
Harm Mark Pit
Dispute Resolution in the EU
The EU Arbitration Convention and the Dispute Resolution Directive
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Dispute Resolution in the EU

Why this book?
The resolution of international tax disputes is an important element of the OECD/G20 BEPS Project, and the outflow of this Project is likely to further accelerate the steady rising of these types of disputes. Within the European Union, there has, since 1990, already been a mechanism available to resolve transfer pricing disputes among Member States (disputes on the allocation of income between associated enterprises and on the attribution of profits to permanent establishments), namely the EU Arbitration Convention. Since its adoption, the Convention has been an important instrument in resolving these disputes. Furthermore, as from 2002, attempts have been made to improve the Convention's function via a Code of Conduct, which has been developed by the EU Joint Transfer Pricing Forum.

The first part of this book discusses, analyses and evaluates the governance and functioning of the EU Arbitration Convention. The primary focus is on whether the current provisions in that Convention, supplemented by the Code of Conduct, are sufficient to enable transfer pricing disputes to be resolved within a timeframe of 3.5 years. Attention is also paid to the legal and governmental structure of the Convention, its embedment in the European legal order and the number of cases dealt with under its procedures. Based on this description and analysis, detailed recommendations are presented to improve the Convention's governmental structure and its functioning.

The second part of the book focuses on recent developments regarding tax dispute resolution within the European Union: the adoption of the Directive on tax dispute resolution mechanisms in 2017. Next to discussing and analysing the background of its adoption, its objectives and its provisions, the book also includes an evaluation as to whether the Directive – for each of its proceedings and on an overall level – will constitute an improvement to tax dispute resolution within the European Union.

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Preface

Before you is the result of my study on the governance and functioning on the EU Arbitration Convention and the Directive on Tax Dispute Resolution Mechanisms in the European Union, the result of 7 years of research that started on 1 September 2010. The past years of research were intense, but nonetheless interesting: I learned to manage a substantial project, met interesting people and got in-depth knowledge about the working of international tax law for a specific subject. The interesting feature of tax dispute resolution within the European Union is that the existence of double taxation within the EU internal market causes distortions that may hamper cross-border economic activities and, in the end, economic growth. A strict and binding dispute settlement mechanism would benefit taxpayers within the European Union and also could contribute to more cross-border economic expansion. However, tensions persisting in the national electorate, the threat of losing grip on revenue and the desire to retain sovereignty as much as possible make Member States hesitant to make real progress in the area of direct taxation. To speak with Led Zeppelin, "The song remains the same"; whether it concerns the forming of a banking union or an integrated fiscal system, Member States are not likely to put Europe first. But exactly this struggle between the benefit of resolving cases of double taxation through a well-functioning dispute resolution mechanism versus the desire to retain sovereignty made it interesting to study how the EU Arbitration Convention was developed, how – and more importantly, if – it functions in practice and how it is governed. Member States have committed to a binding dispute settlement mechanism, but statistics clearly show that they fail to meet their treaty obligations. What would be the reason? Is it the Convention itself or the Member States' attitudes towards this Convention? After the finalization of the book, an important development took place within the European Union, namely the adoption of a directive on tax dispute resolution mechanisms in October 2017. The book has been supplemented with an analysis that answers the question of whether this directive has improved the difficulties encountered with the EU Arbitration Convention.

Apart from the study itself, performing the study subtracted substantial time from my social life. As always, Mia stood by me fiercely and patiently, not only in taking care of business, but also in her never-ending willingness to listen to my new findings as well as reading my output. I honestly can say that without her support, the project would have taken much longer or might even not have been finished at all. It is time to fulfil my promise made to her 7 years ago. Further, I would like to thank my promoter, Professor Burgers, who gave me the opportunity to perform this research, greatly supported me

along the way and provided me with many valuable suggestions to further improve my output. Also, I would like to thank Professor Gormley for his thorough and sharp review of the concepts. Especially, I want to thank my parents, who made it possible to fully focus on this dissertation for some time and for their enduring support. I end with a quote of a Dutch writer, Frederik van Eeden, which, for this study, is a perfectly suited remark:

> Ieder wetenschappelijk man, zelfs de geheel in details verdiepte specialiteit, moet nu en dan eens opkijken van zijn werk en zorgen dat hij het overzicht van 't groote geheel niet kwijt raakt. Anders wordt hij een geesteloos werker, een bekrompen vakman, die den voortgang van 't geheel belemmeren zou, ter wille van zijn eigen speciaal uitbouwseltje.[1]

1. F. Van Eeden, *De Spiritistische Verschijnselen*, in *Studies: Eerste reeks* (W. Versluys 1897), p. 203. English translation: "Every scientific man, even the specialist wholly engrossed in details, must now and then look up from his work and should take care that he does not lose the big picture. Otherwise he will end up as a mindless worker, a narrow-minded professional, who will hinder the progress of the whole, only for the sake of his own special piece of work."

