JOINT AUDITS: A NEW TOOL TO COMBAT CROSS-BORDER TAX EVASION

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INTRODUCTION

A key message arising from international initiatives to eliminate cross-border tax avoidance is the need to strengthen cooperation and enhance transparency between (i) taxpayers and tax administrations and (ii) the various tax administrations that are stakeholders in a cross-border business operation. To this end, the O.E.C.D. has introduced a new array of legal tools, one of which stands out for its innovative features: the joint tax examination.[1] This article examines the initial pilot program between Italy and Germany, comparing the joint audit process to the traditional administrative and legal processes that taxpayers must follow to challenge a proposed adjustment under a normal transfer pricing examination.

The joint audit is intended to (i) effectively tackle cross-border tax evasion, (ii) address aggressive tax planning, and (iii) establish a new cooperative and transparent relationship between revenue bodies and taxpayers. From a practical standpoint, joint audits enable examiners of different tax administrations to work as a team in jointly performing examination activities. The collection of data, the analysis of data, and face-to-face interview are conducted jointly by examiners in each of the countries involved.

In recent years, the European Commission has been urged to adopt this new examination tool[2] to address cross-border tax issues such as transfer pricing, dual residence, and aggressive tax planning schemes. The goal is to reduce the backlog of unresolved mutual agreement procedures ("M.A.P.'s") by having the relevant tax administrations conduct the examination jointly, thereby eliminating the need for M.A.P. once an examination has been completed in one country. By its nature, M.A.P. is a lengthy process that leads to uncertainty of financial results for a multinational group and is costly for tax administrations and taxpayers.

The results of the pilot project have been mixed. On the positive side, a joint audits have the potential to reduce administrative burdens for both taxpayers and tax administrations because of their streamlined fact-finding process. In addition, tax administrations believe they result in more effective tax compliance. On the other hand, critical issues have been encountered that raise questions about the availability of enough resources for tax administrations to make this tool effective. Cooperation between the tax administrations has not been as great as anticipated. The two

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1. O.E.C.D. (Forum on Tax Administration), *Joint Audit Report*, Sixth Meeting of the O.E.C.D. Forum on Tax Administration, Istanbul (September 15-16, 2010), p. 2.

2. See Communication from the Commission to the European Parliament and the Council an Action Plan to Strengthen the Fight Against Tax Fraud and Tax Evasion, COM (2012) 722.

sides frequently adopted different views as to the same transaction or methodology. Staffing was problematic. Yet, if allowed to develop may be the standard way to conduct tax examination of a multinational enterprise in Europe.

WHAT IS A JOINT AUDIT?

In September 2010, the O.E.C.D. issued its first joint audit report commissioned by the Forum on Tax Administration in October 2009 (the "Report"). In accordance with paragraph 7 of the Report, a joint audit can be described as follows:

- Two or more countries join together to form a single team to examine one or more issues or transactions of one or more related taxable persons (both legal entities and individuals) with cross-border business activities, perhaps including cross-border transactions involving related affiliated companies organized in the participating countries and in which the countries have a common or complementary interest.
- The taxpayer jointly makes presentations and shares information with the countries.
- The joint audit team includes competent authority representatives, joint audit team leaders, and examiners from each country.

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When referring to "cross-border transactions involving related affiliated companies," it appears the focus of a joint audit report is to facilitate streamlined examination activities that target transfer pricing issues of multinational enterprises. This is an area where tax adjustments by one country can produce massive increases in taxable revenue, often producing double taxation for the multinational enterprise unless a refund of tax is obtained in another jurisdiction.

Overall, the Report provides a useful set of principles and practical guidance for governments to perform joint audits. However, the Report clearly stipulates that joint audits must be performed in accordance with the boundaries set forth by domestic provisions and within the international legal framework of each country.[3] From a European standpoint, Directive No. 2011/16/EU[4] – on the administrative cooperation in the field of taxation ("D.A.C.") – introduced the first comprehensive legal basis for E.U. Member States to conduct joint audits. According to the D.A.C., a tax administration of a Member State may submit a joint audit request to another Member State through its competent authority. The Member State receiving the request must agree to proceed. If the request is accepted, the tax examiners of the requesting Member State may take the following steps:

- They may be present in the requested Member State offices where the tax authorities carry out their duties.
- They may be present during administrative inquiries carried out in the territory of the requested Member State.
- They may interview the taxpayers of the requested Member State.

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3 See the Report, at 8.

4 Council Directive 2011/16/EU on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1.

- They may obtain access to documentation from the tax examiners of the requested Member State.[5]
- In light of the above features, the key components of a joint audit are as follows:
- The Member States may form a mixed single examination team, consisting of examiners from the requesting Member State and the requested Member State
- All of the examiners in the joint team are permitted to perform examinations in each of the countries involved with the same authoritative powers.
- Onsite examination activities may be performed in the requesting Member State and in the requested Member State

In 2012, the European Commission issued Communication No. 722/2012 in an effort to combat tax fraud and tax evasion, recommending Member State's develop methodologies for using simultaneous tax examinations[6] in the short term and for implementing the joint audit tool in the long term. Additionally, in the Tax Inspectors Without Borders report,[7] the O.E.C.D. referred to joint audits as a prominent way to share knowledge and build the capacity of a developing country's tax administration.

