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Joint audits, ICAP, and the role of risk assessment

Cross-border cooperation in transfer pricing risk assessments and audits has presented cost saving opportunities, but increased reporting obligations for MNEs. Deloitte's Manfred Naumann and David Varley explore the experience in Germany and the US.

The additional reporting requirements introduced by BEPS Action 13 for multinational enterprises (MNEs), and the mechanisms for exchanging the reported information between tax authorities, has seen a greater cooperation among tax authorities and transparency of taxpayer information, ultimately presenting both opportunities and challenges.

In particular, taxpayers with higher risk profiles may face increased scrutiny as a byproduct of increased reporting transparency, but cooperation between tax authorities during the audit stage may reduce instances of double taxation (if the participating tax authorities properly take into account the effect of collateral adjustments in a coordinated audit). Conversely, taxpayers deemed to have a lower risk profile during the risk assessment stage (that is, before a taxpayer is selected for audit) may reduce their likelihood of audit.

All the while, international developments – especially the recent OECD papers (such as the discussion drafts and guidance on profit splits, financial transactions, permanent establishment taxation, and hard-to-value intangibles) – have increased the risk of international tax conflicts substantially. The phrasing of these papers is sometimes ambiguous, and the tax authorities of different countries may interpret them differently. Some of these papers are only drafts for discussion, and the final outcome, if any, may be quite vague. However, these papers may provide different countries an opportunity to tax MNEs, depending on the OECD's wording.

Looking at the OECD statistics, the number of international disputes concerning TP cases, for which a corresponding adjustment under income tax treaty mutual agreement procedures (MAP) is agreed upon internationally, continues to grow year to year. From a practical point of view, these growing numbers are difficult for taxpayers and tax authorities to manage.

In addition, there may be numerous un-identified cases of international TP conflicts each year, with cases that may not make it to the MAP because the process seems too burdensome.

Against these tendencies, several recent initiatives have highlighted multilateral coordination: the international compliance assurance programme (ICAP), a voluntary programme for multilateral cooperative risk assessment; a forum on tax administration (FTA) to improve and coordinate risk assessment between different tax authorities; and an FTA project to investigate how to facilitate greater use of joint audits, supplemented by a recent paper of the EU Joint Transfer Pricing Forum dealing with the (positive) effects of joint audits.

While it is still too early to assess the impact of ICAP, there has been an increasing use and desire to conduct joint audits among European tax authorities. This article will examine some of these initiatives from the perspective of Germany and the US.

ICAP and risk assessment

The intent of the ICAP is to provide MNEs an opportunity to engage proactively and transparently with multiple tax authorities in exchange for increased tax certainty regarding their activities and transactions. The ICAP was also developed to further the OECD goals of allowing tax administrations to better focus their resources by creating a process to both remove MNEs with a lower tax risk from additional compliance actions and to keep unnecessary disputes from entering the MAP inventory.

The ICAP review process is streamlined with carefully articulated timing requirements. During the ICAP review process, tax administrations will continue to use their existing jurisdiction- specific tools for risk assessment. However, they will be encouraged to adopt a coordinated approach with respect to timing and manner of engagement with the MNE. An ICAP risk assessment will proceed in four discrete phases.

Phase I

In the first phase, the MNE will provide standard documentation to the participating tax administrations, after which the MNE will meet with the participating tax administrations to introduce its business, potential tax risks, and mitigation strategies.

Phase II

The tax administrations will then perform a level one risk assessment, during which the participating tax administrations will meet to discuss the MNE's presentation and documentation package. The tax administrations may also request additional information from the MNE.
A level one risk assessment can end in the following ways:

- The tax administrations agree that there is no tax risk, or low tax risk;
- The tax administrations determine that, contingent on specific changes being made to the MNE's tax filings, there is no risk or low risk; or
- A more comprehensive review is required.

Phase III

If a more comprehensive review is required, the tax administrations will perform a level two risk assessment. During this risk assessment, the tax administrations will coordinate to highlight risk areas and identify information gaps. The tax administrations will also request additional information from the MNE through written communication and an additional meeting, through which the parties will agree on a time frame to provide the requested information.

