

Alternative dispute resolution: Alleviating burdens all round

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The number of tax disputes is increasing rapidly around the world. The trend is encouraging governments to turn to alternative dispute resolution (ADR) in a bid to reduce backlogs in the courts. While ADR is well established in some jurisdictions, in others it is just getting going. Aaran Fronda looks at how ADR has become an increasingly viable solution for resolving tax disputes.

Fiscal instability has led governments to grant revenue authorities ever more pervasive powers of enforcement, leading to tax authorities taking an increasingly aggressive approach with taxpayers, particularly in regard to their tax planning practices. As a consequence, the number of disputes which the legal system must process is applying significant pressure on all involved, as well as on the system itself.

ADR aims at relieving some of this burden by offering taxpayers, advisers and authorities a new approach to handling the dispute resolution process. Practices used in ADR help avoid time-consuming, and often costly, litigation, by giving revenue authorities and taxpayers - usually with the assistance of a third-party mediator or arbitrator - the opportunity to work together to come to an agreement. Different jurisdictions have their own approaches to it, however, not all countries have incorporated ADR mechanisms into their tax code, but those jurisdictions can learn a lot from those that have. With the volume of tax disputes around the world showing no signs of abating, ADR is a mechanism that can bring benefits to all, if done properly.



"Ready for your first lesson in conflict resolution?"

ADR creates dialogue and prevents both parties butting heads

ADR is common in the UK, with the civil procedure rules introducing ADR practices back in 1998. But until recently, arbitration in tax disputes was rare. In 2009, new legislation was introduced, requiring the First-Tier Tribunal (FTT) to ensure that taxpayers and HM Revenue & Customs (HMRC) make use of its methods. ADR was formalised at a time when tax litigation was becoming a drain on the courts and there was a general recognition that greater cooperation between taxpayers and HMRC was necessary to relieve some of that burden. This prompted HMRC to create a dispute resolution unit and include ADR within its Litigation and Settlement Strategy (LSS).

"ADR is now a formal HMRC procedure for tax dispute resolution, and it is used in a growing number of cases," says KPMG's Kevin Elliott. "The approach is considered appropriate in cases where the parties are at an impasse and litigation might have to be considered."

Mediator confidentiality is key to the success of ADR; its effectiveness would suffer without it. Involvement and collaboration between taxpayers and the revenue collection body is crucial, and this is a key area where arbitration can act as a catalyst for progress.

"The mediator is appointed by both sides allowing him to develop a confidential relationship with both parties who split his fee equally," explains barrister, Peter Nias, a member of Pump Court Tax Chambers's ADR unit and CEDR panel mediator (Centre for Effective Dispute Resolution) in London. "I am in the middle of one at the moment where I was able to have frank conversations with both sides trying to get to the bottom of the issues, speaking openly to both of them, because of that impartiality. This allows the mediator to get a much better idea of where both sides are

coming from, which they would have difficulty doing themselves because of the absence of the same level of trust between the two."

Disputes inundate India

Since its inception, the UK's ADR regime has been a useful tool in resolving disputes. However, in India, where most of the mechanisms remain in their relative infancy, similar techniques have been less effective. Another reason why disputes are slow to resolve in India is the tax law. It is extremely complex, making it easy for multiple interpretations to be reached. This extends the appeals process - which possesses multiple levels - meaning the probability of a higher court having a different opinion to that of a lower one is greater than in many other jurisdictions. As of April 2013, around 32,000 cases each have reached the level of the Income Tax Appellate Tribunal and the High Court, with nearly 5,800 cases reaching the Supreme Court. These cases have an estimated Rs4,000 billion (\$65.7 billion) at stake. The time consuming nature of Indian tax disputes means these figures are only going to get larger.

This suggests that India would benefit substantially from the use of ADR in tax cases, but it has not been around for long and it is taking its time to produce results.

"Most ADR mechanisms in India have been instituted recently, and as such, we haven't seen significant release of pressure from courts by ADRs," says Maulik Doshi of Sudit K. Parekh & Co. "One of the most hyped and talked about forms of ADR that was introduced by the government in 2009 was the dispute resolution panel (DRP), [but] there was a significant gap in the DRP that was instituted."

This gap meant the panel was lacking two features restricting its capacity to function effectively as an ADR device: (i) The power to mediate or negotiate - one of the most important aspects of any ADR mechanism - was removed; and (ii) The tax authorities can appeal against orders made by the DRP. But DRP is not the only ADR device that requires an overhaul if India is going to improve its ADR process.

