2020
Handling Tax Disputes in Europe
Foreword

Tax audits do pay for governments. In the current economic climate in Europe, where it is difficult to increase taxes locally or introduce new taxes, many governments rely on tax law enforcement to mitigate public budget deficits. For this reason, taxpayers in Europe are experiencing more frequent and more aggressive tax audits. For taxpayers operating in more than one jurisdiction, the handling of tax disputes is usually not a purely domestic issue. In an increasing number of cases, tax authorities in Europe engage in multijurisdictional tax audits where members of the same group established in different jurisdictions are audited simultaneously, and where the information obtained is exchanged between the tax authorities in an attempt to identify double non-taxation, the use of qualification conflicts, inconsistent reporting and abuses of laws, to name a few. In addition, members of foreign tax administrations increasingly tend to directly become involved in domestic tax audits. All this requires an informed, pro-active, coordinated and consistent approach by the taxpayer toward handling tax audits and tax disputes in general as part of the management of tax risks.

If the resolution of tax disputes during an ongoing tax audit is not possible, litigation is usually not the only option. Alternative settlement techniques are country-specific. In many European countries, settlements tend to be more achievable at the tax office level, either before or after the release of post audit tax assessment notices. Experience has shown us that in some countries, settlements through negotiations are possible even at court level. In any case, successful settlements require a lot of experience and creativity on the side of the taxpayer.
Sometimes, however, tax litigation cannot or should not be avoided. This is not a purely domestic issue anymore either. Over the last years, the Court of Justice of the European Union has played an increasingly important role in determining the compliance of domestic tax laws with Community law. As a consequence, the use of Community law has become an important element in the representation of clients in tax disputes in almost all EU Member States, and at every stage of the process.

Parallel to similar projects in the US, Latin America and Asia, Baker McKenzie Europe set up the "EMEA Tax Dispute Resolution Practice Group"—a team of highly experienced tax attorneys who, almost exclusively or to a large extent, represent clients in handling their tax disputes. The representation of clients in tax disputes includes every stage, from the time before the tax authorities even begin their examination to audit through a satisfactory settlement, including, where necessary or appropriate, litigation, arbitration or the use of alternative dispute resolution techniques. Our goal has always been to convey a general consistency in the quality and approach that clients can expect from Baker McKenzie tax attorneys the world over when handling their tax disputes.

This handbook addresses a number of the main issues that 17 of the European countries deal with when anticipating, preparing for, and managing tax disputes in Europe. It also provides detailed information about litigation before the Court of Justice of the European Union, the competent authority process, and alternative tax dispute resolution mechanisms within the European Union.

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Section One

Country Analysis
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I. Managing the tax audit process

1. General

In light of declining tax revenues and the Base Erosion and Profit Shifting (BEPS) initiative, in which Austria has taken a proactive approach in regard to several points, the Austrian tax authorities continue to invest large amounts of money and resources in the education of their specialized tax auditors. The Austrian tax authorities continue to target so-called "high-risk" companies, i.e., companies with high cash flows or close ties to foreign jurisdictions (e.g., service enterprises across industry boundaries, subsidiaries of big global companies and businesses with specific structures subject to special provisions in the Austrian tax code). In the past couple of years, specific tax audit techniques and programs have been refined and adapted to the new possibilities with respect to information exchange. Since the introduction of electronic audit software, the Austrian tax authorities have managed to keep up with the electronic documentation and compliance programs currently used by modern multinational corporations.

(a) Expected periodicity

Austrian audit provisions are not based on a fixed periodic reoccurrence for regular audit processes. The question if and to what frequency an Austrian taxpayer will be audited depends on various factors. As a general rule, tax authorities focus on taxpayers that have not been audited for a certain period of time. The tax authorities' internal data processing system chooses taxpayers based on the date of their most recent tax audit and thereby chooses taxpayers that have not been audited for the longest time. However, there is no clear reoccurrence and despite that general approach, some taxpayers are audited more frequently than others due to a number of other factors (e.g., so called "high-risk business sectors"), which weigh into the overall selection process. Larger companies (based on their overall gross sales) are audited more frequently, and usually have an audit every fiscal year or are audited for several fiscal years at once.
(b) Selection of tax audit targets

In addition to the taxpayer’s audit history, other criteria are considered in determining eligibility for audit. To prevent predictability for the taxpayer, and the tax officials themselves, the Federal Data Center uses a computer-generated randomized algorithm to choose the respective taxpayers based on undisclosed criteria. This may result in a taxpayer being subject to audit in two consecutive years.

Besides the regular audit system, there is a non-regular tax audit system that may be initiated if the tax authorities, for example, disclose inconsistencies or irregularities upon reviewing tax returns; or a taxpayer has returned incomplete information or does so with delay; or the tax authorities find inconsistencies of another taxpayer that has regular business dealings with that taxpayer; or the tax authorities are notified (mostly on an anonymous basis) that a taxpayer does not comply with provisions of the tax code.

Full-scale audits cover all taxes, such as corporate income tax, communal tax and VAT; however, in many cases, the audit is limited to certain taxes and certain periods. More often, audits that only cover a category or a special kind of taxes are initiated, covering isolated tax issues, such as VAT, wage taxes (the social insurance contributions are usually audited together with the wage tax) and stamp duties. In many cases, the corporate income tax audit would be combined with a VAT audit, as both audits require similar and overlapping sets of data.

2. Advance preparation for tax audits

The scope of the tax audit (categories of taxes and time periods to be audited) is determined by the competent tax authority. The taxpayer that is subject to a tax audit is notified about the initiation of the tax audit, and the respective taxes and periods to be covered, the contemplated date of the initial formal meeting and the name of the tax auditor. In many cases, this notice is delivered to the taxpayer itself, which names the place (often
its tax attorney’s office) where the audit should take place. Such notice, given in writing, is an administrative act that is, however, not subject to appeal.

In most cases, the period between the written notification and the first initial meeting is around one week, but if the object of the tax audit would otherwise be put at risk, the tax audit may also commence immediately. In other cases, the time between the notification and the initial meeting is longer if the taxpayer needs more time to gather the relevant information. In other cases, the audit starts with a specific list of documents and data that need to be delivered within a couple of weeks, followed by an in-house audit.

In most cases, the tax authorities observe the time period as outlined in the Federal Tax Act. As this notification period is rather short, it should be used efficiently and wisely to prepare for the upcoming tax audit. Depending on the category of taxes and the audits emphasis, a proper preparation should include:

Assembling the required documents, the accounts in question, the respective balance sheets and all relevant agreements that were effective during the years under audit. It is vital to provide all documents for an audit in a timely manner, in a transparent way and completely, in order not to raise the tax auditor’s suspicions. As the tax authorities’ electronic capabilities have evolved over the last decade, they now prefer to receive big bulks of data in electronic form instead of hard copies.

- Certain topics should be discussed internally with the client and the competent counsel. Potential "hot topics” such as aggressive tax planning made in the past, systematic mistakes in returns filed for years under audit that have not yet been corrected, or issues that could qualify as negligent tax underpayment or even as tax fraud should be scrutinized before the audit begins. The Austrian Fiscal Criminal Act provides for the possibility of rectifying past transactions...
that may constitute tax evasion by filing one or several amended returns accompanied by a comprehensive depiction of the errors, and of those who are responsible for the errors (*Selbstanzeige*).¹

- To receive exemption from punishment as provided by the respective provisions in the Austrian Fiscal Criminal Act, the amended returns and the accompanying statements must be filed prior to the tax auditor’s first visit or the tax auditor should be notified thereof on their first visit, but before they officially commence the tax audit.

- If any risks have surfaced during the discussions with the taxpayer’s counsel, it is advisable to discuss the strategy in regard to these risks during the audit.

- The auditors often would like to have direct communications with local company managers with knowledge of the business and its operations. This is a risky area for the tax advisor, because they cannot monitor all communication between the auditor and the company personnel. It is therefore advisable to limit the number of persons the auditor may contact for gathering information. The respective employees should, in any case, discuss the information to be delivered with the tax advisor first, so that the process remains monitored and controlled at all times, as well as precisely document the flow of information to the auditor. It is vital that there is a complete documentation of all the information the auditor has received.

- According to the law,² the tax auditor is requested to perform the audit in the premises of the business. It is common practice to provide a separate room in which all relevant documents are already compiled for the auditor’s use. If at all possible, the audit should be held at the office of the taxpayer’s consultant, as an on-site audit might allow the tax auditor to gather information in an informal way from employees

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¹ Section 29 of the Fiscal Criminal Act.
² Section 141 of the Federal Fiscal Code.
working on the premises. An audit has to take place at the tax
advisor’s office if an on-site audit would disturb the normal course of
the business.

As a result of the current Organization for Economic Co-operation and
Development’s (OECD) BEPS developments and related domestic
legislation, Austrian tax audits have recently begun to focus on BEPS-
related items, like substance in the companies that are part of
intercompany transactions, revenue drivers in the supply chain and
permanent establishment issues (specifically where commissionaires are
involved).

From an advisor’s point of view, it is therefore imperative to identify those
areas prior to the commencement of the audit to check the available
documentation, and therefore be able to prepare a viable defense strategy
together with the client.

3. Limitations period for assessments

The Federal Fiscal Code (*Bundesabgabenordnung* or BAO) provides for the
following statutes of limitations:\(^3\)

- Three years for consumption taxes and statutorily fixed stamp duties
  and their refunds
- Five years for all other taxes and their refunds
- Ten years in the case of tax fraud (taxes evaded in the event of a tax
  crime)

For taxes levied by way of assessment (i.e., the taxpayer files a tax return
and the authorities subsequently issue a tax decree), a specific rule applies.
For such taxes — which include income tax, corporate income tax and VAT
— the limitations period is extended from five years to six years.

\(^3\) Section 207 of the Federal Fiscal Code (BAO).
Hence, for assessed taxes such as income tax, corporate tax and VAT, the applicable period is always six years (five years plus one year).

The limitations period will be extended by one year if the tax authorities take action in order to assess the tax due (i.e., by contacting the taxpayer by letter or by phone. The issuance of the initial decree is also an action extending the limitations period for all taxes assessed by a decree, which explains why the limitations period is always five years plus one year in the case of assessed taxes such as income tax, corporate income tax or VAT).4

Despite the above-mentioned possibility of extending the limitations period, the right to assess taxes is, in any case, statute-barred 10 years after the tax liability arose. Hence, the limitations period always elapses after 10 years (absolute or final limitations period), with the only exception that during a tax proceeding the limitations period – including the final limitations period – can never elapse. Such tax proceeding, which commences as a result of the taxpayer’s appeal, can either take place before the tax court of first instance (federal fiscal court – Bundesfinanzgericht or the federal administrative court – Verwaltungsgerichtshof).

Assessment of the above-mentioned taxes is only admissible within the limitations period. If the tax assessment is already final and a tax decree has already been issued, a change of the decree (in other words, a reopening of the tax case) is also only admissible within the limitations period. In addition, such change of a decree has to be in compliance with specific rules set forth in the Federal Fiscal Code;5 these rules allow, among other things, the issuance of a new decree in the following cases:

- The tax assessment was induced by criminal activities (i.e., falsified documents were used).

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4 Section 209 para. 1 of the Federal Fiscal Code.
5 Section 303 et seq. of the Federal Fiscal Code (BAO).
• The tax office becomes aware of new facts or new evidence that had not been brought forward earlier (the latter case is of utmost practical importance).

Finally, it should be noted that a tax assessment will usually be changed in order to implement the results of a mutual agreement procedure. In this case, the issuance of a new decree is admissible even if the limitations period has already elapsed (due to specific rules in the applicable tax treaty following Article 25 para. 2 of the OECD Model Convention).

The above-mentioned limitations periods commence, in all cases, at the end of the calendar year in which the tax liability arose. For income tax, corporate income tax and VAT, this is always at the end of the respective calendar year. Hence, the limitations period for these taxes always commences by 31 December.

Special rules apply when it comes to the recovery of already assessed taxes. In recoveries of due taxes (i.e., execution of the tax decree), the limitations period is five years; this five-year period within which to recover taxes will not start prior to the end of the year when the tax was due. As the five-year period restarts after any action taken by the tax authorities to recover the tax claim, it does not have any major practical importance. A final or absolute statute of limitations does not apply to the right to execute a lien for the taxes due.

4. **Areas of tax auditors’ special attention**

In cases where the auditor is not in possession of any specific indicators of wrongdoing, the general approach is to review the general accuracy of the taxpayer’s returns on the basis of the taxpayer’s relevant books and records, including correspondence and files. Generally speaking, the taxpayer is obligated to provide all relevant information electronically if bookkeeping is undertaken electronically. Since the law does not provide a definition on which information is considered "relevant," it is advisable to inform the auditor if there are more details on the given information.
available if they require these. In this respect, it is noteworthy that the law enables the auditor to examine all factual and legal circumstances that may be relevant in determining the tax to be levied. The auditor must therefore be granted access to all information and documents they may consider relevant or they deem helpful or necessary to be supplied. However, neither the taxpayer nor its advisors have to grant the auditor access so that they can find such documents themselves. In any case, it is vital to honor information requests promptly and comprehensively.

In general, the tax auditor commences the audit by ascertaining details of the business transactions of the taxpayer. After reviewing these, the auditor will generally have identified certain critical areas on the basis of "sample testing" or "cross referencing." The following points will be in the focus of an audit:

(a) Procedure and form

(1) Financials and accounting

Austrian law provides for specific rules relating to the obligation of businesses to maintain books and records and to produce financial statements. As a general rule, a person or business obligated to keep books and records pursuant to commercial law will also be obligated to keep books for tax law purposes. Specific tax-related documentation obligations apply to taxpayers that receive (part of) their revenues in cash.

(2) Formal requirements

Such books, records and financial statements are also required to be kept for tax purposes and generally need to be maintained for seven years. In the event a tax audit is initiated prior to the lapse of this period, the documents need to be maintained for as long as they may be of influence.

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6 Section 189 et seq. of the Commercial Code.
7 Section 131b of the Federal Fiscal Code.
8 Section 132 para. 3 of the Federal Fiscal Code.
on the proceedings initiated. Certain documents relating to real estate need to be maintained for 22 years for VAT purposes.

Books and records have to be established on a contemporaneous basis, which means either monthly or quarterly, depending on whether the taxpayer is subject to monthly or quarterly VAT reporting. Every receipt of cash payments has to be recorded on a daily basis.⁹

All documents should be written in a living language and may also be established and stored abroad. However, the taxpayer must be able to bring these to Austria within a reasonable period of time to be set by the tax authorities.¹⁰ Further, the tax authorities may request a certified German translation, which would trigger additional costs and would certainly also prolong the audit procedure. It should also be noted that, depending on the scope of the books, records and financial statements, procuring a certified translation might take longer than the period set by the tax authorities.

Documents that have a journal function and therefore may be considered important basic records (Grundaufzeichnungen) have to be stored in Austria. However, any of these documents may also be stored on a data carrier.

(3) Documentation of intra-group transactions

Business transactions among related parties (i.e., entities under the same ultimate parent company) are only recognized for tax purposes if the transactions meet the following conditions:¹¹

- All agreements must be documented and in writing.

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⁹Sections 131 para. 1 No. 2 et seq. of the Federal Fiscal Code.
¹⁰ Section 131 para. 1 of the Federal Fiscal Code.
¹¹ See, for example, Federal Administrative Court Decision 22.2.2000.99/14/0082.
The respective agreements must be clear, unambiguous and understandable to any third party.

The conditions of any dealing between affiliated parties must be at arm’s length.

Not only do the results of a deal between affiliated parties have to be at arm’s length, but also the process that leads to the conclusion of the agreement. The tax authorities often request documentation that an agreement was subject to negotiations or is based on transparent factors. Where such requirements are not met, the transaction might be assumed to have arisen out of the shareholder-subsidiary relationship, and related expenses may not be tax deductible.

In 2010, the Austrian Federal Ministry of Finance issued domestic transfer pricing guidelines. It also provided guidance on the documentation requirements; however, it should be noted that these guidelines, while binding on the tax authorities as internal guidelines, are not binding on the taxpayer. Additionally, the OECD transfer pricing guidelines have been adopted by means of decrees of the Austrian Federal Ministry of Finance and are therefore applicable in Austria.\(^\text{12}\) The Austrian fiscal authorities are obligated to apply the OECD transfer pricing guidelines when examining compliance with documentation requirements in connection with transfer pricing matters.\(^\text{13}\) However, in cases where the domestic transfer pricing guidelines differ from the current OECD guidelines, it is safe to assume that the fiscal authorities will abide by the domestic transfer pricing guidelines.

In light of the new Country-by-Country Reporting (CbCR) introduced by the OECD BEPS project, Austria has introduced a new Transfer Pricing Documentation Act (TPDA), which was passed by the Austrian parliament


on 6 July 2016. The TPDA is based on the BEPS Action 13 of the OECD and significantly increases the documentation burden for multinational corporations with entities in Austria.

The new documentation requirements are effective for financial years commencing on 1 January 2016. In cases where the sales in the two previous years exceeded EUR 50 million, Austrian entities will have to prepare a master file and a local file. Multinational entities (MNEs) generating more than EUR 750 million consolidated sales additionally have to prepare a CbCR.

The master file must contain comprehensive overall information on the whole multinational group, mainly comprising the following:

- Organizational structure
- Description of the business activity
- Intangibles financing activities within the group
- Financial and tax position

The local file should contain specific information regarding the business transactions of the respective entity, in particular, information about financial transactions as well as the comparability analysis.

A group of companies that, combined, exceeded consolidated sales of EUR 750 million in the previous fiscal year, additionally has to prepare a CbCR. This third part of the transfer pricing documentation provides a standardized overview of how the sales, the earnings before tax, the taxes paid, the number of employees, material assets and the separate business activities are distributed globally. This third part of the report has to be filed in Austria in the following cases:

- The parent company is an Austrian resident company.
• The parent company does not have to file the CbCR in the respective other country.

• No qualified agreement regarding the exchange of the CbCR exists.

• Such a qualified agreement exists, but the automatic exchange was suspended or failed during a prolonged period.

Austrian companies have to prepare a master file and a local file if their sales revenues exceed EUR 50 million in the two previous fiscal years. The TPDA does not only oblige separate legal entities to set up both documentation parts, but dictates the same obligation for permanent establishments under specific circumstances which will mostly be fulfilled. However, an Austrian entity (a separate company or a permanent establishment) will only be covered by the TPDA if it is part of a multinational group of companies (i.e., apart from a local Austrian entity, another entity has to exist abroad).

The CbCR has to be filed electronically via FinanzOnline no later than 12 months after the last day of the fiscal year. The master file and the local file have to be available at the moment of filing the tax returns, as these have to be presented to the fiscal authorities within 30 days upon request. Generally, it is possible to prepare the transfer pricing documentation in English. Non-filing is penalized with up to EUR 50,000. Penalties for gross negligence go up to EUR 25,000.

The TPDA will lead to significant additional efforts and costs for MNEs. According to the preamble of the initial draft of the TPDA, the Austrian legislator estimates the initial costs for setting up a CbCR at approximately EUR 200,000 and those for preparing the master file and the local file at about EUR 400,000.

(4) Disclosure of creditors and payees

A provision often subject to tax audits is Section 162 para. 2 of the Federal Fiscal Code, which provides that, "debts and expenses may not be
recognized for taxation purposes if the taxpayer fails to sufficiently answer a request of the tax office to give precise information concerning the creditors or recipients." The respective provision is applied frequently, since it is the taxpayer's obligation to provide the necessary information. If the tax auditor suspects that the "official" creditor or recipient of payments is an intermediary acting as a fiduciary, they will almost certainly use this section. The provision is almost always applied in cases of payment of commissions for soliciting contracts or when the recipient is an offshore holding company. This provision is supplemented by Section 109b of the Income Tax Act, which outlines explicit documentation and reporting requirements for domestic taxpayers receiving certain services from foreign service providers. Details such as the name and address of the service provider, as well as tax numbers, the international country code and the amounts paid, need to be registered. The failure to provide the requested information results in these payments being unrecognized for tax purposes. The reporting obligation does not apply if the amounts paid in one year do not exceed EUR 100,000 or if payments are made to a foreign company that is subject to a corporate income tax that is not more than 10 percentage points lower than the Austrian corporate income tax rate.

(5) Enhanced obligation to cooperate

Under domestic law, Sections 124 through 132 of the Austrian Federal Fiscal Code or BAO require taxpayers to provide sufficient documentation that will enable the tax authorities to assess the taxes correctly. In cases where foreign parties and/or entities are involved, the Austrian courts render that taxpayers are obligated to provide more than customary cooperation with the competent tax authorities; hence, taxpayers have a so-called "enhanced obligation to cooperate" (erhöhte Mitwirkungspflicht; see Section 115 para. 1 Federal Fiscal Code). The respective provisions oblige the taxpayer to keep the necessary evidence available.

14 See for example Federal Administrative Court Decision (VwGH) 22.3.1995, 93/13/0076.
(Beweisvorsorgepflicht)\textsuperscript{15} and to provide the tax authorities with the requested evidence (Beweismittelbeschaffungspflicht),\textsuperscript{16} since the capabilities of the Austrian tax authorities to investigate are very limited in respect to foreign countries.

The fact that the taxpayer is subject to the enhanced obligation to cooperate with tax authorities raises the question of how this obligation relates to the possibilities tax authorities have to obtain information from foreign tax authorities under international provisions governing exchange of information (such as double tax treaties (DTTs) or the Council Directive 2011/16/EU).

Due to previous court decisions, the international exchange of information has priority over the taxpayer’s enhanced obligation to cooperate.\textsuperscript{17} The court’s holdings have, however, not been repeated in subsequent jurisprudence.\textsuperscript{18} Due to tax authority practice, the taxpayer’s enhanced obligation to cooperate prevails, which means that tax authorities first request documents or other evidence from the taxpayer before making use of the international exchange of information procedure.

(b) Substantive issues

(1) Permanent establishment/residency

Taxation and the right to tax are closely related to the residency of a person or business. Therefore, it is decisive whether a person or company is

\textsuperscript{15} Before the introduction of Section 115 para. 1 Federal Fiscal Code in 2017, the enhanced obligation to cooperate was derived from court jurisprudence and tax authority practice; see for example VwGH 25.5.1993, 93/14/0019; Austrian Ministry of Finance (BMF) 6.4.1998, SWI 1998, 281 [= EAS 1239]; BMF 17.7.1995, ecolex 1995, 757.


\textsuperscript{17} VwGH 22.3.1995, 93/13/0076.

\textsuperscript{18} See the analysis made by Schwandtner/Urtz in Aigner/Kofler/Tumpel (editors), DBA-Kommentar (2016) Article 26 No. 389; see also VwGH 4.3.2009, 2008/15/0275, which might be understood as a turnabout in the court’s jurisprudence.
residing in Austria and is thus subject to unlimited tax liability, or whether they are, or it is, not residing in Austria and subject only to limited tax liability. In the latter case, the taxpayer will be taxed only on income derived from sources in Austria. The tax auditor will therefore closely examine the personal circumstances, such as the permanent home or habitual abode in the case of an individual and the place of effective management in the case of a company, each leading to residency in Austria and thus, to unlimited tax liability.

Whenever a foreign company is involved in performing transactions in Austria, the tax auditor will also check whether this company maintains a permanent establishment in Austria. Any income derived through this permanent establishment would be subject to corporate income tax, and the permanent establishment, as such, would also be subject to communal tax. Especially where former distributors are changed to commissionaires, it will be examined if the commissionaire can be considered a permanent establishment of the principal. This issue has gained particular importance after the OECD delivered the final report on BEPS Action Item 7, broadening the definition of permanent establishment to certain commissionaire arrangements.

(2) Transfer pricing: intangibles

As a general rule, the Austrian tax authorities do not recognize royalties for tax purposes if the recipient is only a "letter-box company" and the taxpayer does not name the ultimate shareholder of its company or the beneficial owner of these payments. In connection with BEPS, Austria also introduced new legislation that does not recognize interest and royalty payments to group companies in low tax jurisdictions for tax purposes. BEPS and the recent legislature on intangibles certainly have had an impact on the Austrian authorities and it is to be expected that Austrian

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19 Federal Administrative Court Decision 9.9.1998, 93/14/0170.
authorities will inquire into the substance and functions of holding companies in jurisdictions outside of the EU more thoroughly.

(3) **Transfer pricing: tangibles**

Transactions among related parties involving tangibles must be accordingly documented. The Austrian Transfer Pricing Guidelines clearly state that taxpayers are obligated to prepare transfer pricing documentation based on the Federal Fiscal Code’s general provisions concerning bookkeeping, recordkeeping and the disclosure requirement for tax purposes. Regarding the content and scope, documentation must be in line with the documentation requirements according to the OECD Guidelines (also see the new TPDA requirements above in Section 4(a)(3) "Documentation of intra-group transactions"). The documentation must present and explain the reasons for applying a certain transfer pricing method, as well as the comparables used and excluded. Any cost-sharing or cash-pooling agreement that is in place in a group structure must be clear, in writing and brokered at arm's length. In the event a cost-sharing agreement is in place, the contents of this agreement must be clear, and it should be committed to writing to be recognized for tax purposes. The following figures should be determined in the cost-sharing agreement:

- Names of the pool members and other related beneficiaries
- Precise description of the type and scope of services regulated by the agreement
- Duration of the agreement
- Determination of the benefit expected by each of the participants and the method used in order to assess the expected benefit, including any eventual forecast
- Determination of the character and the amount of the costs to be shared and how these have been allocated to each pool member, as well as a description of how the initial service contribution and later
service contributions shall be determined and uniformly allocated to all pool members

- Type and scope of accounting control among the pool members
- Provisions for and consequences of the entry of new pool members and the early withdrawal of current pool members
- Provisions on compensation payments or the adjustment of the agreement in the event of altered economic circumstances

(4) Restructuring/business re-engineering

The tax-neutral restructuring of groups under the application of the provisions of the Austrian Reorganization Tax Act will be scrutinized in regard to the correct valuation of the assets/shares transferred (i.e., at book value or at fair market value), especially if any of these reorganizations go cross-border and infringe Austrian taxation rights (exit taxation).

Reorganizations under the Austrian Reorganization Tax Act are eligible for binding ruling requests to the tax authorities. A binding ruling significantly lowers the risk of legal uncertainties in regard to highly complex reorganizations and provides a certain level of comfort for the stakeholders involved.

In regard to hidden reorganizations (gradual shifting of risks and functions between entities and jurisdictions) the Austrian tax authorities apply strict transfer pricing measures. The tax authorities will specifically examine whether risks and functions have been shifted to another party, (e.g., the foreign distributor), which would then have an impact on the margin to be applied if the transfer price is based on the resale price method or the transactional net margin method (TNMM). Additionally, whether compensation payments would have been due and if so, in what amount, will likely be closely examined. It is of paramount importance to properly document the transfer pricing principles applied, to document and explain
the reasons for changing the existing structure and whether or not tangibles and/or intangibles were transferred. In light of recent BEPS measurements, it is expected that the Austrian tax authorities will pay additional attention to such restructuring efforts.

(5) Constructive dividend

A constructive dividend is a decrease of, or a prevented increase in, a corporation's property that is the result of the shareholder-subsidiary relationship, which has an impact on the corporation's income and does not result from a proper dividend resolution.

In its most common form, the corporation enters into a transaction that is not at arm's length with one or several of its shareholder or affiliated parties of its respective shareholders. The following are examples of potential constructive dividends:

- Payments made to others for the personal benefit of the shareholder
- Payments to family members of shareholders
- Excessive compensation/purported loans to shareholders
- Loans to shareholders at "below-market" interest rates
- Improvements to shareholders' property
- Bargain purchases of corporate property/free use of corporate property by a shareholder

Constructive dividends are not formally declared or designated as a dividend. As a result, the dividend is treated as a business expense on the level of the corporation and is not subject to dividends taxation at the level of the receiving shareholder. From a tax point of view, there is no difference between a formal dividend and a constructive dividend; therefore, the tax consequences that would apply to an open dividend distribution are (retroactively) applied to these hidden dividends. To the
extent the tax authorities categorize expenses as a constructive dividend, the affected corporation’s taxable income will be accordingly increased, and will thereafter be deemed to have been distributed, thus triggering dividend-withholding tax (which is the dividends tax of the receiving shareholder).

(6) Donations

Donations are generally not deductible as a business expense, but have been made deductible under very limited circumstances. Donations are recognized only as a business expense if the donations are given to specifically named institutions in the current provisions of the Austrian Income Tax Act and to specifically enumerated charities that have applied for a special status and are listed in a separate list annually published by the Ministry of Finance. Further, the amount to be donated is limited to 10% of the annual profit of the year the donation is being made.

5. Special tax audits

(a) VAT/Customs

Since VAT revenues are one of the major tax revenue sources, the Austrian tax authorities quite frequently perform special VAT audits. There are essentially two different kinds of VAT audits. The more frequently performed kind of VAT audit focuses on the advance turnover tax return the taxpayer has to file monthly or quarterly under the Austrian VAT Act. These audits usually focus on the accuracy of the advance turnover tax returns, as well as the correctness of the tax basis declared by the taxpayer. These audits seldom go into depth, but mostly concentrate on formal aspects.

The other kind of special VAT audit has a broader and more detailed approach than the audit of the advance turnover returns, and the

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20 Section 4a of the Income Tax Act; Section 20 para. 1 No. 4 of the Income Tax Act.
21 As provided in Section 151 of the Federal Fiscal Code.
taxpayers to be audited are chosen according to a special "risk analysis." The tax authorities use specific software comparing all stored VAT data of the businesses concerned. The software filters certain risk factors, which are undisclosed and based on the determination of whether a business should be subject to a special VAT audit or not. There are certain sectors that are focus groups for such special VAT audits.

(b) Payroll tax

This is a form of audit that is specific to corporations that have a (significant) workforce. The audit focuses on the correct calculation, withholding and remittance of payroll tax, employer’s contributions, and other taxes and duties relating to payroll tax. In many cases, the payroll tax audit is simultaneously conducted with a social insurance audit. If the auditor realizes during the audit that a disproportionately high degree of effort would be necessary to determine the exact amount of additional payroll tax to be claimed for each employee, the tax authorities may simply determine, after an assessment, a lump sum to be paid.

(c) Stamp duty

Certain agreements, contracts and documents are subject to stamp duty in Austria. The taxpayer either has to self-assess the stamp duties due (for example, if a rent contract is being concluded) or the tax authorities have to be notified of the agreement and they will assess the stamp duties payable. Agreements that are subject to stamp duties include rent contracts, assignments (cessions) of receivables, guarantees and out-of-court settlements. The special audit concerning stamp duties focuses on the timely and correct notification of the agreements subject to stamp duties, as well as on the correct calculation of the duties to be self-assessed. It is therefore important to document the basis on which the calculation was made.
6. **Electronic data processing (EDP) access during audit**

In case bookkeeping is undertaken in electronic form, Austrian taxpayers are obligated to provide all relevant data electronically as well. The mere printout of such data will hence no longer suffice. Austrian tax auditors work with a particular audit file that is regularly set down for all systems. The taxpayer is further obligated to install the necessary software to allow for the creation of such an audit file. This audit file is similar to an electronic form that is filled in by the various software programs used.

In 2016, a new law was introduced that obligates all businesses: (i) generating more than EUR 15,000 in annual gross sales per year; and (ii) having business premises generating at least EUR 7,500 in sales, to record by using a cash register all transactions done in cash. If payments are not generated in cash (e.g., vouchers, payment via telebanking or paying-in slip and standing orders), there shall be no obligation to record such takings in a cash register. The obligation to use a cash register commences as soon as the respective limits have been exceeded for the first time at the beginning of the fourth month after the expiry of the preregistration period. In addition to the cash register obligation, beginning on 1 April 2017, all cash registers must be equipped with a security system/anti-manipulation system. The details of that system are fairly complex and are the subject of a special directive by the Ministry of Finance. As soon as the above annual gross sales thresholds have been exceeded for the first time (at the latest by the fourth month after expiry of the preregistration period), the business owner must have a suitable cash registry system to provide details for VAT calculation (calendar month or calendar quarter).

Also beginning on 1 January 2016, every business owner that accepts cash payments will be obliged to produce a receipt and to hand it to the customer. Each receipt must include the following contents:

- Name of the business delivering goods/providing services
• An unbroken consecutive series of numbers with one or more numerical sequences that serve to identify the business transaction in question
• The day the receipt was produced
• Amount and common commercial name of goods or services
• Amount paid in cash

The obligations described above (cash register, specific cash registry system, production of a receipt) are and will be subject to enhanced special audits to improve compliance among taxpayers after the relevant provisions have been issued.

7. Information-gathering powers

(a) Information obtained from unrelated parties

Under the Federal Fiscal Code (BAO), tax authorities may request information either from the taxpayer or from third parties. Third parties may either be informants (Section 143 et seq.) or — more formally — witnesses (Section 169 et seq.). However, informants or witnesses will only be requested to provide information in case the taxpayer refuses or is unable to give the desired information to the tax authorities (the so-called "principle of subsidiarity"; Section 165). Based on the above-mentioned regulations, tax authorities may request any desired information, including documents or commercial books, from customers or suppliers. However, if information is requested from a bank, certain restrictions apply (Austrian bank secrecy). Tax authorities have to demonstrate that they have reasonable doubts that the taxpayer’s tax return is correct, and that the taxpayer has not been able to dispel these doubts.

Further, the federal fiscal court (Bundesfinanzgericht) has to give its consent to the disclosure. Under the aforementioned restrictions, Austrian bank secrecy can be broken by tax authorities. If the auditor uses
information from a witness against the taxpayer, the taxpayer concerned may request that the name of this person be disclosed. The Austrian tax authorities do not, however, use "secret comparables" in cases involving transfer pricing issues. They are also entitled to request documentation that the taxpayer stores abroad. This is frequently done in cases with transfer pricing issues where, for example, transfer pricing documentation is stored in a foreign-associated enterprise and the request is based on the increased obligation of the taxpayer to cooperate (Section 115 para. 1 Federal Fiscal Code). However, the request of the tax authorities needs to be reasonable and must not take impossible, unreasonable or unnecessary measures.

In tax audits involving international transfer prices, these limits are not applied as restrictively as in cases that only concern national taxpayers. According to the federal administrative court, the increased obligation to cooperate results in an obligation to provide the tax authorities with the evidence that they request. In any event, limits to this obligation are given if legal obstacles exist, if the information is confidential, or if an official secretly bars the taxpayer from obtaining the requested information. Please note that foreign legal prohibitions to disclose information (i.e., according to the Swiss Criminal Law Act), which would result in a criminal prosecution in the event the taxpayer infringes such laws, do not release the taxpayer from the obligation to provide the information.

The tax authorities may also request the required information from other official bodies (such as the criminal courts) and the Austrian national bank. Such bodies are obliged to provide the requested information.

Individuals appearing as witnesses in the course of an assessment procedure may be bound by an obligation of secrecy, such as bank secrecy and the confidentiality privilege applicable to lawyers, tax consultants or CPAs, notaries public, medical doctors and similar individuals. As to bank secrecy, it should be noted that in domestic cases, tax authorities are entitled to request banking information, provided that: (i) tax authorities
have reasonable doubts about the accuracy of the taxpayer’s tax return; (ii) the request is adequate and proportionate; and (iii) the federal fiscal court (*Bundesfinanzgericht*) gives its consent to the disclosure. In cross-border cases, however, the aforementioned restrictions do not apply. Because of the Act on the Execution of Administrative Assistance (*Amtshilfedurchführungsge setz*), which is applied in connection with international rules covering the exchange of information (such as DTTs or the Council Directive 2011/16/EU on administrative cooperation in the field of taxation), banks have to provide the information requested by a foreign tax authority without any restrictions to be taken into account and without any previous court procedure (the taxpayer neither has the right to be heard nor to appeal against the information to be exchanged). As indicated above, legal representatives of the taxpayer (lawyers and/or tax consultants as well as CPAs or notaries public) may refuse to release evidence on facts about the taxpayer that they learned in their capacity as legal representative.

(b) Cross-border exchange of information

In the field of direct taxes, information may be exchanged based on the following legal regulations:

- DTTs (or other bilateral agreements such as the Austrian-German Agreement on Administrative Assistance)
- Tax information exchange agreements (TIEAs) (These are usually concluded bilaterally if a bilateral DTT has not been settled.)
- The Multilateral Convention on Mutual Administrative Assistance in Tax Matters (amended by the 2010 Protocol and also amended in 2016)
- As far as VAT is concerned, information exchanges are normally executed on the basis of Council Regulation (EC) No. 1798/2003 of
7 October 2003, amended on 7 October 2010 (Council Regulation No. 904/2010) on the administrative cooperation in the field of VAT.

Further, it shall be mentioned that in case the requested information is in the hands of an Austrian bank, additionally, the Act on the Execution of Administrative Assistance (Amtshilfedurchführungsgesetz) is applied (this act merely governs the practical procedure of the exchange of information).

Basically, three different types of cross-border exchanges of information are possible. These are: the exchange of information upon request; the (voluntary) spontaneous exchange of information; and the automatic exchange of information, which is especially required under Council Directive 2011/16/EU. Information is also exchanged in the course of a simultaneously performed tax audit or in case of a secondment of tax auditors.

Generally, the tax authorities submit a request for the submission of information to the competent authority, which in Austria is the Ministry of Finance. Information may be given only if there is a legal basis for it (see the examples given above). Please note that the exchange of information between some countries (for example, Austria and Germany) is very active.

The Austrian Ministry of Finance usually exchanges information upon request. As regards spontaneous exchanges of information, Austria is very reluctant to allow a comprehensive spontaneous information exchange. The requesting country normally submits a standardized request to provide certain information after a tax audit has been completed and Austria returns the filled-in request (Kontrollmitteilung).

Recently, the automatic exchange of information has gained major importance. This is not governed by DTTs but by a specific multilateral agreement as well as by Council Directive 2011/16/EU. This multilateral agreement, together with the Council Directive 2011/16/EU (as updated by Directive 2014/107/EU) set up the so-called Common Reporting Standard.
(CRS), which is — due to the Council Directive — mandatory for all Member States. Under the CRS, banking information is exchanged. Austrian banks have to report account holders and account balances to the Austrian Ministry of Finance, which subsequently undertakes the international exchange of information.

Most Austrian DTTs, as well as the Council Directive 2011/16/EU, have adopted the OECD-Standard 2005, which means that Austrian bank secrecy no longer offers protection to taxpayers (see Article 26 para. 5 OECD-Model Convention as updated in 2005). The Act on the Execution of Administrative Assistance (Amtshilfedurchführungsgesetz) governs the practical procedure of information exchange in case the information requested by foreign tax authorities is in the hands of an Austrian bank. Hence, Austrian bank secrecy has, de facto, been abolished vis-à-vis foreign tax authorities.

Also note that under the Council Directive 2011/16/EU, Member States are obliged to automatically exchange tax rulings with the EC Commission and other European Member States.

Currently, as matter of utmost importance, the EU-Meldepflichtgesetz (EU-MPfG), which transposes the Council Directive (EU) 2018/822 of 25 May 2018, amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements into national legislation, has to be taken into consideration. The new law entered into force on 1 July 2019 and obliges primarily the intermediary, but also in some circumstances the taxpayer itself, to report cross-border arrangements. An "intermediary" is basically any person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border arrangement. Such an arrangement is subject to registration if it presents an indication of a potential risk of tax avoidance, if it is designed to circumvent reporting under the Common Reporting Standard or if it is aimed at providing beneficial owners with the shelter of non-transparent
structures. Moreover, the arrangement has to fall under § 5 or § 6 EU-MPfG. These paragraphs differentiate between arrangements, which are only notifiable in case of fulfilling a certain condition and those which have to be reported unconditionally. The condition laid out in § 6 EU-MPfG is met whenever, in light of all the relevant circumstances, one of the main benefits that a person can expect is obtaining a "fiscal advantage." Eventually these arrangements must be implemented between 25 June 2018 and 30 June 2020 or be implemented, designed, marketed, organized or made available for implementation after 1 July 2020. The competent authority to report to is the Minister of Finance or their authorized representative. The penalty for a violation of the obligations mentioned in the EU-MPfG occurs in the form of a fine of up to EUR 25,000 in case of negligence or even up to EUR 50,000 in case of intent.

8. Multijurisdictional tax audits

(a) Simultaneous tax audits

The simultaneous performance of tax audits in different jurisdictions is a specific form of administrative assistance, which also provides for an exchange of information between the tax authorities of the countries involved. In the event of a multijurisdictional tax audit, information is often exchanged spontaneously, which requires a spontaneous exchange of information to be admissible (whether a spontaneous exchange of information is admissible on the basis of a DTT is subject to discussions; due to Article 9 – admissible on the basis of the Council Directive 2011/16/EU).

According to the definition of the OECD, a tax audit simultaneously performed in different countries is an agreement between the involved countries to audit at the same time, yet independently, either the same taxpayer or different taxpayers in which the tax authorities of the

22 See, for example, Schwandtner/Urtz in Aigner/Kofler/Tumpel (editors), DBA-Kommentar (2016) Article 26 No. 234.
countries involved are interested in order to exchange information gained. The Austrian tax authorities perform such audits only based on specific bilateral agreements. The Council Directive 2011/16/EU explicitly provides for simultaneous tax audits, therein referred to as "Simultaneous Controls" (Article 12).

The main targets of such tax audits are parent companies and their foreign subsidiaries, or other related parties and permanent establishments. The focus of the audits is on transfer prices and the use of tax havens and harmful tax structures. Especially in transfer pricing matters, the Austrian tax authorities routinely try to initiate cross-border audits. Some countries, such as the UK, are open to such procedure. Others, like Switzerland, tend to decline this offer. Recent years have shown that Austrian tax authorities have become more aggressive in conducting their audits and this should be taken into consideration by taxpayers that face such an audit.

