragmatic character and the taxpayer acquires a stronger legal position through this review mechanism. But to reach that state, the arbitration procedure still needs a number of adjustments. Some of these adjustments can be found in the continuum between the mutual agreement procedure and the arbitration procedure; a separate appeal on the arbitration procedure ought to be possible under certain conditions (see in detail chapter 7, section 7.5). Other adjustments require a modification of the arbitration procedure itself, which is the continuation of an ongoing process, *viz.* the creation of a 'higher' procedure in which states have less and independent experts more influence (see in detail chapter 7, section 7.4). For its design consistency and transparency of rules will be basic. Further, a significant error is the way in which the arbitration commission has been designed in the various regulations. What is

remarkable is that this commission, notwithstanding the participation of independent experts, may be more or less subjective through the participation of representatives of the states involved in the conflict. This participation can be disputable if there is insufficient counterbalance in the sense that these representatives are in the majority and that taxpayers, unlike the states, do not have the right to reject an arbitrator if they suspect certain impartialities for which they can produce evidence. In short, an arbitration commission can only be sufficiently objective notwithstanding the participation of the states – which is a somewhat artificial construction chiefly aimed at maintaining tax sovereignty –, if it includes, anyhow, a majority of independent members of whom one is president (for instance, a group of five persons including three independent experts).

The fundamental question that also applies to international arbitration is to what extent the procedure needs adjustment so that it will comply with the ECHR standards and the preliminary procedure of mutual consultation will be approved of as well (see for the latter above, item ii of 'the adverse aspects of mutual consultation'). In particular, the question arises to what extent adjustments are possible in the current transfer pricing practice, in which the arbitration procedure is already considered to be a large step. Realistically, the arbitration procedure will never, as has been pointed out in chapter 6 in the introductory section 6.1, be able to be completely equated with the traditional judicial proceedings and to comply fully with the ECHR standards. These standards provide, however, appropriate instruments on the basis of which several different options for improvement can be suggested (see in detail chapter 7, section 7.4). The examination referred to seems indicated, given the vital role of arbitration in the dispute resolution framework as a final instrument for the resolution of transfer pricing disputes, and also as a review mechanism afterwards. Although it should not be forgotten that this is a treaty instrument with a corresponding objective, it should as much as possible be striven for that this procedure is available as a fair and decisive instrument for the taxpayer. This is particularly necessary because of the lack of a remedy at national and international level. The arbitration procedure will, therefore, have to be developed further within the limits of the procedural rules and diplomacy, which will require a careful balancing of interests in which the taxpayer's legal position should be an important factor. In this consideration so-called legal cornerstones of international arbitration can play a supporting role, as will be more fully explained hereafter.

Chapter 6, section 6.1, lists legal cornerstones of international commercial arbitration. These are: (i) access to the procedure under an arbitration agreement, (ii) free selection of quality arbitrators under a set of arbitration rules, (iii) proceedings in a closed session based on the relevant arbitration rules, and (iv) implementation of the outcome based on national regulations and/or a convention. These cornerstones, which generally apply in international arbitration, are not all of them sufficiently safeguarded in the arbitration procedure used in transfer pricing conflicts. This is not surprising given the design of this procedure of which the framework is different from what is usual in arbitration. The transfer pricing or,

more generally, the tax variant of the arbitration procedure as laid down in the tax treaties is not devised by both parties involved in the conflict (*viz*. the taxpayers and the states), but unilaterally designed by the states in accordance with the provisions agreed between them at treaty level. Here the 'principle of representation' becomes a consideration again: the states are deemed, on behalf of the taxpayers and in their interest, to agree on an arbitration clause that in due time, can be used in a cross-border conflict. As argued above, this formula is not satisfactory. The states have their own interests too, which makes their role controversial. Therefore, not the comparison against the more general arbitration procedure in which by common accord parties agree on a clause pursuant to which in case of a conflict they submit their dispute to, for instance an independent arbitration institute, should serve as a reference, but rather the comparison with the traditional judicial proceedings in which the taxpayer applies an existing dispute resolution framework by means of which he endeavours to have his conflict brought to an end. With the arbitration procedure in its present shape the taxpayer falls between two stools: he enjoys neither the advantages of international arbitration (by having influence on the performance of a clause as a contracting party) nor the advantages of the traditional judiciary proceedings (by obtaining judicial protection as a party in the proceedings). With the present procedure the states have, therefore, brought the taxpayer in an indefinable position while their own position seems to prevail. The procedure would have been remarkably more in line with the ECHR standards, if for the design of this treaty instrument, the states had stuck more to the nature of arbitration as expressed in the aforementioned cornerstones. In that case, the states could also have retained their intent, the limitation of loss of tax sovereignty. Compliance with ECHR standards can still be achieved by safeguarding access to the procedure, by giving the arbitration commission a more independent character, by giving the taxpayer influence on the composition of the commission and by effectuating the outcome of the procedure (see in detail chapter 7, section 7.4 en 7.5).