Abstract

General overview of the content of this book

This book discusses, analyses and evaluates the governance and functioning of the available tax dispute resolution mechanisms in the European Union: the EU Arbitration Convention and the Dispute Resolution Directive. The EU Arbitration Convention was adopted as a multilateral convention by the then-12 Member States on 23 July 1990. The origin of this Convention is to be found in 1976, when the European Commission issued its proposal for a directive for the elimination of double taxation in connection with a profit adjustment between associated enterprises. Because Member States preferred a multilateral convention rather than a directive, the Council could not reach the unanimous agreement required for the adoption of the proposed directive. A proposal for the Convention was submitted by the Netherlands in 1978, which formed the basis for discussions among Member States and led eventually to its adoption in 1990. At that time, the Convention was considered a landmark in international taxation, as then, only a very limited number of double tax conventions included an arbitration procedure to settle international tax disputes, whereas the EU Arbitration Convention is directly applicable in all 28 EU Member States and provides for a compulsory and binding dispute settlement procedure for transfer pricing disputes. The Convention first provides for the traditional mutual agreement procedure, in which the Member States concerned mutually have to strive to agree on how to settle the dispute. If they do not reach such agreement within a 2-year term, they are obliged to establish an advisory commission that has to give a non-binding opinion on the dispute within 6 months. Thereafter, the Member States concerned have another 6 months to agree on a final solution for the case. If they fail to reach an agreement, the opinion becomes binding on them. In 2002, the Commission set up the EU Joint Transfer Pricing Forum (EU JTPF), which, inter alia, examined improvements to the European Arbitration Convention. This resulted in a Code of Conduct on the effective implementation of the Convention in 2006, which was revised in 2009 and for which a further revision was proposed in 2015. This Code of Conduct includes guidance on how the Convention should be applied in practice.

The governance and functioning of this Convention formed part of an academic study, finalized by the end of 2016 and with the outcome that numerous modifications were necessary to improve both its governance and functioning. Within the European Union, a similar conclusion was reached, resulting in the European Commission issuing a directive proposal in October 2016. This Dispute Resolution Directive was adopted by the

Council on 17 October 2017 and requires implementation by all Member States as per 1 July 2019. After 40 years, a process thus has been finalized that started in 1976. The academic study performed primarily focused on the EU Arbitration Convention and concerned a critical evaluation of the functioning and governance that Convention and seeks whether – and if so, what – changes should be made so as to improve this governance and functioning. The outcome of this study forms the primary focus of this book. Because important developments with respect to the resolution of tax disputes within the European Union have taken place since then, this book also includes a critical evaluation of the Dispute Resolution Directive and tries to answer the question of whether it has constituted an improvement to the governance and functioning of the EU Arbitration Convention.

Part I: The EU Arbitration Convention

Two hypotheses underlie the study on the governance and functioning of the EU Arbitration Convention, the outcome of which is laid down in Part I of this book:

– the Convention's governance (i) is not properly regulated in light of state sovereignty and EU law; (ii) is not efficient in that the process involves a range of actors whose competences and practical involvement are ambiguous; and (iii) is not effective in that the it does not lead to a timely and successful settlement of all disputes brought under the Convention; and
– after 28 years of existence, the Convention is not able to fulfil its principal objective, despite the adoption of a Code of Conduct in 2006, its revision in 2009 and its proposed revision in 2015.

To test whether these hypotheses are correct, the research question of this study is:

> Should changes be made to improve the governance and functioning of the EU Arbitration Convention, and if so, what changes and on what grounds?

Three sub-questions were formulated in order to answer the research question.

> Sub-question 1: How is the EU Arbitration Convention governed, is this governance consistent with the EU Arbitration Convention's legal status and the associated competences and does this governance adhere to the principles of effectiveness and efficiency?

In order to properly evaluate how the EU Arbitration Convention is and should be governed, it is important first to understand the Convention's legal status under EU and international law in order to answer the question of which institutions, from a legal perspective, are competent to be involved in the Convention's governance. Chapter 5 sets out this analysis, which leads to the conclusion that the EU Arbitration Convention is a multilateral convention under international public law and does not constitute secondary EU law. However, despite this legal status, EU institutions were involved in the decision-making process on the accession of new Member States to the Convention and the adoption of the Code of Conduct, even though they had no proper legal competence to be involved. This leads to the conclusion that the decision-making process on both of these occasions was not properly performed. Chapter 6 discusses the relationship of the Convention with double tax conventions between Member States and Member States' domestic legislations, concluding that, under the *lex specialis derogat generali* rule, the Convention has precedence over double tax conventions between Member States and Member States' domestic legislations, unless they provide for wider obligations (e.g. a more efficient and effective dispute settlement mechanism).