"Everyone acknowledges that the level of tax litigation is far higher than acceptable and hence there is a need to strengthen the ADR process," says Sanjiv Malhotra of BMR Advisors. "Two aspects which require immediate reconsideration in India involve providing for mandatory arbitration if the competent authorities are unable to reach to a settlement in a defined time and allowing for MAP/bilateral advanced pricing agreements (APAs) in relation to transfer pricing disputes with countries wherein India does not have Article 9(2) in the DTAA."

It is imperative that India makes these changes, as the US is one of its most important treaty partners and as Malhotra explains, unless this "impasse is broken and significant progress is made to clear the backlog of cases and facilitate a bilateral APA regime to progress between the two countries" the amount of litigation in India in cross-border tax disputes will become difficult to manage, threatening relations between the two.

"APA has the potential to act as a very effective ADR tool to settle transfer pricing disputes and given the fact that transfer pricing disputes form a majority of the tax disputes in India, the significance of the APA regime cannot be overstated," says Sanjay Sanghvi of Khaitan & Co.

Methods in mediation

Though there are no explicit ADR rules in German law, the 2012 Mediation Act shows the inroads that alternative methods can make in resolving disputes, even if it is not mandatory, and its use is left to the discretion of the courts.

"Mediation is a structured, non-public process in which the participants work with the quality judge to resolve issues voluntarily and autonomously to achieve a satisfactory solution for all parties," explains Jan Uterhark of KPMG. "Quality judges must undergo extensive training, and they must be strictly neutral in mediating the conflict: they cannot make decisions or offer advice [and] once consensus is reached, the mediation agreement is recorded by the court and is binding on all parties."

A pragmatic approach to tax audits is another reason why ADR can play a significant role in reducing the number of disputes.

"The German system of negotiating with the tax auditors is advantageous for both sides, [as] it saves time, costs, and increases the tax security," says Alexander Voegelé of NERA economic consulting. "It is based on the exchange of rational arguments and both sides usually are able to find a fair compromise."

The success of the audit process in Germany can be attributed to the fact that tax offices can afford trained specialists. These skilled professionals work with the taxpayers tax teams to reach a position that both sides can agree upon. Once a compromise is reached, an agreement is signed by both parties and it is binding.

Jurisdictions such as Canada, Germany, Netherlands, the UK and the US have seen the benefits of ADR in resolving tax disputes. But while ADR is more common in these countries, numerous jurisdictions have no formal ADR practices in place, leaving no option except costly and often time-consuming litigation.

Tax disputes in Brazil are strictly reserved for the courts, because the Brazilian tax code has never formally regulated ADR. If a taxpayer receives an assessment from the state revenue authority, the only option is to submit it to the administrative court, which will then analyse the case, and if it chooses to permit the initial assessment, the taxpayer has no choice but to challenge the decision through the court system. Pursuing tax disputes through such channels, however, often leads to issues of timing, with individual cases sometimes taking more than 10 years to be concluded. Consequently, the national congress has initiated a project to create a form of ADR for tax purposes. If successful, Luiz Gustavo of Bichara, Barata & Costa believes Brazil could benefit greatly from its implementation.

"It will enable the possibility to take into consideration the

peculiarities of each case and each taxpayer," he said.

This capacity to look at the nuances of a specific case is one of the core advantages of mediation. But the chances of ADR being fully implemented by the Brazilian government are minimal, at least for the time being

"In Brazil, the most controversial element regarding the implementation of ADR rules in tax cases is, for sure, the risk of corruption, and unequal treatment to taxpayers that are in the same situation," says Gustavo. This is disappointing because the country could benefit fiscally from ADR in a similar fashion to Portugal, where it was adopted in 2009, during the height of the EU crisis. "In Portugal, the effects of the economic crises were devastating, creating, at that moment, a serious fiscal solvency problem," adds Gustavo. "A substantial parcel of the public debt was collected with ADR practices."

Authorities: Learning to let go

Changes to anti-avoidance rules have contributed to an increase in the number of cases in Canada, creating a large backlog and an over-burdening of the Tax Court of Canada (TCC). The problem is made worse by the budget of the Canadian Revenue Agency (CRA) being tightened and fewer appropriate staff available to tackle disputes effectively. While ADR is not a regularly used Canadian dispute resolution tool, the CRA inaugurated a mediation pilot programme, but later scrapped it, leaving taxpayers and officials to try and reach an agreement without the involvement of a third party to facilitate conversation.