Finally, the author comes to the *external* review of international arbitration, which means the arbitration procedure considered as proceedings on appeal (chapter 6, section 6.6). In principle, the arbitration commission also pursues objectives of review procedures, so as to provide legal protection to litigants as well as correction of errors committed in an earlier proceeding. Ideally, arbitrators should, like a higher court, review the mutual agreement procedure and its outcome, maintain the uniform application of the legal provisions (*in casu* the arm's length principle as laid down in the tax conventions) and further legal certainty as well as development of the law. The research showed that this is not always the case to the same extent. Dependent on the type of arbitration (for instance, 'baseball' arbitration or full review) and on that account on the scope of the examination by the arbitrators, such supervision may be effectuated to a varying degree. A basic requirement should, of course, be that in the review procedure the complete proceeding needs not to be repeated, but can be restricted to the open issues. In the present form there is no such justifiable restriction on examination. The factual investigation that the consultation body undertakes during the preliminary

mutual agreement procedure has an insufficiently objective and transparent character. The arbitration commission cannot, therefore, rely on the activities of that body. Apart from a judicial assessment, the arbitrators will also have to deal, if and in so far as required, with a further examination of the facts. Such an examination is not always possible within the limited forms of arbitration (think of 'baseball' arbitration or the variant as laid down in the provisions of the OECD Model Tax Convention in which only those issues are submitted to the commission that are not resolved by the states by mutual agreement). There is another reason why the arbitration procedure is not satisfactory as a body of appeal, which concerns its restricted accessibility. The procedure cannot be invoked independently from the mutual agreement procedure for the purpose of further examination of a denial of mutual consultation by the states or of a mutual agreement reached. Arbitration, therefore, functions insufficiently as a review procedure. Further, the constantly changing composition of the arbitration commissions, which vary for each dispute, impede consistent case law and development of the law. For this reason it is advisable to give the arbitration commission a more permanent character and to extend their powers of judicial review. The fact that, in the framework of an arbitration procedure, in comparison with the mutual agreement procedure, advices of the arbitration commission are more often published, may support this suggestion for an adjustment of the commission.

After the analysis in the first two parts of the research with regard to the current design of the advance pricing agreement procedure, the mutual agreement procedure and the arbitration procedure, part III moves on to the formulation of possible adjustments of each of these procedures. These adjustments aim to provide procedures that are better equipped to the higher standards of procedural law, and that will ultimately lead to a fairer as well as a more efficient and effective dispute resolution framework. Their formulation takes into account the character of these procedures as being governmental and diplomatic processes in order not to lose the mainly pragmatic advantages that may result from it. The author also makes recommendations for a more balanced and consistent national and international legal basis. These recommendations also aim to enhance legal equality in the execution of these procedures, which at the same time shall also enhance legal certainty. For an insight in the solutions offered, more in particular in how they are related to the current design of the three procedures, see chapter 7, section 7.3 and 7.4.

Finally, part III of the research (see in detail chapter 7, section 7.5) discusses a new scheme for mutual consultation and international arbitration, based on the various stages of these procedures as described in chapter 3, section 3.5.2, and in chapter 4, section 4.5.2. It combines the valuable elements of the present dispute resolution framework with the valuable elements taken from the arbitration rules of two prominent arbitration institutes, the UNCITRAL and the ICC. Where necessary, the author has proposed changes in order to create the new scheme. The diplomatic and delicate character of the transfer pricing procedures are taken into account, so that in the future this scheme may find acceptance at national and international level.