(b) Secondment of auditors

Tax auditors will more frequently be seconded to foreign tax administrations to participate in a tax audit performed there, mostly in cases of simultaneous tax audits. This procedure is formally based on existing DTTs and the Council Directive 2011/16/EU (see Article 11).

If foreign tax auditors participate in a tax audit on Austrian territory, the Austrian tax authorities require — even within the scope of the Council Directive 2011/16/EU, that is, in the case of tax officials from Member States — a bilateral agreement. Further, the Austrian tax administration does not tolerate a foreign tax auditor’s active participation in the tax audit, but allows it only to passively gain information. The seconded tax auditor may, however, pose questions to the performing tax auditor, who may then raise them in the course of the tax audit. In this respect, it is advisable to have a local advisor on-site, observing the role of the foreign tax auditor. In the event the seconded tax auditor oversteps their

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23 OECD, Tax information Exchange, No. 86.
authority, the taxpayer has the right to object. We advise that this objection be recorded by the competent auditor in writing. This could be entered in a possible appeal to the court as an infringement of procedural provisions.

9. Burden of proof

The rules of the Federal Fiscal Code (Bundesabgabenordnung) do not explicitly address the burden of proof. However, these rules are unanimously understood in a way that — as a matter of principle — the burden of proof lies with the party claiming a fact to its benefit. The tax authorities, therefore, have the burden of proof with regard to facts leading to an increase in the taxable income, while the taxpayer has the burden of proof in regard to facts resulting in a decrease of taxable income or in those cases where the taxpayer intends to refute a legal presumption.\(^{24}\) It should be noted that this principle is applicable only if the taxpayer complies with the general or increased obligation to cooperate and to provide sufficient documents. If the tax authorities, for example, request further documents to support the tax deductibility of expenses claimed by the taxpayer, the tax authorities may refuse to recognize the expense if the taxpayer does not comply with this request, provided that it is reasonable and the taxpayer is legally or physically able to comply with it. As a general rule, each party — be it the taxpayer or the tax office — is required to provide facts or evidence supporting their claim.

In this respect, it should be noted that books and records diligently kept in accordance with the law are deemed to be correct, and that the tax authorities need to prove the incorrectness of such documents.\(^{25}\) It is thus very important to maintain proper books and records in order to shift the burden of proof to the tax authorities.

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\(^{25}\) Section 163 of the Federal Fiscal Code.
A clear provision concerning burden of proof exists where a fiscal criminal procedure is initiated, in which the taxpayer is alleged to have committed intentional or negligent tax fraud. In this event, an ordinary criminal procedure before a criminal court (or the tax authorities, depending on the severity of the deed) will be initiated, and the tax authorities will have to prove that the taxpayer has acted as alleged.

10. Potential consequences

(a) Adjustment of income

According to the law, the Austrian tax authorities are able to adjust the income declared by the taxpayer and thus assess a higher income as the tax base.\(^{26}\) This occurs, for example, if the tax authorities apply the "substance over form" principle and thus apply a qualification of a transaction that differs from that of the taxpayer, or if a transaction among related parties does not comply with the arm’s-length principle.

(b) Estimate

If the tax authorities are not able to assess the tax base (for example, due to incomplete documents or for other reasons), the taxable income may be estimated subject to certain limitations.\(^ {27}\) A typical example for such an estimate is the setting of transfer prices.

Further, the tax base may also be estimated if the taxpayer does not comply with its — normal or increased — obligation to cooperate and is not able to provide sufficient proof for a certain expense. Problems will almost inevitably arise whenever the tax base is estimated. Although the taxpayer is sure to be heard prior to the assessment of the tax base by way of estimate, this always bears a certain degree of unpredictability.

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\(^{26}\) Section 163 of the Federal Fiscal Code.

\(^{27}\) Section 184 of the Federal Fiscal Code.
(c) Substance over form

The re-qualification of transactions to the disadvantage of the taxpayer is common practice in Austria. This "substance over form" doctrine provides that the commercial purpose of the transaction is generally decisive for the qualification of the transaction for tax law purposes and that tax laws cannot be circumvented by virtue of a misuse of concepts of the law. In the case of any such misuse, the tax arises as it would have arisen had the form been in line with the substance.\(^{28}\)

11. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

Many issues brought up in an audit tend to be resolved by discussion and settled amicably. "Bargaining" — meaning that both parties, the taxpayer as well as the tax authorities, at least partly waive their claims — is officially inadmissible (as the taxes payable have to be assessed strictly according to the law), but de facto happens quite often. The taxpayer’s rights should, of course, always be observed where possible and appropriate and certainly not neglected just for the sake of a good atmosphere. Misconduct on the part of the auditor or the infringement of the taxpayer’s rights — which, however, happens not very often — need not be tolerated.

A specific form of cooperation was introduced in Austria in 2018 (being effective as of 1 January 2019): Upon the taxpayer’s request, an enterprise may opt for a "horizontal monitoring" procedure (Begleitende Kontrolle; see Section 148 paras 3a and 153a to 153g Federal Fiscal Code (Bundesabgabenordnung)). The participation in such "horizontal monitoring" procedure is only available upon request and under certain conditions: the participating enterprise has to have generated annual gross sales exceeding EUR 40 million (in the last two years before the request), and the taxpayer running the enterprise has to be credible under tax laws.\(^{28}\)

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\(^{28}\) Sections 21, 22 of the Federal Fiscal Code.
aspects (which, among other things, means that the taxpayer must not have been sentenced for a tax crime in the last five years before the request; further, "a tax control system" needs to be established). Participation in "horizontal monitoring" means that auditors are present at the enterprises' premises on a day-to-day basis in order to discuss tax issues with the taxpayer and answer their questions. In return, the taxpayer has an enhanced obligation to cooperate (*erhöhte Mitwirkungspflicht*). Participation in a "horizontal monitoring" procedure has the legal consequence that an ordinary tax audit must not take place; in other words, the taxpayer — who is, anyway, monitored — is exempt from a tax audit (however, before participating in the "horizontal monitoring" procedure, a tax audit covering the last five years before the request is required as another prerequisite to prove the taxpayer's credibility).

(b) Settlement or litigation?

As already mentioned, many tax disputes may be settled during an audit. Once an issue has been raised — and settled — in the course of a tax audit, the taxpayer may wish to enter into an agreement about future tax treatment. The legal basis for such an agreement — in the form of a ruling, legally binding for the taxpayer and the local tax office — is Section 118 of the Federal Fiscal Act (*Bundesabgabenordnung*), which — until 31 December 2018 — only applied in certain cases, such as restructurings, group taxation issues and transfer pricing issues. Since 31 December 2018, such ruling procedure has been extended to "international taxation issues" (including transfer pricing issues), VAT issues and potential cases of tax abuse. Further, an agreement — which could also be an advanced pricing agreement — may be based on Article 25 of the OECD Model Convention (Article 25 may be applied even if taxation not being in accordance with the provisions of the DTT has not yet occurred). 29

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Baker McKenzie
If the taxpayer is considering litigating the issue at stake, it should be aware that it might be a time-consuming and costly task (costs to be taken into account are consultant’s costs for the taxpayer, as every party has to bear its own costs. A formal reimbursement of costs, however, does not exist, which means that the taxpayer on the one hand is not reimbursed for its consultant’s costs if it wins the case, but on the other hand is not obliged to reimburse the costs for the tax administration if it loses the case). However, in certain situations, it definitely might be worthwhile to bring the issue to court. In the following events, litigation either should be seriously considered or cannot be avoided:

- If a settlement at court level is expected to be more favorable than at the administrative level (this is especially the case if Tax Authority Guidelines (as issued by the Ministry of Finance) are disadvantageous in the case at hand and the federal financial court is expected to overrule them)

- If questions of fundamental importance for the taxpayer or for the tax administration are at stake

- If certain practices may be, or have been, qualified by tax officials as tax evasion

- If constitutional or EU law issues are at stake, especially if EC fundamental freedoms are violated (i.e., if favorable case law of the CJEU binding the Austrian courts and sustaining the position of the taxpayer is available), or EC directives have not been implemented into domestic law in a timely manner

12. Conversion of a regular tax audit into a criminal investigation

Every audit report established in the course of a regular audit will automatically be examined to determine whether indications of a criminal deed can be discovered. This examination, however, does not lie in the hands of the tax officials entrusted with the audit, but in the hands of
special law enforcement units within the Austrian tax administration. If officials working for these units are of the opinion that there is sufficient evidence that a criminal act has been perpetrated, they will either order a tax audit according to Section 99 para. 2 of the Fiscal Criminal Act or initiate criminal law proceedings. Such proceedings are either pursued by the tax administration or by the criminal prosecutor (Staatsanwalt) before a criminal court (the criminal courts become competent only if the evaded taxes exceed a threshold amount of EUR 100,000 and if the tax crime (i.e., tax fraud) has been committed intentionally).

In any event, the taxpayer should remember that the tax audit is a means of gathering evidence that may be used not only for potential tax adjustments, but, if the facts warrant, for potential criminal proceedings. While the overall response of taxpayers during a tax audit is usually a cooperative one, the taxpayer nevertheless is well advised to insist on its fundamental rights, which are further discussed below.

(a) Taxpayer’s right to notice

As the taxpayer’s rights and obligations in a tax audit that is examining criminal actions differ from those in a regular tax audit, the taxpayer has to be notified immediately after criminal prosecution (meaning the shift to the criminal tax audit, according to the Fiscal Criminal Act) has been initiated.

(b) Seizure of documents

Seizure of documents is only admissible in the course of criminal proceedings (if such seizure was exercised during an ordinary tax procedure, the taxpayer would have a specific remedy against it; for details see Section 283 of the Federal Fiscal Code). If the tax auditor exercises its right to seize the originals of the documents it deems relevant, the taxpayer should insist on the impoundment of the documents by the tax auditor in the taxpayer’s premises (a room, a closet, etc.) as opposed to the release of the same.
Generally, seized documents are to be stored with the tax authorities, but it will be up to the discretion of the tax authorities to leave the documents with the taxpayer if impoundment in the premises of the tax authorities triggers difficulties.\textsuperscript{30} In order to preserve the taxpayer’s rights, the documents the auditor wants to remove from the premises should not be surrendered voluntarily, and the taxpayer should insist on its legal right to receive an exact listing of any documents taken.\textsuperscript{31}

(c) Right to counsel

In a criminal investigation, the company’s tax counselor (a tax consultant or a CPA) and/or lawyer should be notified immediately. The taxpayer has the right to have representation during the investigation, which should not start prior to the arrival of the chosen counsel.

(d) Unnecessary admissions

In a criminal tax investigation, it is advisable to keep statements to the tax auditor to a minimum when counsel is not present. Counsel will ascertain the issues in which the tax auditor is interested and thereby contain the scope of the audit. A tax auditor can be expected to attempt to elicit incriminating statements from the taxpayer, particularly if the taxpayer volunteers information in the absence of their counsel.

(e) Panicked reactions

Panicked reactions, such as taking trips abroad or emptying bank accounts, may — in criminal law proceedings before a criminal court — be grounds for arrest, and should, therefore, be avoided.

(f) Limitations on the auditor’s power

If a tax auditor requests information or urges the taxpayer to waive its right to appeal in exchange for favorable treatment by the criminal

\textsuperscript{30} Section 90 of the Fiscal Criminal Act.
\textsuperscript{31} Section 91 of the Fiscal Criminal Act.
prosecutor or the criminal court, the taxpayer should become suspicious, as the tax auditor has no influence on the criminal charge. Criminal prosecution lies either in the hands of special law enforcement units within the Austrian tax administration or in the hands of the criminal prosecutor (Staatsanwalt).
II. Resolution procedures

1. Administrative level

(a) During audit

During a tax audit, the auditor usually seeks to discuss the issues at stake with the taxpayer and the counsel. Thus, a number of meetings will take place in order to discuss or, if possible, resolve issues of importance that have arisen prior to the final meeting. The final – mandatory – meeting is scheduled prior to the close of the tax audit for the purpose of a final discussion of problems, and, of course, for negotiations (bargaining) between the auditor and the taxpayer. If the parties have already reached an agreement or if the tax audit did not result in the adjustment of the income, the parties may also waive the right to hold the final meeting.

The settlement of problems or disputes between the auditor and the taxpayer through negotiations is routine. During such negotiations, bargaining is quite common. The outcome of such negotiations is de facto binding, but not de jure. Since a tax assessment has to be always strictly in accordance with the law, it is de jure in that it is not admissible to enter into a binding agreement with the tax administration (except from certain cases – among them transfer pricing issues – which allow a binding ruling due to Section 118 Federal Fiscal Code).

Normally, if the parties come to an agreement, the tax auditors urge the taxpayer to waive its right to appeal. If the taxpayer does so, it should be aware that such a waiver means not only that it may not challenge the findings of the tax audit, but also that this may have an impact if a criminal procedure is initiated. In this event, the factual statements contained in the audit report may not be contested. In addition, a waiver is valid only if the taxpayer has been given advance notification in writing of the exact amount of the tax due.
It should also be noted that the application to initiate competent authority proceedings – based on Article 25 of the OECD Model Convention – where a cross-border context is involved is always possible, in addition to domestic litigation of the pending tax audit. It is recommended that such competent authority proceedings begin prior to the final assessment of the tax audit or during the domestic litigation, as the countries involved may come to a solution before the assessment becomes final. That way, certain domestic formalities relating to the procedure for revoking an assessment after it has become final may be avoided.

(b) After the release of tax assessment notices

The tax authorities will issue a formal assessment based on the audit report. Unless the taxpayer files an appeal within the appeal period, a tax assessment is deemed to be final after the lapse of one month following the taxpayer’s receipt of the assessment notice.32 "Final" means that, as a matter of principle, the assessment is no longer subject to appeal or change.

The appeal has to be filed with the tax authorities that issued the final assessment.33 Filing the appeal with the federal fiscal court will be considered a timely appeal if filed within the deadline. There will be no difference in the results whether the appeal is filed with the tax authorities or with the federal fiscal court. The local tax office (Finanzamt), having issued the initial assessment, is required to decide on the appeal (the so-called pre-decision (Beschwerdevorentscheidung)). Only after a second appeal against the pre-decision (Vorlageantrag), does the federal fiscal court become competent. The decision of the federal fiscal court may be challenged in court if it is unfavorable to the taxpayer. The tax authorities have to decide on the appeal within six months.34 If this period is

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32 Section 243 of the Federal Fiscal Code.
33 Section 249 of the Federal Fiscal Code.
34 Section 284 of the Federal Fiscal Code.
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exceeded, the taxpayer may apply for the federal fiscal court to decide on the issue (Säumnisbeschwerde).

If the tax authorities do not render a decision within the legally set period and if this delay leads to damages on the part of the taxpayer, the taxpayer may file a claim for damages against the tax authorities. 35

2. Tax dispute resolution mechanisms in the European Union

Recently the Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union has been transformed into national law. The EU-Besteuerungsstreitbeilegungsgesetz (EU-BStbG) and its accompanying provisions, e.g., in the Federal Fiscal Code, entered into force on 1 September 2019 and laid down rules on a mechanism to resolve disputes between two or more Member States. Said law is applicable to any complaint submitted relating to questions of dispute in regards to income or capital earned in a tax year commencing on or after 1 January 2018. The aim is to achieve effective resolutions of such disputes in all cases in a timely manner.

The above-mentioned mechanism contains a two-step procedure for dispute resolutions regarding the interpretation and the implementation of double tax treaties as well as of the convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC).

The proceedings are initiated by the taxpayer filing a complaint. After the tax authorities have declared the complaint as admissible, the inter-administrative two-stage procedure begins. The mutual agreement procedure (MAP) starts as the first step of the process, in which the competent authorities try to find a resolution for the so-called question in dispute. If a solution cannot be reached, the affected person has to be informed. At that time, the second step of the procedure kicks in, in which

35 “Amtshaftungsklage” according to the Amtshaftungsgesetz - Act on official liability.
the affected person is given the right to apply for the establishment of an arbitral tribunal. This Advisory Commission is obliged to provide an independent opinion on how to resolve the dispute. As an alternative to the Advisory Commission, an Alternative Dispute Resolution Commission can be set up. This commission also has to deliver an opinion on how to resolve the question in dispute.

Six months after the deliverance of the independent opinion of the Advisory Commission or the opinion of the Alternative Dispute Resolution Commission the Austrian competent authorities have to come to an agreement with the other competent authorities whether the question in dispute shall be resolved in accordance with the opinion or not. If they cannot find a consensus in due time, the opinion becomes binding.

The solution is referred to as final decision and has to be sent to the affected person within 30 days. Within the following 60 days, the affected person has to declare their consent, a waiver of certain remedies and make a statement concerning the publication of the final decision. Eventually, if these requirements are met, the final decision will be placed in a declaratory decision and implemented.

3. Judicial tax litigation

(a) Federal fiscal court

As previously mentioned, the federal fiscal court is generally the competent body with which to file an appeal against a final assessment resulting from a tax audit. Such an appeal has to be filed within one month; however, this appeal period can be extended by the competent tax office in case the taxpayer has "sound reasons" for such extension. The Federal Fiscal Code (*Bundesabgabenordnung*) requires the competent local tax office (*Finanzamt*), which issued the initial assessment to render a so-called pre-decision (*Beschwerdevorentscheidung*), in which it either revokes or confirms the initial assessment. After the tax office has rendered such a pre-decision on the appeal, the taxpayer may either accept it (if it is
favorable to it) or may request that the appeal be submitted to the federal fiscal court. As Austria does not have a principle stating that assessments may not be altered to the disadvantage of the taxpayer, the latter option will be chosen in cases where the taxpayer does not expect the court’s decision to be more disadvantageous compared to the tax office’s pre-decision. If this risk is too high, the filing of an appeal should be subject to careful consideration.

The request to submit the appeal to the federal fiscal court (Vorlageantrag) needs to be filed within one month after the taxpayer receives the pre-decision from the tax authorities. As a result of said appeal (Vorlageantrag), the tax office is obliged to forward the case to the federal fiscal court as well as to file a report on the case (Vorlagebericht) within a period of two months. If the tax office violates this obligation, the taxpayer may file a reminder thereof (Vorlageerinnerung), which will have the effect that the federal fiscal court automatically becomes competent. The federal fiscal court will schedule a hearing upon the taxpayer’s written request or if the federal fiscal court deems it necessary. The federal fiscal court will find the facts de novo and may also change the decision to the disadvantage of the taxpayer. In this procedure, each party has to bear its own costs, so that no additional costs will be imposed on the taxpayer, aside from the fees of its consultant.

(b) Federal administrative court

If the appeal of the taxpayer does not lead to the desired outcome, the taxpayer may challenge the decision of the federal fiscal court by filing an administrative appeal with the federal administrative court (Verwaltungsgerichtshof). This administrative appeal is admissible only if the taxpayer has gone through all prior steps. Gaining direct access to the federal administrative court, thus avoiding the setting of the procedure before the federal fiscal court, is not admissible. This appeal needs to be filed within a period of six weeks and the taxpayer needs to be represented by a lawyer, a (certified) tax consultant or a CPA. It may bring
forward the illegality of the decision of the federal fiscal court due to its content or due to an infringement of the formal procedure. However, facts are not to be de novo at this level. In the event the taxpayer is not successful in an administrative appeal, it will bear the costs of the tax authorities as well as any associated court fees (these costs, however, should not exceed a few hundred euros). Aside from this, an administrative appeal can be a rather lengthy procedure and may last a couple of years.

(c) Constitutional court

In addition to appealing a decision from the federal fiscal court to the federal administrative court, the taxpayer may also appeal to the constitutional court if it believes that its constitutional rights have been violated. This appeal is admissible only if the taxpayer has gone through all of the previous steps. Gaining direct access to the constitutional court, avoiding the procedure before the federal fiscal court, is not possible. The appeal needs to be filed within a period of six weeks, but it may be filed in parallel to the appeal to the federal administrative court.

Further, the taxpayer must be represented by a lawyer. Representation by a certified tax consultant or a CPA is not admissible. The taxpayer may appeal against the decision rendered by the federal fiscal court (Article 144 Constitutional Act).

The main purpose of such an appeal is usually to fight legal provisions not in accordance with the Austrian constitution. If the constitutional court has
reservations that either a provision of statutory law or an administrative regulation might violate the constitution, it commences specific procedures:

- A legal audit of the statutory provision applied (Gesetzesprüfungsverfahren), Article 140 of the Constitutional Act
- A legal audit of the administrative regulation applied (Verordnungsprüfungsverfahren), Article 139 of the Constitutional Act

The constitutional court generally decides following a hearing. The taxpayer should be aware, however, that either procedure before the constitutional court is very time consuming; proceedings can be expected to last from one to three years.

In the event a third taxpayer has initiated a legal audit of the administrative regulation applied before the constitutional court and if this administrative regulation also concerns the first taxpayer, the first taxpayer should also appeal to the constitutional court prior to the first public hearing to be held in the course of the other appeal. The taxpayer will benefit only from a positive decision of the constitutional court (Anlassfall) if the first taxpayer files a timely appeal.

In the event a third taxpayer has initiated a legal audit of the administrative regulation applied before the constitutional court and if this administrative regulation also concerns the first taxpayer, the first taxpayer should also appeal to the constitutional court prior to the first public hearing to be held in the course of the other appeal. The taxpayer will benefit only from a positive decision of the constitutional court (Anlassfall) if the first taxpayer files a timely appeal.

(d) Court of Justice of the European Union

If the taxpayer believes that the applied statutory provision violates EC law, it may request that the court submit a request for a preliminary ruling to the CJEU.
The constitutional court (under certain conditions) and the federal administrative court are obligated to file such a request with the CJEU, unless the CJEU has already rendered a decision in a case of a similar nature. If it has, based on that decision, the decision in the case at hand would be clear (*acte claire*). The federal fiscal court is not obliged to, but is allowed to file such a request, which it frequently does.

If a court (e.g., the federal fiscal court or federal administrative court) submits a request for a preliminary ruling to the CJEU, the domestic procedure is suspended for the duration of the CJEU procedure. The assessment will therefore not become final until the domestic court has ruled on the basis of the CJEU decision. In the event the CJEU has to decide on the conformity of a domestic provision with EC law, the CJEU decision has *ex tunc* effect. This means that it generally has retroactive effect with regard to the date the provision in question was enacted unless the CJEU states otherwise in its decision. The CJEU decision will thus generally also have an effect on final assessments. The tax authorities may revoke a final assessment due to a change in the case law at their sole discretion and within the periods provided in the Federal Fiscal Act. For this reason, it is advisable to file an appeal against the assessment if a procedure involving the same issue is pending before the CJEU. This way, the commencement of the period mentioned above will be avoided. Please also note that a CJEU decision is not a valid reason to grant a *restitutio in integrum*.

If the Austrian legislator has not implemented an EC directive in a timely manner or at all, the Republic of Austria must pay compensation for damages. The taxpayer may thus also claim compensation for damages in the event the damage results from the omitted or delayed implementation of an EC directive.
4. Miscellaneous matters: payment of tax

Once the tax authorities have issued the final tax assessment, taxes are normally due and payable within one month after receipt of the notice by the taxpayer or on the date determined by the tax office. Except as discussed below, these taxes must be paid even if an appeal is filed against the assessment. To avoid the payment of taxes once an appeal has been filed, the taxpayer has the right to request suspension of the execution of the payment demand from the tax office. This request must not be submitted prior to filing the appeal, as in this event, the tax authorities would immediately dismiss it.

Granting the suspension of execution is at the discretion of the tax authorities and, according to the law, it may be granted only if the appeal has a certain prospect of success. As a rule of thumb, however, if the final assessment leads to an additional payment that has deviated from the tax return and an appeal has been filed, the request will most likely be granted. The taxpayer should bear in mind that a suspension of execution will trigger interest of 2% above the applicable base rate in the event the appeal is rejected. There will be no further penalties imposed for late payment. The application may be filed either with the federal fiscal court or with the tax authority issuing the assessment, but only the latter may decide on it.
III. Competent authority

To prevent double taxation resulting from changes in income allocation effected either by Austrian or by non-Austrian tax authorities, the Austrian DTTs in place provide for competent authority proceedings that the taxpayer is entitled to apply for. The wording of the respective provisions is, in most cases, similar to Article 25 of the OECD Model Convention. As far as the EU is concerned, double taxation issues can be addressed on the basis of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, ratified by Austria on 1 January 1996.\textsuperscript{36}

The Austrian taxpayer has a great deal of flexibility, as the request to initiate competent authority proceedings may already be filed even if there is only the mere possibility of double taxation.\textsuperscript{37} It is therefore not necessary for the alleged double taxation to have already occurred, nor is it necessary for the taxpayer to have already filed an appeal in Austria. The taxpayer may very well request the initiation of competent authority proceedings prior to filing an appeal, especially since the countries involved are not forced by law to come to an agreement and the proceedings may take several years. For these reasons, it would be advisable in most instances to simultaneously file a domestic appeal against the decision.

Generally, the taxpayer needs to file its request within three years after it has been notified of the action that led to taxation not complying with the DTT in place.\textsuperscript{38} The request needs to be filed with the Federal Ministry of Finance as the competent authority.

\textsuperscript{38} Some treaties provide shorter periods, for example (figures in brackets equal the years): Belgium (2); France (1, but not obligatory); Canada (2); Malta (3); and Portugal (2).
Prior to the opening of competent authority proceedings, the Austrian tax authorities will determine if, and to what extent, the taxpayer’s petition can be satisfied domestically (i.e., without involving the other states). If this is not possible, the Austrian Ministry of Finance will approach the competent authorities of the other country involved and initiate the competent authority proceedings, which are usually conducted in writing. If the competent authority proceedings fail, the Austrian tax authorities will examine whether double taxation may be avoided if it would otherwise cause hardship.39

In the event a procedure under the European Arbitration Convention is initiated, the parties to the procedure are obligated to reach an agreement within two years after the case is first submitted.40 The parties to the procedure are the same competent authorities as in the competent authority proceedings. If they fail to reach such an agreement, they must set up an advisory commission charged with delivering its opinion on the elimination of the double taxation in question.41 This commission will give its advice within six months, and the parties involved will have to come to an agreement within another six months. According to Article 14 of the convention, full avoidance of double taxation is granted.

39 This can be achieved based on Section 48 of the Federal Fiscal Code, among other things.
40 Article 6 of the Arbitration Convention.
41 Article 7 of the Arbitration Convention.
IV. International exchange of information

Basically, three different types of cross-border exchanges of information are possible. These are: the exchange of information upon request; the spontaneous exchange of information; and the automatic exchange of information. Information is also exchanged in the course of a simultaneously performed tax audit or the secondment of tax auditors.\(^4^2\)

The formal basis of the exchange of information is as follows:

- DTTs (or other bilateral agreements such as the Austrian-German Agreement on Administrative Assistance)
- Or TIEAs are usually concluded bilaterally if a bilateral DTT has not been concluded
- Or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (amended by the 2010 Protocol and also amended in 2016)

As far as VAT is concerned, information exchanges are normally executed on the basis of Council Regulation (EC) No. 1798/2003 of 7 October 2003, amended on 7 October 2010 (Council Regulation No. 904/2010) on the administrative cooperation in the field of VAT.

Further, it must be mentioned that if the requested information is in the hands of an Austrian bank, the Act on the Execution of Administrative Assistance (Amtshilfedurchführungsgesetz) is also applied (this act merely governs the practical procedure of the exchange of information).

\(^4^2\) As outlined under item 7.b below.
Generally, the tax authorities submit a request for the submission of information to the competent authority; in Austria, this is the Ministry of Finance. Information may be granted if it is in compliance with the above-mentioned legal provisions. The exchange of information between some countries (for example, Austria and Germany) is very active.

The Austrian Ministry of Finance usually exchanges information upon request. As regards the spontaneous exchange of information, Austria is very reluctant to allow a comprehensive spontaneous information exchange. The requesting country normally submits a standardized request to provide certain information after a tax audit has been completed and Austria returns the filled-in request (Kontrollmitteilung).

Recently, the automatic exchange of information has gained major importance. Such automatic exchange is not governed by DTTs but by a specific multilateral agreement as well as by Council Directive 2011/16/EU. This multilateral agreement together with Council Directive 2011/16/EU (as updated by Directive 2014/107/EU) set up the so-called CRS, which is — due to Council Directive — mandatory for all Member States. Under the CRS, banking information, specifically, is exchanged. Austrian banks have to report account holders and account balances to the Austrian Ministry of Finance, which subsequently undertakes the international exchange of information.

Most Austrian DTTs — as well as the Council Directive 2011/16/EU — have adopted the OECD-Standard 2005, which means that the Austrian bank secrecy concept no longer offers protection to taxpayers (see Article 26 para. 5 OECD-Model Convention as updated in 2005). The Act on the Execution of Administrative Assistance (Amtshilfendurchführungsgesetz) governs the practical procedure of the exchange of information in case the information requested by foreign tax authorities is in the hands of an Austrian bank.
Hence, Austrian bank secrecy has, de facto, been abolished vis-à-vis foreign tax authorities.

Also note that under Council Directive 2011/16/EU, Member States are obliged to automatically exchange tax rulings with the EC Commission and other European Member States.

Currently, as matter of utmost importance, the EU-Meldepflichtgesetz (EU-MPfg), which transposes the Council Directive (EU) 2018/822 of 25 May 2018 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements into national legislation, has to be taken into consideration (for details see Chapter 1.7.b).

According to the Austrian Federal Fiscal Code, the Austrian tax authorities may request certain information from third parties. However, this provision is to be considered a "last resort" that should be used only if the taxpayer themselves refuses or is unable to give the desired information to the tax authorities. According to this provision, the tax authorities may, for example, request certain documents from suppliers, customers or banks (account statements), or talk to individuals as witnesses. Should the auditor use information gained from a witness against the taxpayer, the taxpayer concerned may request disclosure of the name of this person. The Austrian tax authorities do not, however, use "secret comparables." However, this provision is to be considered a "last resort" that should be used only if the taxpayer themselves refuses or is unable to give the desired information to the tax authorities. According to this provision, the tax authorities may, for example, request certain documents from suppliers, customers or banks (account statements), or talk to individuals

43 Section 143 of the Federal Fiscal Code.
44 Section 165 of the Federal Fiscal Code.
46 Section 165 of the Federal Fiscal Code.
as witnesses. Should the auditor use information gained from a witness against the taxpayer, the taxpayer concerned may request disclosure of the name of this person. The Austrian tax authorities do not, however, use "secret comparables" in cases involving transfer pricing issues.

The tax authorities are also entitled to request documentation from the taxpayer that is stored abroad. This is frequently done in transfer pricing issues where, for example, the transfer pricing documentation is stored in a foreign-associated enterprise and the request is based on the increased obligation of the taxpayer to cooperate. However, the request of the tax authorities needs to be reasonable and may therefore not contain impossible, unreasonable or unnecessary measures. With regard to tax audits involving international transfer prices, these limits are not applied as restrictively as in cases only concerning national taxpayers.

According to the Federal Administrative Court, the increased obligation to cooperate results in an obligation to provide the tax authorities with the evidence that they have requested. In any event, limits to this obligation are given if legal obstacles exist, such as if the information is confidential, or if an official secretly bars the taxpayer from obtaining the requested information. Please note that foreign legal prohibitions to disclose information (i.e., according to the Swiss Criminal Law Act), which would result in a criminal prosecution in the event the taxpayer infringes such laws, do not release the taxpayer from the obligation to provide the information.

The tax authorities may also request the required information from other official bodies (such as the courts) and the Austrian national bank. These

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48 Expressly governed by Section 115 para. 1 of the Federal Fiscal Code.

49 See, for example, EAS 604 dated 27 March 1995, which has references to the prevailing case law of the Federal Administrative Court.

50 Federal Administrative Court Decision dated 8.4.1970, 1415/68.

51 Federal Administrative Court Decision dated 24.11.1987, 86/14/0098; 7.9.1990, 90/14/0089.
bodies are obligated to provide the requested information. In addition, a notary public acting as a state commissioner may not refuse to respond to an information request by invoking its professional secrecy obligation.

Individuals appearing as witnesses in the course of an assessment procedure may be bound by an obligation of secrecy and the duty of confidentiality applicable to lawyers, tax consultants or CPAs, as well as notaries public, medical doctors and similar individuals.\(^{52}\) In addition, legal representatives of the taxpayer (lawyers and/or tax consultants) may refuse to give evidence on facts about the taxpayer that they learned in their capacity as legal representatives.\(^{53}\) If a person appearing as a witness is not bound by such an obligation of secrecy, they are obligated to provide the tax authorities with all of the documents requested, including the commercial books.

\(^{52}\) Section 9 para. 2 of the Lawyer’s Act, Section 91 of the Tax Consultant’s and CPA’s Act, Section 37 of the Notary Public Act, Section 54 of the Medical Doctor’s Act.

\(^{53}\) Section 171 para. 2 of the Federal Fiscal Code.
Handling Tax Disputes in Belgium

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I. Managing the tax audit process

1. General

Income tax matters are handled by the Department of Direct Taxes (Administration des contributions directes). VAT, registration duties and other indirect taxes matters are managed by the Department of VAT, Registration and Properties (Administration de la TVA, de l'enregistrement et des domaines).

On 1 January 1996, the Department of Fiscal Affairs was created to draft legislation, provide commentaries on the Belgian Income Tax Code (ITC), oversee international affairs and address tax fraud issues.

A Royal Decree of 6 July 1997 created the Department of Enterprises and Income Taxation (AOIF or AFER), which took up its duties on 1 February 1998. This department is headed by the Central Tax Department and is structured per regional directorate, of which there are 15 for direct taxes. Each region is headed by a director who not only has administrative duties, but also handles tax litigations. Each department has a number of tax inspectors, some of whom are responsible for the application of the law in a certain area or for a certain class of taxpayers, as well as for assisting the local control offices in more difficult matters. Other inspectors handle tax complaints. At the local level are control offices, which conduct routine tax audits of enterprises and are headed by a chief inspector. Additionally, there are 49 audit centers that perform income and VAT tax audits of companies and self-employed persons.

In 2006, a specialized transfer pricing department, which focuses on carrying out transfer pricing audits of multinationals active in Belgium and which serves as a knowledge center to local tax inspectors in respect of transfer pricing, was created within the AOIF/AFER. Since its establishment, the department has carried out many audits of Belgian subsidiaries and branches of multinational companies.
The Royal Decree of 9 December 2009 provides for a new organizational structure of the Federal Public Service of Finance, as a result of which, among other things, the AOIF/AFER was renamed the General Department of Taxation. Additionally, this department has been divided into three "taxpayer-oriented" departments: individuals, SMEs and large enterprises.

In more complex cases or cases of fraud, the AOIF/AFER is assisted by the Special Tax Investigation Department (BBI or ISI). This administrative body can become involved in an audit, either on its own initiative or through a referral from the competent tax inspector.

2. Tax audits — selection of tax audit targets

Since 1998, the idea has been that a thorough tax audit by an AOIF/AFER audit center would take place, as a rule, every six years and that in the interim, a simple tax audit by the normal tax control offices would take place. This policy, however, is not consistently implemented.

For a couple of years now, the tax authorities have been relying on data mining to select which taxpayers should be subject to a tax audit.

With data mining, the data available within the tax departments is used in a mathematical model that can be applied to all or certain groups of Belgian taxpayers. Data mining should enable the tax authorities to detect taxpayers with a higher tax risk profile and, therefore, determine which taxpayers should be audited.

Data mining makes it possible to establish a correlation between substantial amounts of data in order to obtain more significant data. Especially in VAT matters, data mining has made it possible to establish a correlation between VAT fraud perceived by VAT authorities in the past and certain characteristics of the tax behavior of the VAT payers.

For obvious reasons, the tax authorities do not disclose which behavioral characteristics are used within their mathematical model.
3. Advance preparation for tax audits

An audit normally starts with a review of the tax return and its attachments, followed by a tax questionnaire addressed to the taxpayer. As a rule, the taxpayer has one month to answer the questionnaire, but one can request an extension of this period if needed. The tax authorities generally grant an extension unless there is a risk that their claim(s) will become statute-barred.

After reviewing the answers to the tax questionnaire, a tax auditor may request a visit to the taxpayer, during which the auditor asks follow-up questions or requests additional documentation. Usually, the tax authorities informally notify the taxpayer that they intend to conduct an audit, and they agree with the taxpayer on the date of their first visit and inform the taxpayer about the scope of their audit.

Regardless of the above, there has been a recent surge in tax dawn raids, meaning that the tax authorities (generally the STI Department) carry out an unannounced visit at the taxpayer’s premises, during which they interview employees and/or directors, take a copy of the server and/or email boxes and take away hardcopy documents.

Properly conducted preparation with respect to tax audits should include the following:

- Collection of the financial statements for the years under audit and all related invoices, as well as all agreements in effect during those years. Information requests that cannot be honored promptly or completely might raise suspicion and trigger additional requests for information and for visits.

- Discussion with the taxpayer’s counsel of potential "hot topics" such as aggressive tax planning done in the past, mistakes in returns filed for years under audit that have not yet been corrected, or issues that could qualify as tax fraud.
• Discussion with the taxpayer’s counsel about strategic considerations during the audit

• Designation of contact persons: Contact with the tax auditor should be limited, if possible, to one or two local company accountants and one local manager with knowledge of the business and its operations. Where group transactions with an international dimension have become a material issue, it might be advisable to schedule one or more meetings with a foreign tax officer at group level who knows the transfer pricing policy of the group.

• Designation of a workplace for the tax auditor: If the tax auditor is reviewing documents or interviewing personnel at the place of business, a separate room should be designated for the auditor’s use. While at the business site, the tax auditor may attempt to mingle and converse with personnel other than the designated managers, and the taxpayer should ensure that employees refrain from facilitating this type of informal information gathering.

• Setting up copying and documentation procedures: The copying of any document should not be done by the tax auditor, but by a designated employee of the taxpayer, so that an exact duplicate of all documents taken by the tax auditor can be retained by the taxpayer.

4. Limitations period for assessments

For Belgian income tax purposes, the period of reference is the assessment year. For calendar year taxpayers, the assessment year is the year following the calendar year; for non-calendar year taxpayers, the assessment year is the calendar year in which the accounting year ends.

The normal assessment period is three years from 1 January of the assessment year (“three-year period”). That deadline is extended by four years in the event of fraud (“seven-year period”). In certain specific cases, the statute of limitations for assessing income tax can be longer (e.g., in
criminal investigations or in exchanges of information by foreign tax authorities). If Belgian tax authorities obtain information from a foreign country in the framework of a bilateral or multilateral tax treaty or an EU Directive or Regulation, which indicates that taxable income in Belgium has not been reported in one of the five years (seven years in the case of tax fraud) preceding the year during which such information was notified to the Belgian tax authorities, Belgian tax authorities have 24 months as of such notification to issue an additional tax assessment. An additional 12-month assessment period is granted with respect to Belgian taxes resulting from a transfer pricing adjustment made on the basis of the European Tax Arbitration Convention or on the basis of the mutual agreement procedure (MAP) in a tax treaty.

Tax audits may be conducted within the three-year period without any specific justification. Tax audits may also be carried out within the seven-year period, provided either that the tax authorities state in writing, prior to the audit, the indications of fraud that they have found, or that the audit is carried out following information provided by another state with which Belgium has concluded a legal instrument that provides for the exchange of information regarding tax matters. If an audit is conducted at the very end of the three-year period or the seven-year period, the tax authorities will probably not have sufficient time to issue a tax assessment before the end of such periods, taking into account that the tax authorities must serve the taxpayer a "notice of amendment of the tax return" one month prior to their assessment of the tax. The taxpayer must reply within that one-month period, and if the tax authorities do not accept the taxpayer’s arguments, they have to communicate their reasons in writing before conducting the tax assessment.
5. Areas of tax auditors’ special attention

(a) Procedure and form

(i) Financials and accounting

Books and records, as well as related accounts and vouchers, must be maintained for income tax purposes until the end of the seventh accounting period following the tax year to which they relate. The same obligation also exists for accounting and VAT purposes.

The Law of 1 July 2016 adopted formal mandatory requirements regarding transfer pricing documentation to be prepared and filed, based on the minimum standard identified by the OECD under BEPS Action 13 on Transfer Pricing Documentation and Country-by-Country Reporting. These transfer pricing documentation requirements follow a three-tier approach.

The first tier consists of a master file, to be filed by each Belgian group entity that exceeds, during the penultimate closed financial year, one of the following criteria: (i) EUR 50 million operational and financial income (excluding non-recurrent income); (ii) EUR 1 billion balance sheet total; or (iii) an annual average of 100 FTE. The master file includes information relevant to the entire group, such as the nature of the business activities, the value creation of the group entities, the intangibles, etc., and will have to be filed within a period of 12 months after the closing of the group’s reporting period.

The second tier consists of a local file, which must be filed by the same Belgian group entities, together with their corporate income tax return. The local file consists of a general part containing information about the local Belgian group entity and a detailed part for each division/business unit that has intra-group transactions exceeding EUR 1 million, and must contain a transfer pricing analysis of the intercompany transactions, a benchmarking study, etc.
The third tier concerns the CbC report, which should contain information with respect to revenue, income tax paid, paid-up capital, number of employees, etc. The CbC report has to be filed within 12 months after the closing of the consolidated financial statements of the group by the ultimate Belgian parent companies of multinational groups with gross operational, financial and other revenue of EUR 750 million or more during the penultimate closed reporting period (or by Belgian group entities under certain specific circumstances).

On 2 December 2016, three royal decrees and an announcement were published, which contain the official transfer pricing documentation forms and filing instructions (i.e., Forms 275.MF, 275.LF, 275.CBC and 275.CBC NOT).

Even before the adoption of the Law of 1 July 2016, it was standard practice during an intercompany pricing audit for the tax authorities to request that the taxpayer provide copies of all relevant documentation to support the transfer price, including contracts, invoices, vouchers and other supporting documentation (see circular letter of 28 June 1999 (“Circular Letter”)).

