KPMG International

To	Directorate-General for Taxation and Customs Union Unit TAXUD/D2	Date	10 May 2016
From	Montserrat Trape, EMA Region Leader, Global Transfer Pricing Services, KPMG International	Ref	Public Consultation on Improving Double Taxation Dispute Resolution Mechanisms
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Comments on the European Commission's Public Consultation on Improving double taxation dispute resolution mechanisms

KPMG member firms and professionals from KPMG's Global Transfer Pricing and Dispute Resolution Practices ("KPMG") welcome the opportunity to provide comments on the European Commission's Public Consultation on Improving double taxation dispute resolution mechanisms (hereinafter the "EC consultation").

The EC consultation's stated aims are to gather all stakeholders' views on:

- the relevance of removing double taxation for enterprises operating cross border;
- the objectives which are suggested to be pursued at the EU level and which are aiming at fulfilling the Action Plan[1] commitment of an improved dispute resolution mechanism;
- the solutions which are discussed.

We have responded to the consultation questionnaire published on the European Commission's website, and as provided for in Section 5 of the questionnaire, take this opportunity to provide further support and illustration of KPMG's views on this issue.

Introduction

With the ever-increasing internationalisation of trade, the increasing complexity of domestic tax laws, and the developing importance of new and emerging markets, the risk of double taxation continues to be a significant concern for multinational enterprises. The potential for suffering more than one corporate income tax on the same business profits can lead to uncertainty and distort investment decisions, even within the EU. It can also lead to inequitable treatment of taxpayers. Whilst remedies for double taxation exist, the differences in domestic legislation (and the different approaches of tax administrations), variations in double taxation articles in bilateral tax treaties, and the lack of binding arbitration in many circumstances, mean that double taxation remains a

[1] June 2015 Action Plan for Fair and Efficient Corporate Taxation in the EU

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barrier to international trade and an obstacle to the functioning of the EU single market. Further, the remedies that do exist are often unduly limited in scope, inconsistently applied, and burdensome, both in terms of time as well as cost, in operation. The result of this is that multinational enterprises frequently accept instances of double taxation, taking the view (rightly or wrongly) that achieving relief will be uneconomical either in terms of cash expense or diverted management time (or, most frequently, both). Measures to address double taxation, and the effectiveness of those measures, are therefore of great importance to all multinationals.

Double taxation conventions ("DTCs")

On suffering double taxation (e.g. through a transfer pricing adjustment made by the tax administration of Country A in respect of a transaction between a multinational's subsidiaries in Country A and Country B) a multinational enterprise's first recourse will generally be through a DTC between the two relevant countries. Whilst coverage is not universal, in most cases such a DTC will be available, and will include a mutual agreement procedure article (most commonly based on Article 25 of the OECD Model Tax Convention ("MTC")). Whilst in most cases an application for mutual agreement under the relevant DTC will result in the taxpayer receiving relief from double taxation, Article 25 of the MTC (and hence most DTCs) states that:

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.

There is therefore no binding requirement on the competent authorities of the relevant jurisdictions to reach an agreement which eliminates double taxation. Although most cases are resolved, the completion rate varies significantly by country, and failure to reach agreement does happen. Also, a solution is often reached only after significant time has elapsed. As a result, taxpayers are often deterred from going through the time and expense of a MAP application. Further, tax authorities may find reasons not to accept the application.

DTC arbitration clauses

In 2008, a suggested clause was added to the MTC allowing for binding arbitration in situations where the competent authorities could not reach agreement on eliminating double taxation. Whilst welcome, it is clear that many pre-2008 DTCs continue in operation, and many post-2008 DTCs have been concluded without an appropriate binding arbitration clause. Some countries have taken a positive approach to binding arbitration, and some solutions have been innovative, e.g. the "baseball arbitration" approach of the US-Canada DTC. Under baseball arbitration, the two parties are required to reach a stated position on their assessment of the correct allocation of profit, and the arbitrator has to choose one of these positions (rather than, as is traditional, finding a compromise position somewhere between the two stated positions). The advantage of this approach is that it

encourages competent authorities to take a less extreme position in negotiation, as they know that doing so will increase the risk of the arbitrator accepting the other party's position. This can often lead to the case being settled without the need for arbitration, as there is less distance between the two positions.

