Discussion Draft on Chapter 4: Special issues faced by developing countries (and LDCs in particular)[1]

3.1 Issues and experience in developing countries

3.1.1. Legal issues and experiences

Economies are different and every country and every region has specific approaches to tax policy, varying economic circumstances, and more or less resources available. However, there is a set of issues concerning international tax dispute resolution that has been observed in many different places over the last years. Those issues are in particular:

- Limited treaty networks
- Acceptance of international legal obligations
- Fundamental disagreements on tax treaty interpretation
- Uncertainty on the adherence to international soft law
- Uncertainty on the interrelation between domestic and international tax law
- Weak protection of taxpayer rights
- Duplication of problems in the domestic application of international standards
    - Lack of technical abilities
    - Lack of confidence
- General lack of resources
- Missing trust of taxpayers in institutions and procedures

Limited treaty network. Developing countries and in particular, least developed countries often do not have an extensive treaty network. Some jurisdictions do not follow either the OECD or UN Model treaty in their tax treaty policy. Additionally, not all of their treaties contain a dispute resolution clause. And more often, developing countries are not willing to accept arbitration clauses. The Multilateral Instrument[2] seeks to combat those issues, but countries are still left with a lot of flexibility when it comes to introducing dispute resolution instruments and MAP in particular.

To be included: Footnote with IF countries with less than 10 treaties

Including a MAP clause in a double tax treaty creates legal obligations for contracting states, of which not all countries are aware of. Respective provisions usually only foresee the obligation to endeavor finding a solution but not to actually solve a case and countries retain the right to reject cases for specific reasons. Whether such provisions implicitly create the obligation to set up an institutional framework to generally be able to conduct MAP is at least arguable. Such framework would require equipping a competent authority with the necessary legal powers to conclude and implement decisions found during a dispute resolution procedure, and to have respective human capacity available. Countries not always consider those necessitioes already during treaty negotiations.

To be included: Country practice Chile

[1] Draft provided by Norbert Roller.

[2] To be included: details on MLI

Developed and developing countries sometimes disagree fundamentally on concepts and interpretations of tax treaty rules. Competent authorities from developed countries and developing countries may disagree on broad concepts contained in tax treaties such as 'permanent establishment' or 'royalties'. Being aware of the (presumed) power imbalance between developed countries and developing countries in MAP negotiations, some developing countries fear the implementation of unwanted concepts through the backdoor of MAP. But even in the absence of fundamental disagreements rules will sometimes be applied and interpreted differently by different tax administrations. As a matter of fact, double taxation can occur sometimes when two tax administrations apply the same tax treaty rules on the same set of facts, however, both acting in good faith and being convinced that they apply rules correctly.

To be included Box on interpretative agreements under 25/3

Many developing countries are members of international organizations (IOs) or closely cooperate with them in tax matters. Those IOs are for example the UN, the OECD, the IMF, the World Bank and other, often regional, institutions. The grade of integration varies from being a full member of an IO to merely receiving aid from such institutions. While many IOs produce interpretive materials to international legal standards it is often widely unclear in how far members or cooperation partners follow those products and implement them domestically.

To be included: Box on MEMAP and how it was used pre BEPS

Consistency of international legal obligations with domestic law is often not warranted. Once a country has committed itself to conducting international tax dispute resolution it is necessary for such country to regulated interference with institutions of domestic tax law. Typically, this includes clarification on the interrelation with domestic time limits, the preconditions for domestic implementation of decisions found in international procedures, and the reconciliation with general matters of constitutional law, particularly regarding the binding effect of (supreme) court decisions. Quite often attempts to reconcile international and domestic rule are missing.

Case Study I:

A European company (Eco) entered into a contract with a Central Asian company (Cco) to jointly build a road in Central Asia. Payments for the project were firstly received by the Cco and then, according to actual delivery of services, passed on to Eco. On those payments the Cco withheld a tax of 10% applying domestic tax law.