The general approach taken by the tax auditor is to review the accuracy of the taxpayer’s tax returns on the basis of the taxpayer’s relevant books and records. Belgian corporate income tax is based, in the first instance, on the comparison of the balance sheet at the end of the year and the previous year’s balance sheet.

The profit and loss account will be thoroughly audited. Expenses, depreciations, provisions and any extraordinary results accounts are areas that will draw the tax auditor’s special attention.

Tax auditors have the right to review, and therefore to request and have access to, the documents they may consider relevant. The tax auditors may also request that additional information they deem helpful or necessary be supplied. The taxpayer is expected to honor information requests promptly and completely.

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(2) Formal requirements

Belgian taxpayers must file their annual income tax return in due time (i.e., before the date mentioned on the income tax return, which, as a rule, falls before the end of the sixth month following the closing of the fiscal year), it being understood that a taxpayer has always at least one month following the receipt of the tax return to file it.

Each year before a certain date (usually around April), Belgian taxpayers must report the salaries paid to their employees and (prior to 30 June) the fees paid to any persons or companies that are not subject to the accounting legislation and are also, not at the same time, a VAT taxpayer (see item (4) below). Belgian taxpayers must answer the questions asked in writing by the tax authorities within one month.

(3) Documentation of intra-group transactions

According to the Circular Letter dealing with transfer pricing matters, if the taxpayer submits documentation that substantiates the arm's-length nature of its transfer pricing, the tax auditor may consider that the risk of intra-group profit shifting is small and proceed with a less-thorough tax audit. Conversely, the tax auditor must pay more attention to the case of a taxpayer who, when requested to justify its transfer pricing practice, only supplies information that is vague, irrelevant or insufficiently documented.

One of the major focuses of an intercompany pricing audit is to obtain details on the corporate transfer pricing policy and to ensure that the taxpayer is not reducing its income through transfer pricing.

The Law of 1 July 2016 has adopted formal requirements regarding transfer pricing documentation to be prepared and filed by Belgian group entities of multinational groups as from assessment year 2017 (master file, local file and CbC report). The master file and local file will have to include information on intra-group transactions.
In the case of a late or incomplete filing of the transfer pricing documentation forms, a penalty may be due, which ranges, as of the second infringement, from EUR 1,250 to EUR 25,000. In the case of bad faith, a penalty of EUR 12,500 may be due for the first infringement and a penalty of EUR 25,000 may be due as of the second infringement.

After discussions with the taxpayer, adjustments, if any, will be proposed in a notice of amendment. The taxpayer has one month (subject to a possible extension) to respond to the notice of amendment. If the tax authorities do not agree with the arguments of the taxpayer, they will have to communicate in writing the reason why they disagree, before assessing the tax based on the income as amended. The taxpayer’s counsel may be involved at any stage of the audit process.

(4) Disclosure of creditors and payees

As from tax year 2010, taxpayers that are subject to corporate income tax are obligated to report all payments directly or indirectly made to any person (whether individual or legal person), permanent establishment (PE) or bank account located in a "tax haven." For the purpose of such reporting obligation, a "tax haven" is defined as: (i) any country that has been considered by the OECD Global Forum on Transparency and Exchange of Information as a country that has not substantially and effectively implemented the OECD exchange of information standard; and (ii) a country mentioned in the Belgian blacklist of countries without income tax or with low tax rates. The latter list includes countries that are not members of the EER and: (i) that do not levy corporate income tax with respect to domestic or foreign income; (ii) that have a nominal corporate income tax rate lower than 10%; or (iii) that have an effective corporate income tax rate lower than 15% with respect to foreign-sourced income. Undisclosed payments will not be tax deductible (Article 198, Section 1, 10° of the ITC). In this context, the Court of Appeal of Antwerp has recently held that a late filing of payments to tax haven companies can be
assimilated to a non-filing of said payments, with the consequence that such payments are automatically non-deductible.

Disclosed payments shall be tax deductible only if the taxpayer can show that these have been made within the framework of "actual and bona fide transactions" and to persons other than "artificial constructions." There is an exemption of such reporting obligation if the payments made to persons located in a tax haven amount to less than EUR 100,000 during the considered tax year.

Aside from the above, there is no specific requirement with respect to creditors or payees who are subject to VAT. The reason for this is that VAT requirements are sufficient to identify both creditors and payees.

With respect to creditors or payees who are not subject to VAT, taxpayers are required to disclose their identity and the amounts paid to them on specific forms depending on the creditor/payee, e.g., compensation paid to employees (Forms 281.10 and Summary Statements 325.10) or directors (Forms 281.20 and Summary Statements 325.20) and fees paid to self-employed individuals or companies that are not subject to VAT and, at the same time, are not subject to accounting legislation (Forms 281.50 and Summary Statements 325.50).

Such forms must be filed on or before certain dates, which are communicated each year by the tax authorities. The penalty for not complying with such filings is a 103% tax on the undisclosed payments (reduced to 51.5% if the beneficiary is a legal entity). The taxpayer may nevertheless avoid such penalty by showing that said undisclosed payments were actually reported by the beneficiaries on their own tax returns or, if the said payments were not reported in a tax return, that the beneficiaries can unequivocally be identified at the latest two years and six months following 1 January of the assessment year concerned (insofar as the assessment period for levying tax in the hands of the beneficiaries on the undisclosed payments has not yet expired).
In addition to this increased tax, a penalty ranging from EUR 50 to EUR 1,250 may be imposed in the case of a late or incomplete filing of the forms.

(b) Substantive issues

(1) Permanent establishment/residency

An issue may arise from the inconsistency between the definitions of a PE according to the Belgian ITC and those in tax treaties to which Belgium is a party.

As a rule, a foreign company with a PE, under Belgian law, must file a non-resident tax return in Belgium even where it has no PE under the relevant tax treaty and its income is thus not taxable in Belgium. In this case, the tax auditor will try to characterize the Belgian activities of such foreign taxpayer as a Belgian PE under the relevant tax treaty. Belgian tax authorities generally accept the OECD commentaries for treaty interpretation purposes.

It is important to prepare a tax audit focusing on the existence of a Belgian PE with the taxpayer’s counsel. It is also important for the taxpayer’s counsel to meet with people who engage in such Belgian activities and have practical knowledge of these actions.

(2) Transfer pricing

According to the Circular Letter, the tax auditor must establish the following financial ratios on the basis of the accounts of a taxpayer who is member of a multinational concern:

- Gross profit/net profit
- Net profit/net sales
- Operating costs/net sales
- Gross profit/operating costs
• Gross profit/average net worth

The taxpayer’s financial ratios are compared with those of its industry. If these deviate from the latter to a significant degree, an in-depth examination of the taxpayer’s transfer pricing practices will have to be made.

The examination of a taxpayer’s transfer pricing practice starts with the identification of the characteristics of the transaction under consideration so as to permit differences to be taken into account when the comparability test is applied.

A functional analysis must then be carried out. The functions effectively exercised by the individual members of the group with respect to the transaction have to be identified. To this effect, the following functions are considered:

• Research and development
• Production
• Storage
• Sale and distribution
• Marketing
• Administration
• Shipment and transportation

The Circular Letter provides a further description of the functions of "production" and "distribution" and lists specific functions within those broad categories. It also enumerates the risks borne and the intangible
assets used by the taxpayer that must be taken into account in the performance of the functional analysis:

i) **Risks**
   - Market risks
   - Inventory risks
   - Credit risks and bad debts
   - Foreign exchange risks

ii) **Intangible assets in production**
   - Research and development
   - Trademarks and patents
   - Miscellaneous

iii) **In marketing**
   - Trademark and name
   - Reputation of enterprise
   - Capability of supplying quality service
   - Marketing network

The Circular Letter, in its Annex I, refers to the example of a published list of questions applied to the functional analysis by an international audit firm.

The next step is identifying an enterprise that carries out similar functions in a similar transaction. For the purposes of establishing comparability, economic circumstances and business strategies are considered. The taxpayer may refer to points of comparison in foreign markets to determine the level of the transfer prices, as long as the impact of the
geographical differences on transfer pricing is taken into account. The tax authorities are supposed to use information that applies at the time the transaction took place and not take subsequent events into account, unless these could have been foreseen.

Belgian tax authorities bear the burden of proof. Obtaining information from the taxpayer is crucial in this process. The mandatory transfer pricing documentation requirements, as introduced by the Law of 1 July 2016, will be essential in this respect in the sense that as from assessment year 2017, all Belgian group entities of multinational groups (as defined by the law) will have to prepare and file certain transfer pricing documentation (consisting of a master file, a local file and a CbC report).

The Circular Letter, in its Annex II, refers to the OECD Report 1995-1996. That report provides that, in jurisdictions where the tax authorities bear the burden of proof requiring them to show _prima facie_ evidence that the taxpayer’s prices are not in line with the arm’s-length principle, the tax authorities may still reasonably oblige the taxpayer to produce the records they need to undertake an examination of the transactions in question (p. 5 no. 18). The report (in its Chapter IV-6 paras. 4.15 and 4.16) also deals with the problem that may arise when the taxpayer relies on burden of proof to avoid cooperating with the tax authorities. It considers the case where the taxpayer, being a local (Belgian) subsidiary, is unable to provide information that is available only to the parent company, which sets the transfer prices and is not obligated to provide information to show that its transfer pricing was at arm’s length because the burden of proof rests with the tax authorities. The taxpayer should use restraint in relying on the burden of proof and on its strict legal rights in the course of the examination of a transfer pricing case. Taxpayers should be prepared to show in good faith that their pricing is consistent with the arm's-length principle, regardless of where the burden of proof lies.

This OECD recommendation on a fair application and appropriate behavior leads Belgian tax authorities to advise enterprises to establish transfer
pricing behavior and to gather information that will show that their transfer prices are at arm’s length. To the extent that they cooperate with the tax authorities and transmit the documentation, said documentation constitutes a valuable basis for the tax audit. If the taxpayer has made the appropriate analyses and has drawn meaningful conclusions from them that are substantiated by reliable documentation, the tax authorities should use these analyses and conclusions to determine arm’s-length prices, and may accept the price fixed by the taxpayer. However, if the taxpayer is unwilling or unable to supply the information, the tax auditor must look at other sources of information.

(3) Restructuring/Business re-engineering

Corporate reorganizations (such as a merger, a split-up or a contribution of an entire business) may trigger taxation of the latent gains if such reorganization has tax fraud or tax evasion as its principal objective or one of its principal objectives (i.e., the reorganization should have a business purpose), which is the equivalent to the business purpose test that exists in a number of countries. Moreover, the tax losses carried forward may be reduced or lost as a result of such corporate reorganization.

Often, Belgian taxpayers file a ruling request to the effect of obtaining a ruling confirming that the contemplated corporate reorganization meets the aforementioned business purpose test. If a ruling request is not filed by the taxpayer, the tax authorities are likely to investigate whether the transaction meets the business purpose test and whether the reduction in tax losses has been properly calculated.

In the event of a liquidation of a company, it is also likely that there will be a tax audit.

(4) Constructive dividend

A constructive dividend is a decrease of, or a prevented increase in, a corporation’s property as a result of the shareholder-subsidiary relationship, which has an impact on the corporation’s income and does
not result from a proper dividend resolution. As a general rule, the constructive dividend theory is not accepted by Belgian courts. To the extent expenses would nevertheless be characterized as a constructive dividend, the affected corporation’s taxable income would be increased and would be deemed distributed, thus potentially triggering corporate income tax and dividend withholding tax consequences.

(5) Thin capitalization

Belgium has a general thin capitalization rule, providing for a 5:1 debt/equity ratio.

Article 198 Section 1, 11° of the ITC disallows interest payments made by Belgian corporate income taxpayers to beneficial owners that are: (i) not subject to income tax or benefit, with respect to the interest received, from a tax regime that is considerably more favorable than the Belgian income tax regime; or (ii) part of the same group (i.e., related companies) and such to the extent that the debt owed to these beneficial owners exceeds five times the Belgian debtor’s equity.

The new thin capitalization rule excludes certain companies from its scope of application, including the following:

- Companies active in the leasing of movable assets
- Companies of which the principal activity is the leasing of real estate and factoring, provided that these companies operate within the financial sector and to the extent that the funds are effectively used for those activities
- Companies of which the principal activity is the execution of a project in the framework of a public-private partnership (PPP)

There is also a specific netting rule provided for intra-group treasury companies.
An interest deduction limitation rule was introduced that overrules, to a large extent, the above-mentioned thin capitalization rule and which entails that the net borrowing costs will be tax deductible only up to EUR 3 million or 30% of the adjusted EBITDA, whichever is higher. This rule applies as of assessment year 2020 (financial year 2019). An exception is made for standalone entities, the financial sector and public infrastructure projects. Loans concluded before 17 June 2016 will be grandfathered, provided that no essential elements of the loan are modified after that date, and will remain subject to the thin capitalization rule. The tax authorities issued a circular on 11 September 2019 that provides more guidance on what is considered an essential element of a loan. The thin capitalization rule also continues, in any case, to apply to interest payments made to tax havens (but, in that case, in addition to the application of the 30% EBITDA rule).

(6) Transactions with tax havens

Taking into account that Belgian tax legislation provides for the obligation to report all payments made to tax havens (see item I. 5. (a) (4) above regarding the reporting requirement and application of the non-deductibility provision in Article 198, Section 1, 10° of the ITC) as well as for a number of specific anti-abuse rules in relation to transactions with tax havens, such transactions will always be closely scrutinized. The main examples of such anti-abuse rules are as follows:

- Article 26 of the ITC provides that abnormal or gratuitous benefits granted by a Belgian enterprise to a related third party are added to its tax base, unless the Belgian enterprise shows that the benefit is part of the tax base of such third party. There is no such exception where the third party is a non-resident that is either affiliated with the Belgian enterprise or located in a tax haven.

- Article 54 of the ITC provides that interest, royalties and fees paid in compensation for services (including management fees) are not deductible if paid (directly or indirectly) to a non-resident entity...
located in a tax haven or in a country where the taxation of such expenses in the hands of the beneficiary thereof is substantially more advantageous than in the Belgian tax regime. The taxpayer is, however, allowed to prove that those payments relate to actual transactions and do not exceed arm’s-length standards.

- Interest payments to entities located in tax havens also fall under the general thin capitalization rule (see item (5) above).

- Article 344 Section 2 of the ITC provides that any transfer of securities, patents, trademarks, knowhow and other similar intangibles, or cash to a non-resident taxpayer located in a tax haven is not binding on the tax authorities, except if the transferor shows either that the transaction meets the "legitimate needs of a financial or economic nature" (the so-called "business purpose" test) or that such transferor has received actual compensation-producing income that is effectively subject to a tax burden in Belgium, similar to the tax burden to which the transferred assets would have been subject if the transfer had not taken place.

(7) **Anti-abuse rule**

If certain types of transactions have taken place (e.g., redemption of shares), the tax authorities can check whether they cannot re-characterize the transaction into another transaction that triggers more tax pursuant to the general anti-abuse rule (Article 344 Section 1 of the ITC). The general anti-abuse rule was rewritten in 2012, with a view to providing the tax authorities with a more efficient tool to combat tax abuse.

Under the new general anti-abuse rule, a legal act or a series of legal acts is not binding on Belgian tax authorities if the latter can demonstrate, through presumptions or any other acceptable means of evidence and on the basis of objective circumstances, that such a legal act or series of legal acts constitute an abuse of tax law. In this case, the taxpayer can still demonstrate that the legal act or series of legal acts were driven by
sufficient motives other than tax abuse (e.g., financial or economic motives).

Since the tax authorities often tend to conclude rather quickly that the conditions of the anti-abuse rule are met in the event of tax-aggressive structures, they will often ask the taxpayer to show, at an early stage, that the characterization given to a transaction is not merely, or mainly, tax driven.

Irrespective of whether the tax authorities could actually apply the general anti-abuse rule in a specific case, it is always beneficial if the taxpayer can come up with valid business reasons for a specific transaction at an early stage. Doing so may allow the taxpayer to avoid further discussion and audit.

At an early stage, disputing the right of the tax authorities to make use of the anti-abuse provision in specific circumstances is unlikely to be productive. Of course, the taxpayer should mention that in its opinion, the anti-abuse provision cannot be applied to its specific case, but the emphasis should be on the existence of the business reasons for its transaction (if any); the technical arguments regarding the non-applicability of the anti-abuse provision should be saved for a later stage.

6. Special tax audits

(a) VAT/Customs

VAT audits are often conducted together with income tax audits.

(b) Wage taxes

In Belgium, wages are subject to individual income tax. The approximate amount of tax thereon is withheld at source by the employer and paid every month (or every three months) to the Treasury. Specific wage tax returns must be filed at the same time.
Wages must also be reported by the employer on Forms 281.10 and Summary Statements 325.10 (see item I. 5. (a) (4) above). The employee must report the salary in their individual income tax return since the wage withholding tax applied does not fully correspond to the final income tax due.

The amounts reported in the wage tax returns, the specific forms and the individual tax return are crosschecked by computers. If a discrepancy is found, the tax authorities are automatically informed.

The tax authorities have also increased their focus on equity-based compensation plans and the application of specific withholding tax reductions and exemptions (e.g., R&D, night and shift work, etc.).

7. **Electronic data processing (EDP) access during audit**

The tax authorities are authorized to consult a company's "books and documents" that are deemed necessary to determine its taxable income. This notion is interpreted in a broad manner and also includes electronic files, such as mailboxes and information stored in the cloud.

As a matter of principle, the tax authorities cannot carry out so-called "fishing expeditions," i.e., asking for the submission of any documents or electronic files without identifying the files' purpose during the investigation. In this respect, a taxpayer can, in principle, object to the submission of full copies of all electronic files or hard drives if the request by the tax authorities is not limited to well-defined facts or events. A taxpayer can also object to the submission of correspondence or private emails that are protected by professional secrecy (e.g., client-attorney privilege).

The investigation powers of the tax authorities are "passive," in the sense that all documents and electronic files must be presented to them. Consequently, the tax authorities are, in principle, not authorized to actively search for relevant documents in the business premises of the
taxpayer, to gain access to computers by force, to search electronic files and to make downloads themselves. They may request, however, that the taxpayer show them the specific data they want to see on the computer and provide them with a printout or electronic copy of the same, which they may take with them.

In recent years, the tax authorities have applied an increasingly extensive interpretation of their investigation powers. In some cases where taxpayers refused to provide information (or were deemed to have provided insufficient information), the tax authorities have effectively proceeded to conduct an active search of books, documents and computers.

It is heavily debated whether the tax authorities have such authority and case law is mixed on the subject. The constitutional court, however, has recently dealt with this question in its decision of 12 October 2017, and stated that the tax authorities have free access to the business premises, as well as to any documents or records present at the business premises (without prior request). If access is denied by the taxpayer, however, the tax authorities have to respect this and cannot force access to the premise or any specific document. In this case, the tax authorities may apply a penalty (a maximum of EUR 1,250) and in certain cases they may also issue an ex officio assessment (see below under 8. (a)). There is also risk that, as a result of such refusal by the taxpayer to cooperate, the tax authorities will suspect tax fraud and communicate this to the public prosecutor. The prosecutor could decide to carry out a criminal house search. In this case, an "active" investigation would be allowed. In the case of fraudulent intent, a criminal sanction (a maximum of EUR 500,000 or, in exceptional cases, a prison sentence of up to five years) could be imposed.

If the tax authorities abuse their investigation powers, tax assessments based on information invalidly obtained are null and void.
8. Information-gathering powers — production of foreign-based information

(a) Domestic law

Belgian resident taxpayers are required to supply the information and documentation requested by the tax authorities to determine how much of their income may be taxed. This may include information with respect to their foreign transactions, including information regarding their foreign subsidiaries. Belgian tax authorities cannot require the submission of information that a Belgian resident taxpayer may not be able to obtain, including information regarding parent companies (to which a subsidiary normally does not have access).

Foreign enterprises are subject to the obligation to supply information and records upon request, but only if they maintain a taxable PE in Belgium or if they are otherwise taxable in Belgium. The PE is required to attach the annual accounts of the establishment to its return, as well as those of the foreign company.

Non-compliance exposes Belgian resident or non-resident taxpayers to a penalty (a maximum of EUR 1,250) but, more importantly, to an *ex officio* assessment. If the taxpayer has not filed the tax return or the documents and information requested was not provided in due time, an *ex officio* assessment may be made, which will be based on income the tax authorities can presume, according to the information in their possession (e.g., on the basis of VAT returns). *Ex officio* assessments are often based on the turnover found in the VAT returns without deduction for expenses. If an *ex officio* tax assessment is made, the burden of proof is transferred from the tax authorities to the taxpayer.

Under constitutional principles (and in the absence of a treaty), Belgian tax authorities may not supply information and documents requested by the authorities of another state for the purposes of foreign taxation, but in a case involving the voluntary exchange of information and documents...
between the Belgian Customs authorities and the French authorities, relating to the fraudulent importation by a Belgian enterprise into France, the Brussels Court of Appeals found that such an exchange was not only in accordance with the applicable treaty provision, but that it was also in accordance with executive sovereignty principles (17 October 1977, Pas. 1978, II, 39).

(b) International initiatives on exchanges of information

Exchanges of information are regulated by the following:

- Bilateral tax treaties entered into by Belgium
- The EU Regulation (CE) 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of VAT, as amended by EU Regulation 517/2013 and EU Regulation 2018/1541
- The OECD and European Council Convention on Mutual Administrative Assistance in Tax Matters of 25 January 1988, for all tax matters except those related to custom duties, as amended by the 2010 Protocol
  - The Multilateral Competent Authority Agreement on Automatic Exchange on Financial Account Information
  - The CbC Multilateral Competent Authority Agreement

The exchange of information with the authorities of states with which Belgium has concluded a bilateral treaty that provides for the equivalent of Article 26 of the OECD Model Convention (e.g., Article 25 of the treaty between Belgium and the United States) is allowed.
Under Article 26 Section 2 of the bilateral treaties, Article 17 Section 4 of EU Directive 2011/16/EU and Article 54 Section 4 of the Council Regulation 904/2010/2003, the exchange obligation does not impose the disclosure of trade or business secrets. In its decision of 5 September 1980 (not published), the Court of First Instance of Brussels questioned the decision of Belgian tax authorities to supply information to the Italian tax authorities concerning the identity of Italian sales agents who were receiving commission fees that were, in turn, deducted by a Belgian enterprise. The court judged that the exchange violated a trade secret and that the Belgian state was liable for the damages incurred by the Belgian enterprise, whose commercial network suffered therefrom.

Based on Article 26 (or its equivalent) of the bilateral treaty with certain countries, Belgium has concluded specific bilateral treaties or "competent authority agreements" regarding the exchange of information and the conduct of bilateral tax audits (e.g., treaties with the Netherlands, Italy and Ukraine).

Traditionally, Belgian tax authorities were not allowed to collect information from banks or financial institutions regarding their clients, except in certain cases of fraud. Such "bank secrecy" was invoked by Belgian tax authorities when refusing to provide foreign tax authorities with information from banks or other financial institutions.

In November 2006, the tax treaty between Belgium and the United States opened the first breach into bank secrecy by explicitly allowing Belgian tax authorities to collect such information for the purpose of providing it to the IRS.

On 15 February 2011, the EU Council adopted Directive 2011/16/EU on administrative cooperation in the field of taxation, which, as of 11 March 2011, replaces Directive EC/77/799 of 19 December 1977 regarding the mutual assistance of the competent authorities of the Member States with respect to direct taxes and taxes on insurance premiums. The directive
aims to strengthen administrative cooperation in the field of direct taxation, so as to enable the Member States to better combat tax evasion and tax fraud.

Under the new directive, the Member States are no longer allowed to refuse to exchange information on the sole ground that the requested information must be collected from a bank.

Since 1 January 2010, Belgium has been exchanging information with other EU Member States with respect to savings accounts kept in Belgium by residents of other EU Member States, as provided for by the Savings Directive (2003/48/EC). To prevent an overlap between the Savings Directive and the new automatic exchange of information regime to be implemented by the Council Directive 2011/16/EU, the Savings Directive was repealed on 1 January 2016 (1 January 2017 in the case of Austria).

Furthermore, Belgium has committed itself to applying the OECD standards regarding administrative assistance as provided for in Article 26 of the OECD Model tax treaty in all its treaties. In this respect, Belgium has included provisions that allow it to exchange such information collected from Belgian banks in all treaties that have been renegotiated since March 2009.

Moreover, Belgium has sent draft protocols to more than 90 countries with which it has concluded a tax treaty in order to allow the exchange of information collected from Belgian banks. A number of protocols have already been signed and ratified, several of which have entered into force.

Those treaties and protocols allow Belgium to convey requests to Belgian banks from foreign tax authorities with respect to certain non-resident clients of the banks. This principle has also been confirmed in the Law of 14 April 2011, which introduces a substantial exception to bank secrecy.

Belgium has also concluded specific bilateral treaties or "arrangements" regarding the exchange of information in specific matters, such as the
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exchange of information regarding inheritance tax and gift tax with France (12 August 1843), Luxembourg (11 October 1845) and the Netherlands (24 May 1845), or the automatic exchange of certain information regarding salaries, business income, director fees, the ownership of real estate properties, etc., with the Netherlands (see the Notice in the Belgian Official Gazette of 5 August 2004).

On 23 April 2014, Belgium and the US signed a tax information exchange agreement to implement the Foreign Account Tax Compliance Act (FATCA). This agreement was implemented into Belgian law by the Law of 16 December 2015. FATCA was enacted to counter tax evasion and it obliges foreign financial institutions (FFIs) to report details of their US clients to the IRS. These FFIs must identify US account holders or entities in which US taxpayers hold a substantial ownership interest and report these US account holders. Failure to sign up to FATCA exposes the FFIs to a 30% withholding tax on any payment they receive from the US.

On 29 October 2014, the OECD announced that 98 jurisdictions (including Belgium) have committed to the automatic exchange of information under the OECD’s Common Reporting Standard (CRS) model. More than 40 of those jurisdictions (including Belgium) have committed to the exchange of information by 2017. The other signees are expected to follow in 2018.


The Directive extends the scope of the mandatory automatic exchange of information between tax administrations and implements the aforementioned CRS issued by the OECD. Many EU Member States have already committed to adopting the CRS, but the Directive is intended to ensure a common adoption approach across the EU.
All Member States (except Austria) have committed to the exchange of information by 2017, which requires financial institutions to implement reporting and due diligence rules from 1 January 2016.

The Directive provides a common basis for an exchange of information between all Member States and will remove the need for Member States to agree to separate competent authority agreements in order to implement the enhanced exchange of information. The approach substantially reflects the decisions made at OECD level, although some differences exist between the revised Directive and the OECD CRS.

The Directive 2011/16/EU on administrative cooperation in the field of taxation (as amended by the Directive 2014/48/EU) and the CRS had been implemented into Belgian law by the Law of 16 December 2015.

On 8 December 2015, the EU Council adopted Directive 2015/2376, which extends the scope of mandatory automatic exchange of information to advance cross-border tax rulings and advance pricing arrangements, and on 25 May 2016 the EU Council adopted Directive 2016/881/EU related to country-by-country reporting. Finally, on 25 May 2018, the EU Council adopted Directive 2018/822, which provides for a mandatory disclosure of cross-border tax arrangements by intermediaries or taxpayers to the tax authorities and which introduces an automatic exchange of this information between EU Member States.

The Law of 31 July 2017 implemented the mandatory automatic exchange of advance cross-border tax rulings, advance pricing arrangements and country-by-country reports into domestic law.

The advance cross-border tax rulings and advance pricing arrangements with respect to which information will be automatically exchanged under the new legislation are the following:

- Advance rulings and pricing arrangements that have been issued, changed or renewed as of 1 January 2014
Advance rulings and pricing arrangements that were issued, changed or renewed between 1 January 2012 and 31 December 2013, insofar as they were still valid in January 2014

The information that will be exchanged includes: (i) the identification data of the company and the group; (ii) a summary of the content of the advance ruling or pricing arrangement; (iii) the start and end dates of the validity period of the advance ruling or pricing arrangement; and (iv) the transfer pricing method used or the transfer price and the criteria used in order to determine such price, etc. Certain data will also be communicated to the European Commission.

Finally, based on the Law of 31 July 2017, country-by-country reports will be exchanged with the tax authorities of the EU Member States of which any group entity of the Belgian company is a tax resident. The Law of 11 August 2017 also approved the Multilateral Competent Authority Agreement on the exchange of Country-by-Country Reports allowing for an automatic exchange of country-by-country reports with OECD Member States.

(c) Information obtained from unrelated parties/provided by foreign tax authorities

Taxpayers that reside in Belgium are required to supply information and documentation requested by the tax authorities to determine the amount of their income that may be taxed. This may include information with respect to their transactions with other taxpayers, which may be used by the tax authorities for the taxation of such third parties.

Information provided by the tax authorities of a foreign state pursuant to its domestic law or to any treaty to which such foreign state is a party or to EU law can be used by Belgian tax authorities to assess Belgian taxes.

Where such information from a third party or from foreign tax authorities has been unlawfully provided, it cannot, in principle, be used by the
Belgian tax authorities. The Supreme Court ruled, however, that the use of unlawfully obtained information by the tax authorities will, in certain cases, be allowed if the law does not provide for a specific sanction with respect to illegality. The Supreme Court stated that unlawfully obtained evidence should, in such case, only be disregarded if the use thereof violates the right to a fair trial or if it goes against decent behavior of the tax authorities, such that the evidence should in any case be deemed inadmissible. This case law seems to have been overruled, however, by the CJEU. In WebMindLicenses, a VAT case, the CJEU ruled that illegally obtained evidence should be disregarded if any of the fundamental rights of the EU is not respected. The Supreme Court recently asked the CJEU for a preliminary ruling on whether the Belgian doctrine of allowing unlawfully obtained information to be used in certain cases is compatible with the CJEU's case law. The advocate general is of the opinion that the CJEU is not competent to answer the request and that the WebMindLicenses case law does not entail an automatic exclusion of illegally obtained evidence. It remains to be seen, however, what the final decision of the CJEU will be in this regard.

9. Multijurisdictional tax audits

As mentioned in Section 7, Belgium has concluded a limited number of specific bilateral treaties regarding the exchange of information and the conduct of bilateral tax audits on the basis of Article 26 (or equivalent) of the relevant double tax treaty. Bilateral tax audits are currently quite rare.

Multijurisdictional tax audits can also be conducted on a multilateral basis under the EU Directive 2011/16/EU on administrative cooperation in the field of taxation (i.e., multilateral controls). Under the Fiscalis 2020 Programme, we have recently seen an increase in multilateral controls. The number of such audits can be expected to further increase in the future.
10. Burden of proof

As a rule, the burden of proof with respect to the amount of the taxable income lies with the tax authorities, while the burden of proof regarding any deductible expenses (including provisions, depreciations, etc.) is borne by the taxpayer.

With respect to corporate taxpayers, the tax authorities must, in principle, respect the information as mentioned in the financial statements unless they demonstrate that such information is not correct or is not sufficiently documented.

If the taxpayer has not filed the tax return or the documents and information requested in due time, an *ex officio* assessment may be issued based on income that the tax authorities can presume, according to the facts in their possession (e.g., the VAT returns of the taxpayer). In such case, the taxpayer bears the burden of proof.

With respect to the general anti-abuse rule (see item I. 5. (b) (7)), the tax authorities tend to believe that in the event of tax-aggressive structures, the legal conditions for applying the general anti-abuse rule are automatically met. For that reason, they will often ask, at an early stage, that the taxpayer demonstrate that the choice for the legal act or the series of legal acts is justified by other motives than the avoidance of (income, transfer or inheritance) taxes. However, the burden of proof is as follows:

1. The tax authorities must establish that a given legal act or a series of legal acts constituting the same transaction constitutes tax abuse.

2. If the tax authorities succeed in obtaining such proof, the taxpayer must submit the counterproof that the choice for the legal act or the series of legal acts constituting the same transaction is justified by other motives than the avoidance of (income, transfer or inheritance) taxes (e.g., financial or economic motives).
3. If the taxpayer cannot submit counterproof, the tax authorities may restore the taxation of the relevant transaction so that it is in accordance with the objectives of the relevant tax provisions, as if the tax abuse did not take place.

11. Potential consequences

If, as a result of the audit, the taxable income of the taxpayer is found to be higher than its taxable income as reported in the tax return, such taxable income will be adjusted and subject to tax at normal rates. The Law of 25 December 2017 on the corporate income tax reform introduced, as of 1 January 2018 (for financial periods starting as of that date), a new rule that tax adjustments resulting from a tax audit will be effectively taxed (without the possibility of offsetting such tax adjustments against tax losses carried forward or other tax deductions (with the exception of the current year dividends received deduction)). This measure only applies if a tax increase equal to or higher than 10% is effectively applied (see below).

In addition, the following consequences will apply:

(a) Tax increases

Tax increases from 10% to 200% may be applied if the tax return is incomplete or inexact (or in the case of late or non-filing). However, the tax authorities may waive the tax increase if the taxpayer acted in good faith. Moreover, the tax authorities should not apply any penalty if the taxpayer proves that the incorrect reporting was due to circumstances beyond its control and the action was made in good faith.

In the event the tax authorities invoke the anti-abuse rule as described under item 10, the prevailing view is that they may not apply any tax increase. The tax authorities have, however, explicitly reserved such right in several circular letters.
(b) Late payment interest

As a rule, assessed taxes must be paid within two months as of the date on which the tax authorities send the assessment notice. In addition, late payment interest is due on unpaid taxes as of the first day of the month following the date on which the tax should have been paid.

If a tax assessment is combined with a penalty of 50% or more (i.e., in the event of fraud), interest can be claimed as of 1 July of the second year following the assessment year.

When (part of) a tax assessment is contested, late payment interest on such tax is suspended during the period: (i) beginning on the first of the month that follows the six-month period, as of the date on which the tax authorities received the tax protest; and (ii) ending on the last day of the month during which the tax authorities rendered a decision or the taxpayer filed an appeal before the court of first instance, whichever is earlier.

Since 1 January 1999, the interest rate has been equal to 7% per year.

The Law of 25 December 2017 on the corporate income tax reform, however, has introduced new rates that are applicable as of 1 January 2018. According to this new law, late payment interest due by the taxpayer amounts to a minimum of 4% and a maximum of 10%, and is linked to the linear bond interest rate. The rate will be reviewed on an annual basis. For 2019 and 2020, this late payment interest rate amounts to 4%. Interest due by the tax authorities is 2% lower than the late payment interest and thus amounts to 2% for 2019 and 2020. The taxpayer should send a notice to the tax authorities in order for the late payment interest to start running. A tax complaint is in this regard considered as such a notice.
12. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

Undergoing a tax audit in Belgium is a fact of business life and must be handled in an informed and responsible manner. Although the taxpayer is normally burdened with numerous requests for information, which may disrupt the running of its day-to-day business, a tax audit should be dealt with cooperatively by the taxpayer and settled on an amicable basis wherever possible. The taxpayer’s rights should, of course, always be observed where possible and appropriate, and the taxpayer should generally refuse to provide information that it is not legally required to provide. The taxpayer should not cooperate if the position taken by the tax authorities is unreasonable. In certain situations, the taxpayer should emphasize its willingness to litigate, while in other situations it may be better to state that one will accept the auditor’s point of view because one does not want to litigate, while emphasizing at the same time that one does not agree at all with the auditor’s point of view and that this point of view is unlawful.

(b) Who should run the show?

Experience tells us that Belgian tax authorities like to deal with a high-ranking officer from the taxpayer’s offices (e.g., the local managing director or the head of the taxpayer’s Belgian tax department) and/or, depending on the importance of the amount at stake, from its parent company (e.g., the head of the taxpayer’s European or global tax department). The taxpayer’s counsel should also be present and should have detailed knowledge of the facts, as well as experience in how to deal with tax officials. The taxpayer’s counsel should not, however, appear to be running the show alone.

(c) Settlement or litigation?

Tax disputes may be finalized during an audit, as a result of a tax complaint, or at court level. Depending on the case at stake, the taxpayer
may try to amicably settle the matter with the tax authorities. For instance, in certain transfer pricing disputes, settling the matter by accepting the principle of a correction in the transfer prices while minimizing such corrections instead of refusing any correction of such prices and starting litigation before the courts can be more productive. In other instances, however, litigation cannot be avoided mainly because, if the taxation of certain items is accepted as a matter of principle, there is no room to negotiate the amount of the tax.

One should also keep in mind that a number of Belgian tax provisions may be contrary to either the Belgian constitution or EU law. In such cases, litigation should not be avoided.

13. **Conversion of a regular tax audit into a criminal investigation**

Upon the discovery by the tax auditor of information suggesting criminal tax evasion, a routine tax audit can be converted into a criminal investigation, but such conversion is quite rare. Most cases of conversions are due to the fact that the taxpayer did not cooperate with the tax authorities. In such case, the tax authorities might decide to file a criminal claim in order to obtain certain information that they will be unable to obtain otherwise. This may be the case with respect to foreign-based information.

Filing a criminal claim can also be a way of putting pressure on a taxpayer in order to obtain its consent to settle tax litigation, with the tax authorities promising that they would waive their claim if a settlement is reached. In these kinds of situations, the taxpayer is strongly advised to review the matter with its tax counsel and decide on the strategy to be followed, which will depend on a number of circumstances that may or may not be related to the tax position of the taxpayer.

In 2012, new legislation was adopted providing for “one-way” prosecution of tax fraud (the so-called *una via* principle). Following this principle, tax fraud cases are either prosecuted by the public prosecutor’s office or dealt
with by the tax authorities, following consultation between the two bodies. This legislation aims to make the detection and prosecution of tax fraud more efficient and prevent taxpayers from being penalized twice for the same tax offense (the *non bis in idem* principle). Simultaneously, the existing criminal tax fines have been substantially increased. After the constitutional court had partially annulled the 2012 legislation, the legislator recently adjusted the *una via* legislation, based on case law from the European Court of Human Rights (*A & B v. Norway* no. 24130/11 and 29758/11 and *Ragnar Thorisson v. Iceland*, no. 52623/14), which confirmed that the *non bis in idem* principle does not prohibit parallel procedures covering the same factual elements, to the extent that these procedures form an integrated and coherent system. The legislation introduces an obligation for the tax authorities to file the case with the office of the public prosecutor’s office as well as a mandatory consultation between the two bodies with respect to cases of serious tax fraud. Under the new regime, only the criminal court will be competent to rule both on the criminal complaint and on the civil tax claim (the so-called integration principle). The criminal court will thereby need to take into account the amount of administrative fines and tax increases due in order to come to an overall sentence, which is not unreasonably severe for the taxpayer. The new legislation will enter into force at the latest on 1 January 2020.

A taxpayer should obviously take all appropriate steps to reduce its exposure to criminal sanctions. The following section contains a series of principal guidelines that should be observed if a criminal investigation is commenced in Belgium. While the overall response of company officials in either circumstance should be an informed and, where appropriate, cooperative one, the differing potential consequences may require that different guidelines be followed.

**(a) Premises that may be searched**

In a normal tax audit, the auditor is in principle not allowed to search the premises. There has been a recent trend in case law, however, to interpret
the applicable legal provisions broadly and to allow the auditor to search for documents in business premises. However, if the taxpayer objects, the auditor cannot *manu militari* continue the search.

A criminal investigation, in contrast, often begins with a house search. Such a search can be carried out in the business's premises, in the workplace and in the employees' homes. These searches are conducted by the judicial police, not by the tax auditors. Nevertheless, former tax auditors are "delegated" to the financial section of the judicial police. The taxpayer has little, if any, power to prevent the searches.

(b) Seizure of documents

In a normal tax audit, the auditor will normally not seize documents, but has the right to go through (and copy) any and all documents potentially relevant for the audit of the taxpayer. In the case of a dawn raid, the tax authorities usually make copies of all information on the taxpayer's servers and the mailboxes of certain employees, and then take this electronic copy with them. In this case, it is important to try to exclude privileged information, such as client-attorney privileged information and private emails of employees. If this is not possible during the dawn raid, one should put the electronic copy in a sealed envelope and try to exclude the privileged information afterwards in consultation with the tax authorities. It happens that the Special Tax Investigation Office temporarily seizes certain documents (the legality of which can be contested). In this case, they typically return the documents after having copied them at a later date.

In the context of a criminal investigation, the criminal authorities may seize the original copies of any document deemed relevant. In this case, the taxpayer may be deprived of access to these documents for the duration of the investigation, which can be long. When the investigation is closed, the taxpayer may have access to (and take a copy of) all the seized documents.
(c) Right to counsel

The presence of tax counsel is optional in a normal tax audit.

In a criminal investigation, the taxpayer should immediately notify its lawyer. The taxpayer has the right to have representation during the investigation. It is highly recommended that the taxpayer’s lawyer specializes in both criminal and tax law or that the lawyer works in close cooperation with the taxpayer’s tax counsel.

(d) Unnecessary admissions

Pursuant to Article 6.1 of the European Convention on Human Rights, information that the tax authorities may require from the taxpayer may not always be used in a criminal investigation of the taxpayer.

In a criminal investigation, the taxpayer may invoke the right not to incriminate itself and therefore to remain silent. Depending on the circumstances, it might be advisable to keep statements to the criminal investigator to a minimum.

(e) Panicked reactions

Panicked reactions, such as taking trips abroad or emptying bank accounts, may be grounds for arrest and should therefore be avoided.
II. Resolution procedures

1. Administrative level

Disputes may be settled at any time during the audit or litigation process. If the matter is not settled at the audit level and an additional tax assessment is issued, the taxpayer may file a protest against the assessment with the regional tax director. The protest must contain specific grounds for objection to the tax assessment and must be filed within six months from the third business day after the date on which the assessment was dispatched.