The EU Arbitration Convention

Addressing the fundamental conflict between double taxation within the European Union, and the Union's principles of removing barriers to cross border economic activity, the EU Arbitration Convention established a binding mechanism for ensuring the elimination of double taxation in disputes between EU member states. It initially entered into force in 1995, although issues have arisen relating to the use of an inter-governmental Convention (rather than a Directive) and procedural issues around extension of the original 5 year term, ratification by member states, and extension to new member states.

The Arbitration Convention often makes double taxation issues more manageable within an EU context, and the guarantee of elimination of double taxation makes an application for relief more attractive to a taxpayer than an application for MAP through a DTC with no binding arbitration clause. However, there are limitations in its scope (e.g. the Arbitration Convention cannot bind member states in questions of the existence of a permanent establishment ("PE")) and accessibility (tax administrations may argue that applications are invalid because, for example, they have levied a "serious penalty"). Tax administrations may take the view that an adjustment is based on domestic legislation, rather than Article 9 of the applicable DTC, or they may even propose that settling the case at local level is an impediment for accessing the arbitration convention. These situations provide clear evidence that this is a far from perfect solution to the issue of double taxation.

OECD Base Erosion and Profit-shifting ("BEPS") initiative

In October 2015, as part of the BEPS initiative, the OECD published its final report in respect of BEPS Action 14, *Making Dispute Resolution Mechanisms More Effective*. The report followed extensive discussions between governments of G20 economies (and others) and consultation with various stakeholders. It proposed minimum standards, best practices and monitoring processes for tax administrations addressing instances of double taxation. It also included a commitment towards mandatory binding arbitration by a group of countries. There remains, however, no consensus on the adoption of arbitration among all OECD and G20 countries.

It has been noted by many stakeholders that while BEPS Actions that impose greater burdens on taxpayers have moved rapidly towards international agreement and legislation, Action 14 (which could be considered the one BEPS Action designed to remove burdens on taxpayers) has led to a much weaker agreement with limited scope for enforcement.

KPMG's position

We have set out below our position on the relevant issues, both specifically related to the EC consultation, and the related options for improving dispute resolution mechanisms.

BEPS Action 14 and related EU initiatives

KPMG responded to the consultation on the Action 14 Discussion Draft (issued on 18 December 2014) on 17 January 2015. Many of our comments are equally relevant to the EC consultation.

KPMG welcomed the efforts of the OECD in identifying the obstacles to efficient dispute resolution, and in putting forward potential options. KPMG's comments included the following observation in respect of specific obstacles:

- *Inadequate funding of the MAP process* – many countries have failed to fund the necessary personnel, training and travel to actively negotiate the growing number of MAP (and APA) cases. This can cause long delays in the MAP process and discourage taxpayers from making applications.
- *Audit settlements requiring waiver of MAP rights* – KPMG member firms frequently see examples of tax administration officials in various countries formally or informally requiring taxpayers to commit to waiving their rights under the relevant DTC in order to reach a negotiated settlement. While such waivers cannot be seen to be binding, taxpayers are often reluctant to assert such a right for fear of antagonising their local tax officials.
- *Requirement for payment of tax before a MAP claim may be brought* – some countries require the payment of tax before they will consider a MAP claim. This can lead to undue hardship for taxpayers who effectively suffer the double taxation for the period of MAP negotiation.
- *Rejection of MAP claims* – some countries will unilaterally determine that a case is not appropriate for MAP, meaning that the bilateral MAP never begins. There is frequently no recourse in law for taxpayers in this situation.

KPMG concluded that the most important contribution the OECD's Action 14 work could make to the efficiency and effectiveness of MAP would be to support the adoption of binding mandatory arbitration in some form.

The existence of a binding arbitration process tends to increase the number of resolved MAP cases, as tax authorities are more inclined to reach agreement knowing that failure will lead to arbitration. Where the willingness to reach an agreement outside of arbitration is due to the concern that the outcome may otherwise be outside the control of the tax authorities concerned, this seems a good thing. But where it arises from the concern that arbitration represents a long term burden on tax authorities' resources, it may be questioned whether an earlier 'solution' – that may not always be a full resolution from the taxpayer's perspective - is a good thing. Subject to this, arbitration could, if well implemented, address the obstacles outlined above.