According to the applicable tax treaty the threshold for constituting a permanent establishment was set at 12 months, providing for a taxing right in the source state only in the case of a permanent establishment. Other rights for withholding taxes on payments for commercial or technical services were not foreseen in the respective tax treaty. However, the work conducted by the Eco in Central Asia only lasted for 7 months.

Hence, Eco requested refund of taxes withheld, but the claim was rejected by domestic tax authorities. After appealing this decision by Eco, it was eventually approved by the supreme court.

After the final decision of the supreme court Eco requested the initiation of a MAP in its state of residence. The request was accepted and forwarded to the competent authorities of the other State, where it has been rejected on the grounds of being unable to deviate from a supreme court decision.

Taxpayer rights are neglected or even ignored in international dispute procedures such as MAP. It is widely accepted that every taxpayer has certain rights versus tax administrations even in a procedure like MAP, that is legally only conducted between states, but directly effects taxpayers. Typically, such rights would be, the right to be heard, the right that the procedure is conducted fairly and not discriminatory, the right of confidentiality etc. The protection of taxpayer rights varies between different countries and particularly in countries which only recently started their work in international tax law, it is observed to be sometimes fairly weak, which may impact voluntary taxpayer compliance negatively.

3.1.2. Administrative Issues and experiences

Three major groups of cases have been observed in international disputes: (i) transfer pricing cases, (ii) permanent establishment cases, and (iii) residence cases. Tax administrations not focusing on those matters during audits, as observed in some developing countries, will have difficulties in arguing such cases in international procedures for their lack of respective experience. Especially, this is true for transfer pricing cases, since they particularly require well trained personnel to be successfully defended. The lack of domestic experience may even lead tax administrations to refusing to enter into international procedures in so far.

Problems developing countries are facing in the domestic treatment of international cases recur during tax controversy. During a tax dispute, the responsible authority has to reassess the case at hand. Accordingly, whenever the first instance of a tax administration had to face challenges that are typical for developing countries, those problems will likely resurface in the dispute procedure. Such problems can be (a) of a technical nature, or (b) be a result of the tax administration’s lacking confidence. E.g. A subsidiary of a multinational enterprise is situated in a developing country. The audit division of this country (a) adjusts the respective profits using a domestic safe harbor or secret comparables in the absence of publicly available data on third party transactions[3] or (b) doesn't feel comfortable with issues of international tax law and hence does not scrutinize transfer prices at all. In a later tax controversy, which can even arise in situation (b) depending on the other state's tax assessment, the competent authority of the adjustment making country will have to cope with the same challenges as the first instance did, but will not be able to rely on purely domestic solutions, as used in the example above.

Tax disputes require a lot of resources. Resolving cases of international tax controversy necessitate highly specialized personal which is usually scarce. It needs time and effort to gain the respective theoretical and practical knowledge, and the demand for those skills in the private sector is high. Hence, especially in developing countries, only a few people in a tax administration have the required skills, and those who have them will often be tempted to leave for higher salaries in the private sector. Additionally, international tax disputes are often very time consuming, which makes them even more expensive. On top of that extraordinary expenditures such as traveling-costs need to be covered. Looking at the availability of resources and costs, many developing countries will also likely favor using their capacity for income generating functions, considering that deploying them in dispute resolution could lead to a shortfall in functions like TP audit. Certainly, resolving international disputes is not only costly for developing countries, but those countries are likely hit harder in comparison to their richer peers, considering their financial capabilities.

The organization and functioning of the Competent Authority (CA) is crucial for international dispute avoidance resolution. DTC delegate the application to the CA, including avoiding and resolving disputes arising from those treaties. According to a DTC, the CA is usually defined as the Minister of Finance or the Head of the Tax Administration. However, it is up to the countries to organize this work practically, since those highest representatives will have to delegate the tasks to subordinated bodies. To be able to fulfill their tasks CAs not only have to be experts in the substantive matters they are discussing but also have to have a high degree of independence from other functions of a tax administration, such as the audit function, otherwise jeopardizing the ability to compromise on difficult cases. Establishing a well working CA is a difficult task that many countries are struggling with.