Then, each tax administration will inform the MNE of its recommendations and findings, and the MNE will be invited to raise points or ask questions. A level two risk assessment can end in the following ways:

- The tax administrations agree that there is no tax risk, or low tax risk;
- The tax administrations determine that, contingent on specific changes being made to the MNE's tax filings, there is no risk or low risk; or
- The tax administrations determine it is not possible to conclude that all risks are low or there is no risk.

Phase IV

Each participating tax administration will issue an outcome letter to the MNE. Upon finding low or no risk, the letter will include a statement that compliance resources will not be dedicated to a further review of the risks for a period of time (generally the period covered by the ICAP and the following two tax years). If the tax administrations are unable to conclude there is no risk or low risk, the outcome letter may set out the compliance actions that will be taken.

While participating in the ICAP, it will not provide an MNE with legal certainty, the MNE will receive insight on which transactions are considered low risk by the participating tax authorities. In situations in which the tax authorities are unable to provide assurance with regard to risk, the MNE may still benefit during future audits from the information gained during the ICAP process.

ICAP participation globally

The ICAP pilot began in January 2018, with participation from the tax authorities of eight jurisdictions (Australia, Canada, Italy, Japan, the Netherlands, Spain, the UK and the US), as well as select MNEs with activities in those jurisdictions. The risk assessment for the selected MNEs began in the first half of 2018 and was expected to last approximately 12 months.

Within the US, the Internal Revenue Service (IRS) is also developing additional risk assessment tools to reduce the resources required for monitoring domestic compliance. The IRS's large business and international (LB&I) division is reportedly creating algorithms and other data-driven tools to identify high- risk transactions that have an increased likelihood of adjustment.

The German tax administration does not participate in the ICAP project. One of the main reasons is the federal structure of the German tax system, which is based on the German constitution (Grundgesetz). As a result of this federal structure, German tax cases are not initially considered cases of the Federal Republic, but rather cases in the 16 Bundesländer (or states). Cooperation between the Federal Republic and the respective Bundesland (not always a straightforward proposition) would be necessary for Germany to participate in the ICAP.

It is difficult to imagine that the Bundesländer would waive their right to render an initial decision in one of 'their' tax cases. There are other issues – for example, whether participation in the ICAP would be consistent with the German constitutional requirement of equal treatment for all taxpayers, given that the ICAP seems to result in tax advantages accruing to a limited number of the largest MNEs.

Coordinated audits

Another byproduct of BEPS Action 13 is a renewed focus on multilateral tax examinations of MNEs with activities in multiple jurisdictions. Article 8 of the Multilateral Convention on Administrative Assistance in Tax Matters (MCAA), one of the information exchange mechanisms highlighted in Action 13, encourages tax administrations to conduct simultaneous tax examinations of transactions between associated enterprises in situations where "international tax avoidance and evasion is suspected".

The concept of multiple tax authorities acting in concert with respect to an MNE is not new, and multiple authorities provide for simultaneous tax examinations in connection with a request for information, including Article 26 of the OECD Model Tax Convention, Article 8 of the Council of Europe, and the OECD's Convention on Mutual Administrative Assistance in Tax Matters.

There are two types of coordinated audits: simultaneous tax examinations and joint audits. Simultaneous tax examinations are conducted separately within the framework of national law. That is, each tax administration audits the activities of an MNE group's relevant entities within its jurisdiction pursuant to the application of its local law. However, in concert with the separate audit activities, the tax administrations will exchange relevant information gained in the individual audits, with the goal of agreeing on a consistent set of facts.

Conversely, a joint audit is a coordinated effort by multiple tax authorities to not only reach consensus on the facts of the case, but also to reach an agreement on the tax treatment of the audited transaction.

The German experience

Within the European Union, an EU Directive allows forms of administrative cooperation relevant to intra-EU cross-border tax audits, including the presence of officials of one EU member state in another member state during administrative enquiries.
Germany has implemented this directive in a way that allows Germany's participation in joint audits. From the German point of view, a joint audit consists of two (or more) separate domestic audits by the countries concerned.