John Tobin of Torys' Toronto office, is in favour of implementing formal ADR rules, but acknowledges that this would require senior policy makers and tax administrators to embrace it.

"[The] CRA seems to have a reluctance to take taxpayers at their word on larger files and won't resolve disputes without going to the full court process," he says. "CRA's attitude is that taxpayers game the system by taking aggressive positions and then even if challenged settle with some benefit beyond what they would have achieved had they done nothing. As well, CRA seems very concerned that they over-enthusiastically preserve the revenue base where, historically, they were perceived to be motivated by doing the right thing. There should be, and there used to be, a different result for tax motivated transactions than ordinary course business transactions, but the two seem to be blended and treated the same."

The CRA, traditionally, has been reluctant to allow third-party involvement in disputes, but the TCC does have its own means of resolving cases before they go to court. Taxpayers and the revenue authority may arrange a settlement conference, where a TCC judge presides over the discussion between both parties. However, the judge is only permitted to make non-binding recommendations, resulting in many cases proceeding to a court hearing.

"The difficulty for Canadian tax professionals who seek to find negotiated solutions to tax disputes is that all tax disputes must be

resolved on a principled basis in accordance with fiscal statutes," says Michael Bussmann of Gowlings - Taxand Canada. "It may be possible to negotiate on matters of valuation or reasonableness, as reasonableness pertains to allocations, deductions, expenses and so on, however, if a case is based on a single technical legal question there is no ability to settle on a compromise basis taking into account litigation risk."

This is one area where arbitration can be extremely useful. Mediation involving third parties allows both parties greater assurance and clarity. Trained mediators can act as go-between, and because they are impartial it allows both parties to talk openly, helping to identify and smooth out areas of contention.

Having alternatives for resolving disputes outside the boundaries of tax legislation is extremely advantageous, as it allows for cases to be looked at in a broader sense. Up until 2010, the French had a *cellule fiscale* (tax team), which worked closely with the finance and budget secretary in examining tax disputes. The team was not bound by administrative interpretation of tax legislation and could make recommendations for resolving disputes, which took into account wider issues when determining how to resolve the case. Taxpayers were free to accept or discard the tax team's decision. But the *cellule fiscale* was dissolved, despite being largely accepted by the business community.

Though there is no formal ADR practice in place in France, a number of administrative processes exist which act in a similar manner in trying to reduce incidents of cases reaching court, such as appeals committees on advance rulings; a national committee on abuse of law; and national and local committees involved in reassessment. One of the key reasons why France lacks a formal ADR is control.



"As exemplified with the termination of the tax cell in 2010, the official point of controversy is the risk of inequality and the lack of judicial review on compliance with the law," says Philippe Derouin of Skadden, Arps, Slate, Meagher & Flom. "Also, it should not be excluded that the administrative courts and the tax authorities are reluctant to reduce their powers."

One of the most common reasons for the delay and backlog of cases is down to the simple inefficiency in how taxpayers and officials communicate, which is an area where ADR can be so effective.

"I would not single out the inspector, adviser or customer as being more to blame than the others for the delay, but the traditional way of dealing with a dispute, through a formal exchange of correspondence, rather than getting around the table for discussion is one of the main reasons for there being the time lag," says Nias. "ADR can be a catalyst for reengaging discussion, getting to the heart of the issue and helping both sides explore the evidence to help develop a level of trust... sometimes it takes the catalyst of a third party with mediation skills to galvanise them."

Disputes can take up to 10 years (sometimes even more) to reach a conclusion and this is simply too long. By using ADR, relationships between both parties can be enhanced and help create a win-win situation that is attained amicably, avoiding the courts. The privacy that is available through ADR is also a big pull for MNCs, which are keen to avoid the public scrutiny that comes with litigation, especially when commercial integrity is at stake.

You only need to look at the PR disaster sustained by Starbucks in the UK to see the damage that can be done. Perhaps, as Nias points out, the problem with ADR is in the name. He thinks that in the context of a tax dispute, ADR is not actually alternative at all, but instead part of the collaborative process, preferring the acronym to stand for appropriate dispute resolution.