Some countries might reject MAP requests from taxpayers because they do not have sufficient resources available. Usually the resources in international tax law will be firstly allocated to income generating functions, like tax auditing, and only later to secondary functions, like dispute resolution or more broader the competent authority function[4]. Also, it has to be considered that those resources will not only be needed to conduct cases but also to

---

[3] A Toolkit for Adressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses has been published in 2017 by the Platform on Collaboration in Tax (OECD; IMF, UN; Worldbank)

[4] According to the OECD and UN MC the competent authority, as defined in the specific convention, is responsible for conducting MAP and administrating everything that comes with it. The same applies for the Exchange of Information. Hence, it is usefull to consider both responsibilities in designing the institutional framework for the competent authority function.

set up the institutional framework, like designing internal and external guidance and developing model processes. It could well be that in an early phase of work on international tax law, a country would actually want to conduct MAP but is not able to do so because of capacity constraints.

To be included: Box with country example of case rejection

Taxpayers are concerned about reliability and predictability of MAP. In a recently published report of OECD/IMF[5] on tax certainty the importance of tax certainty and predictability for taxpayers has been pointed out. According to this report concerns over the inconsistent approaches of different tax authorities towards the application of international tax standards ranked in third place among sources of uncertainty identified by businesses[6] and unpredictable and inconsistent treatment by courts also ranked high in this regard[7]. While this applies to all countries, it might be particularly relevant for countries with no track record of past cases, like many developing countries. Though, if taxpayers do not trust MAP they won't apply for it. A taxpayer will not use MAP even if there are issues and MAP is available, if there is no trust in the procedure, also considering political pressure to abstain.

Some countries may even make a deliberate policy decision to not conduct MAP. In the light of obligations in most tax treaties and in particular of the BEPS minimum standard on action 14, such general approach would currently be likely criticized heavily by other states, MNEs and international organization. Moreover, it would also increase the risk of defensive measures taken by those other stakeholders.

Countries with high GDP per capita rates sometimes experience similar problems. The issues described above are typical for developing countries who have not engaged at all in international tax dispute resolution or have only very limited experience in this field. However, it has to be noted that also rich countries, particularly smaller ones, have experienced many of the problems enumerated above not a long time ago. Indeed, resource constraints are very common in small economies, even with high GDP per capita rates, because of their relatively small tax administrations.

3.1.3. Statistical data

Case numbers in developing countries are significantly lower. As all available statistics reveal. However**,** a detailed and comprehensive analysis of case numbers is currently not possible, since only a limited number of countries publish statistics. However, all OECD[8] and EU[9] countries publish such data. And, the availability of data for developing countries will likely change in the coming years because of the BEPS minimum standard on dispute

[5] OECD/IMF. 2016. G20 Tax Certainty Report
[6] OECD/IMF. 2016. G20 Tax Certainty Report p 25
[7] OECD/IMF. 2016. G20 Tax Certainty Report. Appendix B – Business Report Table 17.B
[8] OECD MAP Statistics (http://www.oecd.org/tax/dispute/map-statistics-2015.htm)
[9] Statistics published by the EU Joint Transfer Pricing Forum on cases under the EU Arbitration Convention (http://ec.europa.eu/taxation_customs/business/company-tax/transfer-pricing-eu-context/joint-transfer-pricing-forum_en)

resolution[10]. This standard foresees the obligatory publication of statistics[11], and countries[12] of the Inclusive Framework (IF) are committed to implementing it.