Based on the outcome of the analyses in chapters 5 and 6, chapter 7 proceeds with the examination of which parties are, in practice, involved in the Convention's governance. The chapter aims to clarify (i) how the governance of the EU Arbitration Convention has emerged; (ii) whether this governance is consistent with the Convention's legal status; (iii) the associated competences; and (iv) whether it adheres to the principles of efficiency and effectiveness. The following specific issues are discussed: (i) how developments with regard to the Convention were construed; (ii) why certain steps in this governance were chosen; (iii) which parties were involved; and (v) the role that these parties played. These issues were clarified by using a subtheory of the international relations theory: constructivism. In developing and improving the Convention's rules and procedures, the Member States did not act on a stand-alone basis, but made use of experts in the field of international taxation. The European Commission established the EU JTPF by bringing together a group of actors in a network that share the same beliefs, norms and/or values and that have similar ideas or ideologies as to how these beliefs, norms and/or values are to be realized. The Forum's output is a Code of Conduct, developed through consensus and taking into account states' interests, as well as the interests of other stakeholders. This mixture fits with the trend within the European Union to involve non-state actors in the policy-making process (combining formal and informal governance) and to combine hard-law and soft-law instruments.

The answer to the first sub-question is contained in chapter 8, which is as follows: the Convention's administration and the process of developing and improving its functioning is properly performed in light of state sovereignty and EU law. However, the governance of the Convention itself is not properly performed in light of state sovereignty and EU law in so far as it concerns the adoption of the Code of Conduct and the accession of Bulgaria, Croatia and Romania to the Convention. With regard to these issues, the Commission/Council acted beyond their legal powers and should have refrained from taking legislative action in this field.

Sub-question 2: Is the EU Arbitration Convention's content able to fulfil – in line with the fundamental principles of tax law and taking into account the provisions included in the Code of Conduct – its principal objective, i.e. to eliminate cases of double taxation arising from transfer pricing profit adjustments by providing for a compulsory and binding dispute settlement mechanism that is limited in time?

The second sub-question of this study focuses on the Convention's functioning, which comprises:

– formal scope of application: this concerns multiple subjects relating to the formal and legal foundations of the Convention;
– material scope of application: cases covered by the Convention (terms for application) and its tax principles (the arm's length principle and the rules for attributing profits to permanent establishments); and
– procedural functioning: the five phases of the EU Arbitration Convention, namely (i) application; (ii) unilateral review; (iii) mutual agreement procedure; (iv) arbitration procedure; and (v) implementation.

In order to be able to answer the question of whether the content of the Convention is able to fulfil its principal objective, the provisions included in the EU Arbitration Convention as well as in the Code of Conduct are evaluated in chapters 9-16 against the principles of clarity and simplicity, transparency, efficiency, effectiveness, legal justice, legal equality and legal certainty. This leads to the conclusion that these provisions are not sufficiently descriptive in all aspects and that they do not ensure that cases that fall within the Convention's scope of application can be settled within the given time limits. In other words, these provisions do not adhere to the principles of clarity and simplicity, transparency, effectiveness and efficiency. In addition, application of the Convention's provisions and its procedures do not provide an outcome that adheres in all cases to the principles of legal justice, legal equality and legal certainty. The main conclusion is that there is an error in the institutional design of the EU Arbitration Convention,

which causes cases to not be referred to the arbitration procedure if, after expiry of the 2-year deadline of the mutual agreement procedure, the competent authorities concerned have not reached an agreement that eliminates double taxation for the specific case under review. In other words, due to the absence of a proper default mechanism, Member States' failure to act – even though they legally committed themselves to act – cannot be sanctioned. There is thus no fallback to guarantee that the Convention can fulfil its primary objective. This is reinforced by available statistics, which show that approximately 18% of all pending cases are pending for longer than 2 years under the mutual agreement procedure and are not referred to the arbitration procedure, although they are eligible for such reference. Hence, in a substantial number of cases, it takes far longer for them to be resolved than the time limits set in the EU Arbitration Convention. It is, in particular, the insufficient legal protection of taxpayers against non-compliance by Member States that causes problems.

Sub-question 3: Which changes should be made to improve the governance and functioning of the EU Arbitration Convention, and how could/should these improvements be implemented in practice?