The protest results in a review of the tax assessment by a tax inspector (or a tax official designated by it), although the decision itself on the matter will be rendered by the regional tax director (or its delegate). During this review, the tax authorities may request all information they deem useful, including information from third parties such as lists of their suppliers, clients and banks. The taxpayer or its counsel may make oral or written submissions to the tax inspector as long as no decision has been made. The regional tax director may confirm the tax assessment as issued, issue a revised tax assessment or cancel the tax assessment; it cannot increase the tax assessment. The review of the tax assessment may take several years, but late payment interest stops after a period of six months from the filing of the protest until the end of the month during which either the decision of the regional tax director is made or an appeal before the court of first instance is filed.

2. Judicial tax litigation

In the event a tax protest does not result in an acceptable solution, the taxpayer may file an appeal against the decision of the regional tax director before the court of first instance. The appeal must be filed with the court and communicated to the regional tax director within three months following the dispatch of the decision of the regional tax director. Moreover, the taxpayer is allowed to file the appeal in the event the
regional tax director does not make a decision six months (or nine months in the event of *ex officio* taxation) after the date on which the protest was filed.

The taxpayer and the tax authorities may reach a settlement during the tax litigation pending before a court, but this kind of agreement is not binding as such upon the court, since tax law is mandatory law designed to protect the interests of society at large and/or the Belgian state as a whole (*lois d'ordre public*). If the settlement agreement relates to the interpretation of the law (as opposed to factual issues), it is conceivable that the court will not accept the settlement.

The taxpayer may appeal against the decision of the court of first instance before the court of appeal. The appeal must be filed with the court of appeal within one month following the notification (by the bailiff) of the decision of the lower court.

The taxpayer or the tax authorities may appeal against the decision of the court of appeal before the Supreme Court. The appeal must be filed with the Supreme Court within three months following the notification (by the bailiff) of the decision of the court of appeal. The Supreme Court will review only questions of law. If the Supreme Court reverses the decision of the court of appeal, the case will be remanded to another court of appeal for final determination.

Since 2007, Belgian law has provided that the losing party has to pay a lump sum procedural indemnity to the other party to cover the latter’s lawyer’s fees. The indemnity varies from EUR 90 to EUR 36,000, depending on the amount at stake and the complexity of the case. If the amount at stake exceeds EUR 1 million, the standard indemnity is EUR 18,000, while the maximum indemnity is EUR 36,000.

At any stage of the judicial procedure, the taxpayer may ask the competent jurisdiction to request a preliminary ruling from the Belgian Constitutional Court or the EU Court of Justice regarding the compatibility...
of a disposition of Belgian law or of an interpretation of such disposition with respect to the Belgian Constitution or EU law.

3. Miscellaneous matters

(a) Payment of tax

Once the tax authorities have issued a notice of tax assessment, taxes are due and payable within two months after receipt of the notice by the taxpayer.

These taxes must not be paid, however, if and to the extent that the tax assessment is contested. To avoid pursuit of the payment of disputed taxes, the taxpayer should notify the tax collector that a tax protest has been filed with the tax director or request that the tax director communicate this to the tax collector.

The tax collector will then determine that part of the tax assessment that is not contested (if any), which should be paid immediately.

It is always possible to voluntarily pay disputed tax assessments. This does not, as such, prejudice the legal position of the taxpayer in litigation regarding the relevant tax assessment. In this case, if the court eventually orders Belgian tax authorities to reimburse the tax unduly paid, the taxpayer is entitled to late payment interest at a rate of 2% per year (for 2019 and 2020). Case law is divided as to whether such interest may be capitalized each year, if such capitalization has been explicitly requested.

(b) Arbitration convention

(1) General

The tax treaties concluded by Belgium generally do not include an arbitration clause to allow an agreement to be reached when the competent authorities have been unable to reach one through negotiations. A few tax treaties, however, such as those with the US and the UK, do contain arbitration clauses. Furthermore, Belgium has signed
and ratified the European Tax Arbitration Convention "on the elimination of double taxation in connection with the adjustment of profits of associated enterprises." The Convention entered into force on 1 January 1995. It improves the competent authority process among EU Member States by providing a better time frame (a three-year time limit for presenting the case and a two-year limit for reaching an agreement). The Arbitration Convention applies to both economic double taxation and legal double taxation. The Convention's arbitration procedure guarantees the elimination of double taxation within a reasonably short period and, unlike the competent authority process under tax treaties, expressly recognizes the legal position of the taxpayer.

Article 7(3) of the Convention provides that, where the domestic law does not permit the competent authority to derogate from the decisions of its judicial bodies, the arbitration procedure will not apply unless the enterprise has allowed the time for an appeal to expire or has withdrawn its appeal.

Although Belgium did not expressly reserve the right to apply that provision (as France and the UK did), Belgian tax authorities have indicated that this provision also applies in Belgium.

Belgium applies the exception in Article 8 and may stay and refuse the arbitration procedure where legal or administrative proceedings have resulted in a final ruling that the enterprise concerned is liable to a severe penalty. In its unilateral declaration, it defines that term to mean a criminal or administrative penalty where common-law offenses are committed to evade tax or where the ITC is infringed with the intent to commit fraud or cause injury.

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(2) Notification formality

When Belgian tax authorities issue a "Notification of Amendment of the Tax Return" or a "Notification of Ex officio Taxation" to a Belgian taxpayer, with which they indicate their intent to adjust the transfer prices and profits of such Belgian taxpayer, the latter should inform the foreign affiliate involved, giving it the opportunity to inform its own tax authorities.

If the foreign tax authorities involved agree with the adjustment by the Belgian tax authorities, the foreign tax authorities involved will then make the corresponding adjustment, preventing double taxation and ending the procedure.

(3) Competent authority process

If the Belgian taxpayer does not agree with the proposed adjustment and the Belgian tax authorities issue a tax assessment notice, the Belgian taxpayer should consider filing a protest with the Belgian tax director, together with a request for initiating the arbitration procedure, indicating the other contracting states that might be involved in the procedure. The protest with the Belgian tax director must be filed within six months of the notification of the Tax Assessment Notice. The request for initiating the arbitration procedure must be filed within three years as of the notification of the Tax Assessment Notice.

As the Arbitration Convention does not allow subsequent notifications, it is recommended that a protective notification concerning other contracting states that may later become involved be made. Although the Arbitration Convention does not provide for a standard form of request, Belgian tax authorities have issued guidance regarding the information to be mentioned in the request (cf. Circular letter no. AAF/Intern.ISR/98-0170 dd. 07.07.2000).

Pursuant to Article 6(1) of the Arbitration Convention, Belgian tax authorities must notify the foreign tax authorities of the countries
involved in such case "without delay." It is recommended that the Belgian taxpayer follow up with Belgian tax authorities to make sure that the notification is made in due time and to expedite the procedure. According to Article 6(2) of the Arbitration Convention, Belgian tax authorities will first examine whether the request for the arbitration procedure is well founded. If they deem that it is not, they may simply dismiss the request. Although many authors found such condition discretionary, we believe that the Belgian tax authorities must have a good reason to refuse to start the arbitration procedure (for instance, because the request would not be bona fide).

The Belgian and the foreign tax authorities involved should reach an agreement within two years as of the filing of the request for the arbitration procedure.

However, if the Belgian taxpayer files a protest with regard to a Belgian tax director who has not rendered any decision after the two-year period has lapsed, under Article 7 of the Arbitration Convention, Belgian tax authorities will not: (i) implement any agreement reached with the foreign authorities within the framework of the competent authority process (if any); or (ii) set up the Advisory Commission (see below) unless the Belgian taxpayer waives the protest.

If the Belgian tax director has rendered a decision, the Belgian taxpayer has three months to file an appeal with the court of first instance. If the Belgian taxpayer files an appeal, Belgian tax authorities will suspend the arbitration procedure until the Belgian taxpayer waives the appeal.

If the court issues a decision, Belgian tax authorities will definitively end the arbitration procedure, pursuant to Article 7 of the Arbitration Convention.
(4) Arbitration procedure

If the Belgian and the foreign tax authorities do not reach an agreement within the two-year period pursuant to the competent authority process (and subject to the above rules in the event of parallel domestic litigation), they must set up an advisory commission that will issue an opinion within six months. The competent authorities will then have six months to make a decision that will actually eliminate the double taxation.

(5) Corresponding adjustment

In the event of a transfer pricing dispute between a foreign taxpayer located in the EU and its local tax authorities, Belgian tax authorities will enter into the competent authority process (if requested in a timely manner) and then into the arbitration procedure, unless the matter is already pending before the Belgian courts. In this case, the taxpayer may waive the procedure before the Belgian courts if no decision has been rendered yet.

If Belgian tax authorities agree, as a result of the competent authority process or the arbitration procedure, to make corresponding adjustments, they will do so even if the Belgian tax assessment has already become final under domestic law rules. If the Belgian tax that has been imposed pursuant to such procedures had already been paid, it will be reimbursed with late payment interest pursuant to Article 418 of the Belgian ITC.
III. Competent authority

In practice, the tax authorities will generally accept competent authority requests in economic double taxation cases and will, if they consider them well founded on the merits and amounts, consult with the foreign competent authorities.

In accordance with the OECD Commentaries to Article 25 (No. 25/37), the tax authorities believe that they have a duty to negotiate and use their best endeavors to reach mutual agreement in economic double taxation cases, but they do not consider themselves under any duty to achieve a result. Under the MAP-provision of the OECD Multilateral Instrument (which implements the minimum standard under BEPS Action 14) the tax authorities are under no obligation to achieve a result but merely to endeavor to resolve the case. Under EU Directive no. 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, it is possible for the taxpayer to request the set-up of an advisory commission.55 This commission will render an opinion to solve the matter in case no agreement is reached between the competent authorities of the Member States involved within six months after the date on which it was set up (an extension of three months is possible). This opinion becomes binding in case the competent authorities do not reach an agreement within 6 months after notification of this opinion.

The tax treaties concluded by Belgium generally do not include an arbitration clause that will allow an agreement to be reached when the competent authorities have been unable to reach one through negotiations. The only current exception in this respect is the treaty with the US, which contains an arbitration clause in its Article 24(7).56

55 The competent authorities may also decide to set-up an alternative dispute resolution commission instead of an advisory commission (which may differ in form and composition).
56 No statistics are available concerning the number of cases examined by the Belgian authorities under the specific case provision, or of their success ratio and their allocation.
However, the OECD Multilateral Instrument contains an arbitration clause, which Belgium has opted to apply to the tax treaties covered by the MLI.\textsuperscript{57} A binding arbitration clause will hence apply as of the date of entry into force of the MLI for tax treaties with Belgium (at the earliest on or after 1 January 2020 for withholding taxes and for other taxes as of taxable periods beginning on or after 1 April 2020, depending on the deposition by the counterparty to the tax treaty of its ratification instrument), provided that the treaty partner has also opted for arbitration.

Under EU Directive 2017/1852, the taxpayer can also request an Advisory Commission to be set up to deliver an opinion if the competent authorities were not able to come to an amicable agreement under the MAP procedure. This Advisory Commission will consist of three independent members appointed by the Member States concerned and representatives of the competent authorities. It must deliver an opinion within six months, which the Member States concerned must implement unless they agree to another solution within six months following the opinion.

The practical application of the competent authority procedure in Belgium can be summarized as follows:

- The resident enterprise files a protest or request for \textit{ex officio} tax relief in the domestic form of Article 366 or Article 376 ITC.

\textsuperscript{57} From a Belgian perspective, the double tax treaties with Switzerland, Germany and Norway are not covered by the MLI, as Belgium prefers to re-negotiate these treaties on a bilateral basis. In addition, the treaty with Japan is not covered, as this treaty was recently negotiated and is deemed to meet the MLI’s minimal standards. Finally, the double tax treaty with the Netherlands is not covered, as the Netherlands has not notified this treaty.
• Belgian tax authorities will normally set the competent authority procedure in motion, but may refuse to do so on grounds relating to the treaty.

• The initiation of the international procedure does not prevent the taxpayer’s right of recourse to the procedural remedies available under domestic law. It may commence both procedures with the view to pursuing its claim before court if no satisfactory agreement is reached. The tax authorities, however, generally do not implement an agreement reached under the MAP if the taxpayer does not put an end to the other procedures initiated under domestic law regarding the same assessment.

• The tax authorities report that the average period for negotiations is approximately two years, but in some cases (such as with the US), the procedure lasted more than 10 years.

• Most Belgian treaties do not have a provision to the effect that "any agreement reached shall be implemented, notwithstanding time limits in the domestic laws of the contracting State" (Article 25, para. 2, OECD Model).

The domestic time restraints (three or five — now seven — years) on the investigative and audit powers of Belgian tax authorities (see 4. Limitations period for assessments) led them to adopt a policy many years ago of refusing mutual agreements if the request is related to a period of more than five years prior to the year during which relief was requested. The restrictive policy was mainly applied to procedures with slow-contracting states, such as the US. Nowadays, the tax authorities will in principle no longer invoke such time limitation.

In view of the strict time limits for tax assessments and refunds, the original assessments will not be changed under domestic law. However, the transferring enterprise is permitted to establish an invoice for the amount of the adjustment in the year of the agreement.
Some informed authors have suggested that the legal nature of the mutual agreement is an agreement in simplified form between the two states concerned and, as such, is binding on Belgian tax authorities and judicial bodies, although other authors consider agreements between competent authorities executive in nature and non-binding upon the courts. However, the tax authorities should be bound by it under the principle of good administration (\textit{patere legem quam ipse fecisti}).

The treaty procedure is amplified by reference to the domestic procedure, among other things, with respect to the application of interest. Since 1 January 1999, the interest rate has been 7% per year. This rate was reduced to 2% in 2018 and will be reviewed annually.

Mutual agreements are not published.

In the event of a transfer pricing dispute, the taxpayer should consider filing a protest with the tax director together with a request for initiating a competent authority procedure.

It is also recommended that such a request for initiating the competent authority process be filed with the tax authorities of the country of the affiliated entity as soon as possible, so that such tax authorities cannot invoke the statute of limitations to refuse the possible adjustment in their country.

Belgium has a network of over 90 tax treaties that are mostly substantially based on the OECD Model Convention. Their articles that are relevant to transfer pricing cases correspond to Article 7(2) and Article 9(1) and (2) of the OECD 2010 Model Convention.

Prior to 2003, Belgium reserved the right not to insert Article 9(2) into its treaties at the time this paragraph was introduced into the 1977 Model Convention. As a result, this provision is missing in a number of Belgian treaties. The MLI will introduce, in all covered tax treaties, Article 9(2) of the OECD Model Convention, allowing for corresponding tax adjustments
(i.e., Article 17 of the MLI). The MLI will enter into force with respect to non-withholding taxes for taxable periods beginning on or after 1 April 2020 (depending on the deposition by the counterparty to the tax treaty of its ratification instrument).

The Belgian tax authorities have been aligned with the OECD commentaries to Article 9 for many years (No. 25/1-110 of the 2010 OECD Commentaries).

This means they accept that for treaties containing only the first and not the second paragraph of Article 9, economic double taxation resulting from adjustments made to profits by reason of transfer pricing falls within the scope of the MAP provided for under Article 25.

Belgium is only committed to making an adjustment if it considers that the adjustment by the other country is justified both in principle and as regards the amount, in line with the OECD Commentaries to Article 9 (No. 9/6 of the 2010 OECD Commentaries).

As of 19 July 2004, the possibility of (negative) correlative adjustments, as provided for in Article 9 § 2 OECD Model Convention, is also provided for in Belgian tax law and consequently, equally applicable to non-treaty situations.
Handling Tax Disputes in the Czech Republic

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I. Managing the tax audit process

1. General

In 2018, the Czech tax authorities completed approximately 11,715 tax audits (which is a decrease of approximately 16% compared to 2017) and found additional tax liabilities worth approximately CZK 10,149 million (which is a decrease of approximately 17% compared to 2017). From this amount, the largest portion was additionally assessed on VAT (CZK 7,763 million), corporate income taxes (CZK 2,024 million) and personal income taxes of individuals filing tax returns (CZK 216 million). In 2,533 of these cases, the Czech tax authorities initiated criminal proceedings in relation to tax evasion and other tax-related crimes (which is a similar number to 2017).

In the current political situation in the Czech Republic, where it is difficult to significantly increase taxes or introduce new ones, the Czech government relies on tax law enforcement to mitigate the public budget deficit. For this reason, taxpayers in the Czech Republic can expect to be audited more frequently and more aggressively in the future.

The New Tax Administration Act entered into force on 1 January 2011 and altered numerous principles established by the Tax Administration Act, which took effect on 31 December 2010.

Whether or not a Czech taxpayer is audited will depend on various factors. The Czech tax authorities tend to audit larger taxpayers and taxpayers that were not subject to audit in the past. Taxpayers registered with financial offices that have fewer taxpayers (especially outside Prague) tend to be audited more frequently.

Based on certain statistics, taxpayers registered in the district of Prague 10 are, on average, subject to an audit approximately once every 156 years. On

As of December 2018, the exchange rate was approximately CZK 25.54 = EUR 1.
the other hand, taxpayers registered in certain areas outside Prague are, on average, subject to an audit approximately once every seven years. These statistics, however, do not reflect the scale of the taxpayers.

An ordinary full-scale audit typically covers income tax, VAT and withholding tax for a three-year period. Simplified tax audits (postup k odstraneni pochybnosti) are frequently initiated for VAT upon the declaration of a negative VAT liability and a request for a VAT refund. In 2018, the Czech tax authorities completed approximately 19,840 simplified tax audits (which is an increase of approximately 35% compared to 2017).

2. **Advance preparation for tax audits**

   A tax audit is normally commenced upon the signing of a protocol on the beginning of a tax audit specifying the audited taxes, scope of the audit and tax periods. As the commencement of a tax audit has a significant influence on statutes of limitations (certain periods may be statute-barred if the tax authorities do not commence a tax audit in time) and on the possibility of voluntary disclosure (it is not possible to file an additional tax return once the tax audit is commenced), the Czech Supreme Administrative Court has developed significant case law that will address this issue. In particular, the Czech Supreme Administrative Court has indicated in its case law that the mere formal signature of a protocol that is not followed by a tax audit within a reasonable period of time should not interrupt the statute of limitations period. The new Czech Tax Administration Act follows this case law and commences the tax audit subject to the actual activity of the tax inspector.

   The new Czech Tax Administration Act generally provides significantly lower penalties in the case of voluntary disclosure in the form of an additional tax return. However, taxpayers are not allowed to file an additional tax return once the tax audit is commenced.

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59 Simplified tax audits can be, however, used for any type of tax.
60 See, for example, Supreme Administrative Court, decision of 20 June 2005, ref. No. 5 Afs 36/2003–87.
additional tax return once a tax audit is commenced. Consequently, in order to increase the efficiency of tax audits and tax collections, the Czech tax authorities frequently, albeit informally, encourage taxpayers to file additional tax returns before a tax audit can be formally commenced. This approach allows taxpayers to reduce potential penalties and avoid potential criminal liability. Thus, the Czech tax authorities can avoid possible disputes and collect undeclared taxes rather quickly.

Following an informal notice to file an additional return, taxpayers should consider the following:

- Determining the periods open for the audit that are not statute-barred
- Collecting relevant accounting documents, agreements and other records
- Identifying potential hot topics such as overly aggressive tax planning, lack of documentation or inconsistent documentation of specific transactions
- Filing a voluntary disclosure in the form of an additional tax return (but only up to the moment of the commencement of the tax audit)
- Designating a workplace for the tax inspector

Pursuant to the new Czech Tax Administration Act effective as of 1 January 2011, a tax may be assessed for a period of three years: (i) following the deadline for filing the tax return; or (ii) if no tax return is due following the due date for payment of such tax.

If, however, in the last 12 months of this period the additional tax return is filed, a tax assessment is issued, an appeal decision is issued or an

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61 See, for example, Supreme Administrative Court, decision of 26 April 2007, ref. no. 8 Afs 110/2005-82.

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extraordinary appeal is launched, the three-year period is extended by an additional year. Moreover, if the tax audit is commenced, the three-year period commences anew from that moment.

Additionally, the statutory limitations period is paused during: (i) administrative or constitutional court proceedings related to the particular tax assessment; (ii) criminal proceedings related to such tax; and (iii) mutual assistance procedure with foreign tax authorities.

Regardless, pursuant to the new Czech Tax Administration Act, the Czech tax authorities are not allowed to assess or additionally assess tax 10 years after the expiration of the deadline for the filing of the tax return or, if no tax return is due, after the due date for the payment of such tax.

If the criminal court has come to a decision concerning tax evasion, tax may be assessed by the end of the calendar year following the year in which the decision of the criminal court became final and binding.

These rules in principle also apply to tax periods that were not statute-barred under the Tax Administration Act, which came into effect on 31 December 2010.

3. Areas of tax auditors' special attention

(a) Procedure and form

The general approach taken by tax inspectors is to review the accuracy of the taxpayer’s returns on the basis of the taxpayer’s relevant books and records, including correspondence and files.

The tax inspector has the right to be given access to accounting records, accounting documents and other documents that are evidence of transactions and that are necessary for the proper assessment of tax.

Normally, the tax inspector commences an audit by reviewing the trial balance and VAT records. Subsequently, the tax inspector will identify
certain critical areas on the basis of testing sensitive accounts in the general ledger and "sample testing."

(b) Financials and accounting

The Czech Act on Accounting requires various groups of entrepreneurs (businesses), including companies (such as partnerships and corporations), to maintain books and records and to produce financial statements in accordance with the Czech Act on Accounting. Books and records are then, in principle, used as a starting point for the assessment of the income tax base.

If the tax inspector determines that the books and records have not been properly maintained and that tax may not have been assessed based on other evidence, the tax inspector generally has the right to use an estimate in order to determine the proper tax base.

Books and records must be maintained in the Czech language and the currency used must be Czech Republic koruna. There is no restriction on the outsourcing of bookkeeping and, subject to reasonable access, books and records may be kept outside the Czech Republic (but again, only in the Czech language and in Czech Republic koruna).

(c) Formal requirements

The Czech tax authorities are primarily focused on the formal documentation of business transactions. It is therefore recommended that all accounting documents, as well as incoming and outgoing invoices, be carefully verified, collected and stored.

(d) Substance over form and abuse of law concepts

The Czech tax authorities frequently use the substance over form concept in order to reclassify certain abusive transactions. Due to recent developments of the case law of the Czech Supreme Administrative Court, the Czech tax authorities (and Czech courts) tend rather to apply the abuse of law concept in order to prevent taxpayers from obtaining unwanted tax

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benefits. The Czech courts tend to follow the principles established by the Court of Justice of the European Union (CJEU) in this area.

(e) **Transfer pricing**

The review of a taxpayer’s business transactions with related parties is one of the primary focuses in every tax audit. Typically, the tax inspectors' interest is directed toward the following types of transactions:

- Intercompany loans
- Cost-sharing agreements and similar arrangements
- Intercompany service agreements
- Contract manufacturing and limited risk distribution models
- Restructuring of business operations
- Transactions with low-tax jurisdictions

In 2004, the Czech Ministry of Finance published Decree No. D-258 of the Czech Ministry of Finance Concerning the Application of International Standards to the Taxation of Transactions between Associated Enterprises — Transfer Pricing. This decree contained an overview of the most important provisions of Czech law relating to transfer pricing. The major part of the decree originates from the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"). In 2010, Decree No. D-258 was replaced by Decree No. D-332 of the Czech Ministry of Finance Concerning the Application of International Standards to the Taxation of Transactions between Associated Enterprises — Transfer Pricing, which contains an overview of the most important provisions of Czech law relating to transfer pricing and was subsequently replaced by Decree No. D-34 of the General Financial Directorate.

At present, Czech income tax law does not contain an explicit reference to the OECD Guidelines, nor are these guidelines incorporated into Czech law.
In Decree No. D-34, the General Financial Directorate claimed that the OECD Guidelines are relevant for the Czech Republic in light of Article 31 para. 2 of the Vienna Convention on the Law of Treaties. Czech Supreme Administrative law has not confirmed this position and has referred to the OECD Guidelines as "soft law." 62

The Czech tax authorities are frequently focused on formal documentation of business transactions. Companies are therefore recommended to carefully verify, collect and store all accounting documents, as well as incoming and outgoing invoices.

There are no specific mandatory documentation requirements for transfer pricing purposes in the Czech Republic. Nevertheless, as part of the introduction of binding ruling procedures for the method of determining prices in related-party transactions (advance pricing agreements or APAs), the Czech Ministry of Finance issued Decree No. D-293 of the Czech Ministry of Finance Concerning the Scope of Documentation of Prices between Related Parties ("Decree No. D-293"), which sets out the scope of the recommended documentation of prices between related parties. In 2010, Decree No. D-293 was replaced by Decree No. D-334 of the Czech Ministry of Finance Concerning the Scope of Documentation of Prices between Related Parties.

The concept adopted by Decree No. D-293 and Decree No. D-334 is largely based upon the principles of the EU Code of Conduct on Transfer Pricing Documentation for Associated Enterprises, which aims to eliminate disparities in transfer pricing documentation requirements across EU Member States.

According to the Czech Ministry of Finance, documentation set out in Decree No. D-334 should be sufficient for the tax authorities to determine whether the prices agreed on between related parties are at arm’s length.

62 Supreme Administrative Court, decision of 25 June 2007, ref. no. 8 Afs 152/2005-72.
Only in exceptional cases, and with the appropriate justification, may the tax authorities request further information.

4. **Simplified tax audits**

If, following the filing of a tax return, the Czech tax authorities have doubts about its correctness or completeness, they may initiate a simplified tax audit (*postup k odstranení pochybnosti*) by requesting that the taxpayer provide further evidence or that the taxpayer address these doubts.

A simplified tax audit is frequently initiated for VAT returns in cases of negative VAT liability and requests for a VAT refund.

5. **Electronic data processing (EDP) access during audit**

In general, relevant tax and accounting documents may be stored electronically. Conditions vary, depending on the particular tax/accounting law, but in principle, the following conditions must be met:

- Conversion to electronic form must ensure true conversion, (i.e., the electronic copy has the same content as the original in hardcopy).

- The electronic form must be secure so that any change to the content of the records may not be made.

- The electronic form must be readable (either directly or using special tools).

- In certain cases, the electronic form must include an electronic signature (certificate).

- In certain cases (e.g., for VAT purposes if the server is located abroad), free online access for the tax authorities must be ensured.

Documents do not have to be stored in the Czech Republic, but they must be presented to the Czech tax authorities upon request. For VAT and
certain other purposes, a Czech subsidiary must notify the Czech tax authorities about the fact that tax documents are stored outside the Czech Republic and indicate the location of that storage space.

Additionally, for documents that are stored electronically, the server does not need to be located in the Czech Republic.

For VAT and certain other purposes, a Czech taxpayer only has to notify the Czech tax authorities that tax documents are stored outside the Czech Republic and indicate the place of storage.

In practice, tax inspectors usually require the provision of relevant tax and accounting documents in paper. This also allows the taxpayer to properly manage and monitor the flow of documents to the tax inspectors. Recently, the Czech tax authorities began requiring taxpayers to provide electronic data that has been tested by special software designed to identify errors, duplicities and inaccurate disclosures. It is not fully clear whether the tax inspector is permitted to request direct access to the taxpayer’s accounting system. At the moment, the Czech tax authorities, in practice, do not request such direct access.

Although the Czech Tax Administration Act assumes that original documents should be provided to a tax inspector, tax inspectors frequently find copies sufficient and, only in certain cases, require the disclosure of original documents.

6. Information-gathering powers

(a) Production of foreign-based information

The Czech Tax Administration Act does not include any specific provisions related to foreign-based information. As a general rule, upon the request of a tax inspector, requested records and documents must be presented by the taxpayer no matter where these are stored.
Documents and records in foreign languages must be presented with an official Czech translation, unless the tax inspector allows for the presentation in a foreign language or with an unofficial translation. The Czech Tax Administration Act generally does not give a tax inspector the right to ask a taxpayer for documents and records that are kept by a related party of the taxpayer. In practice, taxpayers also disclose documents and records kept by related parties as long as those documents and records have proof of transactions that are immediately related to the Czech taxpayer.

(b) Information obtained from unrelated parties

Tax inspectors in the Czech Republic have the right to request the provision of tax-relevant information not only from a taxpayer, but also from third parties, including the following:

- Various public bodies
- Persons keeping registers of persons and assets
- Persons providing supplies subject to tax
- Persons administering proceedings related to assets subject to tax
- Persons obtaining information necessary for tax administration
- Banks and insurance companies
- Utility companies
- Advertising publishers

(c) Information provided by foreign tax authorities

As far as the cross-border exchange of information is concerned, Czech tax authorities are well equipped to not only honor informational requests from abroad and supply information to other tax authorities, even on a
spontaneous basis, but to also request information from other states. These rights are set forth in the following documents:

- The over 70 Czech tax treaties in existence containing exchange of information clauses
- Specific treaties on exchange of tax information
- Council Regulation (EU) No. 904/2010 of 7 October 2010, on administrative cooperation and combating fraud in the field of VAT (recast)

Cross-border exchange of information and the use of such information in tax audits is a common practice in the Czech Republic. It is difficult, if not virtually impossible, to prevent tax inspectors from using information obtained from abroad.

7. Multijurisdictional tax audits

There is virtually no information available on the engagement of Czech tax authorities in multijurisdictional tax audits.
8. Burden of proof

The Czech Tax Administration Act generally assumes that a taxpayer is required to disclose all facts disclosed in a tax return; if not, the Czech tax authorities may ask that these be produced and shown.

This general rule has been eroded by the case law of the Czech Supreme Administrative Court and regional courts, which has shifted the burden of proof to the Czech tax authorities if the taxpayer has exhausted all available and reasonable means. As an example, if a tax inspector believes that prices agreed on between related parties do not follow the arm’s-length standard, the tax inspector will have the burden of proof to demonstrate what the appropriate arm’s-length price is.63

9. Potential consequences

(a) Tax assessment

Following the filing of a personal income tax return, corporate income tax return, VAT return, road tax return and excise duty return, Czech tax authorities do not normally send a tax assessment to the taxpayer unless: (i) they are requested to do so by a special provision; (ii) they are requested to do so by the taxpayer; or (iii) they initiate simplified tax audits (postup k odstranění pochybností). The tax is normally deemed to have been assessed as the amount declared in the tax return without a formal tax assessment.

It is, therefore, unusual to receive a formal tax assessment following the filing of the tax return.

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10. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

Undergoing a tax audit in the Czech Republic is a fact of business life and must be handled in an informed and responsible manner. A typical tax audit in the Czech Republic is dealt with cooperatively by the taxpayer and is eventually settled amicably. Unquestionably, the taxpayer's rights should always be observed where possible and appropriate. The maintenance of a "good working climate" during an audit will be disadvantageous for the taxpayer in one of the following circumstances:

- The taxpayer does not exercise the rights they are expected to exercise.
- The taxpayer accepts without complaint the misconduct or infringement of laws or regulations by the tax auditor.
- The taxpayer is seeking a good working climate, because of uncertainties relating to factual or legal questions.
- It is intended to divert from poor preparation.

(b) Who should run the show?

Experience has taught us that it is the local people, (i.e., the managing director, the head of the taxpayer's Czech tax department, and/or the taxpayer's counsel) who have thorough knowledge of the facts and the best experience in how to deal with tax officials. They know the rules of conduct best and should be expected to have sufficient ingenuity to bring even a difficult tax audit to a successful conclusion. For this reason, they should run the show. It is only in isolated cases that it is advisable to have people from foreign affiliates, such as the European tax director or the head of the worldwide tax department, directly participating and meeting with the tax officials.
(c) Settlement or litigation?

Tax disputes may be finalized during an audit at the tax office level prior to the release of the tax assessment, which takes into account the tax inspector’s findings as a result of an appeal, or at the court level. Although the taxpayer should, at all times, emphasize to the tax inspector their willingness to litigate, the taxpayer should be mindful of settlement opportunities during an audit, if appropriate, if only because the duration of tax litigation proceedings in the Czech Republic, during which the taxpayer does not have the comfort of knowing whether or not the contested practices will eventually be accepted, is lengthy.

There is no regulation that will allow the Czech tax authorities to settle a tax dispute. As a matter of fact, tax inspectors are prepared to take a certain position in respect of the facts discovered during a tax audit and then record these in the audit protocol accordingly. This type of settlement is, in general, achievable during the process of a tax audit until the finalization of the audit protocol.

11. Conversion of a regular tax audit into a criminal investigation

Criminal prosecution is strictly separated from tax proceedings. It is carried out by a competent state prosecutor and the police investigation office.

Generally speaking, Czech prosecuting authorities may commence criminal proceedings, provided that they have identified reasonable facts indicating that a criminal offense was committed and, further, provided that there is reasonable evidence that this criminal offense was committed by a particular person.

Under Czech criminal law, tax avoidance is deemed to be a criminal offense if the amount involved is at least CZK 50,000. Additionally, it must be proved that the individual involved intended to not pay the relevant tax or acted recklessly. Pure negligence does not trigger criminal liability under the Czech Criminal Code in respect of tax avoidance. Generally speaking,
such tax avoidance can be in the form of intentionally not filing a tax return or intentionally filing an incorrect tax return.

Criminal liability in respect of tax avoidance ceases to exist if there is voluntary disclosure followed by settlement of the damage (i.e., payment of the tax due). It is especially necessary that the disclosure be voluntary.

Pursuant to applicable case law, if the tax authorities commence a tax audit, it is usually not possible to qualify for voluntary disclosure once the tax authorities identify the relevant facts and there is a direct threat of criminal proceedings. On the other hand, voluntary disclosure qualifying for lower administrative penalties is strictly limited to the period up to the commencement of the tax audit.

Upon the discovery by the tax auditor of information suggesting criminal tax evasion, the Czech tax authorities may file a criminal notice with the competent state prosecutor of the police investigation office.

In 2018, the Czech tax authorities filed approximately 2,533 criminal notices relating to estimated tax evaded in the amount of CZK 6,775 million.
II. Resolution procedures

1. Administrative level

(a) During audit

During a tax audit, a number of meetings between the tax inspector and taxpayers generally will take place in order to discuss and, when possible, resolve issues of importance that have arisen prior to the final meeting on the audit protocol.

Issues of importance are normally communicated to the taxpayer by the tax inspector prior to such a meeting, either verbally or in writing. The final meeting is scheduled prior to the close of the tax audit for the purpose of signing an audit protocol from the tax audit, highlighting the key findings of the tax inspector. The final meeting usually does not provide chances for negotiation. During the final meeting, the taxpayer has the right to comment on the findings identified in the protocol and on the manner in which the findings were discovered. The taxpayer also has the right to suggest supplementation of the protocol. The taxpayer should sign and obtain one copy of the audit protocol. At this stage, it is usually not possible to reverse the tax inspector’s findings.

(b) Between the final meeting and release of tax assessment

Once the audit protocol is finalized and signed by the tax inspector and the taxpayer, there is usually no further formal communication between the two parties.

Tax assessments most frequently incorporate the findings highlighted in the audit protocol.

(c) After the release of tax assessment notices

Until 31 December 2009, the Czech tax authorities were generally not obligated to include reasoning in an additional tax assessment. On the other hand, the taxpayer has the right to ask the Czech tax authorities for
an explanation of the reasons for the additionally assessed tax. As long as the Czech tax authorities do not respond to this request, the appeal period is interrupted.

After 1 January 2010, the Czech tax authorities had to include reasoning in an additional tax assessment, or at least refer to the reasoning included in the audit protocol.

The taxpayer has the right to appeal the additional tax assessment within 30 days following the delivery of the additional tax assessment. After this period, the additional tax assessment will be deemed final unless the taxpayer files an appeal within this period. An appeal may be filed with the tax office that originally issued the tax assessment.

A filed appeal is first examined by the tax office that originally issued the tax assessment. This tax office has the right to amend the additional tax assessment, provided it satisfies the appeal in full. If this is not the case, the tax office will forward the appeal (together with the files) to the appeal financial directorate.

The appeal financial directorate reviews the entire legal and factual background of the case and then issues its decision on the appeal, whether in favor or to the detriment of the taxpayer.

2. Judicial tax litigation

(a) Regional administrative courts

A taxpayer may file a lawsuit with the regional court aiming at a cancellation of the decision of the appeal financial directorate within two months of the delivery of the decision of the financial directorate to the taxpayer.

After receipt of such a lawsuit, the regional court will ask the appeal financial directorate for its written response, collect the tax files and schedule an oral hearing for the case, unless the taxpayer and the appeal
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financial directorate consent to a decision without an oral hearing. An oral hearing can take one to several years to schedule.

At the oral hearing, the taxpayer will present their lawsuit and the tax directorate will present its response. Subsequently, the regional court will carry out evidence taking. At the end of the oral hearing, the taxpayer and the tax directorate will present their final positions.

Once the oral hearing is completed, the regional court will issue its decision, either upholding or cancelling the decision of the financial directorate.

(b) **Supreme Administrative Court**

The right to appeal a decision of the regional court is rather broad and mainly includes cases where the decision of the regional court is based on an incorrect interpretation of the law or various procedural failures of the regional court.

An appeal may be filed either by the taxpayer or by the tax directorate. The appeal must be filed within two weeks of the delivery of the regional court’s decision.

The Supreme Administrative Court relies on facts recorded in the files by the regional court and mostly reviews the legal questions presented in the case.

The Supreme Administrative Court could take an additional year or two before rendering its final decision on the appeal. An oral hearing is rarely scheduled. The Supreme Administrative Court may either uphold or cancel the decision of the regional court.

(c) **Constitutional court**

Taxpayers have the right to file a constitutional complaint against a decision of the Supreme Administrative Court if they believe that such a decision infringes their constitutional rights. The constitutional complaint
must be filed within 60 days of the delivery of the decision of the Supreme Administrative Court to the taxpayer.

Although the constitutional court is only supposed to review the conformity of the decisions with the taxpayers’ constitutional rights, the constitutional court also reviews the proper interpretation of the tax laws in certain cases.

The constitutional court could take an additional year or two before rendering its final decision on the constitutional complaint. An oral hearing is rarely scheduled. The constitutional court may either uphold or cancel the decision of the Supreme Administrative Court.

(d) Court of Justice of the EU

Czech courts must apply "directly applicable" community law provisions even if these contradict Czech tax laws. Any court may request a preliminary ruling, but the Supreme Administrative Court generally must do so in case there is doubt as to whether a Czech tax provision violates community law.

Although Czech taxpayers do not have direct access to the CJEU, they may argue during litigation that the relevant provision violates community law.

Once a provision of Czech tax law has been found by the CJEU to be contradictory to the directly applicable community law, the Czech tax authorities should normally no longer apply this provision.

In cases where a provision of non-Czech tax law similar to a provision of Czech tax law has been found by the CJEU to violate community law, Czech tax authorities have still been rather reluctant to stop the application of this provision. In such a case, Czech taxpayers are well advised to file appeals against the tax assessment.
3. Payment of tax

Once the tax office has issued an additional tax assessment, taxes normally become due and payable within 30 days of the delivery of the additional tax assessment to the taxpayer. Until 31 December 2009, additionally assessed taxes must have been paid even if an appeal was filed against the additional tax assessment. In order to avoid payment of taxes once an appeal has been filed, the taxpayer had the right to request a deferral of the payment demand. The tax authorities would have had to agree to this deferral if the immediate payment would cause serious detriment to the taxpayer or if it would not be possible to collect the entire amount at once.

If the tax authorities consented to the deferral of the payment, the taxpayer must have paid the interest due. The annual interest rate on late payments was equal to the repo rate of the Czech National Bank (currently approximately 1% per annum), increased by seven percentage points.

Since 1 January 2010, an appeal against an additional tax assessment issued after a tax audit suspends the obligation to pay the additionally assessed tax until the final decision on the appeal is issued.
III. Competent authority

In order to prevent double taxation resulting from changes in income allocation, effected either by Czech or by non-Czech tax authorities, a taxpayer is entitled to apply for a competent authority procedure as set forth in the relevant treaty. In most cases, the wording of the respective provisions is similar to that of Article 25 of the OECD Model Convention. The details of such a procedure are not set or published by the Czech tax authorities.

As far as the EU is concerned, double taxation issues can be addressed on the basis of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises.

The Czech Republic taxpayer has a great deal of flexibility because the application for the initiation of competent authority or arbitration proceedings may be filed in the Czech Republic in the following situations:

- Before and after a tax assessment has been issued in the Czech Republic (i.e., in the case of existing or impending double taxation, even if double taxation is merely threatened)
- When an appeal is pending or other legal remedies are not yet exhausted under Czech law or pursuant to the law of the other state
- Irrespective of whether or not Czech tax assessments are final

An application should be filed as soon as possible after an announcement of the Czech or foreign taxation measure leading to double taxation. Whether an application should be filed in the Czech Republic or abroad depends on the facts of the individual case and often involves strategic considerations. With the exception of applications for the initiation of arbitration proceedings according to the Arbitration Convention (where a three-year period applies), the Czech tax authorities will not agree, as a rule, to initiating a competent authority procedure if the taxpayer lets a
period of more than four years pass between their notification of the relevant taxation measure and the application.

In summary, an application for initiation of the competent authority or arbitration proceedings may have particular value due to the following reasons:

- It can be filed before a tax assessment has been issued independent of pending appeals, and even if the Czech tax assessments have become final.

- Czech tax authorities that are different from the ones issuing the original assessment notice or dealing with the appeal had become involved.

- Non-Czech tax authorities, which may adopt a different approach, had become involved.

- Under the Arbitration Convention, relief from double taxation is possible even if the domestic laws of the other state will not permit their local tax authorities to derogate from decisions of their fiscal courts (Article 7.3 of the Arbitration Convention).
Handling Tax Disputes in France

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I. Managing the tax audit process

1. Tax audits

(a) Expected periodicity


In France, enterprises are audited on a discretionary basis. Nevertheless, large companies are audited about once every three years, which corresponds to the standard statute of limitations. The French tax authorities may use databases to identify and follow companies that need to be audited regularly. Some significant events may also trigger a tax audit, such as a merger or liquidation.