To be included: Figure with graph on stats

3.2 Why developing countries have to be concerned with dispute resolution

Developing countries are confronted with international tax cases, as in particular TP cases. International transactions do not only occur between different entities of MNEs located in developed countries but also with entities located in developing countries. And there is no reason to belief that in so far there is less potential of conflict. Recent publicly discussed cases show that in particular transfer pricing cases are common not only in highly industrialized countries. With those cases comes the need to implement mechanisms to avoid double taxation to prevent obstacles to international trade and investment. It has to be noted that the lack of a domestic transfer pricing audit program does not hinder the appearance of those cases in international procedures (but might reduce the number of cases), since they can be rooted in audits or requests in the other countries.

Box x:

The British foods (SAB Miller) case:

https://www.theguardian.com/business/2013/feb/09/british-sugar-giant-tax-scandal

http://taxjustice.blogspot.co.at/2010/11/how-sab-miller-escapes-tax-in.html

To be included: more detailed description of the cases

Multinational corporations have to avoid double taxation. For businesses tax is a cost which reduces profits and liquid funds. Hence, it is in the nature of undertaking business to reduce such costs as far as (legally) possible. Indeed, this is particularly true when profits derived from certain transactions are at risk of being taxed in two or more jurisdictions, since double taxation of profits can significantly influence the overall profitability of a certain undertaking and even result into loss making of an otherwise economically sound transaction. It has been observed that taxpayers sometimes overstep legal boundaries in their attempt to avoid double taxation.

[10] OECD. 2015. Making Dispute Resolution More Effective – Final Report
[11] OECD. 2016. Making Dispute Resolution More Effective - Peer Review Documents (MAP Statistics Reporting Framework)
[12] Regularly updated list provided by OECD under http://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf - June 2017, 99 countries

Box x:

Silent adjustments – an illegitimate way to avoid double taxation without using MAP:

A multinational enterprise is headquartered in country A and has subsidiaries around the world, one of them, company X, is resident of country B. During a tax audit in country A profits of the headquarters are adjusted, because country As tax audit team assumes that services were rendered by the headquarters to company x in year 0, but not charged with an arm's length price. Instead of requesting a corresponding adjustment in country B, X includes a liability in the amount of the adjustment in its accounts, in order to avoid double taxation. Because accounts for the year 0 are already closed, X does so for the year 0+2, the last year open. The tax administration of country B has not been informed about the adjustments in country A, neither about the inclusion of the liability nor about the audit itself, and thus has no opportunity to defend its position unless it randomly selects X itself for a tax audit for the year 0+2.

Effective resolution of tax disputes is needed for guaranteeing tax certainty. Tax certainty is essential for a good business climate, as explained above. Well-functioning processes increase investors trust in a jurisdiction and accordingly have positive effects on their openness to invest in a specific country. In so far, not only tax certainty according to the application of dispute resolution mechanisms such as MAP, has to be considered, but also more general certainty on the consistent application of material tax law.

Domestic dispute resolution often does not help because it primarily does not aim at the avoidance of double taxation. When double taxation occurs, domestic instruments of dispute resolution usually do not warrant satisfying solutions, since they mostly ignore the tax treatment in the other country. Also, domestic solutions usually cannot be enforced in the other involved country. Finally, domestic courts might be biased towards their own tax authorities, although currently no empirical evidence supports this view.

BEPS final report on Action 14[13] formulates a new standard on MAP, that is legally binding for many countries. The standard has three dimensions: (i) Treaty obligations related to the mutual agreement procedure should be fully implemented in good faith and MAP cases are resolved in timely manner; (ii) Administrative processes promoting the prevention and timely resolution of treaty related disputes should be ensured, and (iii) Taxpayers that meet the requirements of paragraph 1 Article 25 should be able to access the mutual agreement procedure. Binding tax treaty arbitration has been discussed during the process, but has not become part of the standard, although it is included in the OECD MC. The legally binding character of the standard is mainly achieved through the inclusive framework, where all members have to commit themselves to its implementation and agree to a peer review process.