Chapter 18 identifies the bottlenecks in the current design of the EU Arbitration Convention and further answers the question of whether the adoption and revisions of the Code of Conduct have contributed to more efficient and effective functioning of the Convention. As this question is also answered negatively, the answer to the central research question on whether changes should be made to improve the governance and functioning of the EU Arbitration Convention is "yes". For that reason, chapters 18-20 include strategic and detailed recommendations on which changes are necessary to improve the Convention's effective and efficient governance, as well as to provide a functioning that conforms to the testing principles of this study. On an overall level, the main recommendations concern:

– Improving the Convention's governance: Strengthening the institutional design of the Convention by introducing a proper default mechanism to ensure that the Convention's provisions are properly complied with by assigning competence to the European Commission to function as a third supervising authority that can take the lead if the Member States fail to comply with their obligations under the Convention. The Commission is particularly chosen because it holds no biased view towards an individual Member State. The main focus of the proposed default mechanism is the reference of cases to the arbitration procedure after expiry of the 2-year deadline of the mutual agreement procedure

without an agreement that eliminates double taxation. In the case of Member States' failure to refer a case to the arbitration procedure, the Commission should be assigned competence to establish the advisory commission and appoint its members accordingly. It is also recommended to establish a central and permanent secretariat; the secretariat that assists the EU JTPF can perform in this role. The secretariat's tasks should be, inter alia, (i) monitoring cases dealt with under the Convention; (ii) performing registration tasks; (iii) assisting advisory commissions in conducting the arbitration procedure; and (iv) maintaining and publishing the list of eligible persons to act as members of an advisory commission. To improve the Convention's governmental structure, it is further recommended that new Member States can only accede to the EU Arbitration Convention through a specific accession convention and that the Commission/Council cannot play a role in this matter, just as they should not play a role in adopting the Code of Conduct.

- Improving the Convention's functioning:
  - establishing a directly binding arbitration procedure and abolishing the final decision phase;
  - introducing proper and common rules for attributing profits to permanent establishments and defining to what extent thin capitalization cases are included in the Convention's scope of application;
  - introducing more sophisticated timelines for the Convention's procedures, especially the unilateral review phase and the mutual agreement procedure;
  - allowing competent authorities to deny the application of the Convention's procedures only in cases of fraud and not in situations in which a penalty was imposed for non-fraudulent offences;
  - providing a better level of protection for taxpayers by allowing the parallel running of the Convention's procedures and domestic appeals procedures, with the latter being suspended until the Convention's procedures have been finalized;
  - clarifying that taxpayers have a right of acceptance of the outcome of the mutual agreement procedure and of the arbitration procedure; and
  - extending the scope of application of the Convention by including disputes on the existence of a permanent establishment and the residence status of enterprises.

Part II: The Dispute Resolution Directive

The outcome of the study conducted is that the EU Arbitration Convention is not functioning properly in light of its principal objectives and that certain institutional changes need to be made to improve its governance and functioning with a view to provide for an effective and efficiently functioning dispute resolution mechanism. The criticism voiced in the book is shared widely in the literature, but also at the level of the EU institutions. The European Commission has repeatedly pointed to the limited scope of the Convention in particular and the non-functioning of dispute resolution mechanisms in the European Union. This primarily concerns the non-enforceability of taxpayers' access to these mechanisms or to the arbitration procedure. To provide for a more effective, efficient and transparent process, the Commission issued a directive proposal on tax dispute resolution mechanisms in the European Union in October 2016. The Directive was – albeit with substantial modifications – adopted within 1 year by the Council, and will take effect as per 1 July 2019. The Directive has five specific aims, namely (i) broadening the scope of the EU Arbitration Convention to all income tax-related disputes; (ii) increasing legal certainty for taxpayers; (iii) improving effectiveness and efficiency of existing dispute resolution mechanisms; (iv) improving transparency; and (v) improving governance. The Directive follows the structure of the Convention, but builds in enforcement and review mechanisms to ensure that eligible cases have access to the dispute resolution procedures and that cases proceed to arbitration and will ultimately be resolved within a given timeframe. As this Directive has a major impact on tax dispute resolution with the European Union – and thus also on the governance and functioning of the EU Arbitration Convention – a second part was added to the book to analyse whether the Directive has constituted an improvement to the Convention. After discussing the history of the Directive and its objectives in chapters 22 and 23, chapters 24-32 discuss in detail the governance and functioning of the Directive and test each of its provisions on whether they indeed constitute an improvement. Chapter 33 answers this question on an overall basis, thereby also focusing on the specific objectives set by the Directive. The outcome of the analysis is that, in many aspects, the Directive indeed has realized an improvement as compared to the Convention, especially with the introduction of review and enforcement mechanisms and the addition of timelines. However, the Directive also falls short in providing for an efficient dispute resolution mechanism and leaves many aspects of the procedural functioning undefined or to be filled in by the competent authorities concerned, which causes uncertainty and ambiguity and may lead to non-uniform application by the Member States.

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