HOW COULD A JOINT AUDIT BE MORE BENEFICIAL THAN A STANDARD EXAMINATION?

As compared to a traditional examination, a joint audit may be more effective for resolving issues of double taxation in cases where it is fundamental to clarify the facts and circumstances in another country. In particular, a joint audit may be a better option with respect to (i) transfer pricing issues, (ii) residency or permanent establishment issues, and (iii) complex tax structures involving aggressive tax planning schemes.

In the first two categories, a joint approach may reduce administrative costs for both tax administrations and taxpayers. For example, the costs derived from providing authorities with substantial documentation may be reduced by simultaneously sharing the same information with multiple revenue bodies. Moreover, joint audits may increase taxpayer certainty by enabling the relevant tax authorities to more quickly establish a joint position in the course of the examination process.

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5 See D.A.C., article 11.

6 The feature that substantially differentiates a joint audit from a simultaneous tax examination – another form of administrative cooperation – is that the latter does not entail the formation of a single audit team; rather, the examiners simultaneously and independently examine tax issues in their own territories with a view to exchanging any relevant information they obtain (see the Report, supra note 2, pp. 15-16).

7 Tax Inspectors Without Borders ("T.I.W.B.") is a joint initiative of the O.E.C.D. and the United Nations Development Programme ("U.N.D.P.") to build tax audit capacity. T.I.W.B. programs complement broader international efforts to strengthen co-operation on tax matters and improve domestic resource mobilization in developing countries.

In the third category, a joint audit is likely to increase transparency and eliminate legal boundaries that enable aggressive tax planning.[8] Indeed, many tax fraud schemes rely on a lack of transparency and communication between tax administrations, and many could have been prevented had the tax administrations established efficient channels for cooperation and information exchange.

Consequences of an Ordinary Italian Transfer Pricing Audit

In order to better understand the potential benefits of conducting a joint audit, it is worth considering the administrative burdens related to an ordinary transfer pricing assessment that results in an upward adjustment in one country without an immediate corresponding downward adjustment in the other country. The phases described below refer to the administrative procedure under the Italian legal framework, which does not differ significantly from the steps in other E.U. countries.

- **Examination Phase:** During the examination phase, examiners analyze the facts and evaluate the arm's length nature of the controlled transactions. In order to complete these examinations, the taxpayer must provide the examiners with a substantial amount of documentation and information. These include accounting and management entries, contracts, financial statements, and trial balances of each group company). Additionally, functional interviews are conducted with local and foreign employees. At the end of the examination, an examination report is issued to the taxpayers and a copy is submitted to the assessment unit of the Italian Revenue Agency. This phase may last up to two years.

- **Assessment/Negotiation Phase:** The assessment unit of the Italian Revenue Agency is in charge of reviewing the content of the examination report and issuing the final assessment. The unit also performs its own analysis and has the authority to increase, reduce, and even cancel the proposed adjustment issued by the examiners. Furthermore, conclusions must also be reviewed by different officers where the taxpayer is entitled to further defend their position. For this reason, officers of the assessment unit may ask the taxpayer for additional documentation and, in some cases, new analysis. An example might be new benchmark analysis, which is often very time-consuming. In this phase, the taxpayer may agree to a settlement with the office. However, if no settlement is agreed upon or if the settlement leads to double taxation, the taxpayer is left with two options, only: enter into M.A.P.[9] or initiate litigation according to domestic legal provisions.

- **M.A.P./Litigation Phase:** In Italy, M.A.P. is not an alternative to the litigation procedure used to prevent claims from the assessment becoming final. According to domestic legal provisions, the Italian Competent Authority cannot enter into an agreement with another competent authority that differs from a final settlement that is reached in the Assessment/Negotiation Phase or final court decision. To this end, in order to initiate M.A.P., taxpayers must (i) file a lawsuit under the domestic provisions, (ii) submit an M.A.P. request, and (ii) if such request is accepted, submit a request for the suspension of litigation.[10]

[8] See the Report, supra n. 2, at 9.

[9] Where the other country signed a convention for the avoidance of double taxation with Italy and actually has an active M.A.P. team in operation.

[10] The suspension is not automatic as the it requires the consent of the Italian Revenue Agency.

If the relevant tax treaty does not include an arbitration clause, the competent authorities are not obliged to reach an agreement. If the M.A.P. ends without an agreement, the suspended litigation will resume under domestic legal provisions. This phase may last up to ten years.

As above described, the ordinary transfer pricing audit process often includes three or four different assessments, which are conducted at different times by different persons.[11] The process is often lengthy and costly, and the outcome is highly uncertain both for tax administrations and taxpayers.

The goal of a joint audit is to limit administrative efforts through the early involvement of the competent authorities and to give certainty to taxpayers by establishing a transparent cooperation with the revenue bodies.