Developing countries have fewer cases, however, budgetary effects can still be significant. Cases that are subject to international procedures can be large with significant amounts of tax at stake (maybe insert example of large case). Hence, the mere fact that a country has low case numbers should not automatically lead to the conclusion that international tax dispute resolution is not (urgently) needed. Additionally, indicators point towards increasing cases of tax

[13] OECD/G20. 2015. Making Dispute Resolution More Effective. Final Report

controversy in the future. Those are i.e.: (i) international tax law is increasingly getting more complex (ii) ascending numbers of multinational enterprises are active or are even headquartered in developing countries resulting in numerous cross border transactions, and (iii) businesses demand tax certainty and the application of existing procedures.[14] As a result new capacity has been established in many tax administrations.[15] In fact, it is of particular importance for a jurisdictions' specific policy regarding international dispute resolution to anticipate future case numbers in order to be able to diligently plan resource commitments.

3.3 Specific improvements for developing countries

A successful program in international dispute resolution requires a clear political commitment. Only when responsible politicians and high ranking officials back the conduct of those procedures, competent authorities will have the ability and power to negotiate with other competent authorities and implement international agreements domestically. Without such commitment investments in the respective function of a tax administration are in danger of being inefficient or even completely lost. Before committing to conduct international dispute resolution procedures decision makers have to be aware of the fact that this is not a revenue generating function but, to the contrary, is a function that will necessitate the general preparedness to give up tax adjustments were appropriate. Positive effects on the revenues will mostly materialize indirect through a better investment climate, and will be difficult to measure.

Conducting international dispute resolution procedures requires skilled and well trained personnel. Respective employees should be well trained in international tax law, they should have a good knowledge of domestic tax law, additionally, depending on the world region the country is located, they should speak the most important language of such region, typically, English, Spanish or French, and they should have decent (soft) skills in conducting negotiations. However, officials conducting dispute resolution procedures will learn and develop their specific skills most significantly during their daily work on cases. Having no experience in dispute resolution should not result in rejecting the cases for the lack of such experience.

To be included: Box with job description of a tax dispute person

A well working institutional framework is another prerequisite for conducting dispute resolution. International dispute resolution is a complex function that requires the internal cooperation in a tax administration as well as the authority to represent those administration versus another country, and, importantly, the functions requires having the authority to implement solutions domestically. This complexity usually requires clear upfront definition of responsibilities and processes. However, it is not always necessary to establish a department exclusively for this function. Particularly in small countries this might not be possible and the function can be combined with other functions of international tax law, such as treaty negotiations.

In order to be effective in dispute resolution performance has to be measured. This is in particular important for developing countries to justify spending of narrow resources, and to assure the quality of the work done. In so far tax administrations should be cautious in using indicators that only rely on financial aspects of specific cases, since this could result in ill-

[14] OECD/IMF. 2016. G20 Tax Certainty Report Appendix B - Business Survey
[15] Insert either country example or summary of a capacity building effort OECD/UN/WB

motivated administrations and overly long procedures. Insofar, in the BEPS final report on dispute resolution it is explicitly stated, as part of the minimum standard, that tax administrations should abstain from using protected adjustments as a relevant indicator[16]. Useful indicators will usually build on the number of cases solved and the time needed for those solutions[17]. Additionally, feed-back from taxpayer could also be used in order to evaluate the effectiveness of dispute resolution mechanisms, as foreseen in the Inclusive Frameworks peer review process on dispute resolution[18]. Providing for a well working international tax dispute resolution framework will likely have positive effects on the investment climate and compliance levels.