(b) Selection of tax audit targets

From a practical standpoint, the criteria for selecting companies to be audited are as follows: (i) the company’s declared profits in light of different ratios; (ii) proposition of the local or specific tax authorities; and (iii) request from the central tax authorities.

The French tax authorities could apply a method using different ratios, taking into account the turnover declared, inventories, purchases, labor costs, purchase of assets, debts, income and booked reserves, and depreciation allowances (e.g., cash ratio, inventories’ turnover ratio, VAT-invoiced/turnover net of tax, return of personal ratio, percentage of gross margin, and percentage of net income before tax/turnover net of tax).

The French tax authorities could thus determine average ratios for each activity and compare the ratios of the companies with the "standard ratios" in order to select the companies to audit (ratios higher or lower
than the "standard ratios," evolution of ratios for a company over a number of years). This method is not automatically applied, and the actual selection depends on many criteria.

Furthermore, the local tax authorities (Service des Impôts) monitor the consistency of tax returns and look for errors in order to propose tax audits. Specific tax departments like the National Directorate of Tax Inquiries (Direction Nationale des Enquêtes Fiscales) process information (press, derogatory procedures, etc.) per activity and sector or information concerning, more specifically, large companies or operations.

The General Directorate of Public Finances (Direction Générale des Finances Publiques) has a tax policy that is dependent on strategic sectors and also looks for specific frauds, such as fraud concerning intra-community VAT, new business and R&D tax credit.

European cooperation programs and other forms of tax assistance may lead to exchanges between tax authorities and may result in coordinated tax audits. It also has to be noted that Section L 13 C of the French Book of Tax Procedures (FBTP) provides that any taxpayer may request to have its tax status audited at any time by the French tax authorities (c.f., infra).

In the event of proposed reassessments, the taxpayer may voluntarily regularize its situation and will benefit from a 30% late payment interest relief (Section L 62 of the FBTP).

2. Advance preparation for tax audits

(a) Legal requirements

The French Commercial Code provides for general accounting obligations.

Depending on the activity of the taxpayer, some taxpayers may also be subject to specific accounting obligations. The FBTP provides that books, records and related accounts and vouchers must be maintained for a
minimum of six years. Under commercial law, however, books and records must be maintained for 10 years.

Documentation obligations have also been set up in the field of transfer pricing.

(b) Transfer pricing documentation requirements

Sections L 13 AA and L 13 AB of the FBTP provide for transfer pricing documentation obligations.

These documentation obligations are applicable to legal entities established in France that meet one of the following requirements:

- Annual turnover before taxes or total gross assets on the balance sheet is higher than or equal to EUR 400 million
- Holding, at the end of the fiscal year, directly or indirectly, is over 50% of the capital or voting rights of a legal entity (a legal person, trust or comparable institution established or constituted in France or outside France) meeting one of the conditions set forth under paragraph a
- More than 50% of the capital or voting rights, at the end of the fiscal year, directly or indirectly, is held by a legal entity meeting one of the conditions set forth under paragraph a
- It belongs to a tax consolidated group (Section 223 A or Section 223 A-bis of the French Tax Code) when this group includes at least one legal person meeting one of the conditions set forth under paragraph a, b or c

Under paragraph e, all the companies included in the French tax consolidation group are subject to the documentation obligations.

French permanent establishments (PEs) of foreign entities also fall within the scope of the documentation requirements.
Documentation must be comprehensive and cover all the transactions concluded with related entities outside of France. All types of transactions should be covered without any limitation, including financial transactions as well as nonrecurring transactions (consequences of business restructurings are covered). As regards the format of the documentation, two separate documents must be prepared:

- **A master file** that contains a general description of the group of associated companies with a general description of the legal and organizational structures of the group, of the functions and risks assumed by the related enterprises as far as they impact the results of the audited enterprise, as well as a list of the main intangible assets and a general description of the transfer pricing policy, must be prepared. Changes must also be identified. The guidelines indicate that the main entities of the group must be presented, but that the level of detail of the information provided should depend on the role of each entity in the organization of the group, of its contribution to the activities of the group, and of the importance of its assets and functions for the determination of the transfer pricing policy of the group. It is therefore necessary to determine what the relevant information is to help the French tax authorities understand the economics of the overall organization on the basis of the respective roles of each player.

- **An entity file** must be prepared for each French entity within the scope of the documentation requirements, including specific information regarding the audited entity. It must present a description of the operations of the audited entity with related entities, and provide the details of the amounts of intercompany flows, including royalties (global amount by type of transaction). It must also include a list of the cost-sharing agreements, advance pricing arrangement (APAs) and rulings concerning transfer pricing as far as they impact the profits of the audited enterprise, and a presentation of the transfer pricing methodologies with an analysis of the functions, risks and
assets involved, as well as a comparable study, if relevant. It must also explain the changes that occurred during the fiscal year. The guidelines indicate that for financial establishments and investment enterprises, the information can be segregated by categories of operations or by lines of business, in accordance with the structure and organization of the enterprise.

For entities established in a Non-Cooperative State or Territory (NCST — as defined by Section 238-0 A of the French Tax Code), additional documentation is required, including a balance sheet and profit and loss (P&L) statement complying with French GAAPs (generally accepted accounting principles).

The French tax authorities may request that documents in a foreign language be translated into French.

The French tax authorities are entitled to request the provision of the documentation only within the framework of tax audits targeting these fiscal years (i.e., in practice after the filing of the annual corporate income tax returns).

The documentation must be made available to the French tax authorities upon request at the starting date of the tax audit, which is the date of the first visit of the tax inspector to the company’s premises. In the event of failure to provide the documentation, or in the event of incomplete documentation, documentation must be provided within 30 days after receipt of a formal notice to provide it (this deadline can be increased to 60 days upon request, but the French tax authorities can refuse this extension).

In the event of failure to provide the documentation upon request or within this time period of 30 days, a penalty, which cannot amount to less than EUR 10,000 per fiscal year, can be applied. The amount of the
penalty could be the greater of the following two amounts, taking into account how serious the failure to respond or incomplete the response is:

- 0.5% of the amount of the transactions still insufficiently documented after the formal notice
- 5% of the amount of the transfer pricing reassessments

In addition to the transfer pricing documentation obligations addressed above (Section L 13 AA of the FBTP), which must be prepared on a contemporaneous basis, enterprises not subject to these new obligations remain subject to the provisions of Section L 13 B of the FBTP within the framework of tax audits.

Section L 13 B provides that, when the French tax authorities have collected information in the course of a tax audit leading to the presumption that an enterprise has indirectly transferred profits abroad, as set forth by Section 57 of the French Tax Code, the French tax authorities are entitled to request from the enterprise the information and documentation concerning its transfer pricing policy (the content of this information is similar to the information to be included in the documentation under Section L 13 AA). Therefore, from a practical standpoint, it may be advisable to have transfer pricing documentation prepared, whether or not the threshold of Section L 13 AA is satisfied.

It should be noted that the decree No. 2018-554 dated 29 June 2018 and the French tax authorities’ latest guidelines on Section L 13 AA of the FBTP, specifies the content and format of the transfer pricing documentation, according to OECD standards (BEPS Action 13). French transfer pricing documentation requirements even raise some specificities, going beyond international standards, such as the obligation to submit the transfer pricing documentation in a dematerialized format.
France also implemented the country-by-country reporting rules ("CbC reporting rules"), following the release of the OECD/G20 BEPS Action 13 report.

Section 223-quinquies C was added to the French Tax Code. These provisions are similar to the ones from Directive 2016/881/EU of the EU.

These are applicable to companies established in France that meet the following cumulative criteria:

- Companies that draw up consolidated accounts
- Companies that hold or control, directly or indirectly, one or several entities or branches located outside France
- Companies that have a consolidated annual turnover, excluding VAT, higher than EUR 750 million
- Companies that are not held by one of several entities established in France, which are subject to the reporting obligation in France or held by one of several entities established outside France that are subject to a similar reporting obligation in their country under the law of that country

In addition, companies located in France, held or controlled, directly or indirectly, by companies: (i) not located in a listed state (i.e., a listed state is a state that has implemented CbC reporting rules similar to the ones implemented in France and concluded with France an agreement to automatically exchange CbC reports); and (ii) that would be subject to the French CbC reporting rules if it were established in France, will be subject to these reporting obligations in either of the following situations:

- If they were appointed to do so by their group and had mentioned this information to the French tax authorities
• If they are not able to demonstrate that other companies located in France or in a listed state have been appointed to do so

The reporting information could be automatically exchanged by France with states that: (i) have concluded with it a treaty providing for an automatic exchange of information; and (ii) have rules that penalize the violation of tax secrecy that are at least equivalent to the ones applicable in France.

Failure to comply with the French CbC reporting rules could be subject to a fine amounting to EUR 100,000 per entity.

(c) Requirement to file a transfer pricing disclosure form

Enterprises with annual turnover before taxes or total gross assets on the balance sheet that are higher than or equal to EUR 50 million, and which are subject to the other requirements in Section L 13 AA of the FBTP are now required to prepare a transfer pricing disclosure form, to be filed annually within six months of the due date for filing the income tax return.

The content of the transfer pricing disclosure form set out in Section 223-quinquies B of the French Tax Code is a summarized version of the one in Section L 13 AA of the FBTP. Only cross-border transactions with an aggregated amount that exceeds EUR 100,000 should be included in this form. This requirement takes the form of two tables (form No. 2257-SD) to be filed with very limited write-up.

Non-compliance with this obligation is punishable with a EUR 150 fine for failing to report on time plus EUR 15 for omission or inaccuracy, with the limit of EUR 10,000.

The filing must be performed electronically and by the head of the consolidated tax group (Section 223 A and Section 223 A-bis of the French Tax Code). The latter is in charge of filing its own form and one for each of the tax consolidated entities.
(d) Practical recommendations

Taxpayers obviously must prepare themselves whenever a tax audit can be anticipated. Such preparation consists of preparing in advance and reviewing the documentation that needs to be made available to the French tax authorities or that could be requested by the tax auditor (transfer pricing documentation, corporate documentation).

The best method for anticipating a tax audit is to be prepared to provide the French tax authorities at any time, with the mandatory and appropriate documentation. All mandatory documents also need to be properly filed and made available. Also, before the audit starts, it is necessary to identify all weaknesses so that an audit strategy can be defined.

Upon receipt of an audit notice, an internal review of the sensitive files and topics should be initiated.

(e) Limitation period for assessments

The general rule is that the French tax authorities can only exercise their authority to audit and reassess within three calendar years following the year during which the taxable event occurred (Section L 169 of the FBTP).

As a first exception to this general rule, the statute of limitations is extended to 10 years in the event of a concealed activity (i.e., the taxpayer did not file any tax return for the concerned activity in due time and did not report to the Centre des Formalités des Entreprises (CFE) (agency of formalities for enterprises), or to the Registry of Commerce in the event of flagrant tax violation).

This notion of concealed activity is practically applied by the French tax authorities, for instance, in the context of audits of alleged PEs of foreign companies.
As another exception to this principle, with respect to transfer tax, the three-year statute of limitations only applies to a situation where the French tax authorities are in a position where they must be aware of the existence of the event triggering the taxation (registry of an act, filing of a declaration) without requiring any additional searches. In other situations, such as the discovery of undisclosed operations, when a document (for instance, a share purchase agreement (SPA) or transfer of goodwill) must have been filed with the French tax authorities and has not been filed, the statute of limitations is extended to six years.

The statute of limitations period may also be extended in the following cases:

- Fraudulent acts are discovered and a complaint has been filed (Section L 187 of the FBTP: additional two-year period (i.e., up to a total of five years)).

- The French tax authorities have requested information concerning the taxpayer from foreign tax authorities before the statute of limitations has expired (Section L 188 A of the FBTP). In such a case, the standard statute of limitations period may be extended until the end of the year following that during which the French tax authorities received a response to their request and, in any event, at the latest until the end of the third year following the one for which the initial statute of limitations period expired.

- The French tax authorities may reassess years barred by the three-year statute of limitations if a breach is revealed during litigation up to the end of the year following the one during which the court has rendered its decision, but no later than the end of the 10th year following the year during which the taxable event occurred (Section L 188 C of the FBTP).

- In the event of a tax inquiry concerning tax fraud (see below under Section 4 (c)), subject to certain conditions, the statute of limitations is
extended until the end of the year following the decision ending the judicial inquiry, and at the latest until the end of the 10th year following the one for which the taxation is due (Section L 188 B of the FBTP). The statute of limitations period could be interrupted, in particular, when the French tax authorities send a proposed tax reassessment notice to the taxpayer within the initial statute of limitations period (Section L 189 of FBTP). In addition, the French tax authorities may audit the origin of and reassess tax losses generated during a statute-barred year, which are carried over to a year that is still open to tax examination.

3. **Areas of tax auditors’ special attention**

(a) Procedure and form

(i) Formal requirements

   i) Formal notice

   Before the audit starts, the French tax authorities need to issue a formal notice of tax audit (*avis de vérification*) stating the scope of the audit and the period to be audited. This notice must also advise the taxpayer of its right to be assisted by a lawyer of its choice during the tax audit (Section L 47 of the FBTP). The tax inspector must also notify the taxpayer, in the tax audit notice, of the existence of an information booklet available online (*charte du contribuable vérifié*) that summarizes the main rights and obligations of the taxpayer and of the French tax authorities during a tax audit (Section L 47 of the FBTP). Under French tax law, there is no recourse against the decision of the French tax authorities to perform an audit, which is discretionary.

   ii) Adversarial principle

   The French Tax Code and the FBTP provide that the French tax authorities may have access, within the scope of a full tax audit, to all accounting documents and supporting documents held by a taxpayer.
As a general principle, the tax inspectors may only audit documents relating to operations during the years subject to the tax audit.

The audit is governed by the principle of adversarial debate, meaning that the tax inspector should present their concerns and put the taxpayer in a position to present its comments and arguments.

In an accounting audit, the French tax authorities may audit not only corporate income tax and VAT liabilities, but also other taxes (wage tax, business tax, registration tax, etc.).

Where the taxpayer is an individual, the tax audit takes place, in principle, within the French tax authorities’ premises, with the documents being put at the disposal of the inspector. The audit may not exceed one year as of the notice of audit, extended to two years if undeclared activity is discovered (Section L 12 of the FBTP).

Where the taxpayer is an entity, the tax audit generally takes the form of an on-site tax audit (verification de comptabilité), or, when the French tax authorities consider that such an on-site tax audit is not necessary, and provided the taxpayer uses a computerized accounting system to book its accounts, the audit can also take the form of a remote simplified tax audit procedure (examen de comptabilité à distance).

In the case of an on-site tax audit procedure, the tax audit takes place, in principle, within the premises of the company, with documents and accounting being put at the disposal of the tax inspector. Where accounting is computer-based, the French tax authorities will also audit the accounting system (cf. item 5. infra). Tax audit meetings are normally held at the taxpayer’s residence or place of business. During the first meeting with the auditor, the practical modalities of the audit are discussed and an audit schedule is established.

In certain cases, the tax auditor may ask for a plant tour, as well as for an overview of the company’s operations, its products and a description of
any changes since the last audit. Other normal documentation that might be required would include an up-to-date corporate organizational chart, an internal staff organizational chart, corporate documents, financial statements, invoices and major contracts.

The tax inspector is not authorized to stay for more than three months in the premises of companies having revenues under EUR 789,000 (sales activity) or EUR 238,000 (services activity) (Section L 52 of the FBTP).

In the case of a remote simplified tax audit, pursuant to the Sections L 13 G and L 47 AA of the FBTP, the taxpayer is required to provide to the French tax authorities a copy of its dematerialized accounting files (Fichier des écritures comptables (FEC), cf. item 5. infra) within 15 days after it receives the formal audit notice. The tax authorities may conduct any sorting operations, classifications and calculations needed in order to verify that the data in the FEC are consistent with the taxpayer’s tax returns or other documents. The tax authorities are allowed to request additional information, justifications or clarifications to characterize anomalies detected. This remote tax audit is limited to a maximum six-month period.

In any case, whether the tax audit is conducted on-site or remotely, the tax inspector must indicate in the course of the audit if a reassessment will be made or not (Section L 49 of the FBTP), noting that: (i) once the French tax authorities have finished auditing a taxpayer for a given tax for a given period, they cannot afterward issue a deficiency notice based on information gathered in the course of a subsequent audit (Section L 51 of the FBTP), and any subsequent tax audit for the same period is prohibited; and (ii) the tax inspector should discuss the reassessment decisions with the taxpayer in accordance with the principle of adversarial and oral debate (débat oral et contradictoire).
iii) Strategic and settlement issues

The preliminary stage of an audit includes fact gathering and verification. This stage is followed by an evaluation of the findings and an identification of the issues.

During the audit, it is highly recommended to assist the tax auditors and implement a formal process of questions and answers. For instance, it is possible to request from the tax inspector that they send a list of questions or documents to be prepared for the next meeting. This allows for the preparation of responses and for the provision to the tax inspector of documents with the requested information.

Only authorized persons should be allowed to talk to the auditor. All documents requested by the tax auditor should be reviewed before being physically submitted. Transfer pricing issues, if raised during the audit, are sensitive issues and need specific attention. The nature, content and form of documentation and information to be supplied should be carefully reviewed.

It is advisable to engage in continual discussion with the tax auditor to be able to understand their potential concerns and to allow the procedure to be oral and adversarial. Although the presence of an external tax lawyer during the entire tax audit is advisable, the first and final meetings with the tax auditor are very important and should include this external lawyer.

After discussion meetings with the taxpayer, a closing meeting is scheduled, during which the tax inspector indicates what reassessments they intend to notify. During the closing meeting of the audit, it is quite important to clearly understand the items the tax auditor intends to reassess. This is the last step before the receipt of a proposed tax reassessment notice.

During the tax reassessment procedure, it is necessary to reply to the tax auditor within the 30-day period following the receipt of the tax notice.
There can be a 30-day extension of the initial period upon request of the taxpayer before the initial period expires. It is generally recommended to develop all the arguments that may be relevant, be these factual or legal, as soon as possible, so that at the earlier step of the procedure, all of the elements needed to successfully defend against the audit are brought forward to convince the tax auditor. Some procedural arguments may be developed at a later stage, especially when the French tax authorities may send a new proposed tax reassessment until the expiration of the statute limitation period, which would cancel the first one.

During the entire procedure, one of the main issues is to determine whether the taxpayer should try to enter into a settlement agreement with the French tax authorities or move forward to litigation. This will mainly depend on the arguments of the French tax authorities and the nature of the reassessment. It is recommended, however, to first challenge reassessments and determine the chance of success of the taxpayer’s positions.

(2) French tax authorities’ special prerogatives

Until the statute of limitations has expired, the French tax authorities have the right to proceed with one or more of the following types of tax investigations: request for additional justification or information; right for communication; and search and seizure procedures (which can be conducted when the French tax authorities have material information with which to infer that there would be a presumption of fraud).

i) Request for justification (Section L 16 of the FBTP)

The French tax authorities have the right to make a request for justification (démande de justifications), particularly where the tax return filed by the taxpayer is self-contradictory or is contradicted by other tax returns filed by the taxpayer or other information at the disposal of the French tax authorities (Section L 16 of the FBTP). In addition, a request for
justification may be made in order to require the taxpayer to produce written justifications of the content of its tax return.

The French tax authorities must give the taxpayer at least two months to respond to the request for justification (Sections L 16 and L 16 A of the FBTP). If the taxpayer does not respond to the request on time, the French tax authorities may proceed with a unilateral tax reassessment (Sections L 16 and L 69 of the FBTP). If the information provided by the taxpayer is insufficient, the French tax authorities may send a second request for information, which must be answered within 30 days (Section L 16 A of the FBTP). If the taxpayer does not respond to the second request within 30 days, or if its response remains insufficient, the French tax authorities may proceed with a unilateral tax reassessment on an estimate of the tax base, based on the information put at their disposal. This procedure, which is not a theoretical risk and is actually used by the French tax authorities, shifts the burden of proof onto the taxpayer, who has to demonstrate the inaccuracy of the estimate performed by the tax authorities.

ii) Request for information (Section L 10 of the FBTP)

Another type of request that may be made by the French tax authorities is a request for information (demande d’information). In such a case, the taxpayer is not required to respond to the French tax authorities. In this regard, as a general rule, it is stated that a response is not mandatory. Nevertheless, oral answers should be provided in the course of the discussions with the authorities if other procedural rules do not preclude a response (as, for instance, specific transfer pricing procedure).

Such requests for justifications or information are among the most significant tools used by French tax inspectors in the absence of a formal tax audit.

iii) Right of communication

The French tax authorities may exercise their right of communication (droit de communication) to obtain information from third parties (listed by law...
as business entities, courts, public administrations, insurance companies and employers, as well as some professionals (Sections L 81, L 83 and L 95 of the FBTP). Third parties must provide the French tax authorities with any books, registers or other accounting documents relating to the audited taxpayer, which such parties are required by law to keep (Sections L 83 and L 95 of the FBTP). In order to preserve the tax authorities’ right to information, taxpayers are obligated to keep their accounting and corporate documents for six years (Section L 102 B of the FBTP).

Failure by a third party to allow the French tax authorities to consult these documents is sanctioned with penalties.

According to Section L 76 B of the FBTP and to the sustained case law, the French tax authorities must inform the taxpayer of the nature and origin of the information received from third parties they used to reassess the taxpayer’s income tax base. According to a decision of the French Supreme Administrative Court (Conseil d’État), dated 21 December 2006, and to the tax authorities’ guidelines (BOI-CF-PGR-30-10 No. 250), this obligation is not limited to the information gathered within the framework of the exercise of the "right of communication," but nevertheless does not apply to the yearly mandatory information requested by the French Tax Code (declaration by employers, declaration of revenues of securities, etc.).

In the context of the right of communication, Section L 10-0 AA of the FBTP has introduced the possibility for the French tax authorities to use documents or information regardless of their origin (i.e., illegal or anonymous information can be used). This rule applies to all procedures of tax audits and tax inquiry except for the search and seizure procedure.

iv) Hearing procedure with which to fight international tax evasion

The French tax authorities have the right to hear persons – other than the taxpayer itself – who are likely to provide information useful to fight international tax evasion.
This hearing procedure (procedure d’audition), set forth at Section L 10-0 AB of the FBTP, enables the French tax authorities to hear any person who may be able to provide information useful to their investigation i.e., any person who is likely to hold relevant information (e.g., customers, suppliers, accountants, employees, ex-employees, service providers, etc.).

In practice, the tax authorities must send a request to hear a person at least eight days prior to the date proposed for the hearing. The purpose of the hearing must be indicated on the request. The person has the right to refuse to be heard. If the person accepts, in principle, the hearing takes place in the premises of the tax authorities.

Minutes of the hearing containing, in particular, the questions raised and answers received must be prepared by the tax authorities. It must be signed by the tax authorities and the person heard; the latter can refuse to sign the minutes (such refusal is then mentioned on the minutes).

This recent procedure is autonomous and allows the French tax authorities to gather information. It could therefore be implemented prior to or during a tax audit of a taxpayer.

v) Search and seizure procedures (Section L 16 B of the FBTP)

Under Section L 16 B of the FBTP, the French tax authorities can obtain a right of visit and seizure for the research of evidence of fraudulent acts with respect to direct taxes and VAT.

This right is granted when there are presumptions that a taxpayer did not comply with the filing or the payment of personal income tax, corporate income tax or VAT, by one of the following:

- Realizing purchases and selling with no invoices
- Using or editing invoices or documents that do not correspond to real transactions
Voluntarily not booking certain accounts, or voluntarily booking false or fictitious accounts in documents, the filing of which is mandatory under the French Tax Code.

Searches can only be carried out at the request of the French tax authorities and only under the control of a judicial judge (Juge des libertés et de la détention) who, after a review of the motives of the request, authorizes them by way of a warrant indicating the exact location of the premises to be searched.

Searches can be carried out by tax inspectors, under such special authorization and can only begin between 6 am and 9 pm, in the presence of a police officer designated by the judge in their warrant, the occupant of the premises or its representative, or in the absence of the latter, two witnesses (third parties or occupant) designated by the police officer.

The French tax authorities are only allowed to seize documents (in paper or electronic format) relating to the presumed law infringement for which the search has been authorized by the judge. It is also specified that the French tax authorities are expressly allowed to access and copy data located on servers abroad. If the judge considers that the documents seized are not related thereto, they can order that these documents be disregarded, and no longer be used by the French tax authorities. Minutes of the visit and of the documents seized are issued at the end of the search.

There is an infraction of opposition to a tax raid, which consists of preventing access to records or documents contained in electronic support, their reading or their seizure.

Such an opposition to a tax raid would generate the following main consequences:

- The French tax authorities will be able to copy the documents in electronic support and seize the latter, which is placed under seal. In this respect, they have 15 days from the date of the search procedures.
to access, read, seize and make restitution of the documents contained in the electronic support placed under seal.

- The French tax authorities could subsequently implement the *ex officio* procedure in the context of the future tax audit.

- Penalties of up to 100% may be charged.

When the taxpayer claims that the seizure procedure was unfounded or insufficiently founded (e.g., the French tax authorities did not provide the judge with enough elements resulting in a presumption of tax evasion and still requested that they authorize the implementation of this procedure), it can challenge the judge’s warrant allowing the procedure before the president of the competent court of appeal within the 15 days following the notification of the warrant. The decision to be rendered by the president of the court of appeal can be ultimately challenged before the Supreme Civil Court (*Cour de Cassation*).

The performance of the visit and search procedure can also be subject to appeal before the judge within the 15 days following the receipt of the minutes of the visit or of the seized documents. In any case, the decision rendered by the first president of the court of appeal can be subject to appeal in cassation.

None of these appeals has a suspensive effect, as the French tax authorities can begin analyzing the seized documentation before the decisions are rendered.

The chances of success of such a procedure exist, but are however quite low, based on current case law.

If the court of appeal (*Cour d’appel*) (and the Supreme Court (*Cour de cassation*)) confirms that the authorization to implement the seizure procedure was valid, the French tax authorities could use the seized
documentation in order to sustain the tax reassessments that they could contemplate to propose in the context of a future tax audit.

However, if authorization to implement the seizure procedure is annulled, the items seized must not be used to establish taxes. In this respect, the "tax judge" must discharge the taxes based on these elements.

In June 2019, the lower administrative court (Tribunal administratif) of Paris has indicated that, if the civil judge has not yet ruled on the validity of the seizure procedure (but the taxpayer justifies having duly referred this matter to the court), the "tax judge" must, if no other plea raised before their court is likely to aim in the discharge of the taxes, stay proceeding until the civil judge has ruled on the regularity of the seizure procedure.

There has been an increase in the use of search-and-seizure procedures in France within the context of tax audits of large enterprises, notably in cases where the French tax authorities try to demonstrate the existence of a taxable PE of a foreign company in France.

vi) International exchange of information

Due to the globalization and development of international business exchanges, the French tax authorities use more and more of these kinds of sources of information within the course of tax audits. The French tax authorities may rely on two sets of rules to request information from a foreign tax authority.

First, within the EU, legal instruments have recently strengthened the cooperation between EU Member States in the matter of information exchange:


This Directive has been modified six times, in order to extend its scope: by Directive 2014/107/EU ("DAC 2") related to financial institutions; Directive 2015/2376/EU ("DAC 3") related to the exchange of tax rulings; Directive 2016/881/EU ("DAC 4") related to country-by-country reporting; Directive 2016/2258/EU ("DAC 5") related to anti-money laundering (AML) and Directive 2018/822/EU ("DAC 6") related to the disclosure of cross-border arrangements for taxpayers and intermediaries.

The above-mentioned DAC 3 dated 8 December 2015, which came into effect on 1 January 2017, requires Member States to automatically exchange information on their tax rulings. The directive removes Member States’ discretion to decide on what information is shared, when and with whom.

These rulings – defined widely so as to capture all similar instruments and irrespective of the actual tax advantage involved – have to be exchanged every six months. The agreement also covers existing rulings of the past five years. Member States may ask for more detailed information on a particular ruling.

The automatic exchange of information on tax rulings enables Member States to detect certain abusive tax practices by companies and take the necessary action in response. This initiative also aims to deter tax authorities from offering selective tax treatment to companies since this is open to scrutiny by their peers.

Additionally, the DAC 5 ensures that tax authorities are able to access the AML information held by financial institutions so that tax authorities are...
better equipped to fulfil their obligations under Directive 2011/16/EU and to fight tax evasion and fraud more effectively.

Moreover, DAC 6 (which was transposed into French law by Order No. 2019-1068 dated 21 October 2019) targets, within the framework of BEPS Action 12, aggressive tax planning arrangements and places a reporting obligation upon:

"all actors that are usually involved in designing, marketing, organizing or managing the implementation of a reportable cross-border transaction or a series of such transactions, as well as those who provide assistance or advice."

When such obligation may not be enforced, due to a legal professional privilege or because no intermediaries are involved, the reporting obligations would shift to the taxpayer themselves.

Besides, in double tax treaty (DTT) provisions, the contracting states agree to exchange information within the scope of the tax treaty. The OECD Model Tax Convention relating to the exchange of information and its last commentaries, notably and explicitly allows French tax authorities to ask for information on a group of taxpayers, without naming them individually, as long as the request is not a "fishing expedition."

These kinds of procedures must ensure, however, that the rights and guarantees of the taxpayer are respected. DTTs usually limit the scope of application of the exchange of information.

In addition, Section L 188 A of the FBTP provides for a possible extension of the statute of limitations (cf. supra). The French regulations regarding NCSTs provide that it is necessary to enter a tax treaty with France, providing for administrative assistance and allowing the exchange of information, and sign such a treaty with at least 12 states or territories in order not to be listed as an NCST.
(b) Substantive issues

(1) Permanent establishment/residency

There have been numerous PE assessments for the determination of a PE over the last few years. In the Interhome case, the French Supreme Administrative Court (Conseil d'État) took the position that a PE can be located in a French subsidiary of a Swiss parent company, provided that it is a dependent agent of the Swiss parent and has exercised, and habitually exercises, the authority to bind that Swiss parent in connection with the parent's business. This decision significantly increases the PE exposure of French subsidiaries.

Concerning the French commissionaire of a UK principal, the French Supreme Administrative Court judged in the Zimmer case, based on the fact that the commissionaire acted in its own name, that a commissionaire could not constitute a PE of its principal in France unless this commissionaire can bind its principal in a contractual relationship with third parties (i.e., with end customers).

With this decision, the French Supreme Administrative Court has secured the use of commissionaires’ structures in France. Indeed, it has specified that, under the legal status of the commissionaire under civil law, principals cannot be bound in a contractual relationship with end customers.

However, despite the clear decision of the French Supreme Administrative Court, it appears in practice that the French tax authorities continue to challenge such a decision and have tried to qualify certain French commissionaires as PEs of foreign principals in France. More globally, the French tax authorities have recently had more cases where they consider that a French subsidiary would have, and exercises, the power to conclude contracts in the name of a foreign company, with an extensive view of the contract-concluding authority.

The position of the French tax authorities has been rejected by the lower administrative court (Tribunal administratif) of Paris in the Google case in
judgments dated 12 July 2017 which were confirmed by the Administrative Appeal Court (Cour administrative d’appel) of Paris on 25 April 2019. Both courts found that the employees of a French group entity did not have the authority to conclude contracts on behalf, and in the name, of the Irish principal company, based on Article 2 of the France-Ireland DTT. The Administrative Appeal Court of Paris also rejected the position of the French tax authorities in the Conversant International Ltd case in a judgment dated 1 March 2018.

It should be noted that the definition of PE has evolved, following the final report of the OECD/G20 BEPS Action 7 on Preventing the Artificial Avoidance of Permanent Establishment Status. Indeed, on 7 June 2017, France signed the OECD Multilateral Instrument (MLI) and notably opted to include Article 12 of the MLI, which enshrines a new, broader PE notion based on Action 7 of the BEPS report notably to include situations in which the dependent agent, "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." This new PE notion is, however, only applicable if the other treaty partner has also opted for this new definition. Note also, that even if Luxembourg did not opt for such a broader PE notion, the new tax treaty concluded between France and Luxembourg on 20 March 2018 includes such new notion applicable as from 1 January 2020.

Recently, the OECD presented a program of work to develop a consensus solution to the tax challenges arising from the digitalization of the economy. This program aims at developing a new nexus, which would capture a new concept of business presence in a market jurisdiction reflecting the transformation of the economy and not constrained by physical presence requirements. This nexus would allow market jurisdictions to exercise their taxing rights over the measure of profits allocated to them under new profit allocation rules. Two approaches have
been envisaged in the program of work of OECD dated on 28-29 May 2019 to implement this new nexus:

- Amending the PE definition to deem a PE to exist where an enterprise exhibits a remote yet sustained and significant involvement in the economy of a jurisdiction.

- Developing a standalone rule — on the top of PE rules — which would notably identify and define a new non-physical taxable presence separate from the PE concept.

The Secretariat of the OECD has opted for the second option (Public consultation document: "Secretariat Proposal for a Unified Approach under Pillar One" dated on 9 October 2019), although this position is not yet binding as it does not result from an international consensus.

Section L 80 B 6 of the FBTP provides for a procedure allowing taxpayers to request a ruling relating to the existence of a PE. This procedure has been created for the purpose of improving the legal security of operations carried out in France by foreign taxpayers, while improving the attractiveness of France as a place to do business. The taxpayers must file a precise and complete request with the French tax authorities explaining the factual situation. The French tax authorities must reply within a three-month period.

(2) Transfer pricing: intangibles

French statutory and administrative approaches to transfer pricing are generally consistent with the principles set out by the OECD. In that respect, the published final Guidance on Transfer Pricing Aspects of Intangibles at the OECD level may have significant consequences in France. The implementation of the OECD rules should be carefully monitored.

Article 57 of the French Tax Code allows the French tax authorities to adjust the profits of a French enterprise in the event the latter has indirectly transferred profits to a foreign-associated enterprise by an
increase or decrease in purchase or sale prices, or by any other means. In the event that it lacks precise elements to support the assessment, the French tax authorities determine the taxable profits by comparison with those of similar enterprises that conduct business "normally."

i) Royalty issues

Tax inspectors have frequently audited royalty payments of dependent parties and compare these with royalties between independent contractors in the same or similar industries.

For the tax authorities, a fair rate would depend on many factors, including the nature of the products, the importance of R&D expenditures, and the level of technical assistance provided to the French subsidiary.

The French tax authorities also indicated that, in order to audit royalty rates, the inspector should take into account all direct or indirect benefits to the French company, especially if the French company bears the costs associated with the marketing network and advertising.

Where the beneficiary of the royalties is located in a privileged tax jurisdiction, the French company must prove the following items in order for the royalties to be deductible. First, it must prove that the contract reflects an actual bona fide transaction. The mere existence of written agreements is not sufficient to establish such a transaction. The French company must present evidence that it actually uses the intellectual property rights sold or licensed and must also prove the actual usefulness of those rights (i.e., it must prove that the technical know-how transferred is original and that the acquisition is made for the French company's business interest). Second, the French company must prove that the compensation paid to acquire or use the intellectual property rights corresponds to arm’s-length compensation.
Generally, royalties paid by a French resident to a non-resident are subject to a 31% French withholding tax (Section 182 B of the French Tax Code), as from fiscal years opened from 1 January 2019.

This withholding tax can be reduced to 0% on royalties paid by a French resident to an EU associated company under certain conditions (Section 182 B-bis of the French Tax Code). Also, most tax treaties signed by France reduce this rate or provide for an exemption.

ii) Valuation of intangibles

This issue should be considered when restructuring operations are contemplated or when the business model is amended. The French tax authorities generally audit values under their own standards (using different methods), as well as by also looking at previous restructurings. Overall consistency should always be sought in order to defend against any potential argument of the authorities.

Typically, for instance, a question in a conversion from distributor to commissaire would determine if this creates a transfer of goodwill issue and, in such case, for which value.

OECD works would also impact this question.

All valuations made should always be properly documented from both an economic and a legal perspective. In this respect, it is highly recommended to document these values on a contemporaneous basis, even though documentation can be issued upon request.

(3) Transfer pricing: tangibles

The OECD Transfer Pricing Guidelines are soft laws and are not directly binding under French law. However, the French tax authorities generally follow the OECD guidance. In particular, the five OECD-recognized transfer pricing methods are accepted and used by the French tax authorities. The
French tax authorities generally refer to the OECD Transfer Pricing Guidelines in their published doctrine as well as in tax audits.

There is no specific French guidance concerning the selection of the most appropriate transfer pricing method.

(4) Restructuring/business re-engineering

With the increasing development and globalization of international exchanges, multinational enterprises have grown used to frequent restructurings of their business models to adapt to a rapidly changing environment.

Typically, business restructurings can take the form of changes from traditional business models with fully-fledged entities, to more centralized structures with local entities assuming limited functions and risks. Many enterprises have also decided to scale down their organization, notably through relocation of manufacturing operations to countries with lower cost structures.

Restructurings are generally accompanied by significant exceptional costs and expenses and have become a recurring topic in tax audits of international enterprises. The French tax authorities have traditionally considered the consequences of business restructurings within the framework of tax audits, questioning whether there should be a payment of an indemnity, as a result of the termination of existing commercial arrangements, or of the closure of manufacturing facilities, in exchange for the transfer of an intangible asset, notably in cases of implementation of foreign principal structures, as a result of a loss of potential profit, or in order to cover restructuring costs themselves.

Therefore, when undertaking a business restructuring, multinational enterprises should take into account the potential tax costs that this restructuring may involve, and be prepared to answer questions from the French tax authorities.
The French tax authorities carefully review the tax and transfer pricing consequences of business restructurings in tax audits, questioning whether the French restructured entity should be indemnified for a transfer of intangible assets, for the termination of existing contractual relationships, or for a loss of "profit potential," or in order to cover restructuring costs incurred in France. In this context, the French tax authorities are increasingly focusing their attention on the identification and remuneration of transfers of intangibles, a going concern or clientele.

The French tax authorities' guidelines provide a definition of "going concern," which is in line with French legal principles: a universality of tangible and intangible rights and values used for the operation of a business, among which the main element is a clientele. From a tax standpoint, the French Supreme Administrative Court (Conseil d'Etat) has ruled in the case of Bosc Développement Loire that the notion of going concern corresponds to an activity exercised autonomously, at the risks of the enterprise and through the use of proper means. The clientele is also defined as potential or probable relationships with persons who may purchase products or services.

(5) Constructive dividend

Under French domestic law, transfer pricing adjustments may be regarded as constructive dividends to the beneficiary of the income and subject to withholding tax. The withholding tax may be reduced by the applicable bilateral tax treaty.

In addition, it is possible to avoid this withholding tax reassessment when involving companies located in the EU or in the European Economic Area (EEA), on the basis of Section 119-ter of the French Tax Code.

Indeed, Section 119-ter of the French Tax Code provides that the withholding tax on French-sourced dividends paid to non-resident entities (provided by Section 119-bis of the French Tax Code) is not applicable to
distributions to parent companies located in the EU or in the EEA that meet the following conditions:

- Has its place of effective management and its tax residency in the EU or in a country in the EEA, provided that this country concluded with France a convention on administrative assistance for the purposes of combating tax avoidance and tax evasion.

- Takes one of the forms listed in Annex I, Part A of the Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States or an equivalent form in case the company has its place of effective management in a country of the EEA.

- Holds directly, for at least two years or more (or commits to hold for at least two years), in full ownership or bare ownership, 10% of the shareholding of the distributing company. This rate is reduced to 5% when the company that is the beneficial owner of the dividends holds shareholdings that meet the conditions set by Section 145 of the French Tax Code and is unable to offset the French withholding tax, notably due to an exemption regime applicable in its state of residence or due to its tax status.

Pursuant to the anti-abuse clause set forth by the amended EU Parent-Subsidiary Directive 2015/121 of 27 January 2015, implemented at Section 119-ter, 3 of the French Tax Code, the withholding tax exemption will not apply:

"to dividends paid in the context of an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of [the aforementioned withholding tax exemption], are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part. For the purposes of paragraph 3, an arrangement or a series of"
arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality."

(6) Thin capitalization

Under Section 39, I, 3 of the French Tax Code, interest paid to shareholders is only deductible from corporate income tax, provided that the following conditions exist:

- The share capital of the debtor is fully paid up.
- The interest rate does not exceed the average variable rate applied to credit or financial institutions for loans with a term of more than two years granted to enterprises (this rate is at 1.32% for the fiscal year ending 31 December 2019). However, for interest paid to associated enterprises, a higher market interest rate can be accepted, determined by reference to the interest rate that the borrowing enterprise could have obtained from independent credit or financial institutions in comparable conditions.

For this purpose, companies are associated enterprises if: (i) either one of them has a direct or indirect minimum holding of 50% in the share capital of the other, or exercises, de facto, control over the other company; or (ii) a third company has a direct or indirect minimum holding of 50% in the share capital of the two companies, or exercises de facto control over the two companies.

In addition, the Finance Act for 2019 (Law No. 2018-1317 dated on 28 December 2018) transposed into French law the Anti-Tax Avoidance Directive (ATAD) 2016/1164/EU dated 12 July 2016 on interest limitation rules, repealing several domestic rules for the limitation of the tax deductibility of interest and more globally deeply amending thin capitalization rules, which are applicable in France.
It creates a new general mechanism for limiting net financial expenses, which are compared with the company’s or the tax group’s adjusted earnings before interest, tax, depreciation and amortization (EBITDA), determined on the basis of the pre-taxable income adjusted by such net financial expenses, net depreciation and amortizations and taxable gains and losses subject to corporate income tax at the reduced rate.

The mechanism provides for specific rules depending on whether or not the company or tax group is thin capitalized. A company (or a tax group) is considered to be thin capitalized when the average amount of sums left or made available by all companies, directly or indirectly related to it within the meaning of Article 39, 12 of the French Tax Code, exceeds one-and-a-half times the amount of its equity for the fiscal year, at the opening or at the closing of the fiscal year (at the choice of the company or the tax group).