KPMG also noted that minimum standards for participating countries should include publication of MAP and APA results, personnel headcount, budgets and training costs.

Whilst the OECD final report did address some of these issues positively, we note that on the key issue of binding arbitration, a consensus could not be reached. For taxpayers struggling to respond to the requirements placed upon them by the other BEPS actions, this is extremely frustrating.

The BEPS actions will inevitably involve a great deal of uncertainty over implementation by global tax administrations and therefore more tax disputes than ever before. This has been explicitly recognised in the context of the EU's proposals to implement certain BEPS-related provisions[2].

Without an efficient and effective mechanism for dispute resolution, and without binding arbitration, we foresee an increase rather than a decrease in the number of instances of double taxation arising from the OECD and EU BEPS initiatives.

In the EU context certain double taxation risks have been recognised and provided for in specific areas (such as the controlled foreign company provisions in the proposed 'anti-tax avoidance directive'[3]) with a 'catch all' solution in the recitals calling on EU Member States to give credit relief where a particular provision leads to double taxation. In view of the shortcomings of the existing rules and procedures referred to in this paper, it seems evident that a non-binding 'expression of intent' of this nature falls far short of what is necessary.

The EU Arbitration Convention

In the EU context, there are a number of advantages when compared with the work of the OECD. These include:

- a long-standing principled commitment to removing barriers to trade within the Union
- a legal framework that can give better effect to multinational agreements
- a more narrow spread of cultural, economic and political considerations than at the OECD
- a smaller number of jurisdictions to reach agreement
- an existing basis for binding arbitration, ie the EU Arbitration Convention

We note that these advantages are already being utilised in launching proposals which are in line with the OECD BEPS actions, but which potentially go further. For example, while BEPS Action 13 will require filing of "Country-by-Country" reports with the tax administration of a multinational enterprise's parent company, the European Commission is proposing public disclosure of such information. We contend that it would not be equitable for taxpayers if only actions involving

[2] Communication for the commission to the European Parliament and the Council, COM(2016)23 final.

[3] Proposal for a Council Directive COM(2016)26 final.

further burdens on them are taken a stage further within the EU, but the one key issue that would help taxpayers is not effectively addressed.

As noted above, within the EU, taxpayers have the advantage of the Arbitration Convention. As has also been noted above with respect to binding arbitration generally, the Arbitration Convention appears to act as an incentive for competent authorities to reach agreement more consistently, as their preference is to reach an agreement bilaterally rather than go through arbitration. The Convention then seems to act most effectively merely through its existence, rather than through a significant number of cases actually being arbitrated under its auspices.

However, it must be noted that the Arbitration Convention has its limitations. The Convention applies only to transfer pricing and PE profit attribution cases. It does not apply to disputes regarding the existence or otherwise of a PE. And although it can apply to the setting of interest rates on inter-company financing issues, it cannot generally be used to address thin capitalisation disputes, recharacterisation related issues or even secondary adjustments.

As noted above, with the introduction of BEPS-related provisions in the EU, the need for a more effective resolution procedure will become even more crucial. One possibility would be to extend the Convention to such matters, whereby specific legislative provisions could directly link to this procedure in case disputes arise. It might be noted that such disputes are not necessarily limited to cases of double taxation but may arise more generally in relation to the application and interpretation by different EU tax authorities of the provisions in question.

Also taxpayers frequently complain that they are prevented from accessing the Convention by tax administrations who contend that the taxpayer is barred from its application through abuse of the "serious penalty" clause, where a tax authority might be more inclined to impose such a penalty in order to prevent the taxpayer accessing relief.

Also many of the more usual complaints around the MAP procedure apply equally to the Convention, including slow progress (even with the specific time limits provided in the Code of Conduct) and the associated costs of preparing materials for the tax authorities. In some countries cases are frequently not resolved within the two year time limit, and yet arbitration does not commence.

We note that the European Commission has previously acknowledged that the Arbitration Convention could work more effectively, and has been undertaking work in this area. In the EU Joint Transfer Pricing Forum's final report on *Improving the Functioning of the Arbitration Convention* (March 2015), a number of recommendations were made. Whilst broadly welcoming the recommendations, which if implemented would undoubtedly improve the operating of the Convention, there are a number of key issues that we do not believe the recommendations adequately address.