Some countries will need support in training personnel and creating a proper institutional framework. Such assistance can be provided by IOs, by commercial advisors or by peer countries. Support in the building of capacity by IO is most common. It usually does not require payments and it allows recipients to benefit from a broad variety of experiences and knowledge represented in the respective IO. However, capacity of IOs is sometimes limited itself and those organizations might not be able to support countries as regularly and intensively as required. In contrast, commercial advisors are usually not limited in their capacity and will likely be able to support tax administrations on demand. However, their services are usually more expensive and hence, not every country will be able to afford it. Additionally, countries will sometimes be reluctant in hiring commercial advisors for a presumed lack in experience with peculiarities of public administrations or for a deficit in trust. Finally, support can be provided directly from peer countries. Even more than with IOs capacity of supporters will likely be limited itself. Usually only wealthy economies will be able to afford aid programs for supporting developing countries, hence the support offering countries might have a totally different economic background as the support receiving country.

Box:

TA program UN/WB/OECD

Box:

TA program GIZ

[16] OECD/G20. 2015. Making Dispute Resolution More Effective. Final Report. Minimum Standard 2.4.
[17] OECD/G20. 2015. Making Dispute Resolution more Effective. Final Report. Para 28
[18] OECD. 2016. BEPS Action 14 – Peer Review Documents

CASE II: The Fun Group

The Fun Group (FG) is a MNE in the entertainment business. The ultimate parent (FP) of the group is located in Northstan. FP decides to invest in Centralia. Therefore, it establishes a joint venture with an independent local enterprise with the purpose to build and maintain a casino and entertainment complex in a Centralian costal resort.

FG successfully developed projects like this for the last twenty years in many other regions of the world. Projects of this kind are either set up as wholly owned subsidiaries or, like in the case at hand, by way of joint ventures with local businesses, depending on regulatory requirements.

In order to allow the local joint venture to benefit most from the experience and technical know-how of FG an additional local support infrastructure is established by way of a local office of FP in Centralia. During the initial phase of the project technical and commercial advisors of FG are present in that office, thus constituting a permanent establishment of FP both under domestic and tax treaty law.

For the support delivered by the local office FP receives an annual fee of 100k, of which it attributes 1/3 to the local PE and 2/3 to the headquarters in Northstan. However, the local tax authorities do not accept that attribution of profits, but issue a tax adjustment whereby the full 100k are taxed in their home state.

FP appeals the tax adjustment and, after losing in the tax court (first instance), requests the initiation of a mutual agreement procedure (MAP) in Northstan, its country of residence. Such request it accepted and forwarded to the competent authority of Centralia, where the case is accepted in principal, however, the procedure is suspended until a final decision of the supreme court has been made. In Centralia the competent authority can’t deviate for supreme court decisions in a MAP.

CASE III: The Oil Group

The Oil Group (OG) is a multinational enterprise in the oil and gas sector. The ultimate parent (OP) of OG is located in Highland an OECD member country.

OG holds oil- and gasfields in all major oil- and gas producing regions. 2012 it acquires a new field in Insola. Because of Insola's well trained work force and its huge internal market OG decides to build a refinery in Insola as well, attached to this factory a R&D department is set up to work on enhancing the production processes of the local facilities. Local gas field and factory are both held by a newly set up subsidiary (OS) of OG in Insola. In 2013 technicians of this R&D department find a new procedure that allows for significant cost saving effects and at the same time reduction of chemical emissions. This new process is immediately used by all other factories of the group. It has the most significant impact in countries with strict regulations on chemical emission, like Highland itself, where it is used as well.

All members of the group who use the innovation have to pay a yearly fee to OS. The fee amounts of 7,5% of the assumed cost saving effects of the respective entity and is based on a sophisticated analysis using third party benchmarks.

During an audit in Highland the deduction of such fee is denied because of OP's financing function in OS's R&D activities. OG considers applying for a MAP in Insola, however, is reluctant because Isola has no track record of conducting MAP and recently issued an Anti-Corruption Guidance according to which taxpayers are not allowed to liaise with tax authorities, and particularly are not allowed to present opinions on pending cases other than in written form, except for formal court procedures.

After a diligent risk analysis OP decides to not apply for MAP but go with the tax assessment of Highland, although it doesn't consider it being in line with the OECD TPG, particularly considering the recent amendments of chapter VII.