Therefore, the difference between a joint audit and a simultaneous tax examination is that during the latter, foreign tax auditors are are physically present during the domestic audit, and have the ability to ask the taxpayer questions. The goal of the cooperation is to establish agreed facts of the case as a result of a joint audit.

The German tax auditors (in most cases the local auditors of the respective Bundesland) are entitled to act as competent authority (CA), only for purposes of the exchange of information (not to settle cases). Germany considers the latter task to be within the exclusive purview of the Federal Republic, to be performed by the Federal Central Office of Taxation (BZSt), which always needs the agreement of the respective Bundesland to settle a case.

Therefore, if the auditors of the two (or more) countries agree on the facts but not on the taxable results, a separate MAP conducted by other 'federal' tax officials is necessary. In practice, in all known cases, the auditors found an agreement on the facts and on the taxable results, but this agreement regarding the results that avoids double taxation is only informal.

The German-Dutch pilot

A pilot coordinated audit programme between Germany and the Netherlands resulted in outcomes that avoided otherwise possible international tax conflicts. The pilot programme included five MNEs in different business segments; four were publicly traded companies and one was privately held. The German and Dutch tax administrations formed two unilateral audit teams with an agreed working language.

Both tax authorities participated in defining the scope of the audit, including the audit period, the tax items under audit, the information to be requested, and the employees to be interviewed. The audit procedures, including issuance of two identical joint audit reports and an agreement with the respective taxpayer, were concluded within 12 months.

Upon conclusion of the audits, both the MNEs and the audit teams provided feedback. The MNEs had positive feedback regarding the avoidance of MAPs, quicker issue resolution, and cementing agreements for the future, because following the joint audit the taxpayer may apply for an advance pricing agreement (APA).

However, the MNEs also expressed that more coordination was needed between the two audit teams, and that the audit itself needed to go beyond simultaneous examinations. This would be difficult for Germany, unfortunately, because of the constitutional situation described above. The examination teams had the following suggestions regarding the pilot programme:

- Auditors should be included in the taxpayer selection process;
- Differences in audit approach between the two teams should be resolved beforehand; and
- All auditors must have language proficiency and TP skills.

In addition, if reasonable, the taxpayer should have the opportunity to apply for a joint audit, if international tax conflicts are likely to arise in a given case. This could help to avoid situations in which a country rejects any adjustments because of timing issues.

To date, it appears that Germany has conducted joint audits with more than 20 countries, mostly, but not exclusively, with EU countries.

The German-Dutch pilot

The confluence of three factors (increased taxpayer reporting, information sharing between tax administrations, and a demonstrated willingness by tax authorities to develop tools that will single out the riskiest transactions) has increased pressure on MNEs' TP policies, but may ultimately result in beneficial tax outcomes for taxpayers.

Prior to the introduction of the ICAP, a tax authority would engage directly with the taxpayer through an audit and make jurisdiction-specific adjustments. However, through the ICAP process, any individual tax authority would be encouraged to develop a position consistent with those of their peers.

Even if tax authorities move past the risk assessment stage and select a taxpayer for audit, the taxpayer (through careful management of the process) may benefit from a coordinated audit. Compared to the currently available MAP mechanism, an efficiently executed coordinated audit, whether a 'mere' simultaneous examination or a 'true' joint audit or something in between (respecting the constitutional and legal constraints of the countries involved) may provide the taxpayer with significant time savings and extended tax certainty.

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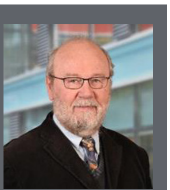

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Manfred Naumann was a German tax official until January 2016 and is now a consultant with Deloitte Germany. He has been involved in international taxation for more than 30 years, with a strong focus on international transfer pricing during the past 15 years in the German Ministry of Finance. He has been a member of the OECD's Working Party 6, which deals with international transfer pricing, and the EU Joint Transfer Pricing Forum, a working group of the EU Commission dealing with simplifications of international transfer pricing in the EU.

Between 1991 and 2002, he worked as a lecturer at the Bundesfinanzakademie and conducted seminars primarily in international tax law.

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