Under the new provisions, the tax deduction for net financial expenses of companies or tax groups that are not thin capitalized is limited to the higher of the following two limits: 30% of their adjusted EBITDA or EUR 3 million. However, an additional deduction of 75% of the net financial expenses, not allowed as deductions, is provided for in the event that the ratio of net equity over total asset of the company or the tax group, that is not thin capitalized, is higher than that of the group determined at the consolidated group level.

For thin capitalized companies, two basis are determined based on the proportion of: (i) debts to third parties (the related financial expenses being deductible within the same limit as for non-capitalized companies — see above); and then (ii) debts to related companies not exceeding one-and-a-half times the amount of net equity over the company’s total debts.

The limit on the deductibility of financial expenses relating to debts to related companies has been reduced to EUR 1 million or 10% of the adjusted EBITDA. However, it should be noted that there is a safeguard
clause for companies or tax groups whose debt-to-equity ratio is higher than the same ratio determined at the consolidated group level. In this case, only the limit of 30% of the adjusted EBITDA or EUR 3 million would apply to all net financial expenses.

A possibility of carrying forward net financial charges that are not deductible is provided for as follows:

- In the case of companies that are not thin capitalized, net financial expenses that are not deductible may be carried forward without any restriction in amount or duration, provided that the possibility to deduct these financial expenses by the company (or the tax group) in respect of these future financial years is not already fully used with respect to the financial expenses incurred during these years.

- In the case of thin capitalized companies, net financial expenses that are not deductible may also be carried forward without any time limit restriction, but after application of a discount representing two-third of the amount of these expenses linked to the basis used for debts to associated companies. This residual amount will be included in the financial expenses that can be carried forward without any time limit restriction.

The legislator also allows companies or tax groups to carry forward their unused deduction capacity in respect of a fiscal year. The deduction capacity for a fiscal year is equal to the positive difference between: (i) the deductibility limit applicable to companies or tax groups that are not thin capitalized (i.e., EUR 3 million or 30% of the adjusted EBITDA); and (ii) the net financial expenses incurred and fully deducted for that fiscal year. This deduction capacity may be used to compensate for a lack of deduction capacity over the next five years but cannot be used as a basis for allocating financial expenses carried forward.
All financial expenses incurred during fiscal years beginning on or after 1 January 2019 are affected by these new rules, including those relating to loans set up before that date.

Also, the Finance Act Draft for 2020 has transposed into French law the Anti-Tax Avoidance Directive (ATAD 2) 2017/952 dated 29 May 2017 and continue the transposition of ATAD dated 12 July 2016. It aims at creating a new rule, mainly applicable from fiscal years opened from 1 January 2020, to tackle hybrid arrangements resulting from payments carried out in the context of a financial instrument, hybrid arrangements that are the result of differences in the allocation of payments made to a hybrid entity or institution, the hybrid arrangements that result from payments made by a hybrid entity to its owner or payments deemed made between the head office and the establishment or between two or more establishments, and finally the effects of double deduction. In a nutshell, this new rule would either prevent a French-based entity from deducting an expense related to a hybrid arrangement, or tax in France an expense related to a hybrid arrangement that has been deducted abroad.

Finally, when the acquiring company is part of a tax consolidation group (intégration fiscale) and acquires the shares of another company from a common shareholder, the deductibility of interest at the group level could also be affected. Indeed, under the French consolidated tax group regime, the so-called "Charasse amendment" is applicable where a company member of a group purchases another company, which is, or will become, a member of the tax consolidated group through a shareholder controlling the group. In such a case, the deductibility of the interest expenses related to the acquired company and incurred by the purchasing company is subject to limitations.

Due to the complexity of the above-mentioned rules, precise conditions need to be checked on a case-by-case basis.
4. Special tax audits

(a) VAT/customs

(1) Right of investigation

According to Sections L 80 F to L 80 H of the FBTP, the French tax authorities may use a procedure of administrative inquiry in order to verify that billing is compliant with VAT obligations.

According to this procedure, the French tax authorities can have access to documents (bills, accounts and professional documents connected with billing). They may also draw up an inventory of tangible assets used in the business and obtain information and justifications. The audit may be made on the premises (but only between 8 am and 8 pm and during working days) or in the offices of the tax authorities.

The French tax authorities have access to professional (business) premises, land and warehouses, as well as to the vehicles used for professional purposes and to the load contained in these vehicles.

Upon completion of the inquiry (i.e., not more than 30 days after it has begun), the French tax authorities must prepare an official record specifying any breaches. The taxpayer can make comments within 30 days. The audit conclusions can only be used against the taxpayer in a regular audit. This procedure may also be used by the customs administration for non-compliance with invoicing rules that apply only to operations realized inside the EU (Sections L 80 I and L 80 J of the FBTP).

Pursuant to Section L 16 D of the FBTP, the French tax authorities can audit, in the scope of a general audit, all operations performed or invoiced by a taxpayer subject to the simplified VAT declaration regime after two months following their performance or their invoicing. It is an exception to the rule that a tax audit can only start after the deadline for filing the tax return.
(2) **On-site audit for VAT credit refund requests**

Pursuant to the amended Section L 198 A of the FBTP, after issuance of a formal notice, the French tax authorities can launch an on-site audit in order to make a decision on VAT refund requests, especially in case of doubt about their genuineness. The on-site audit takes place on the premises of the taxpayer and allows the tax authorities to access the accounting records and any other documents relating to the refund request.

The tax authorities must then make a decision: (i) within a 60-day period from the first intervention on-site; and (ii) within a four-month period after the issuance of the formal notice. Any decision to reject the VAT refund request must be justified. Failure to issue a decision within the required period is considered an acceptance of the VAT refund request.

This procedure applies to VAT refund requests filed as from 1 January 2017.

(3) **Right to check customs warehouses**

Sections L 80 K and L 80 L of the FBTP set forth that the tax and customs authorities can use their right of inquiry in the same manner as described above in order to identify non-compliance with the obligations and formalities to open a customs warehouse. All audited documents must be directly or indirectly connected with the customs warehouses’ activities.

(4) **Customs controls**

According to Section L 83 A of the FBTP, the French tax and customs authorities may voluntarily exchange information or documents.

(b) **Social administration audits**

Social Administration (Union de Recouvrement des Cotisations de Sécurité Sociale et d’Allocations Familiales or URSSAF) inspectors must provide the French tax authorities with a notice of the different detected
infringements of the tax rules (Section L 99 of the FBTP), together with the social security contributions reassessments that have a tax impact.

Section L 97 of the FBTP also obliges the Social Administration to voluntarily transfer a statement to the French tax authorities on an annual basis, indicating the social security forms that were filed by social security affiliates for each medical professional.

Concerning profit sharing and participation agreements, the French tax authorities are informed of any adjustments applied by the Social Administration.

The Law No 2018-898 On the fight against fraud (Loi relative à la lutte contre la fraude) dated 23 October 2018 provides that Social Administration inspectors now have direct access to certain French tax authorities' databases (Section L 135 ZK of the FBTP).

(c) Legal procedure for specific inquiry concerning tax fraud

There are specific proceedings for a tax inquiry in the event of use of fake documentation or of accounts held directly or indirectly in NCSTs (see below section 7. Specific Provisions Targeting Non-Cooperative States).

These specific proceedings (Sections L 228 and L 188 B of the FBTP and Section 28-2 of the French Book of Criminal Procedure) apply in the event of characterized presumptions of tax fraud, for which there are risks that proof may disappear.

When characterized presumptions of tax fraud exist, the public prosecutor is generally not allowed to prosecute the taxpayers of their own initiative.

The public prosecutor is allowed to prosecute the offense of tax fraud in cases where the French tax authorities lodge a criminal complaint. This complaint shall be filed after the French tax authorities have obtained the agreement of the specific committee in charge of tax fraud (Commission des infractions fiscales) in cases where the French tax authorities consider
that the taxpayer has committed the offense of tax fraud or directly to the public prosecutor where the French tax authorities consider that the taxpayer has committed the offense of aggravated tax fraud.

In addition to the possibility for the French tax authorities to file complaints for tax fraud, Law No. 2018-898 On the fight against fraud, dated 23 October 2018, provides that the French tax authorities are compelled to report facts to the public prosecutor where these facts lead to (i) a tax reassessment exceeding an amount of EUR 100,000 and (ii) the application of a) or b) or c) below:

(a) The application of the 100% penalty provided for by Section 1732 of the French Tax Code (ex officio procedure).

(b) The application of the 80% penalties provided for by paragraph 1 c of Section 1728 of the French Tax Code (concealed activity, which is to date often applied by the French tax authorities in PE cases) or by para. b or c of Section 1729 of the French Tax Code (abuse of law or fraudulent behavior).

(c) The application of the 40% penalties provided for by para. 1 b of Section 1728 of the French Tax Code (late submission of a tax return) or by para. a of Section 1729 of the French Tax Code (deliberate breach) have been applied and the taxpayer has been subject to (i) the penalties listed at a), b) or c) in the context of a previous tax audit during the previous six calendar years or (ii) a complaint of the French tax authorities further to a previous tax audit.

Once the facts have been reported, the public prosecutor is entitled to prosecute for the offense of tax fraud.

Also, in case the French tax authorities filed a criminal complaint for tax fraud regarding a taxpayer, the public prosecutor can extend criminal charges to other taxes and other years without the need for a further
criminal complaint or reporting for those years from the French tax authorities.

Once the complaint has been filed or the facts have been reported, judicial investigation can, under the judiciary authorities’ control, be conducted by tax agents benefiting from judicial powers.

Tax audit proceedings are also be impacted in case the French tax authorities filed a criminal complaint for tax fraud regarding the following aspects:

- **Extension of the statute of limitations**: Provided specific conditions are met for the filing of the complaint, the statute of limitations is extended until the end of the year following the decision ending the procedure, and, at the latest, until the end of the 10th year, following the one for which taxation is due.

- **Exception to the prohibition of tax audit repetition**: When the filing of a complaint leads to a judicial investigation for tax fraud, French tax authorities may repeat a tax audit for taxes and years already audited.

- **Absence of time limitation for audits on the premises**: The three-month limitation for small enterprises does not apply when a judicial investigation is in process.

5. **Electronic data processing (EDP) access during audit**

Entities (whether incorporated in France or not) established in France – or even only registered with VAT responsibilities in France – that use a computerized accounting system to book their accounts must provide the tax auditor with Dematerialized Accounting Files (Fichier des écritures comptables, or FEC).

One separate FEC per audited year must be provided during the first audit meeting, and as a measure of tolerance, no later than on the second meeting.
The FEC must be compliant with formal legal requirements. The penalty, in the event an entity’s FEC is not compliant with the legal requirements, amounts to EUR 5,000 per missing or non-compliant file or 10% of the amount reassessed in the context of the audit (even without any link with the FEC files) if higher.

As a matter of principle, the format of the FEC should comply with strict formatting and content standards. In substance, FEC consists of the book of original entries (*livre journal*) of the entity (i.e., all the accounting entries of the fiscal year presented in a chronological order, in a format that is strictly defined). Furthermore, accounting records of French companies should be in the French language, and should now also natively be held under French GAAP.

In the event the company cannot provide the French tax authorities with all the requested documents, there is a risk of a unilateral reassessment procedure (*procedure d'évaluation d'office*) and the application of a penalty at the rate of 100% of the amounts reassessed for obstruction to the tax audit (Section 1732 of the French Tax Code).

Considering the difficulties faced by taxpayers and time spent to ensure the compliance of their FEC with these rules, due to the applicable strict conditions of the presentation of such files, it is highly recommended for entities that have never provided such files not to wait until they receive a tax audit notice to prepare their FEC.

Where accounting is computer-based, the French tax authorities could also audit the accounting system with a specific audit team (the so-called *Brigade de Vérification des Comptabilités Informatisées*) through specific data requests.

When the audit of the accounting system requires electronic data processing (EDP), data processing is carried out, at the choice of the taxpayer, either on the equipment of the company (by the tax authorities
or by the taxpayer itself) according the indications of the tax authorities, or by means of copies provided by the company in electronic format.

When the taxpayer elects to carry out EDP itself, it must make available to the tax authorities, within 15 days following their request, copies of the documents, data and processes audited. Similarly, when the taxpayer elects for EDP to be carried out by the French tax authorities off-site, these files must be placed at their disposal within 15 days following the option. In both cases, the French tax authorities can carry out on these files all or part of the processes necessary to the audit.

In the case where the EDP gives rise to tax reassessments, the tax authorities must communicate the results of the EDP to the taxpayer, at the latest, upon issuance of the proposed tax reassessment notice.

6. Information-gathering powers

Due to the globalization of supply chain and group structures, the French tax authorities use more and more of these kinds of sources of information within the course of tax audits. The French tax authorities may rely on two sets of rules to request information from a foreign tax authority.

First, within the EU, legal instruments have recently strengthened the cooperation between EU Member States in matters of information exchange:


- A Council Directive dated 15 February 2011 (No. 2011/16/EU) in the field of direct and indirect taxes, which repeals Directive 77/799/EEC. This directive has been modified six times in order to extend its field: by DAC 2 related to financial institutions; DAC 3 related to the exchange of tax rulings; DAC 4 related to country by country reporting; DAC 5
related to AML; and DAC 6 (transposed in French law with the Order No. 2019-1068, dated 21 October 2019) related to the disclosure of cross-border arrangements for taxpayers and intermediaries.

Second, in DTT provisions, the contracting states agree to exchange information within the scope of the tax treaty.

These kinds of procedures must ensure, however, that the rights and guarantees of the taxpayer are respected. DTTs usually limit the scope of the application of information exchange.

In addition, Section L 188 A of the FBTP provides for a possible extension of the statute of limitations (cf. supra).

7. Specific French provisions targeting non-cooperative states and territories

Provisions are dedicated to limiting transactions with NCSTs by penalizing these transactions, notably with regard to deductibility, withholding tax and anti-abuse rules.

(a) Definition of non-cooperative states or territories

Section 238-0 A of the French Tax Code provides for a definition of NCSTs, including countries that: (i) have been subject to the control of the OECD for transparency and information exchange purposes; (ii) have not entered into a tax treaty with France providing for administrative assistance allowing information exchange; and (iii) have not signed tax treaties with such provision with at least 12 states or territories.

The list is updated on a yearly basis to reflect: (1) added states that have refused to sign an information exchange agreement with France or have not fulfilled their information exchange commitment with France; and (2) withdrawn states that have entered into a convention with France.
The latest list was published on 7 January 2020 and covers a limited number of countries (Anguilla, Bahamas, British Virgin Islands, Seychelles and Panama).

In addition to this list, Law No. 2018-898 On the fight against fraud, dated 23 October 2018, added the EU list of non-cooperative jurisdictions for tax purposes, which includes American Samoa, Guam, Samoa, Trinidad and Tobago, Fiji, Oman, Vanuatu and the US Virgin Islands (updated on 14 November 2019, according the press release from the Council of Europe No. 2019/C386/02). These jurisdictions are subject to French NCSTs rules since the publication of a decree in the French Official Journal on 7 January 2020.

French provisions dedicated to limiting transactions with NCSTs are:

- Fully applicable to NCSTs mentioned in the EU list for facilitating offshore structures or arrangements aiming at attracting profits which do not reflect real economic activity in the jurisdiction.

- Partially applicable to NCSTs listed for another reason (i.e., lack of tax transparency, existence of preferential tax measures that could be regarded as harmful, absence of implementation of anti-BEPS measures).

(b) Provisions adopted to fight international tax evasion by companies liable for corporate income tax

There are various provisions with which to dissuade economic actors from conducting transactions with states that do not respect the international standards.

i) Provisions strengthening tax anti-avoidance rules

First, to enable the offsetting of withholding tax borne by foreign-sourced dividends, interest and royalties that fall within the scope of application of Section 209 B of the French Tax Code, the income must come from a state that has signed a tax treaty with France and is not on the list of NCSTs. In
addition, when the entity is established or set up in an NCST, the burden of proof shifts to the taxpayer as it belongs to the legal entity established in France: (i) either to demonstrate that the income is generated by an effective industrial or commercial activity and that it does not exceed the ratios for passive income and intra-group services; (ii) or to communicate to the French tax authorities all documents necessary to evaluate the activity performed and the ratios, as well as to substantiate that the transactions of this foreign company have a primary purpose different from that of locating profits in the concerned state.

Section 238 A of the French Tax Code provides that income from receivables, royalties and payments for services made or owing to beneficiaries (individuals or legal entities), established or domiciled in an NCST, are deductible only if the taxpayer demonstrates not only that these payments correspond to actual transactions and are not abnormal or exaggerated, but also that, “the transaction to which the expenses correspond have a primary purpose and effect different from that of locating profits in an NCST.” The paying company will be required to submit a detailed statement of these expenses with its tax returns.

According to the applicable version of Section 238 A of the French Tax Code, in force as from 1 January 2020, persons shall be regarded as subject to a preferential tax regime in the state or territory concerned, if they are not taxable in that state or territory, or if they are subject to corporate income tax in an amount which is 40% or more lower than the amount to which they would have been liable under ordinary law in France, if they had been domiciled or established there.

ii) Exclusion of the benefit of the parent-subsidiary regime, as well as that of the regime for long-term capital gains on shares held in subsidiaries established in an NCST

Distributed dividends from companies established in an NCST are excluded from the parent-subsidiary regime. Capital gains on shares held in subsidiaries established in an NCST do not benefit from the long-term capital gains tax regime and are taxed at the standard rate. Moreover, it is
only possible to offset the capital losses resulting from such transfers against capital gains of the same nature and not against profits taxed at the standard rate.

For these provisions, a safe harbor clause is provided, according to which the taxpayer can prove the economic purpose of transactions performed with a company located in an NCST.

iii) Increased withholding tax rates applicable to flows with NCSTs

The withholding tax rate is up to 75% (subject to applicable tax conventions) in the following situations:

- Concerning dividends paid outside of France to an NCST (Section 119-bis, 2 of the French Tax Code): This text includes payments made through a financial establishment located in an NCST, regardless of the tax residence of the effective beneficiary (including a French resident). However, this rate does not apply if the debtor demonstrates that the dividend distribution was not made with the purpose of locating profits in an NCST with a tax fraud intention (Section 187, 2 of the French Tax Code).

- Concerning capital gains on transfers of securities (Section 244-bis B of the French Tax Code) made by persons domiciled, established or set up in an NCST, independently of the percentage of holding in the company transferred.

- Concerning royalties and other non-salaried income (Sections 182 A-bis and 182 B of the French Tax Code) paid to beneficiaries domiciled or established in an NCST, regardless of the place of payment of these compensations. However, this rate does not apply to amounts paid as compensation for services of any kind provided or used in France, if the debtor demonstrates that the compensations corresponding to actual transactions have a primary purpose and effect different from
that of locating profits in an NCST. In this context, any gross-up clauses in licensing agreements will require careful drafting.

For certain of the above-mentioned provisions, a safe harbor clause is provided, according to which the taxpayer can prove the economic purpose of transactions performed with a company located in a NCST.

8. Multijurisdictional tax audits

Cooperation between the French tax authorities and foreign tax authorities has increased over the past years, with more frequent and more diligently used exchanges of information. Similar and simultaneous reassessments have been observed in several subsidiaries of the same groups established in different jurisdictions.

Section L 45 of the FBTP provides that the French tax authorities can agree with another Member State to initiate simultaneous audits. Information gathered during the course of these audits will be exchanged between the different tax authorities.

Section L 45 of the FBTP also provides the possibility of initiating joint tax audits involving: (i) the presence of foreign tax auditors in the premises of the French tax authorities; (ii) a joint review of tax files; (iii) a physical participation of foreign auditors in French audits; and (iv) the possibility for foreign tax auditors to exercise the right of communication (right to question suppliers, banks and clients of the taxpayer) and the right to directly ask questions. In this context, refusal to cooperate is treated as a refusal to cooperate with the French tax authorities, which could imply the application of penalties (100%) of the tax reassessments and fines. It shall be noted that as of today, joint audits are rare in France.

In addition, Section L 114 of the FBTP allows the French tax authorities to communicate any information concerning direct or indirect taxes upon the request of another Member State, as long the French tax authorities enjoy reciprocal treatment in the other EU Member State.
9. **Burden of proof**

The question of burden of proof depends on two main factors: the nature of the dispute and the reassessment procedure. Basically, and as a general principle, the French tax authorities bear the burden of proof when they intend to reassess the tax base of a taxpayer. The taxpayer itself must prove that it has complied with legal filing obligations and that its book entries are accurate.

In some specific cases, the proof may be passed to the taxpayer. In transfer pricing matters (under Section 57 of the French Tax Code), case law has established that the French tax authorities must prove that there has been an indirect transfer of profits and that the transfer was "abnormal" in order to transfer the liability. In the *Cap Gemini* case, the French Administrative Supreme Court ruled that the French tax authorities had not proven a transfer of profits abroad, since it had not compared the taxpayer’s controlled transaction with unrelated party transactions; the mere reference to a difference in the conditions between French and non-French subsidiaries was not considered sufficient.

The principle of the allocation of the burden of proof between the French tax authorities and the taxpayer was restated by the Paris Administrative Appeal Court in the *Sté Eduard Kettner* and *Nestlé Finance* cases; it is up to the French tax authorities to ground the reassessment in specific elements drawn from the French company’s accounting and on relevant comparisons.

Conversely, in the *Nestlé Entreprise* case, the court noted that while the burden of proof rests with the French tax authorities, concerning the existence of an advantage granted to a foreign party, once the existence of such an advantage has been established by the French tax authorities, in particular based on comparables, it is up to the taxpayer to challenge the presumption of transfer of profits by demonstrating the existence of a sufficient counterpart.
The burden of proof will also be determined, depending on the reassessment procedure followed by the French tax authorities.

10. Potential consequences

(a) Adversarial or de facto taxation

The French tax authorities may follow two different routes to reassess a taxpayer’s taxable basis.

(i) Adversarial adjustment procedure

If the French tax authorities determine, after an audit, that the taxpayer’s tax return contains a deficiency, omission or concealment, or is inaccurate upon comparison with the latter’s taxable income or transactions, they may initiate a contradictory reassessment procedure (procédure de rectification contradictoire) by sending a proposed tax reassessment notice (proposition de rectification) to the taxpayer (Section L 55 of the FBTP). A proposed tax reassessment notice must set forth, among other things, the amount of the proposed reassessment and the reasons therefore, as well as the tax consequences of such a reassessment (Sections L 57 and L 48 of the FBTP).

Within 30 days from the date of receipt of the proposed tax reassessment notice, the taxpayer must either accept the proposed reassessment or submit a response challenging the reassessment (observations du contribuable) (Section R 57-1 of the FBTP). The taxpayer is entitled to request that the time period granted to provide a response be extended to 60 days (this request must be made within 30 days of the receipt of the proposed tax reassessment notice).

If the taxpayer accepts such a reassessment or fails to respond, it is not barred from challenging the reassessment at a later point in time; such acceptance or failure to respond does, however, cause the burden of proof to shift from the French tax authorities to the taxpayer. If the taxpayer does not accept the reassessment and files a response, the French tax
authorities may thereupon either drop, confirm or modify the proposed reassessment (Section L 57 of the FBTP) by way of an answer to the taxpayer’s comments (réponse aux observations du contribuable).

In this respect, the French tax authorities have an obligation to respond to the observations of the taxpayer within 60 days (concerning industrial and commercial companies whose turnover does not exceed EUR 1,526,000, and companies with a non-commercial activity whose turnover does not exceed EUR 460,000) (Section L 57 A of the FBTP). If they fail to respond within this time limit, the French tax authorities will be deemed to have accepted the observations of the taxpayer. After such notice has been sent by the French tax authorities, the taxpayer may resort to administrative appeals (see Section II 1 (b)).

Moreover, both the French tax authorities and the taxpayer have the right, under certain conditions, to submit the matter to the Commission des impôts directs et des taxes sur le chiffre d’affaires or the Commission Départementale de conciliation within 30 days (Section L 59 of the FBTP). The Tax Commission will issue a non-binding opinion on questions of fact, not of law. The submission to this commission allows for a deferral of the payment of the reassessed tax until the commission gives notices of its position. There is usually a delay of about one year.

After the last letter of the French tax authorities, and in the absence of recourse to the commission, the tax collectors are entitled to issue a formal notice requiring the taxpayer to pay the tax due (Avis de mise en recouvrement).

(2) Unilateral reassessment procedure

In certain instances, the French tax authorities have the authority to unilaterally reassess the taxpayer’s income (Section L 65 of the FBTP). This unilateral reassessment procedure is not based on an audit of the amount of taxable income realized by the taxpayer, but rather on the presumed or estimated taxable income of the taxpayer. The French tax authorities may
only proceed with a unilateral reassessment in any of the following situations:

- Where the taxpayer failed to file a tax return in due time (Section L 66 of the FBTP), and fails to do so within 30 days of the receipt of a notice sent to that effect by the French tax authorities (Sections L 67 and L 68 of the FBTP), except in the event of concealed activity where the procedure is applicable without notice.

- Where the taxpayer filed a return, but then failed to make a timely response to a request by the French tax authorities for information or discovery (Section L 69 of the FBTP).

- Where an individual taxpayer, that does not have its tax domicile in France or a corporate taxpayer that does not have its registered office in France, has income from French sources or assets located in France and fails to designate a tax representative in France when asked to do so by the French tax authorities (Section L 72 and 72 A of the FBTP).

- Where the French tax authorities have been unable to audit a taxpayer’s records because of obstruction by the taxpayer or third parties (Section L 74 of the FBTP).

When the French tax authorities use the unilateral reassessment procedure, the taxpayer may not challenge such a reassessment before the departmental or national tax commission, except with respect to the second situation above. Instead, it may only file an appeal with the departmental director of taxes; upon such appeal, the burden of proof is on the taxpayer. Finally, where a taxpayer is subject to a unilateral reassessment because it filed its tax return late, special tax penalties are imposed.
(b) Specific substance over form procedure

The application of this procedure, set forth under Section L 64 of the FBTP, results in the reassessment of avoided taxes and of penalties of 80% in addition to late payment interest (Section 1729 of the French Tax Code).

Any transaction or contract with the exclusive purpose of hiding or deferring the realization of income, or avoiding the payment of taxes, can be reclassified by the French tax authorities on the basis of the "abuse of law" theory.

The Finance Act for 2019 provided for an additional standard of abuse of law (new Section L 64 A of the FBTP) without penalties and an easier threshold to meet for the French tax authorities, based on any operation with the principal rather than exclusive purpose of hiding or deferring realization of income or avoiding the payment of taxes. The additional standard applies for operations performed as of 1 January 2020, subject to reassessments notified as from 1 January 2021.

Furthermore, and in order to transpose Section 6 of ATAD directive, the Finance Act for 2019 also provided for an additional general anti-abuse rule (new Section 205 A of the French Tax Code) only for purposes of calculating corporate income tax liability (and exclusive of above-mentioned general anti-abuse regulation) under which shall be ignored the "arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances."

Abuse of law does not, however, prevent a taxpayer from choosing the less onerous – from a tax standpoint – of two valid legal solutions.

When the taxpayer disagrees with the tax authorities' reclassification of a transaction, either party can submit the issue to the Abuse of Law Commission (Comité de l'abus de droit fiscal). Submission to this

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Commission suspends the collection of the contested tax and penalties until the commission notifies the taxpayer of its final decision.

Before the Finance Act for 2019, when a reassessment notice consistent with the commission’s opinion was issued, the taxpayer bore the burden of proof before the administrative court on a subsequent tax claim. According to the Finance Act for 2019, as of 1 January 2019, the burden of proof lies with the French tax authorities regardless of whether the commission’s opinion is in line with the reassessment notice.

The abuse of law procedure cannot be used when the taxpayer is protected by an advance ruling.

Taxpayers are allowed to consult in advance with the central office of the French tax authorities (Direction de la Législation Fiscale) in writing concerning the tax consequences of a contract or agreement. This consultation must take place before the contract enters into effect. The written application filed with the French tax authorities must contain and disclose all the information necessary to understand the true character of the proposed transaction. The Finance Act for 2019 also enabled taxpayers to consult in advance with the central office whether the operation they contemplate to perform falls within the scope of the anti-abuse rule provided by the new Section 205 A of the French Tax Code.

(c) Tax penalties

The sanctions for failing to correctly file declarations, pay taxes or fulfil other tax obligations can be divided into two broad categories: tax fines and criminal penalties. Tax fines applied by the French tax authorities are subject to appeal before the administrative courts. Criminal penalties are imposed on serious offenders by criminal courts (cf. item 12. infra).

Penalties could be summarized as follows: a late interest fee of 0.20% per month (2.40% per year) is generally due on all late payment of taxes (Section 1727 of the French Tax Code) (before 1 January 2018, the late
interest rate was 0.40% per month) caused by the late filing of tax returns and other assessment documents, underpayments (errors or omissions) and simple late payments. This late interest fee is not capped. In the case of a tax audit, this late interest fee will apply on the date the payment of tax should have been made until the date the tax reassessment notice has been received. However, during the course of a tax audit, and subject to the good faith of the taxpayer, the late interest can be reduced to 0.14% per month if the taxpayer voluntarily corrects the errors or omissions (Section L 62 of the FBTP).

In addition to the penalties for late payment, the French Tax Code provides for a specific penalty for the failure to file declarations and documents or the failure to file these on time. This penalty is equal to 10% when the late declaration is filed by the taxpayer prior to any notice of the French tax authorities or within 30 days after an initial official notice (mise en demeure); this penalty is increased to 40% if the declaration or information document does not arrive at the tax office within 30 days after the official notice. This penalty may be increased up to 80% in the event of concealed activity (Section 1728 of the French Tax Code).

Further to the basic late payment interest, a penalty of 5% is imposed for the late payment of taxes based on the turnover, registration taxes and wage tax paid by the employer (Section 1731 of the French Tax Code).

In addition to late interest, a taxpayer that, in bad faith, does not declare its tax liability in the event of errors or inaccuracies in tax returns resulting from a deliberate failure, will be subject to a penalty equal to 40% of the avoided tax. This penalty is increased to 80% when the taxpayer engaged in fraudulent behavior or committed abuse of law (see above). Please refer below to the impact of the application of these 40% or 80% penalties from a criminal standpoint.

When the French tax authorities cannot proceed with the tax audit due to the non-cooperation of the taxpayer or of third parties, the tax base is
established using an official estimation procedure (Section L 74 of the FBTP). In this case, tax due is increased by a 100% penalty (Section 1732 of the FBTP).

Under French domestic law, the judge hearing a penalty review case has the authority to reduce or eliminate the penalty depending on the taxpayer’s behavior (40% or 80%), but not to adjust the rate of the penalty in accordance with the fault (i.e., to decide on a rate other than 40% or 80%).

Pursuant to Section L 267 of the FBTP, managers or directors may become jointly and severally liable for taxes and tax penalties assessed on the corporation or other entities when collection is made impossible by fraud or through repeated violations of tax obligations.

(d) Specific tax procedure for flagrant tax violations

Under the French tax rules, taxpayers may only be audited after a tax return has been filed. However, under Sections L 16-0 BA and L 252 B of the FBTP, the French tax authorities are entitled to take action, such as conduct seizures, even before any tax return has been filed, when certain facts put the collection of tax at risk.

This procedure is extended to any completed period for which no filing duty is yet due and to situations where the taxpayer has, for several times, failed its duty to file monthly VAT return forms.

A penalty is also incurred, the amount varying from EUR 5,000 to EUR 30,000 depending on the turnover (Section 1740 B of the French Tax Code).

11. Strategies for dealing with tax audits

It is advisable to engage in continual discussions with the tax auditor to be able to understand their potential concerns and to allow the procedure to be oral and adversarial. Although the presence of an outside tax lawyer
during the entire tax audit is advisable, the first and final meetings with the tax auditor are very important and should include the outside lawyer.

During the closing meeting of the audit, it is quite important to clearly understand the intention of the tax auditor and the items they intend to reassess. This is the last step before the receipt of a proposed tax reassessment notice.

During the tax reassessment procedure, it is necessary to reply to the tax auditor within the 30-day period following the receipt of the proposed tax reassessment notice. It is generally recommended to develop all the arguments that may be relevant, be these factual or legal, as soon as possible so that at the earlier stage of the procedure, all of the elements needed to successfully defend against the audit are brought forward to convince the tax auditor. Still, some procedural arguments may be developed at a later stage, especially when the French tax authorities may send a new tax reassessment notice within the statutes of limitations, cancelling the first one.

During the entire procedure, the remaining main issue is determining whether or not the taxpayer should try to enter into a settlement agreement with the French tax authorities or move forward to litigation. This will mainly depend on the arguments of the French tax authorities and the nature of the reassessment. It is recommended, however, to first challenge all the reassessments and determine the chance of success of the taxpayer’s positions.

12. Conversion of a regular tax audit into a criminal investigation

Under certain circumstances, a regular tax audit may lead to a criminal procedure. Indeed, a taxpayer could be prosecuted when it fraudulently avoids paying taxes or attempts to avoid paying taxes, and may therefore be sanctioned for tax fraud (Section 1741 of the French Tax Code). One constituent element of that offense is the use of a process or procedure to
conceal a person’s tax liability, whatever method is used (voluntary omissions, false records, failure to file, etc.).

When characterized presumptions of tax fraud exist, the public prosecutor is generally not allowed to prosecute the taxpayers of their own initiative (subject to the provisions above, resulting of the Law No. 2018-898, dated 23 October 2018 (Loi relative à la lutte contre la fraude)).

The public prosecutor is allowed to prosecute the offense of tax fraud in cases where the French tax authorities lodge a criminal complaint. This complaint shall be filed after the French tax authorities have obtained the agreement of the specific committee in charge of tax fraud (Commission des infractions fiscales) in cases where the French tax authorities consider that the taxpayer committed the offense of tax fraud, or directly to the Public prosecutor in cases where the French tax authorities consider that the taxpayer committed the offense of aggravated tax fraud.

Where the procedure before the Commission des infractions fiscales is applicable, a complaint can be filed by the French tax authorities only if the commission agrees with their position (Section L 228 of the FBTP). The taxpayer will be informed of such filing by an official notification and should cooperate, but it still has the right to remain silent in accordance with the fundamental rights set forth by the European Convention on Human Rights.

In addition to the possibility for the French tax authorities to file complaints for tax fraud, Law No. 2018-898 On the fight against fraud, dated 23 October 2018, (Loi relative à la lutte contre la fraude) provides that the French tax authorities are compelled to report facts to the public prosecutor where these facts lead to (i) a tax reassessment exceeding the amount of EUR 100,000 and (ii) the application of a) or b) or c) below:

(a) The application of the 100% penalty provided for by Section 1732 of the French Tax Code (ex officio procedure).
(b) The application of the 80% penalties provided for by para. 1 c of Section 1728 of the French Tax Code (concealed activity, which is to date often applied by the French tax authorities in PE cases) or by para. b or c of Section 1729 of the French Tax Code (abuse of law or fraudulent behavior).

(c) The application of the 40% penalties provided for by para. 1 b of Section 1728 of the French Tax Code (late submission of a tax return) or by para. a of Section 1729 of the French Tax Code (deliberate breach) have been applied and the taxpayer has been subject: (i) to the penalties listed at a), b) or c) in the context of a previous tax audit during the previous six calendar years or (ii) to a complaint of the French tax authorities further to a previous tax audit.

Once the facts have been reported, the public prosecutor is entitled to prosecute for the offense of tax fraud.

Besides, in case the French tax authorities filed a criminal complaint for tax fraud regarding a taxpayer, the public prosecutor can extend criminal charges to other taxes and other years without the need for a further criminal complaint or reporting for those years from the French tax authorities.

Once the complaint has been filed or the facts have been reported, judicial investigation can be, under the judiciary authorities’ control, conducted by tax agents benefiting from judicial powers.

The above-mentioned law releases the French tax authorities from their professional privilege with the public prosecutor, with whom they can now exchange privileged information, regardless of whether a complaint has been filed or facts have been reported (Section L142 A of the FBTP).

A person convicted of tax fraud is liable for criminal penalties, notwithstanding applicable tax fines. The criminal penalty is a fine of EUR 500,000, which may be increased to an amount equal to twice the
proceeds of the offense (being noted that the amount of penalties can be increased up to five times the above-mentioned amount for legal entities, which could represent EUR 2.5 million or 10 times the proceeds of the offense) and five years' imprisonment.

Moreover, penalties are increased to EUR 3 million and punished by seven years' imprisonment where the fraud was committed by an organized gang or carried out or facilitated by means of:

- Either bank accounts or contracts concluded with entity established out of France
- Either the interposition of legal persons, companies, entities or trusts established abroad
- Either the use of false identities or documents, according to Section 441-1 of the French Criminal Code, or any other counterfeiting document
- Either a fictitious or artificial tax residence out of France
- Either a fictitious or artificial act or the interposition of a fictitious or artificial entity

The fine of EUR 500,000 (or EUR 3 million) may be increased to twice the amount of the proceeds from the offense (Law No. 2018-898 dated 23 October 2018). According to Section 131-38 of the French Criminal Code, the above-mentioned amount of penalties (EUR 500,000/EUR 3 million/two times the amount of the proceeds from the offense) can be multiplied by five for legal entities (i.e., EUR 2.5 million/EUR 15 million/10 times the proceeds of the offense). In case of concealment, these penalties are applicable only if the concealment exceeds EUR 153 or 10% of the amount that is subject to tax.

Law No. 2018-898 On the fight against fraud (Loi relative à la lutte contre la fraude) dated 23 October 2018 provides for the automatic publication of
court decisions convicting taxpayers for tax fraud, unless specifically ruled otherwise by the judge.

Moreover, any party identified as co-author or accomplice of tax fraud can be sentenced to the same criminal penalties and subjected to an additional penalty of being held liable for the payment of the defrauded taxes (Section 1742 of the French Tax Code).

A law against tax fraud and economic and financial crime entered into effect on 6 December 2013, establishing the office of financial prosecutor whose role consists of the prosecution of all economic and financial crimes, including tax fraud.

Aside from the tax fraud offense, there are related infractions of money laundering (blanchiment, set out in Section 324-1 of the French Criminal Code) or concealment (recel, set out in Section 321-1 of the French Criminal Code) of defrauded tax. In this regard, the Civil Supreme Court (Cour de Cassation) judged in 2008 that:

"the prosecution of money laundering of tax fraud does not require that a prosecution or a conviction for tax fraud itself has already taken place. It is just necessary the elements constituting the fraud tax were established."

These two offenses are not subject to the procedure explained above (i.e., the public prosecutor is allowed to prosecute of their own initiative taxpayers having allegedly committed these offenses).

Besides, and in order to facilitate the resolution of criminal disputes related to tax offenses, the pre-trial guilty plea procedure (comparution sur reconnaissance préalable de culpabilité) and the deferred prosecution agreement (convention judiciaire d'intérêt public) have been introduced by law No. 2018-898 on the fight against fraud dated 23 October 2018.
The *comparution sur reconnaissance préalable de culpabilité* entitles the prosecutor to impose a sentence on the offender that has consented to the procedure and pleaded guilty beforehand. The prosecution can determine any sentence including a maximum prison sentence of up to one year.

The *convention judiciaire d'intérêt public*, which is only applicable to legal entities and does not imply a guilty plea from the offender, consists in a settlement between the public prosecutor and the offender with payment to the treasury of a public interest fine. The settlement is published by the administration on its website.
II. Resolution procedures

1. Administrative level

(a) Before an audit

To encourage taxpayers to regulate their situation spontaneously, Law No. 2018-727 dated 10 August 2018 (Loi pour un Etat au service d’une société de confiance) has established a reduction by half of the amount of late payment interest in the event of spontaneous filing by the taxpayer in good faith, of an amending tax return, accompanied by the payment of the corresponding taxes (amendment of Section 1727 V of the French Tax Code).

(b) During an audit

Section L 13 C of the FBTP provides that certain taxpayers can voluntarily request a tax audit under certain conditions. If the French tax authorities conclude this with no tax reassessment, this finding may not be amended by the French tax authorities in the event of future audits. If this audit leads to a tax reassessment, the penalties for late payment will be reduced by 30%.

Moreover, Section L 62 of the FBTP provides that the taxpayers subject to a tax audit can agree, before any reassessment notice is issued, to correct errors and omissions made in good faith. In this case, and provided it files an additional return within 30 days and pays the reassessed amounts at this moment, late payment interest could be reduced by 30%. Section L 62 of the FBTP is also applicable after a reassessment notice is issued in certain conditions set by the Law No. 2018-727 for a state in the service of a trustworthy society (Loi pour un Etat au service d’une société de confiance) dated 10 August 2018.
(c) During the adjustment procedure

(1) After the release of proposed tax assessments and before tax collection notices

From a procedural standpoint, the use of administrative appeals postpones the collection of the tax reassessments. Therefore, the collection of tax (through the sending of a tax collection notice) cannot be made before the decision of the tax committee has been rendered.

During the tax audit period (i.e., before the tax litigation phase), several administrative appeals are available to the taxpayer in the event of proposed tax reassessment. The chief of brigade \((\textit{Chef de brigade})\) is a former field inspector who has taken responsibility for a brigade. The chief of tax inspectors may have a certain power of decision and it is recommended that meetings within the administrative appeals be held as soon as possible after the receipt of the proposed tax reassessment notice. These meetings may be occasions to propose to the chief of tax inspectors that additional substantive facts or information be provided to review the position of the French tax authorities. The chief of brigade has generally monitored the tax audit operations and provided support to the field inspector.

The taxpayer may also submit its case to the departmental chief \((\textit{Interlocuteur départemental})\) who is responsible for all the brigades in a given area. The departmental chief is generally the person empowered to make settlement proposals that will solve cases. The meeting with the departmental chief constitutes a privileged step into entering a settlement with the French tax authorities or to try to elaborate on the arguments developed in reply to the proposed tax reassessment notice. The departmental chief is the person who has the power to drop any reassessment at this stage of the procedure.