Firstly, the report does not make any recommendations for extending the scope of the Convention. For example, the report notes that the Convention does not apply to the issue of whether a PE exists, and makes no recommendations for this to change, despite the clear risk of double taxation inherent in this question.

Secondly, while acknowledging the issue of tax authorities limiting access to the Convention, the report's recommendation suggests a new addition to the Convention's Code of Conduct stating "Member states should consider providing domestic legal remedies for determining whether the denial of access to the Arbitration Convention by their administrative bodies is justified." We do not believe that the wording of this recommendation is likely to have any discernible effect on those member states who most frequently seek to restrict access to the Convention.

Another area where the Joint Transfer Pricing Forum is undertaking further work involves dealing with triangular cases, either involving three EU member states, or two EU member states and one non-EU state. Both DTC MAPs and EU Arbitration Convention cases are seriously complicated when three jurisdictions are involved in a case. Any long-term solution which addresses the specific problems of such cases would be welcomed.

In its concluding remarks the report also suggests other issues for consideration including alternative approaches to arbitration (e.g. baseball arbitration) and application of the Convention to the existence of PEs and thin capitalisation (as discussed above). KPMG would welcome the introduction of the recommendations of the report, and would also welcome the other issues being progressed at the earliest opportunity.

KPMG Conclusions

The EU consultation frames its questions in terms of the scope, enforceability and efficiency of the current remedies available to EU taxpayers, and the options proposed. We believe that all three criteria are of great importance, and that the Commission should seek solutions which address all three. In this context our concluding comments are:

- We would welcome a firm commitment to improving the working of the EU Arbitration Convention, including accessibility and timescales.
- The work of the EU Joint Transfer Pricing Forum on improving the Arbitration Convention should continue, and existing recommendations should be implemented as a minimum.
- The Commission should ensure any changes either align with the OECD Action 14 recommendations, or take them further. Any changes which contradict the work of the OECD would be unhelpful for multinational enterprises.
- We believe that binding arbitration is the only way to effectively eliminate double taxation, and that the EU Arbitration Convention, whilst not perfect, is a good model for what could be achieved at an OECD level.

- Our preference would be for a practical arbitration process. Whilst a legalistic approach (e.g. the European Court of Justice acting as Arbiter in disputes under the Germany-Austria treaty) has some advantages, the additional costs and timeframes involved may make the process prohibitive, particularly for smaller cases.
- In the absence of a global framework for binding arbitration, the Commission should further consider how the Arbitration Convention could be:
  - Broadened in scope (e.g. extended to address the existence of PEs and thin capitalisation, as well as EU BEPS-related disputes)
  - Made more enforceable (e.g. could the original plans for an EU Directive be revisited?)
  - Made more timely (e.g. could the two year time limit be made mandatory?)
  - Made more efficient (e.g. could a baseball arbitration approach encourage tax authorities to take more reasonable opening positions and therefore reach agreement quicker?) including the dedication of more resources by governments
  - Made more accessible (e.g. limitations to Arbitration Convention access should be exceptional and totally founded. The term serious penalties is not consistently interpreted. No other causes should impede access to the Arbitration Convention.)
- The Commission should conclude on and recommend a preferred arbitration clause that member states should consider including in new DTCs, whether with other member states, or non-EU countries. The current variations in different treaties cause confusion and inconsistencies.
- We believe the EU should support the OECD's recommendations on minimum standards for tax administrations in applying MAP, and should consider whether these minimum standards could be higher, and more effectively monitored, in an EU context.
- Some form of sanction for tax authorities delaying the process should be considered (e.g. an automatic start of the arbitration process if a tax authority delays its response).

Finally, we would re-emphasise that the current OECD BEPS work and the EU work on creating a fair and efficient corporate tax system, are both likely to lead to greater scope for disputes. This is obviously not the intention of the work, but will undoubtedly be the outcome, as is the case with any major change in approach, especially one being implemented globally. It is therefore critical for taxpayers to have access to an efficient, wide-ranging and enforceable process for eliminating double taxation.

We would welcome any opportunity to discuss our comments further.

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KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 155 countries and have 174,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.