Joint Audit Pilot Project Between Italy and Germany

Following the European Commission's recommendation, the Italian and Bavarian tax administrations signed a memorandum of understanding regarding their intent to carry out one or more pilot joint audits on taxpayers with cross-border transactions between Italy and Bavaria. In 2013, the pilot project commenced and was divided into two phases: The first aimed to establish the grounds for performing the joint audit. The second was devoted to carrying out the specific examinations on a joint basis.

In the first phase, several meetings were held in Germany and Italy to coordinate group responsibilities for various tasks, such as the following:

- Identifying the relevant legal framework under which the joint audit would be performed
- Reaching an agreement on the tax issues to be addressed
- Identifying the criteria to select taxpayers for examination
- Forming two mixed teams of examiners, each composed of two Italian and two German examiners

Following the completion of the first phase, two multinational enterprises ("M.N.E.") were selected to be examined in connection with transfer pricing issues. The first company was headquartered in Germany with a subsidiary in Italy and the second was headquartered in Italy and with a subsidiary in Germany. The relevant legal framework was the D.A.C. and domestic law. At the start of the project, Germany had already implemented legislation allowing for joint audits. Italy introduced a joint audit provision into its domestic law in 2014, pursuant to the project.

The six-to-eight-month examination process resulted in an adjustment in prices between the associated companies. The adjustment was shared with the taxpayers involved and was agreed upon by the examiners and competent authorities of both countries. The agreement was the result of the jointly conducted examination.

[11] These include (i) the examiners, (ii) the officers of the assessment unit, (iii) the competent authorities and, where the latter cannot some to an agreement, (iv) the judges. Moreover, in Italy, there are three level of courts (*i.e.*, first, second, and Supreme Court). Therefore, one transfer pricing assessment may become seven.

In each case, the examination team jointly examined the headquarters and then examined the subsidiary. Before each on-site examination, the examination team met to plan the examination activities, including identifying documents that would be requested and the taxpayer personnel to interview. At the end of each day, a daily examination report was drafted and signed by both the examiners and the taxpayers. In the daily examination report, all the activities, documents, and interviews were summarized.[12] The examination team also held several meetings with the taxpayers to share and discuss their findings. In order to standardize joint audit reports and official communications, the documents were drafted in English.

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After finishing each examination, a final joint audit report was drafted. This report was used as grounds to issue an upward adjustment in one country along with a corresponding downward adjustment in the other country in accordance with domestic legal provisions.

The pilot project proved to be useful as it identified advantages and critical issues encountered during a joint audit. Moreover, it established a starting point for developing a more efficient solution to solve cross-border issues.

Some of the advantages of the joint audit pilot project were as follows:

- Joint audits lead to a material reduction of time needed to find shared positions between the countries involved.
- Joint audits decrease administrative burdens, related costs, and uncertainty.
- A joint audit allows for more taxpayer involvement, whereas M.A.P. is mostly limited to a discussion between competent authorities.
- The joint audit process is transparent and interactive, enabling the parties to find a solution in line with business functions, thereby fostering a more compliant environment where taxpayers see tax administrations as advisors rather than external agents to be kept outside of their business.
- A joint audit can address instances of double non-taxation, while M.A.P. can only address cases of double taxation.
- Joint audits are not unilateral tax rulings, as is the case with advanced price agreements. Therefore, State Aid risks are not an issue.
- Joint audits work.

The joint audit pilot project also highlighted certain critical issues:

- It is necessary to harmonize the legal basis for conducting joint audits. To this end, the Multilateral Instrument ("M.L.I.") may provide help in introducing the necessary tools.
- It is also necessary to harmonize the examination process among countries.
- English can be used as the standard for communicating and drafting documents; however, language can still be an issue when analyzing taxpayer contracts and other documents that are not in English.

[12] It is important to note that in Italy it is mandatory to draft a daily audit report, while in Germany it is not required.

- Staffing may pose an issue. In particular, it is necessary to have skilled examiners.
- Taxpayers cannot voluntarily enter into a joint audit.
- The outcome reached is not binding for tax administrations in the years not covered by the joint audit.

CONCLUSIONS AND NEXT STEPS

So far, M.A.P.'s have not been able to provide an efficient solution to the increasing number of double taxation controversies between E.U. and non-E.U. countries. The process is lengthy, costly, and highly uncertain – especially where arbitration is not mandatory. European competent authorities have been inundated with M.A.P. requests,[13] and the increased caseloads leave many instances of double taxation unresolved.

The pilot project conducted by Italy and Germany provides encouraging results. The two tax administrations found a shared position by jointly examining taxpayers and, in the process, avoided the burden of double taxation. The two countries are further developing this tool by investing additional resources in the international tax sector and selecting new joint audit cases. Moreover, other countries have shown interest in this project and are moving forward with first steps toward multilateral cooperation.

The pilot project demonstrated that both tax administrations are committed to the project's success. However, many questions still remain unanswered, particularly with respect to larger, more difficult cases. The pilot project revealed critical issues such as differences in domestic laws and potentially inadequate staffing resources if the number of the joint audits increases in future years. However, the main question is whether joint audits continue to be effective beyond the pilot stage.

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[13] "OECD Releases Mutual Agreement Procedure (MAP) Statistics for 2016," O.E.C.D.

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