Depending on the facts and on the nature of the proposed reassessments, the taxpayer may then submit its case to several different commissions, which are requested to give independent advice.
It may bring the case before the _Commission des impôts directs et des taxes sur le chiffre d'affaires_ directly, which is generally competent to evaluate the facts. This committee is only consultative; that is, its opinions have no binding power on the tax audit team. It is composed of three representatives of the taxpayer (one person from the chamber of commerce, one representative from a professional organization and one certified public accountant) and three representatives of the tax authorities, and is chaired by a professional administrative judge. Even if the opinions of the committee are not binding on either party, a positive opinion can constitute a strong argument before the courts if litigation is initiated.

Notwithstanding the fact that the advice of the tax committee remains only advice and may not bind the French tax authorities, a decision favorable to the taxpayer from the tax committee should result in an absence of reassessments. In order to take into account the specific issues relating to large enterprises (more than EUR 50 million turnover for commercial enterprises and more that EUR 25 million turnover for other enterprises), a specific tax committee has been created on a national level in addition to the committee set up at the local level. This national tax committee is competent in matters concerning large enterprises, as well as in related proposed tax reassessments concerning several companies of a group, and in excessive remunerations (Section L 59 C of the FBTP).

If a hearing before a tax committee is requested, the collection of the adjusted amount of tax is postponed until the decision of the tax committee has been delivered.

The case may also be brought before the _Commission départementale de conciliation_, which is authorized to conduct asset evaluations upon transfer tax or wealth tax reassessment procedures, or before the Abuse of Law Commission, which is applicable to "abuse of law" situations.
After the release of proposed tax assessments and after tax collection notices

Once the tax collection notices have been received by the taxpayers, following the reassessment procedure, taxpayers are entitled to file a contentious claim with the French tax authorities to request once more the withdrawal of the reassessments. Such a claim is mandatory before appealing against an assessment before a court (Section R 190-1 of the FBTP).

The time period within which the taxpayer can file a claim would generally expire on 31 December of the second year following the year when the event justifying its claim occurred, or when the tax bills were received or when the tax was paid. In the event of a tax audit, it will expire on 31 December of the third year following the year when the tax reassessment notice was received.

The French tax authorities will review the claim and have the right to change the stated legal basis for the reassessment, as well as reduce or cancel the reassessment.

The French tax authorities' decision totally or partially rejecting the taxpayer’s claim must be given in writing within a six-month period from the receipt of the claim. It is only upon a response by the French tax authorities to such a claim that the case can be brought to court. In this respect, a lack of response from the French tax authorities after a six-month period has the same effect as a refusal, and allows the action to be initiated with the court.

In principle, once the tax collection notices have been issued, the taxpayer has to pay the tax due even if it intends to take the case to court. The taxpayer must first pay the reassessed tax and later be reimbursed should a court invalidate the reassessments.

However, after having challenged the proposed tax reassessments and during the pre-litigation phase of the procedure, the taxpayer may claim
the benefit of the deferral of payment of the tax due until a decision is granted by the court, provided sufficient financial guarantees are given (Section L 277 of the FBTP).

The French tax authorities therefore send to the taxpayer a request to enter into or provide guarantees supporting the deferral of payment that was claimed. The provision of guarantees is a mandatory procedure required for any payment deferral. In the absence of an answer by the taxpayer, the payment deferral could be rejected and the taxpayer would have to pay immediately. The French tax authorities are obligated to examine all the offered guarantees.

Should they consider the proposed guarantees insufficient, the authorities can reject these in a decision that is supported by adequate grounds, which will be sent to the taxpayer. This decision can be challenged, however, before the tax judge within a period of 15 days as of the receipt of the letter from the public accountant in charge of tax recovery, informing the taxpayer of the refusal of the proposed guarantees. The tax judge will only take a position on the guarantee proposed by the taxpayer, and will not hand down a decision on the merits of the reassessments.

If the taxpayer obtains the payment deferral and if the lower tax court rejects its claim, the taxpayer will have to pay the reassessed tax and penalties plus additional late payment interest. If the lower tax court agrees with the taxpayer’s claim, the taxpayer will be entitled to a refund of the guaranteed taxes. If the taxpayer decides to pay immediately after the receipt of the tax collection notice and if the lower tax court upholds the right to its claims, then it will be entitled to a refund of the sums paid, plus late payment interest.
2. Judicial tax litigation

(a) Ordinary jurisdictional procedure

Appeals against administrative tax decisions will be heard either before the Tribunal Judiciaire (resulting from the merger of the Tribunal de Grande Instance and the Tribunal d'Instance, applicable from 1 January 2020) (for registration duties, or before the lower administrative court (Tribunal administratif)) if these involve direct taxes, VAT, certain indirect taxes and local taxes.

The taxpayer normally has two months to file an appeal against the French tax authorities’ decision before the court of first instance. The two-month period is calculated as of the day the taxpayer received the decision on the administrative claim.

Written pleadings are exchanged between the taxpayer and the French tax authorities until the case is deemed ready to be decided upon by the court.

The procedure before the lower administrative court generally takes from one to three years.

The decision of the administrative court is executable. A suspension of payment can only be granted by the Higher Court when it judges that the execution of the decision would damage a party in a manner that would be difficult to remedy subsequently.

The administrative courts of appeal (Cours administratives d'appel) represent an appeal level between the local lower administrative courts (Tribunaux administratifs) and the Supreme Administrative Court (Conseil d'État), which reviews the decisions of the administrative courts of appeal. The decision of the administrative courts of appeal, however, can only be overturned if it is founded on a procedural error or an erroneous interpretation of law; the Supreme Administrative Court does not consider the facts. Generally, the whole litigation procedure takes in total around
seven to 10 years (depending on the competent lower courts) to have a
decision issued by the Supreme Administrative Court.

During the entire litigation procedure, it is possible to request from the
court that a question to the Court of Justice of the EU and to the European
Court of Human Rights (Cour Européenne des Droits de l’Homme) (since the
Law No. 2018-237 dated 3 April 2018, authorizing the ratification of
Protocol No. 16 of the Convention for the Protection of Human Rights and
Fundamental Freedoms) be submitted.

Due to the increasing number of cases submitted to the courts, these
procedures are very lengthy. Settlements out of court can always be
achieved even if action in court has already been initiated. However, the
judge cannot be involved in such negotiation, and the validity of the
settlement is subject to withdrawal from the actions in court.

(b) Prejudicial appeal before the French constitutional court

Under the procedure of prejudicial appeal before the French constitutional
court (Question Prioritaire de Constitutionnalité), any taxpayer can contest
the validity of a tax law with respect to the rights and guarantees
provided by the French Constitution, provided such taxpayer is involved in
legal proceedings before a court.

While challenging the constitutionality of a law was previously only
offered to deputies and senators under certain conditions, the 2008
constitutional reform has extended this right to any person involved in a
legal proceeding. However, only statutory provisions voted by an official
body entitled to legislate (principally laws enacted by parliament), and not
administrative decisions, can be challenged.

The argument of unconstitutionality can be brought at any moment of the
proceeding, but must be presented in a distinctly written and grounded
request. When the request is presented in the first instance or before a
court of appeal, the request must be transmitted if applicable to the
French Supreme Administrative Court (Conseil d’Etat) or the Supreme Civil Court (Cour de Cassation). The French Supreme Courts must transfer the request to the Constitutionality Council within three months and the Constitutionality Council must render its decision within three months.

3. Non-contentious requests

Section L 247 of the FBTP provides that taxpayers may file a non-contentious claim concerning late payment interest with the French tax authorities, which may grant a refund on late payment interest due. This refund can be obtained after a partial or full refund decision by the French tax authorities or after arbitration, when the reassessed taxes and interest have not become finally due. The decision of the French tax authorities remains discretionary and does not have to be provided with grounds.

Sections R 211-1 and R 211-2 of the FBTP provide that taxpayers that have paid undue taxes related to years barred by the statute of limitations are also entitled to lodge a non-contentious request to obtain a refund. The decision to grant this refund falls within the discretion of the French tax authorities, which can reject the request.

4. Arbitration

Under the European Arbitration Convention, the competent authorities have, in theory, a two-year deadline to reach an agreement in a mutual agreement procedure (MAP). If no agreement is reached by the end of this period, the competent authorities should, in theory, open an arbitration phase, subject to the taxpayer’s agreement. In such a case, the competent authorities will set up an arbitration committee consisting of representatives from two competent authorities, independent members and a chair.

The arbitration committee should then give an opinion on the case within six months of the date when it was appointed. The opinion of the arbitration committee must be based on the arm’s-length principle. It is
not binding on the competent authorities, but if they do not agree on another solution within another six-month period, the arbitration committee’s opinion will prevail.

In practice, very few cases have reached the arbitration phase of the European Arbitration Convention, despite the fact that a significant number of MAP cases have not been resolved within the two-year time frame.

On 10 October 2017, the Council of the European Union adopted new rules to better resolve tax disputes. The proposal for a council directive on double taxation dispute resolution mechanisms, aims at introducing a more coordinated EU approach to taxation dispute resolution, to ensure that businesses and citizens can resolve disputes related to the interpretation of tax treaties or double taxation problems more swiftly and effectively. In particular, a wider range of cases will be covered and Member States will now have clear deadlines to agree on a binding solution, giving citizens and companies more timely decisions. This Directive (2017/1852) has been transposed by the Finance Bill 2019 under French law. It is applicable to any application with the French tax authorities as from 1 July 2019 concerning disputes relating to income or capital received during a fiscal year opened as from 1 January 2018.
III. Competent authority

MAPs may be used to resolve situations of double taxation that are notably caused by transfer pricing or PE reassessments.

France has concluded more than 120 bilateral tax treaties containing a MAP article. For transfer pricing matters resulting in double taxation, a MAP can also be initiated under the European Arbitration Convention. The opening of both procedures can be requested in parallel. The French competent authorities may refuse to open a MAP in the following cases:

- Where the taxpayer does not demonstrate the reality of the double taxation suffered. In effect, the French authorities do not want to create a “double non-taxation” situation.

- Where the assessment, which creates the double taxation, is subject to serious penalties that are not litigated or have been confirmed by the court.

- Where the taxpayer has self-adjusted the double taxation without going through the bilateral treaty mechanism. For instance, assume Company A is subject to a transfer pricing adjustment in a foreign country with respect to transactions with a French-associated enterprise, Company B. Assume that Company A charges the amount of the assessment to Company B, which deducts it from its taxable result in France in order to eliminate economic double taxation. Assume that such charge is denied by the French tax authorities, which regards it as unjustified in the context of an audit of Company A.

Depending on the applicable bilateral tax treaty, the deadline to request the opening of a MAP ranges from three months to three years from the measure that leads to double taxation. In some bilateral tax treaty, no deadline is specified. In practice, it is generally recommended that the opening of a MAP be requested soon after the administrative appeals have been exhausted.
Since 1 January 2014, the opening of a MAP does not suspend the issuance of tax collection notices anymore.

The OECD indicated that there were 972 pending MAP for which France is involved at the end of 2018, including 449 cases started at the beginning of the year.

The MAP can end in an agreement of the competent authorities on the following:

- The proposed tax reassessments can be withdrawn by the French tax authorities. In this situation, the case is solved through an internal discussion between the audit team and the French competent authorities.

- The competent authorities can agree that the reassessments will be maintained. In this situation, a correlative relief of tax is granted to the non-French party in order to prevent double taxation. Also, the effective reimbursement of the corresponding amounts is requested in order to prevent the application of withholding tax on the deemed distributions.

The solution retained can be a mix of these two possibilities, if only parts of the reassessments are maintained.

The taxpayer can accept or refuse the solution, but in the event of acceptance, the taxpayer will have to waive any subsequent claim.

Under bilateral MAP procedures, the competent authorities are not obligated to reach an agreement. A few tax treaties concluded by France include an arbitration clause, consistent with Article 25 (5) of the OECD Model Tax Convention. This is the case, for example, with the 2009 amendment to the tax convention concluded between France and the US.

In the context of Action 14 of BEPS, countries have committed to a minimum standard with respect to the resolution of treaty-related
disputes. The commitment includes the establishment of an effective monitoring mechanism to ensure the minimum standard is met and that countries make further progress to rapidly resolve disputes.

In this respect, Articles 16 to 26 of the OECD MLI aim at implementing the minimum standards enshrined in Action 14 of BEPS and a number of complementing best practices in order to improve the efficiency of MAP procedures and to enable countries to include mandatory binding treaty arbitration (MBTA) in their tax treaties. France opted in for most of these provisions when submitting its instrument of ratification on 27 September 2018.
IV. International exchange of information

Due to the globalization of supply chain and group structures, the French tax authorities use more and more international sources of information within the course of tax audits. The French tax authorities may rely on two sets of rules to request information from a foreign tax authority.

First, within the EU, two legal instruments have recently strengthened cooperation between EU Member States in the matter of information exchange:


- A Council Directive dated 15 February 2011, (No. 2011/16/EU) in the field of direct taxes that repeals Directive 77/799/EEC and progressively strengthens information exchange upon request (without the possibility of opposing bank secrecy), spontaneous exchange of information and the obligation to automatically transfer information for specific incomes. This directive has been modified six times, in order to extend its scope: by DAC 2 related to financial institutions; DAC 3 related to the exchange of tax rulings; DAC 4 related to country-by-country reporting; DAC 5 related to AML; and DAC 6 related to the disclosure of cross-border arrangements for taxpayers and intermediaries. This last directive has been transposed into French Law with the order dated on 21 October 2019 (Order No. 2019-1068).

Second, in DTT provisions, the contracting states agree to exchange information within the scope of the tax treaty. The OECD Model Tax Convention relating to the exchange of information and its last commentaries notably and explicitly allows French tax authorities to ask for information on a group of taxpayers, without naming them individually, as long as the request is not a "fishing expedition."
These kinds of procedures must ensure, however, that the rights and guarantees of the taxpayer are respected. DTTs usually limit the scope of the application of information exchange.

In addition, Section L 188 A of the FBTP provides for an extension of the statute of limitations under certain conditions (cf. *supra*).
Handling Tax Disputes in Germany

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I. Managing the tax audit process

1. General

Tax audits do pay. In Germany, not only has the number of tax auditors been increased over recent years, but so has the amount of additional taxes assessed as a result of tax audits. In the current economic climate in Germany, where it is difficult to increase taxes or introduce new taxes, the German government relies on tax law enforcement to mitigate the public budget deficit. For this reason, taxpayers in Germany can expect to be audited more frequently and more aggressively in the future.

(a) Tax audit selection criteria

The question of whether or not a German taxpayer is audited continuously depends primarily on its size. Large businesses\(^{64}\) are subject to consecutive audits, whereas smaller or medium-sized businesses are normally audited less frequently. Spontaneous tax audits may be initiated if, for example, the tax office discovers inconsistencies or irregularities upon reviewing tax returns, or if a taxpayer has only honored information requests incompletely or with delay. The ordinary, full-scale audit typically covers all taxes for a three-year period, such as trade tax, corporate income tax and VAT. Tax audits may be conducted as "fast-track" audits,\(^{65}\) but may also be conducted for longer periods than the standard three years. Special tax audits may be initiated for isolated tax issues such as, for example, VAT or wage taxes.

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\(^{64}\) Trading — turnover (i.e., revenue) in excess of EUR 8.6 million or taxable profit of more than EUR 335,000; manufacturing — turnover in excess of EUR 5.2 million or taxable profit greater than EUR 300,000; banking — gross assets in excess of EUR 175 million or taxable profit over EUR 670,000; insurance — premium income in excess of EUR 36 million; see Federal Ministry of Finance Pronouncement, dated 13 April 2018, BStBl 2015 I, p. 504.

\(^{65}\) See below under 5.
(b) Statute of limitations

Most taxes are levied by way of assessments, which, in turn, are normally based on the taxpayer’s tax returns. Assessments can only be made within the statutorily prescribed assessment period, which is subject to the statute of limitations for assessments. The assessment period\(^{66}\) is:

- One year for consumption taxes and their refunds
- Three years for customs duties and their refunds (refund application period partly limited to one year)
- Four years for all other taxes and their refunds
- Five years in the event of a grossly negligent underpayment of taxes
- Ten years in the case of tax fraud

In all cases these periods commence at the end of the calendar year in which the tax liability arose. The assessment period will not start to run prior to the end of the year in which the tax return was filed; at the latest upon the expiration of the third calendar year following the calendar year in which the tax liability arose.\(^{67}\)

There are a number of statutory exceptions to the above statutes of limitations for assessment. The most important ones provide that the assessment period will not lapse:

- If a tax field audit was commenced prior to the end of such period\(^{68}\)
- Until the competent tax office or the fiscal court has rendered a final decision about an appeal\(^{69}\)

\(^{66}\) Section 169 para. 2 of the General Tax Code.
\(^{67}\) Section 170 of the General Tax Code.
\(^{68}\) Section 171 para. 4 of the General Tax Code.
\(^{69}\) Section 171 para. 3a of the General Tax Code.
In addition to the rules governing the statutes of limitations for the assessment of taxes, the General Tax Code contains provisions that allow for the change of final tax assessments. Examples with particular practical importance include the following cases:

- The tax office becomes aware of new facts that would have justified the assessment of higher taxes.70

- A set of facts has been taken into account for taxation purposes in more than one tax assessments, either in favor71 or to the detriment72 of one or more taxpayers.

- An incident that has a retroactive effect for taxation purposes occurs.73

- The assessment has to be changed in order to implement the results of a competent authority procedure, or of arbitration proceedings.74

2. **Anticipation of and preparation for the tax audit**

Unless conducted in the form of a "spontaneous tax audit,"75 the competent tax authority determines the scope of the tax audit and notifies the taxpayer about the initiation of the tax audit, the taxes and periods to be covered, the contemplated date of the first visit and the name of the tax auditor. Such a notice, which is given in writing, is an administrative act subject to appeal.

The time period of four weeks, which normally occurs between the receipt of the notice and the tax auditor’s first visit, is important and should be

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70 Section 173 para. 1 no. 1 of the General Tax Code.
71 Section 174 para. 2 of the General Tax Code.
72 Section 174 para. 1 of the General Tax Code.
73 Section 175 para. 1 no. 2 of the General Tax Code.
74 Section 175a of the General Tax Code.
75 See below under 4.
used to properly prepare for the tax audit. Proper preparation should include:

- Putting together the accounts, balance sheets and all agreements that were effective during the years under audit. The taxpayer should be aware that it will raise the tax auditor’s suspicion if information requests cannot be honored promptly or completely.

- Reviewing the status, and possibly completing the taxpayer’s documentation, of intra-group transactions because such documentation has to be submitted within 30 or 60 days of the tax auditor’s request, and severe sanctions would apply if the documentation is submitted late or is deemed to be insufficient.

- Discussing potential "hot topics" with the taxpayer’s counsel, such as overly aggressive tax planning made in the past or issues that could be qualified as negligent tax underpayment. Germany operates rules, under which it is possible to rectify past transactions that may qualify as negligent tax underpayment, by filing a "voluntary disclosure." Under certain conditions, this kind of voluntary disclosure will remove any exposure from the individuals involved in respect of possible sanctions. A voluntary disclosure in cases of tax fraud, however, is possible only prior to the receipt by the taxpayer of the notification about the initiation of a tax audit.

- Discussing with the taxpayer’s counsel strategic considerations during the audit.

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76 Thirty days for the documentation of "extraordinary transactions," 60 days for the documentation of other business transactions, Section 90 para. 3 sentences 8 and 9 of the General Tax Code.

77 Section 162 para. 3 and 4 of the General Tax Code, see also 3. (a) (4) below.
• Designating contact persons: contact with the tax auditor should be limited, if possible, to one or two local company managers with knowledge of the business and its operations.

• Designating a workplace for the tax auditor. If the tax auditor is reviewing documents or interviewing personnel at the place of business, a separate room should be designated for the tax auditor's use. While at the business site, the tax auditor may attempt to mingle and converse with personnel other than the designated managers. The taxpayer should make certain that employees refrain from facilitating this type of “informal information gathering.”

• Establishing computer access barriers for the protection of information that is not relevant for the periods or the taxes covered by the tax audit.78

3. Areas of tax auditors’ special attention

(a) Procedure and form

The general approach taken by the tax auditor is to review the accuracy of the taxpayer’s returns on the basis of the taxpayer’s relevant books and records, including correspondence and files. The tax auditor has the right to review, and, therefore, the right to be given access to, the documents they may consider relevant. The tax auditor may also request that additional information they deem helpful or necessary be supplied. The taxpayer is expected to honor information requests promptly and completely.

Normally, the tax auditor commences the audit by ascertaining details as to the business transactions of the respective taxpayer.

78 See below under 6.
Subsequently, the tax auditor generally will identify certain critical areas on the basis of "sample testing." In respect of procedures and form, the tax auditor will, in particular, focus on the issues mentioned below.

(1) **Financials and accounting**

Germany has specific rules relating to the obligation of businesses to maintain books and records and to produce financial statements.79 As a matter of principle, where a person is obligated to keep books and records and to produce financial statements, this obligation must also be met for tax purposes. Such books and records and financial statements are required to be kept for tax purposes and maintained for a specified period of time, but this will also be for at least as long as they are needed for taxation purposes.80 If these are not in German, the tax office has the right to demand a translation.81 The status of the financials and accounting is normally the first focus of the tax auditor. If these are not in line with legal requirements, this would enable the tax auditor to dismiss parts, or even all, of the accounting of the taxpayer and to base the income determination on an estimate.

(2) **Formal requirements**

Business transactions among related parties may only be recognized where "clear and unequivocal agreements" have been entered into prior to the transaction in question.82 Where such requirements are not met, the transaction may be assumed to have arisen out of the shareholder-subsidiary relationship, and related expenses may not be tax-deductible.

79 Section 238 et seq. of the Commercial Code.
80 Section 147 para. 3 of the General Tax Code.
81 Section 87 para. 2 of the General Tax Code.
(3) Substance over form

The re-qualification of transactions to the disadvantage of the taxpayer is common practice in Germany, either on the basis of "substance over form," or on the basis of Section 42 of the General Tax Code, which provides that tax laws cannot be circumvented by virtue of a misuse of concepts of the law.

In the case of any such misuse, the tax arises as it would have arisen had the form been in line with the substance.83

However, a misuse of concepts of the laws cannot be assumed if the taxpayer is able to present genuine non-tax reasons that were decisive for the structure.

(4) Documentation of intra-group transactions

Germany operates very detailed rules that require, from the taxpayer, the keeping of specific documentation in relation to transactions with related parties in general, and with related parties abroad in particular.84 As a matter of principle, the documentation of transactions with related parties abroad needs to: give information on the type, scope and conduct of transactions; show the appropriateness of conditions agreed; reveal comparables from transactions with third parties, operational data, prognoses and plausibility checks; and state why the taxpayer deems the transfer pricing method applied by them to be appropriate. Such documentation has to be prepared contemporaneously (i.e., within six

83 Section 42 para. 1 of the General Tax Code.
months after the end of the fiscal year during which the transactions at issue took place)\textsuperscript{85} for extraordinary transactions only. However, the scope of "extraordinary transactions" is broad. It comprises predominantly all business transactions with affiliates abroad that go beyond the day-to-day business, such as transfers of material functions and risks, business strategy changes, the conclusion of and even changes to material long-term agreements (i.e., agreements with a material impact on the taxpayer’s income) and the conclusion of cost-pooling arrangements.\textsuperscript{86} Upon request by the tax auditor, the documentation has to be submitted within 30 or 60 days,\textsuperscript{87} regardless of whether the records are kept in Germany or abroad.

Severe sanctions may apply if a taxpayer is deemed to have violated its obligation to cooperate by failing to submit documentation, by having submitted documentation late, if the documentation is deemed to be essentially insufficient, or if the documentation of extraordinary transactions was not prepared contemporaneously. These sanctions include the following:

- A possible (refutable) presumption by the tax auditor that the taxpayer’s income is understated
- An estimation of taxable income (whereby the range will normally be used to the detriment of the taxpayer)
- The shift of the burden of proof for compliance with the arm's-length principle to the taxpayer
- A surcharge of 5% to 10% on income increases as a result of an estimation

\textsuperscript{85} Section 90 para. 3 sentence 3 of the General Tax Code; Section 3 para. 1 sentence 2 of the Documentation Ordinance.

\textsuperscript{86} Section 3 para. 2 of the Documentation Ordinance.

\textsuperscript{87} Section 90 para. 3 sentences 8 and 9 of the General Tax Code.
• Tax penalties of up to EUR 1 million in the case of late submission of documents\(^8^8\)

(5) Non-disclosure of creditors and payees

A provision with real bite in tax audits is Section 160 of the General Tax Code, which provides that, "debts and ... expenses shall, in principle, not be recognized for taxation purposes if the taxpayer fails to honor a request of the tax office to give precise information concerning the creditors or recipients." This provision is frequently applied when the tax auditor is convinced that the "official" creditor or recipient of funds is an intermediary acting as a fiduciary. Section 160 of the General Tax Code will be applied if the person to whom the transactions and payments would normally be attributed to for tax purposes is unknown.

(b) Substantive issues

(1) Permanent establishment/Residency

German income tax laws distinguish between "unlimited" and "limited" income tax liability. Corporate taxpayers are subject to "unlimited" income tax liability; i.e., subject to German income tax in respect of their worldwide income, if they have their seat or their place of effective management in Germany.\(^8^9\) Non-German corporate taxpayers are only subject to "limited" income tax liability in respect of certain categories of income, the most important being the income from business activities derived through a permanent establishment or through a permanent representative in Germany.\(^9^0\)

It is not uncommon for German tax auditors to try to prove that the place of effective management of a non-German corporate entity is in Germany. This is a special risk where the state of the taxpayer’s residence assumes

\(^{88}\) Section 162 paras. 3 and 4 of the General Tax Code.

\(^{89}\) Section 1 para. 1 of the Corporate Income Tax Act.

\(^{90}\) Section 8 para. 1 of the Corporate Income Tax Act, Section 49 para. 1 sentence 1 no. 2. a) of the Income Tax Act.

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that there is unlimited tax liability within its jurisdiction as well, by virtue of the taxpayer’s residency, and the relevant tax treaty with Germany does not provide for relief from double taxation in the case of dual residency. Experience has also shown that a particular permanent establishment/permanent representative exposure exists for principals conducting business with contract manufacturers, contract R&D providers, commissionaires or agents in Germany.

The German Federal Ministry of Finance published a very comprehensive pronouncement dealing with, among other things, the determination and allocation of income between the head office and permanent establishment in a cross-border context. Like all other pronouncements released by the German tax authorities, this pronouncement is not part of German tax laws and is meant to ensure that legal provisions are uniformly interpreted and applied by German tax authorities. Although it is not binding upon the taxpayer, the taxpayer can use this pronouncement to argue its case against the tax auditor, should they intend to allocate an overgenerous portion of the overall income to an alleged permanent establishment in Germany.

(2) Transfer pricing

A review of the taxpayer’s business transactions with related parties is one of the primary focuses in each tax audit. Typically, the tax auditor’s

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91 See, for example, Article 4 para. (3) of the US-German Tax Treaty.
92 See Federal Ministry of Finance Pronouncement dated 22 December 2016, IV B 5 - S 1341/12/10001-03 (Administration Principles for the Allocation of Profit of Permanent Establishments).
interest is directed toward whether or not the following circumstances exist:

- "Clear and unequivocal agreements" have been entered into prior to the transaction in question;\(^93\) such agreements do not have to be in writing, however.
- The transaction is in the interest of, or provides a benefit for, the German taxpayer.
- The conditions are at arm's length.

A very detailed set of rules is contained in Section 1 of the International Transactions Tax Act, which has become the most important provision for transfer pricing adjustments and which enables the tax auditor to adjust the taxpayer’s income upward in the event its business transactions with related parties are regarded as not being at arm’s length. The Court of Justice of the European Union (CJEU) recently held that the provision complies with EU law only, provided that the taxpayer is permitted to submit evidence of the commerciality of the arrangement.\(^94\) Following this decision, the German Federal Ministry issued a pronouncement according to which income adjustments under Section 1 of the International Transactions Tax Act shall not apply where the economic existence of the group is endangered or the transaction qualifies as restructuring measure. The Federal Ministry of Finance further declares that the decision of the CJEU only applies to EU/EEA countries.\(^95\)

In order to ensure that transfer pricing principles are uniformly interpreted and applied by German tax authorities, the Federal Ministry of Finance has

\(^{93}\) See above under 3. (a) (2).
\(^{94}\) *Hornback-Baumark v. Finanzamt Landau*, Case C-382/16, decision dated 31 May 2018.
\(^{95}\) Federal Ministry of Finance Pronouncement dated 6 December 2019, BSBl. 2018 I, p. 1305, (Economic reasons justifying the conclusion of a transaction which is not arm’s length — CJEU as of 31 May 2018).

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released a number of comprehensive and detailed pronouncements dealing with the most relevant aspects of transfer pricing, in particular:

- The determination of arm's-length conditions in general\(^96\)
- The procedures for review
- The attribution of income between head office and permanent establishment\(^97\)
- The attribution of income in cost-pooling structures\(^98\)
- The attribution of income in cases of the secondment of employees\(^99\)

These pronouncements also provide a source of arguments against tax auditors.

The review process is generally based on a function-and-risk analysis that takes into account which company performs routine functions, which enterprise carries the essential entrepreneurial risk, and which enterprise performs more than routine functions without carrying the essential burdens\(^100\). Tax auditors frequently argue that a prudent and diligent independent manager will select the transfer pricing method that is best suited to its individual situation. As a consequence, the German taxpayer will be required to show why they deem the transfer pricing method actually applied by them to be appropriate. A test of its results by the application of other methods, or the provision of reasons why the taxpayer


\(^97\) Administration Principles for the Allocation of Profit of Permanent Establishments.


\(^100\) Annotation 3.4.10.2 of the Administration Principles — Procedures.
regards other methods to be less suitable, is not necessary, however.\textsuperscript{101} Methods other than the standard methods, namely the transactional net margin method (TNMM) and the profit split method, are only accepted in specific circumstances.\textsuperscript{102} The comparable profit method is not recognized.\textsuperscript{103}

German taxpayers should be aware that, contrary to the practice accepted by the tax authorities of many other countries, information from databases, even if the research was properly conducted, will be regarded, as a rule, insufficient to prove the appropriateness of conditions. Records will be deemed "essentially unacceptable" if the documentation of appropriateness is exclusively based on a database study on rates of returns of third-party enterprises (database screening).\textsuperscript{104} For this reason, the use of planning data, including the frequent comparison of estimates with results, plays an increasingly important role in determining the appropriateness of conditions.\textsuperscript{105}

(3) Restructuring/Business re-engineering

Intra-group restructurings (such as mergers, spin-offs and split-ups) and business re-engineering transactions (such as transfers of functions and risks) often result in a decrease of the taxpayer’s ability to generate (taxable) income in Germany. They are therefore typical areas of the tax auditor’s particular interest, whose investigation is multi-level:

- Restructurings and business re-engineering transactions are normally "extraordinary transactions" requiring contemporaneous documentation.\textsuperscript{106}

\textsuperscript{101} Annotation 3.4.10.1 of the Administration Principles — Procedures.
\textsuperscript{102} Annotation 3.4.10.3 b) and c) of the Administration Principles — Procedures.
\textsuperscript{103} Annotation 3.4.10.3 d) of the Administration Principles — Procedures.
\textsuperscript{104} Annotation 3.4.19 c) of the Administration Principles — Procedures.
\textsuperscript{105} Annotation 3.4.12.6 of the Administration Principles — Procedures.
\textsuperscript{106} See above 3. (a) (4).
Restructurings may involve "share transfers." These may be points of reference to disallow the utilization of loss carry-overs.

The transfer of functions and risks is often seen as a constructive dissolution or transfer of goodwill, in respect of which the taxpayer has to comply with very sophisticated valuation rules in order to avoid an adjustment of income by the tax auditor. This may even be qualified as a "transfer of a transfer package" (and may trigger an "exit tax"), which will be determined taking into account the net present value of profits the transferee hopes to gain in the future.  

Intra-group restructurings may create permanent establishment and transfer pricing risks where the agreed functions and risks are, or where the compensation is not, commensurate with the actual functions assumed and risks taken. Also, particular exposure exists if the activities are not in line with the VAT or system structures.

4. Constructive dividends

A constructive dividend is a decrease of, or a prevented increase in, a corporation’s property that is the result of the shareholder-subsidiary relationship, which has an impact on the corporation’s income, and does not result from a proper dividend resolution. To the extent the tax auditor assumes a constructive dividend, the taxpayer’s taxable income will be increased and will thereafter be deemed distributed, thus potentially triggering dividend withholding tax consequences. In many cases it is possible to negotiate with the tax auditor to only increase the income of the taxpayer rather than to assume a constructive dividend, in which case the tax consequences of the alleged distribution of a dividend would be avoided.

107 Section 1 para. 3 of the International Transactions Tax Act.
108 See, for example, the Federal Fiscal Court decisions referred to in footnote 21.
(5) Thin capitalization

Germany operates very complex thin capitalization rules in the form of an interest barrier.\textsuperscript{109} These are a source of frequent disputes between the taxpayer and the tax auditor.

4. Special tax audits

As a rule, a tax audit can be conducted with respect to any particular tax or several (or all) taxes. If the tax audit is limited to only one particular tax (such as VAT, customs or wage taxes), the same procedural rules apply (i.e., there is no separate regime applicable to the special tax audit). The following should be noted, however:

- In VAT matters, spontaneous audits are permissible in respect of which the taxpayer will not be notified in advance.\textsuperscript{110} Such a spontaneous VAT audit can be transferred into an ordinary (full-scale) tax audit even without formal notification to the taxpayer. Because, in this case, the taxpayer will not have the usual four weeks for preparation between the receipt of the notice and the tax auditor’s first visit, the taxpayer should contact its tax counsel immediately when a spontaneous VAT audit has been initiated.

- Transfer pricing auditors and customs auditors have a potential conflict of interest. If goods are imported, for example, the transfer pricing auditor has a tendency to qualify the transfer price as inappropriately high, whereas the customs auditor has a tendency to regard the same value for customs purposes as inappropriately low. Even the Federal Fiscal Court ruled, albeit decades ago, that the value

\textsuperscript{109} Section 8a of the Corporate Income Tax Act in conjunction with Section 4 h of the Income Tax Act; in its decision dated 14 October 2015 (I R 20/15; BStBl. II 2017, 1240), the Federal Fiscal Court took the position that the interest barrier is not in line with the German Constitution and referred the case to the German Federal Constitutional Court (case number 2 BvL 1/16).

\textsuperscript{110} Section 27b of the VAT Act.
of goods for transfer pricing and for customs purposes has to be determined using different principles.\textsuperscript{111}

5. "Fast-track" tax audits

A typical full-scale tax audit in Germany covers a period of three or more tax years and may last for several years. Section 4a of the Tax Audit Ordinance\textsuperscript{112} permits the organization of a tax audit as a "contemporaneous tax audit," as a result of which a number of tax authorities in Germany have engaged in "fast-track audit procedures." Such a fast-track audit procedure is usually not based on an order, but on an agreement with the taxpayer. It requires full cooperation by the taxpayer and is a streamlined process in which materiality thresholds will be established, and both the tax auditors and the taxpayer will focus their resources and time on the most significant issues in respect of the years under examination, thus largely omitting routine and mere timing issues in order to arrive at a less difficult, less time-consuming and less expensive audit process.

The advantages for the taxpayer are obvious: a fixed audit plan, an agreed "minimum documentation" of transfer prices, legal security at an early stage, and less interest on subsequently assessed taxes. In addition, in a FIN 48 context, a contemporaneous tax audit may constitute an important element of risk management.

There is no legal right to a fast-track tax audit. However, this option is available to selected taxpayers whose cooperation, as experience has shown, is rewarded by the tax authorities.

\textsuperscript{111} Federal Fiscal Court decision, BStBl 1967 III, 495; differing position adopted by Fiscal Court of Hamburg, EFG 1990, 607.

\textsuperscript{112} The Tax Audit Ordinance (\textit{Betriebsprüfungsordnung}, BPO) contains a set of administration guidelines established to ensure the uniform interpretation and application of the statutory provisions applicable to the organization of a tax audit in Germany.
6. **Electronic data processing (EDP) access during audit**

German taxpayers are no longer in compliance with their obligation to cooperate if they print out data stored in their EDP system in hardcopy and hand the copies over to the tax auditor. Tax auditors in Germany are entitled to inspect data stored on computers by:

- **Having direct access to the computer system:** The tax auditor is entitled to make use of the taxpayer’s hardware and software, which comprise not only the reading, but also editing (e.g., filtering and sorting of data).

- **Having indirect data access:** The tax auditor is entitled to request from the taxpayer any technical assistance including, but not limited to, an evaluation of data contained in the system.

- **Submitting data stored on a data carrier for purposes of evaluation by the tax auditor.**

Data access comprises the obligation of the taxpayer to provide the tax auditor with the necessary technical equipment to access the data and the necessary instructions for the operation of the computer system.\(^{113}\)

Computer access during the audit allows the tax auditor to apply statistical procedures to discover irregularities or inconsistencies within the documentation prepared and submitted by the taxpayer. It also facilitates the exchange of information among tax authorities in Europe and the handling of control notices for the purpose of cross-checking the treatment of tax-relevant facts in the books of different taxpayers, and thus facilitates the coordination of simultaneous tax audits in more than one jurisdiction. For the taxpayer, computer access during an audit requires the timely establishment of access barriers for the protection of information that is not tax-relevant, and a coordinated effort to avoid

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\(^{113}\) Sections 146 para. 5, 147 para. 1, 2 and 6, 200 para. 1 of the General Tax Code.

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information gathered in one jurisdiction, where it is not tax relevant, being shared with tax authorities in other jurisdictions.

7. Production of foreign-based information

If facts pertaining to circumstances abroad must be ascertained and determined, the taxpayer is required to clarify such situations through disclosures and obtain the necessary evidence, and, in so doing, is obligated to make full use of all available legal and actual means. Related parties are normally expected to assist each other in gathering facts and furnishing evidence. If the taxpayer is the direct or indirect majority shareholder of the related party, it will be deemed to have the necessary legal means to procure information and evidence at its disposal. In these cases, it will be barred from arguing that a foreign related person will not deliver the required evidence or records that are available.

8. Information obtained from unrelated parties

Tax auditors in Germany have the right to not only request the provision of tax-relevant information from the taxpayer, but also from third parties. Of particular importance is Section 93b of the General Tax Code, which entitles German tax authorities to be given electronic access to customer data from banks.

Data in anonymous form from other taxpayers may be used by the tax auditor regardless of whether these are publicly available or not. An example with great practical importance is the Royalty List (Lizenzkartei), a list of royalty rates agreed to by taxpayers in various industry sectors kept by the Federal Central Tax Office (Bundeszentralamt für Steuern), which is not publicly available. However, each database has to satisfy certain minimum quality requirements, otherwise any serious doubts raised by the taxpayer, as to whether or not minimum standards are satisfied, may make...

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114 Annotation 3.3.2 b) of the Administration Principles – Procedures.

115 Sections 93 et seq. of the General Tax Code.
the anonymous database less valuable, if not worthless, as a means of evidence.

9. **Secret comparables**

Tax auditors in Germany are entitled to make use of "secret comparables" (i.e., information obtained in tax assessment proceedings relating to other taxpayers). The use of such "secret comparables," however, may affect the tax secrecy principle, as laid down in Section 30 of the General Tax Code. The taxpayer has the right, as soon as and for as long as its case is pending before a fiscal court, to inspect all files and other documents handed over by the tax office to the fiscal court. The inspection of files by the taxpayer may violate the tax secrecy principle if these contain information about other taxpayers. In such a case, the tax office must abstain from handing over the files to the fiscal court. On the other hand, information contained in the files of the tax office that have not been disclosed to the fiscal court cannot be taken into account in the court's decision. It is this Catch-22 situation that makes the application of "secret comparables" difficult, if not obsolete, in practice.

10. **Information provided by foreign tax authorities**

As far as the cross-border exchange of information is concerned, German tax authorities are perfectly equipped not only to honor information requests from abroad and supply information to other tax authorities, even on a spontaneous basis, but also to request information from other states. These rights are set forth in one of the following:

- More than 90 German tax treaties in existence containing exchange of information clauses
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- Council Regulation No. 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of VAT, as amended

- Bilateral agreements such as the Austrian-German Agreement on Administrative Assistance

The cross-border exchange of information, and the use of such information in tax audits, is common practice in Germany. It is difficult, if not virtually impossible, to prevent tax auditors from using information obtained from abroad.

11. Multijurisdictional tax audits

A multijurisdictional tax audit is an arrangement by two or more countries to examine simultaneously and independently, each on its territory, the tax affairs of related taxpayers with a view of exchanging any relevant information that they obtain. Germany even goes as far as to allow the direct participation of Austrian tax auditors in domestic tax audits, and German tax auditors may directly participate in tax audits in Austria.

Germany has engaged in multijurisdictional tax audits. It can be expected that these audits will play an increasingly important role in the future.\textsuperscript{117}

\textsuperscript{116} The latest amendment to the directive provides for an obligation for intermediaries such as tax advisors, accountants and lawyers to report certain cross-border arrangements that could potentially be used for aggressive tax planning. In cases where professional privilege rules apply, or where the intermediary is not based in the EU, the reporting obligation may shift to the taxpayer. Member States are required to introduce legislation that complies with the amended Directive by 31 December 2019 at the latest. The new rules shall apply from 1 July 2020 and include reportable transactions implemented from 25 June 2018 onward.

\textsuperscript{117} The German Ministry of Finance published a Pronouncement dated 6 January 2017 on cross-border tax audits (IV B 6 - S 1315/16/10016:002) outlining the legal basis and providing guidance on the implementation.
These require special preparation and management, including communication to, and the exchange of information about, the scope, focus of and findings in domestic tax audits with group companies in other jurisdictions, as well as the identification of potential risk areas such as double non-taxation, inconsistent reporting, the use of qualification conflicts and abuses of laws. In addition, proper preparation and management requires the review of whether or not the tax auditor is legally required to inform the taxpayer about the participation of foreign tax auditors, or about the kind and scope of information they intend to share with foreign tax authorities. Finally, it is advisable to develop a "common theory of the case" and a "common defense position" or settlement opportunities with a view toward minimizing the tax exposure of the group, not necessarily of individual group companies.

12. Burden of proof

German tax laws do not contain general principles governing the allocation of the burden of proof. As a rule, the tax authorities have the burden of proof regarding such facts and circumstances that establish or increase the tax claim.

This general rule is restricted if tax-relevant facts and circumstances cannot be completely determined, although the tax office has exhausted all available and reasonable examination possibilities, and the taxpayer has failed to comply with its cooperation obligations.118

In this case, the evidence requirements will be reduced in favor of the tax authorities. As far as transfer prices with related parties abroad are concerned, and in respect of profit allocations between head offices and permanent establishments located in different jurisdictions, the taxpayer

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must comply with detailed valuation rules and documentation requirements.\textsuperscript{119}

Failure to comply with these obligations enables the tax auditor to adjust the taxpayer’s income based on an estimate.\textsuperscript{120} In such a case, the taxpayer has the burden of proof that the tax auditor’s estimates are based on incorrect or inappropriate assumptions.

13. Potential consequences

(a) Adjustment of income

Adjustments of income may have differing tax consequences depending on, among other things, whether the affected taxpayer is the parent or a subsidiary, and the legal basis applied in connection with the adjustment. For example:

• Where a German parent supplies goods to its non-German subsidiary and the sales price is below market price, the taxable income of the parent will be increased in an amount equal to the difference between the actual sales price and the arm’s-length price. The book value of the parent’s investment in the subsidiary will be increased accordingly. Balancing payments made by the subsidiary, as compensation to achieve arm’s-length results, will be treated as capital repayments and will thus reduce the subsidiary’s value on the books of the parent.

• Where a German parent supplies goods to its non-German subsidiary and the sales price is above market price, the difference between the sales price and the arm’s-length price will be deemed to constitute a constructive dividend that, as a rule, is tax-free\textsuperscript{121} in the hands of the

\textsuperscript{119} Section 1 para. 3 of the International Transactions Tax Act; Section 90 para. 3 of the General Tax Code.

\textsuperscript{120} Section 162 para. 3 of the General Tax Code.

\textsuperscript{121} As a rule, 5% of the constructive dividend will be deemed nondeductible expense, so effectively only 95% are tax-free. The participation exemption is not applicable if the shareholding is less than 10%.
parent. Balancing payments made by the German parent to achieve arm's-length prices will be treated as capital contributions.

- Where a German parent grants a loan to its non-German subsidiary and the interest is below market rate, the taxable income of the parent will be increased on the basis of Section 1 of the International Transactions Tax Act without changing the balance sheet entries. Subsequent compensation payments made by the subsidiary will be credited against the amount by which the parent's taxable income has been adjusted, if the compensation payments were actually made within a period of one year after the corrected tax return was released.\(^{122}\)

(b) Gift tax

Under the Inheritance and Gift Tax Act,\(^ {123}\) certain benefits granted between related parties may not only trigger adjustments of income, but may be subject to gift tax as well. Such benefits subject to gift tax could be assumed, for example:

- If the business transactions between the corporation and its shareholder, or a related party to the shareholder, are not at arm's length, thus triggering a constructive dividend.

- If one shareholder makes a contribution to a corporate entity in excess of its pro-rata share in the capital, as a result of which the value of the shares of other shareholders increase, provided that the other shareholders are individuals.

\(^{122}\) Annotation 5.5.1 d) of the Administration Principles — Procedures.

\(^{123}\) Section 7 para. 8 of the Inheritance and Gift Tax Act. See also Coordinated Decree issued by the German Federal States (Gleich lautende Erlasse der Obersten Finanzbehörden der Länder) dated 14 March 2012, BStBl. 2012 I, page 331.
The application of these rules may have disastrous effects:

- A constructive dividend frequently results in an increase of the subsidiary’s taxable income, and will generate dividend income at the level of the shareholder as well. A taxable gift may be assumed in addition to the income tax consequences, which will, in a cross-border context, be taxed at the level of the German entity irrespective of whether it is the parent or the subsidiary. There is no reciprocal tax credit.

- Competent authority or arbitration proceedings, as provided for in the German income tax treaties, are not available for gift tax matters.

- The gift tax rate is 30% for amounts of taxable profits up to EUR 6 million and 50% applicable if the taxable benefits exceed EUR 6 million.

(c) Estimates

Estimates are possible, for example, where the tax auditor dismisses parts or all of the accounting of the taxpayer, or where the conditions of the taxpayer’s business transactions with related parties have not been at arm’s length. In making adjustments, estimates may be made based on return or specific capital or gross profit determiners, or other suitable criteria. If the tax office bases the determination of income on an estimate, as the taxpayer has violated its increased cooperation obligations in the case of business transactions with related parties abroad, such estimates can be determined by exhausting price ranges to the taxpayer’s disadvantage.124

(d) Interest and penalties

Where adjustments result in increased taxes, interest will be assessed at a rate of 6% per annum for the period commencing 15 months after the

124 Section 162 para. 3 sentence 2 of the General Tax Code.
lapse of the calendar year in which the tax liability came into existence and ending on the date at which the tax assessment becomes effective. The interest is only tax-deductible if the tax for which the interest is assessed is also tax-deductible.

If the taxpayer’s income was adjusted as a result of an estimation, because it has violated its obligation to cooperate by failing to submit documentation, or if the documentation is deemed to be essentially insufficient, or if the documentation of an extraordinary transaction was not prepared contemporaneously, a surcharge of 5% to 10% on income increases, but of not less than EUR 5,000, will be assessed. In the case of the late submission of documentation, a surcharge of up to EUR 1 million will be assessed for each relevant assessment period.

14. Strategic considerations

(a) Cooperation or confrontation?

Undergoing a tax audit in Germany is a fact of business life and must be handled in an informed and responsible manner. A typical tax audit in Germany will be dealt with cooperatively by the taxpayer and will eventually be settled on an amicable basis. Of course, the taxpayer’s rights should always be observed where possible and appropriate. The maintenance of a "good working climate" during an audit will be disadvantageous for the taxpayer under the following circumstances:

- The taxpayer does not exercise the rights it is expected to exercise.

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125 Section 233a of the General Tax Code; in its decisions dated 25 April 2018 (IX B 21/18, BStBl II 2018, 415) and 3 September 2018 (VIII B 15/18), the Federal Fiscal Court raised doubts whether the interest rate is in line with the German Constitution. In respect to this question there are currently two constitutional complaints pending at the Federal Constitutional Court (1 BvR 2237/14 for interest periods after 2009 and 1 BvR 2422/17 for interest periods after 2011).

126 Section 162 paras. 3 and 4 of the General Tax Code.
• The taxpayer accepts without complaint the misconduct or infringement of laws or regulations by the tax auditor.

• The taxpayer is seeking a good working climate because of uncertainties relating to factual or legal questions.

• It is intended to divert from poor preparation.\(^{127}\)

(b) Who should run the show?

Experience has taught us that it is the local people (i.e., the managing director, the head of the taxpayer’s German tax department or the taxpayer’s counsel) who have the most detailed knowledge about the facts and the best experience in how to deal with tax officials. They know the rules of conduct best and should be expected to have sufficient imagination to bring even a difficult tax audit to a successful close. For this reason, they should run the show. It is advisable only in isolated cases to have people from foreign affiliates, such as the European tax director or the head of the worldwide tax department, directly participating and meeting with the tax officials.

(c) Settlement or litigation?

Tax disputes may be settled during an audit, at the tax office level prior to the release of the post-audit tax assessment notices, as a result of an appeal, or at the court level. Although the taxpayer should, at all times, emphasize their willingness to litigate, the taxpayer should be mindful of settlement opportunities at every stage of the process, if appropriate, if only because of the duration of tax litigation proceedings in Germany, during which the taxpayer will not have the comfort of knowing whether or not the contested practices will eventually be accepted.

A very common, efficient and flexible settlement technique in Germany, used at every stage of the taxation process, from tax audits through the

\(^{127}\) See Michael Streck, *Die Außenprüfung*, 3. ed., p. 84.
settlement of tax disputes in an administrative appeal and even before the fiscal court, is the formal agreement on facts. This instrument is based on a Federal Fiscal Court decision rendered in 1984\textsuperscript{128} in which the court held, for the first time, that formal agreements on facts between the taxpayer and the tax office are permissible and binding upon both parties. Such formal agreements on facts may relate to the tax bases (e.g., to the taxpayer's revenue or to the amount of deductible expenses), to the determination of values or the useful periods of life of assets, and may also include an agreement on the procedures to estimate the taxpayer's income if the relevant books and records are found to be insufficient. Formal agreements on facts are applicable to past periods only and may, in theory, not cover legal questions. If a tax dispute involves legal issues as well, however, an experienced tax attorney should be able to "convert" these into, and settle these on the basis of, an agreement on the underlying facts. If, for example, whether or not income from certain sources is taxable, is in dispute, the taxpayer may agree that the respective income is, in fact, taxable and the tax office may accept a certain amount of deductible expenses instead. It follows that even if the possible outcome of a tax dispute over legal questions appears to be black-and-white, in reality, there are often many shades of gray in between, if the dispute can eventually be settled by agreement.

Whether during an audit, it is best to try to settle non-controversial and small issues as soon as possible, leaving the problem issues for the final meeting, or whether all issues should be held open until the final meeting, depends on the individual tax audit and cannot be answered in general terms. As a matter of principle, however, even small controversial issues should not be settled prior to the final meeting because these may be of value in their entirety as a trade-off. When reviewing settlement opportunities, the taxpayer should take into account that it has a statutory right to request a ruling after the conclusion of a tax audit.\textsuperscript{129} Such a ruling

\textsuperscript{128} Federal Fiscal Court decision, BStBl 1985 II, p. 354.

\textsuperscript{129} Section 204 of the General Tax Code.
typically covers tax issues relevant for the conduct of the taxpayer’s business and may even be negotiated as part of a settlement in the form of a unilateral APA in respect of past post-audit periods, but also in respect of future periods, and may, in many cases, be a vehicle to reduce the taxpayer’s audit exposure in the future.

If it has not been possible to settle disputes during the audit, settlements tend to be more achievable at the tax-office level prior to the release of the post-audit tax assessment notices, or even after the filing of an appeal (i.e., after the local tax office has examined the case in detail and faces the realities and difficulties of having to litigate the case). In the following events, however, litigation cannot, or should not, be avoided if:

- A settlement at court level is expected to be more favorable than at the administrative level
- Questions of principal importance for the taxpayer are at stake that ultimately have to be decided by the Federal Fiscal Court or the CJEU
- Certain practices may be, or have been, qualified by tax officials as tax fraud

15. Conversion of a regular tax audit to a criminal investigation

Upon the discovery by the tax auditor of information suggesting criminal tax evasion, a routine tax audit can be converted to a criminal investigation. The taxpayer should remember that the tax audit is the means for gathering evidence that may be used not only for potential tax adjustments, but, if the facts warrant, for potential criminal proceedings. The following contains a series of principal guidelines that should be observed if a criminal investigation is commenced in Germany:130

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130 See also Michael Streck, Rainer Spatscheck, *Die Steuerfahndung*, 5th ed., p. 88 et. seq.
(a) Taxpayer’s right to notice

In a normal tax audit, the taxpayer will receive an advance notice of the audit. This notice is normally given in writing.

If a routine tax audit becomes a criminal investigation, the tax auditor is required to provide the taxpayer with immediate formal notification.

(b) Premises that may be searched

In a normal tax audit, the tax auditor will not seek to search the premises. A criminal investigation, in contrast, often begins with a "house search." Such a search can be carried out in the business premises, in the workplace, and in the employees’ homes. The taxpayer has little power, if any, to prevent the search.

(c) Seizure of documents

In a normal tax audit, the tax auditor will not seize documents, but has the right to go through any and all documents potentially relevant to the assessment.

In the context of a criminal investigation, the tax auditor may seize the originals of any documents deemed relevant. If this occurs, the taxpayer should insist on impoundment of the documents by the tax auditor on the taxpayer’s premises (a room, a closet, etc.), rather than releasing the documents. In order to preserve the taxpayer’s rights, documents that the tax auditor wants to remove from the premises should not be surrendered voluntarily, and the taxpayer should insist on being given an exact listing of any documents taken.

(d) Right to counsel

The presence of counsel is optional in a normal tax audit.
In a criminal investigation, the company's tax counsel or lawyer should be notified immediately. The taxpayer has the right to have representation during the investigation.

(e) Unnecessary admissions

In a criminal tax investigation, it is advisable to keep statements to the tax auditor to a minimum when counsel is not present.

A tax auditor can be expected to attempt to elicit incriminating statements from the taxpayer, particularly if the taxpayer volunteers information without counsel being present.

(f) Limitations on the tax auditor's power

Promises made by the tax auditor regarding favorable treatment in exchange for information should be viewed with suspicion. The taxpayer should remember that tax auditors do not have influence on the criminal adjudication process.
II. Resolution procedures

1. Administration level

(a) During audit

During a tax audit, a number of meetings between the tax auditor and the taxpayer will take place in order to discuss or, when possible, resolve issues of importance that have arisen prior to the final meeting. Issues of importance are normally communicated to the taxpayer by the tax auditor prior to such a meeting, either orally or in writing. The final meeting is scheduled prior to the close of the tax audit for the purpose of a final discussion of the tax auditor’s findings and, of course, for negotiations between the tax auditor and the taxpayer. The settlement of problems or disputes between tax auditor and taxpayer by virtue of negotiations is common. The outcome of such negotiations will be binding if it relates to the factual background of the case, and if an official competent for the assessment of taxes participates in the settlement agreement.\(^{131}\) Care should be taken, however, in trying to settle by "mutual understanding" disputes relating to interpretations of the law; such issues are not subject to negotiations and, consequently, any settlement reached will not be binding on the tax authority. If tax bases are subject to changes as a result of the tax audit, this will be addressed and explained in a final written audit report, which thereafter will normally be used by the tax office as a basis for amended tax assessments.

(b) Between final meeting and release of tax assessment notices

It is not uncommon in Germany to leave all or certain of the tax auditor’s findings unsettled. These will be addressed in the final written tax audit report. In order to be able to provide the local tax office with comments on the tax auditor’s unsettled findings, Section 202 para. 2 of the General Tax Code grants the taxpayer the right to request, from the tax office, to

be provided with a copy of the final tax audit report prior to it being used as a basis for post-audit tax assessment notices. The taxpayer will normally send its comments to the tax office in writing, together with the suggestion to meet with the officials in order to discuss the unsettled issues anew. In such a meeting, normally the taxpayer, the tax auditor and representatives from the tax office will participate. However, whereas the tax auditor will make the decisions in the final tax audit meeting, the decision-makers in any post-audit meeting will be the representatives from the tax office, because they are responsible for implementing all or certain of the tax auditor’s findings when preparing the post-audit tax assessment notices. In taking a fresh look at the unsettled issues, the tax officials are often prepared to accept settlement proposals more favorable to the taxpayer than those that appeared achievable during audit.

(c) After the release of tax assessment notices

Unless declared "subject to review"\textsuperscript{132} or "provisional,"\textsuperscript{133} and unless an appeal is filed by the taxpayer within the appeal period, a tax assessment is deemed final after the lapse of one month after receipt of the assessment notice by the taxpayer.\textsuperscript{134} "Final" means that, as a matter of principle, the assessment is no longer subject to appeal or change.

An appeal can be filed with the tax office that originally issued the tax assessment notice, or it can be filed in the form of a leapfrog appeal with the State Fiscal Court directly, subject, however, to the consent of the local tax office.\textsuperscript{135} In many cases, a leapfrog appeal is the more advantageous alternative for the taxpayer as it saves time and money, and because only

\textsuperscript{132} Section 164 of the General Tax Code.
\textsuperscript{133} Section 165 of the General Tax Code.
\textsuperscript{134} If the assessment notice is sent by post, it is deemed received on the third day after posting if posted to an address within Germany and one month after posting if posted to an address outside Germany.
\textsuperscript{135} Section 45 of the Fiscal Court Code.
isolated factual or legal issues will be reviewed by the court rather than the entire legal and factual background of the case.

If, however, an appeal is filed with the tax office, the tax office will review the entire legal and factual background of the case in favor or to the detriment of the taxpayer anew, and will then issue its decision on the appeal, which can, if unfavorable, be appealed to the State Fiscal Court. Within the appeal proceedings, the tax office further has the possibility to amend the assessment notice to the detriment of the taxpayer. The tax office may only make use of this option after informing the taxpayer about it and offering the possibility to withdraw the appeal.

The time period between the filing of the appeal and the decision on the appeal can once again be used to negotiate a settlement. Section 364a of the General Tax Code grants the taxpayer the right to request from the tax office a meeting to discuss the legal and factual issues of the case prior to the decision on the appeal. Because such a meeting is usually the last opportunity to settle before the case is litigated, the tax office will carefully consider the costs and hazards of litigation. This means that settlements can, sometimes, be negotiated at this point even though they appeared unavailable at any earlier stage of the process.

2. Tax litigation

(a) State Fiscal Court

If the tax office’s decision is wholly or partly unfavorable, the taxpayer will then have one month, from the date of receipt of the tax office’s decision, to file an appeal with the State Fiscal Court. In any litigation before that tribunal, the court will find the relevant facts de novo and apply the law valid at that time. Under German practice, the parties brief the facts, the law, and their positions during the months following the filing of the

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136 Section 47 of the Fiscal Court Code.
137 Section 76 para. 1 of the Fiscal Court Code.
appeal. The opening brief is ordinarily filed within the first two to three months. The tax office's brief is filed in response some weeks or months later. The taxpayer then has the right to reply.

Thereafter, the court takes the case under consideration. This can last for a period of one to several years before a trial is scheduled. Settlements through negotiations at court level, possibly with the participation of the judge assuming the temporary role of an arbitrator, are common in Germany. Where this kind of settlement is not possible, however, a decision of the State Fiscal Court is ordinarily issued within a relatively short period after the trial.

(b) Federal Fiscal Court

The right to appeal a decision of a State Fiscal Court is very limited and is subject to a detailed set of rules.138 Where the case involves novel legal questions and could have an impact on other similar cases, so that it is regarded as a case of "general interest," it is more likely that the State Fiscal Court would grant leave to appeal, or that such an appeal, if not granted by the State Fiscal Court, would be accepted by the Federal Fiscal Court.

Appeals to the Federal Fiscal Court have to be filed within one month after the receipt of the State Fiscal Court's decision.139 The Federal Fiscal Court relies upon the factual record developed during the State Fiscal Court proceeding and only reviews the legal questions presented in the case. The Federal Fiscal Court could take another year, or even two, before rendering its final decision on the appeal. If the Federal Fiscal Court deems the fact-finding of the State Fiscal Court insufficient, it may also refer the case back to the State Fiscal Court for sufficient fact-finding and a new decision, which would then be subject to (limited) appeal again.

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138 Sections 115 and 116 of the Fiscal Court Code.
139 Section 120 para. 1 of the Fiscal Court Code.
(c) CJEU

German fiscal courts must apply "directly applicable" community law provisions even if these are contrary to German tax laws. Any fiscal court may request, but the Federal Fiscal Court must request a preliminary ruling in cases of doubt as to whether or not a German tax provision violates community law.\(^\text{140}\) Although German taxpayers do not have direct access to the CJEU, they may argue during litigation that the relevant provision violates community law. German fiscal courts are normally well prepared to request a preliminary ruling from the Court of Justice.

Once a provision of German tax law has been found by the Court of Justice to be invalid, German tax authorities will no longer apply this provision.

However, tax assessments that have not been declared "subject to review" or "provisional," or which have not yet been appealed, should be appealed immediately if the time period for an appeal has not run out and these were based on the invalid provision, because a change of a "final" tax assessment would only be possible under very limited circumstances.

If a provision of non-German tax laws, similar to a provision of the German tax laws, has been found by the CJEU to violate community law, German tax authorities are rather reluctant to stop applying this provision automatically. In such a case, German taxpayers are well advised to file appeals against the tax assessment notices.

3. Application for suspension of payment demands

Once the tax office has issued a tax assessment notice, taxes are normally due and payable within one month after receipt of the notice by the taxpayer or at the date determined by the tax office. Except as discussed below, these taxes must be paid even if an appeal is filed against the assessment. In order to avoid payment of taxes once an appeal has been filed, the taxpayer has the right to request a suspension of the execution of the tax assessment notice.

\(^{140}\) Article 267 of the Treaty on the Functioning of the European Union.
of the payment demand, either from the tax office\(^{141}\) or, under certain prerequisites, from the fiscal court.\(^{142}\) In considering whether to request a suspension, taxpayers typically consider the strength of their arguments in respect of the contested liability, their ability to pay the assessed amounts by the specified payment day, the 6% per annum interest,\(^{143}\) and other strategic factors. A late payment penalty of 1% per month is owed if the taxpayer fails to pay the assessed taxes or, alternatively, to file a timely request for the suspension of execution.\(^{144}\) If the request is submitted in a timely fashion, payment will not be required until such time as a decision by the tax office in respect of the request is reached, and a new payment date (if any) is established.

The requested suspension may be granted at the discretion of the tax officials. A suspension is typically granted if there is a "substantial doubt" on the part of the tax officials that the assessment is correct, or if payment of the taxes causes undue hardship to the taxpayer.\(^{145}\) The taxpayer may either contest in court a negative administrative decision to grant a suspension of execution or apply for suspension of execution at the court level. The application filed in court may have strategic value, as it provides a first indication of the merits of the case from a fiscal court judge’s perspective.

\(^{141}\) Section 361 of the General Tax Code.
\(^{142}\) Section 69 of the Fiscal Court Code.
\(^{143}\) Imposed upon the unpaid taxes in the event that suspension of execution was granted, if the appeal is later unsuccessful (Sections 237 and 238 of the General Tax Code), or paid on taxes already paid from the date of the filing of an appeal with the court in the event the appeal is later successful (Section 236 of the General Tax Code).
\(^{144}\) Section 240 of the General Tax Code.
\(^{145}\) Section 361 para. 2 of the General Tax Code.
III. Competent authority/Arbitration convention

In order to prevent double taxation resulting from changes in income allocation, effected either by German or non-German tax authorities, the taxpayer is entitled to apply for a competent authority procedure or for arbitration proceedings, as set forth in the relevant treaty. In most cases, the wording of the respective provisions is similar to Article 25 of the OECD Model Convention. The details of such proceedings from a German perspective are set forth in a Federal Ministry of Finance pronouncement dated 13 July 2006. As far as the EU is concerned, double taxation issues can be addressed on the basis of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, in force since 1 January 1995.

The German taxpayer has a great deal of flexibility because the application for the initiation of competent authority or arbitration proceedings can be filed in Germany in the following circumstances:

- Before and after a tax assessment has been issued in Germany (i.e., in case of existing or impending double taxation, even if double taxation is merely threatened)

- When an appeal is pending or other legal remedies are not yet exhausted under German law or pursuant to the law of the other state

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147 90/436/EEC. The German Implementation Act was adopted 26 August 1993 (BStBl 1993 I, p. 818).
148 Annotation 2.3.1 of the MAP Pronouncement.
149 Annotations 2.3.1 and 2.4.2 of the MAP Pronouncement.
150 Annotation 2.1.5 of the MAP Pronouncement.
Irrespective of whether or not German tax assessments are final\textsuperscript{151} An application should be filed as soon as possible after the announcement of the German or foreign taxation measure leading to double taxation. Whether an application should be filed in Germany or abroad depends on the facts of the individual case and often involves strategic considerations. With the exception of applications for the initiation of arbitration proceedings according to the Arbitration Convention, where a three-year period applies, and with the exception of applications based on treaties providing for special application periods, German tax authorities will not agree as a rule to the opening of a competent authority procedure if the taxpayer lets pass a period of more than four years between the receipt of the notification of the relevant taxation measure and the application.\textsuperscript{152}

Prior to the opening of a competent authority procedure, or of arbitration proceedings, the German tax authorities will determine if, and to what extent, the taxpayer’s petition can be satisfied domestically (i.e., without involving the other state).\textsuperscript{153} Decisions declining the opening of competent authority or arbitration proceedings may be examined by the German fiscal courts.\textsuperscript{154}

German tax authorities will request that agreements with the other state be implemented in Germany only if:

- The German taxpayer agrees to the implementation in writing.
- Pending appeals will be settled.

\textsuperscript{151} Annotation 4.1 of the MAP Pronouncement, Section 175a of the General Tax code, insofar, Article 7.3 of the Arbitration Convention is inapplicable in Germany.

\textsuperscript{152} Annotation 2.2.3 of the MAP Pronouncement.

\textsuperscript{153} Annotation 2.4.1 of the MAP Pronouncement.

\textsuperscript{154} Federal Fiscal Court, BStBl 1982 II, p. 583.
• The taxpayer explicitly waives its right to appeal the assessment notice that implements the agreement with the other state. ¹⁵⁵

If the competent authority or arbitration proceedings fail, the German tax authorities will examine whether double taxation may be avoided if it would otherwise cause hardship. ¹⁵⁶

In summary, the application for the initiation of competent authority or arbitration proceedings may have particular value due to the following:

• It can be filed before a tax assessment has been issued, independent of pending appeals, and even if the German tax assessments have become final.

• German tax authorities different from the ones issuing the original assessment notice or dealing with the appeal become involved.

• Non-German tax authorities, which may adopt a different approach, become involved.

• Under the Arbitration Convention, relief from double taxation may be possible even if the domestic laws of the other state would not permit their local tax authorities to derogate from the decisions of their fiscal courts (Article 7.3 of the Arbitration Convention).

¹⁵⁵ Annotation 4.2 of the MAP Pronouncement.
¹⁵⁶ Annotation 8 of the MAP Pronouncement, Section 163 of the General Tax Code.
Handling Tax Disputes in Hungary

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I. Managing the tax audit process

1. General

This chapter presents a comprehensive overview of the audit practices of the Hungarian tax authority (Nemzeti Adó- és Vámhivatal or NAV), concentrating on the rules and practices that apply to legal entities. This chapter will not perform a special analysis of the tax authority’s audit practice as they relate to individuals.

The most important procedural rules are incorporated into Act 151 of 2017 on Taxation Procedure ("Taxation Procedure Act"). The Taxation Procedure Act, which has significantly changed the previous tax audit rules, took effect on 1 January 2018. It is important to highlight that Hungary's new Administrative Litigation Code also took effect on 1 January 2018. The new Administrative Litigation Code and the new Taxation Procedure Act have significantly reshaped how taxpayers deal with tax disputes, both on administrative and judicial levels. The most important change is that taxpayers must gather and present their evidence at the administrative level. In the court procedure, the taxpayers are generally not allowed to present new facts or evidence.

The Taxation Procedure Act provides for several types of audits: (i) an audit may take place either at the registered seat of the company or in the local office of the tax authority; (ii) an audit may cover all tax forms and obligations or just one (e.g., VAT audit); (iii) an audit may concentrate on taxes or on customs duties; and (iv) an audit may be mandatory or optional for the tax authority.

2. Tax audits

(a) Expected periodicity

As far as the expected periodicity of audits is concerned, taxpayers that make the largest tax payments can expect an audit at least once every two years.
However, the tax authority aims to audit all other taxpayers approximately once every five years.

(b) Selection of tax audit targets

The Taxation Procedure Act differentiates between two types of audits:

- A mandatory audit must be carried out, among others, if a company qualifying as a "risky taxpayer" is undergoing a dissolution procedure, upon the order of the competent minister or of the State Audit Office. In the case of municipal taxes, among others, a mandatory audit must be carried out under the resolution of the council of representatives of the municipal government.

- Other audit activities are carried out based on targeted selection systems and individual risk analysis.

If the tax authority suspects that the taxpayer has committed accounting or taxation errors, the tax authority may initiate a supporting procedure instead of a tax audit. In a supporting procedure, the taxpayer and the tax authority are able to communicate regarding the tax issues and the taxpayer can commence a self-assessment. The tax authority cannot impose tax penalties in the supporting procedure. If the tax issues are not dealt with, the tax authority commences a tax audit.

3. Advance preparation for tax audits

A tax audit begins with a prior written notification, by the personal delivery of the notification or the presentation of a general notification by the auditor. The notification might be delivered electronically as well. The notification contains the name of the auditor and the audited taxpayer, the periods and taxes covered, and the type of tax audit. If the taxpayer refuses to accept the notification, the audit will begin in front of two administrative witnesses.
The beginning of the audit is recorded in the tax authority’s official minutes if the taxpayer refuses to accept the notification.

Generally, the tax audit must be completed within 90 days beginning on the day the notification is received. The audit may be extended by an additional period of 90 days maximum by the auditor’s superior. Under extraordinary circumstances, the extended period shall be extended by an additional 90 days maximum by the auditor’s supervisory authority and by an additional 90 days maximum by the president of the NAV. In special cases where one of the taxpayers making the largest tax payments is audited, the audit must be completed within 120 days. The Taxation Procedure Act provides that the maximum length of a tax audit cannot exceed 365 days. The law does not specify the period between the written notification and the first visit. In practice, however, a maximum period of one week will be granted to the taxpayer to prepare for the visit. This practice is completely understandable from the tax authority’s point of view, since the shorter the preparation time, the less opportunity the taxpayer will have to amend its books and records.

Since the preparation period for the audit is rather short, it is essential to use this time properly and to accurately keep all books and records so that the tax authority may be provided with the required documentation at any time. All books and records, vouchers and other documentation should be maintained for eight years. Prior to the commencement of the audit, any inconsistency or mistake may be corrected in a formal tax return under the scope of a self-revision procedure. Self-revision corrections will result in significantly lower penalties (see Section 8).

Proper preparation should include, among other things:

- Collecting all documentation (books and records, vouchers, accounts, balance sheets, filed tax returns and all agreements in connection with the period under audit) required by the tax authority or that may be required by the tax authority at a later stage of the audit (any delay
by the taxpayer in providing the tax authority with the requested information may be viewed as a lack of willingness to cooperate with the tax authority)

- Discussing with the taxpayer’s counsel potential “hot topics,” strategic considerations and potential inconsistencies in the taxpayer’s books and records
- Checking documents and agreements for formal weaknesses
- Designating a contact person who has an overview of the taxpayer’s businesses and accounts
- In the event of an on-site audit, appointing a suitable workplace for the auditor at the taxpayer’s registered seat; all requested documents should be collected in this room (to avoid an informal information flow between the auditor and the taxpayer’s employees, communication between the auditor and employees should be limited to formal discussions)
- Gathering all documentation potentially stored in a place other than the taxpayer’s registered office (in the accountant’s office, in a branch office, etc.)

4. **Limitations period for assessments**

As a rule, the period within which the tax authority can carry out a tax assessment is limited. The general limitation period is five years for all taxes and customs duties, beginning on the last day of the year in which the tax return was filed or was required to be filed. In the event of tax fraud, the tax assessment period equals the statute of limitations of the fraud charges. If the taxpayer carries out a self-revision correction to their favor, the statute of limitations period restarts with regard to the self-corrected type of tax.
Although the statute of limitations lapses in five years, the taxpayer is obligated to keep all books and records, and related documents, for an eight-year period.

5. **Areas of tax auditors' special attention**

(a) **Procedure and form**

(1) **Financials and accounting**

As mentioned above, the Taxation Procedure Act stipulates the taxpayer’s obligation to document taxable events and retain the tax-related documents within the limitations period. In addition, according to Act C of 2000 on Accounting, annual financial statements, the supporting inventory, general ledger, valuation and other statutory registers, as well as accounting records and other accounting-relevant documents must be stored for a minimum of eight years. Therefore, it should be confirmed prior to the first day of the actual audit that all documents that may be potentially requested are made available to the auditors. Further, if receipts are not in the Hungarian, English, German or French languages, the tax authority may demand a certified translation of these, provided that the information contained in the receipt is relevant to the audit.

(2) **Formal requirements**

The tax authority may only demand and examine documents that are related to and necessary for the audit. Hungarian laws do not allow documentation to be collected for future purposes.

On the other hand, the tax authority is authorized to do the following:

- Enter all premises of the taxpayer's business
- Gather all information necessary from the taxpayer, its representative or its employees
• Inspect objects, documents and working processes related to the taxpayer’s activity

• Verify the identity of all persons taking part in the taxpayer’s activity and the legal basis for their participation

• Carry out a purchase test

• Start a related audit at the taxpayer’s business partners’ businesses

• Gather any other proof that the auditor deems to be relevant to the audit

The tax authority is also authorized to take samples.

The taxpayer is entitled to know the purpose of the audit and the tax auditor’s identity, as well as to attend the tax audit in person or through a representative. During the tax audit, the taxpayer is entitled to ask questions and to be informed of the content of the minutes taken by the auditor. The taxpayer also has the right to inspect the file of the audit and to propose an evidentiary procedure.

(3) Documentation of intra-group transactions

As of financial year 2018, a new ministerial decree is applicable, which implements the two-tier transfer pricing documentation requirements recommended by the Organization for Economic Co-operation and Development (OECD) (master file and local file). The new decree is applicable regarding fiscal years beginning on or after 1 January 2018. The documentation obligation applies to all controlled transactions between the taxpayer and a related party.

The documentation obligation does not extend to the following:

• A taxpayer who qualifies as a small-sized enterprise (i.e., on a group level: (i) the number of its employees is fewer than 50; (ii) its annual net revenues or the balance sheet total does not exceed EUR 10
million; and (iii) the ownership interest held in the taxpayer by the state or municipality does not exceed directly or indirectly 25%)

- Contracts concluded by the taxpayer with a private person
- Long-term contracts concluded by small- or medium-sized related parties in the interest of joint purchases and sales to overcome competitive disadvantage, provided that the small- and medium-sized enterprises hold more than 50% of the voting rights in the related party
- Transactions concluded on the stock exchange
- When the taxpayer applies a price determined by an authority or by the relevant laws
- Transactions where the affiliated company recharges the fee of a product or service that was supplied by a third unrelated person
- Delivering cash or other financial assets free of charge
- Transactions where the net arm’s-length payments under the contract do not exceed HUF 50 million (approximately EUR 150,000 as of November 2019) in the financial year
- When the arm's-length price has been determined by the tax authority (advance pricing agreement or APA)

The taxpayer should prepare/obtain those documents that are indispensable for a reasonable assessment of transfer prices and that can be obtained without generating a disproportionately high cost.

The taxpayer must prepare a master file and a local file regarding the fiscal year. The master file must contain standardized information relevant for all multinational enterprise (MNE) group members, while the local file must contain information specifically related to the taxpayer and its
transactions. Hungarian transfer pricing (TP) legislation follows the OECD’s recommendation on the content of the master file and the local file. In addition, in line with the OECD recommendations, the taxpayer must update the searches in the database for comparables every three years. The taxpayer must update the financial data for the comparables annually.

If the taxpayer prepares the local file in due time according to Hungarian law, but the ultimate parent company of the MNE group has not yet prepared the master file, the taxpayer is deemed compliant with the Hungarian TP requirements for a maximum of 12 months from the last day of its fiscal year solely by having prepared the local file. Nevertheless, the taxpayer must prepare the master file on the date that the ultimate parent company prepares the master file (or similar document) according to its domestic laws.

i) Low-value-adding intra-group services

Simplified documentation may be prepared regarding the low-value-adding intra-group services if the arm’s-length payments due under the contract do not exceed HUF 150 million (approximately EUR 450,000 as of November 2019) in the given tax year and do not exceed 5% of the service provider's annual net revenue or 10% of the operating costs and expenditures of the user of the service.

Low-value-adding intra-group services are low-risk routine services that do not fall under the principal activity of the whole group or of another company or companies of the group. Such services include, among others, IT services, management of real estate, and educational and administrative services.

If the transfer pricing documentation is prepared under the rules of the low-value-adding intra-group services, the arm’s-length price shall be determined by the cost-plus method, without the use of comparable data. Under this provision, the transaction is considered to be at arm’s length if the margin falls between 3% and 7%.
This provision cannot be applied if the company provided or used low-value-adding services under comparable circumstances to or from an unrelated company and the price of such services demonstrates that the above margin would not be at arm’s length.

(4) Increased obligation to cooperate

The Taxation Procedure Act expressly provides for the taxpayer’s increased obligation to cooperate with the tax authority during the audit. The taxpayer must provide assistance to support the tax authority’s work in tax audits carried out on the premises of the taxpayer and must make a declaration upon the request of the tax authority. The taxpayer must provide the information requested by the tax authority. The tax authority is not entitled to request such information from the taxpayer that the taxpayer is not obliged to produce or retain by law.

(b) Substantive issues

(1) Residency/permanent establishments (PEs)

It is important to remember whether a company qualifies as a Hungarian resident for tax purposes. Hungarian resident companies are subject to corporate income tax on their worldwide income, while foreign resident companies are only subject to corporate income tax on their income realized in Hungary through their PE (limited tax liability).

In determining the residency of a company, Hungarian law applies a formal test and considers a company a resident if it is incorporated pursuant to the laws of Hungary or if it is incorporated pursuant to foreign laws but it has its effective place of management in Hungary. During an audit, one of the first and most relevant factors examined by the tax authority is the question of residency, as it can in certain cases lead to worldwide tax liability.

A non-resident enterprise carries out business in Hungary through a PE if:
(i) it has a fixed place of business (i.e., it has a physical presence there,
premises, equipment, etc.); and (ii) commercial activity is effectively carried out in this location. The following examples may qualify as a PE: a place of management, a branch, an office, a factory or workshop, a warehouse (if this is the main activity of the taxpayer), a place used for the purchase and sale of goods, and a mine or any other place of extraction of natural resources.

Business profits of a PE are taxed in Hungary. Therefore, if a non-resident company acts in Hungary through a PE, the tax authority will carry out an in-depth analysis to determine which activities of the company are taxable in Hungary. If Hungary has entered into a double tax treaty with the state where the foreign company is resident, the PE status must be determined under the double tax treaty.

(2) Transfer pricing

According to the Taxation Procedure Act and the Corporate Income Tax Act, related parties entering into transactions that are not at arm’s length (that is, transactions that apply prices that are different from fair market prices) must adjust their corporate income tax bases with the difference (spread) between the fair market price and the price applied to the transaction. Related legal entities must demonstrate in transfer pricing documentation that the prices applied among members of a company group are at arm’s length. To determine the arm’s-length price (fair market price), one of the following methods is applied:

- Comparable uncontrolled price (CUP) method: The arm’s-length price equals the price charged in a comparable transaction between unrelated parties. Adjustments may be necessary to arrive at the CUP, whereby the following, among other aspects, may be relevant:
  - Quality of the product
  - Contractual terms
  - Level of the market
- Geographical market
- Foreign currency risk
- Alternatives available to buyer and seller

- Resale price method: The arm’s-length price equals an actual price (resale price) charged by a group member (reseller) to a non-related party reduced by an appropriate gross margin that represents the costs and a reasonably appropriate profit.

- Cost-plus method: This method measures the arm’s-length price by adding an appropriate gross profit (gross profit mark-up) to the taxpayer’s costs of producing the product. This method is useful in the event of the sale of semi-finished products, joint facility agreements, long-term buy-and-supply contracts or the provision of services within a multinational group.

- Transactional net margin method: This method examines the net profit margin relative to an appropriate base (e.g., costs, sales or assets) that a taxpayer realizes from a controlled transaction. The net profit margin of the taxpayer from the controlled transaction is established by reference to the net margin earned by the taxpayer in comparable uncontrolled transactions or by reference to the net margins that would have been earned by independent enterprises in comparable transactions.

- Profit split method: This method first identifies the profit to be split between the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot be readily
assigned to one of the parties, such as the profit arising from high-value, sometimes unique, intangibles.

- Other methods may also be applied if the arm's-length price cannot be determined by applying any of the above-mentioned methods.

- The taxpayer may also request the tax authority to determine the applicable transfer pricing method and the arm's-length price under an APA.

- During a transfer pricing audit, the taxpayer must be able to provide credible proof in a verifiable way that services were actually rendered among the members of the group concerned.

(3) Restructuring/business reengineering

Restructuring and business reengineering transactions have always attracted the tax authority's interest and, consequently, have raised the likelihood of a tax audit. If related parties are affected by the restructuring, transfer pricing audits are also likely to follow.

During a restructuring or business reengineering transaction, special attention must be given to the correct evaluation of the value of the transferred assets. Exceptional attention should also be given to the proper implementation of the deferred loss and to the accounting of business goodwill.

6. Special tax audits

(a) VAT audits

Prior to completing VAT refunds, the tax authority will carry out VAT audits. Apart from the rules on tax refunds, no special rules apply to VAT/customs audits, as these are often carried out simultaneously with income tax audits.
(b) Wage tax audits

Wage tax audits concentrate on taxpayers with employees and focus on the taxpayers’ withholding, reporting and tax-paying obligations. These audits also examine whether all employees are registered with the competent authorities.

The anti-abuse rule is another important issue related to wage tax audits. According to the Taxation Procedure Act, contracts and other acts of the taxpayer are to be classified based on their content. If the tax authority concludes during a wage tax audit that a contract formally entered into as a contract for services has the substantive characteristics of an employment contract, then the tax authority may regard the contract of services as an employment contract, which will correspond with the tax consequences of an employment contract. In such case, the tax authority assesses tax underpayment related to payroll taxes and social contributions.

7. Information-gathering powers

(a) Information obtained from unrelated parties

The Taxation Procedure Act authorizes the tax authority to request information from third parties. Most often, third-party taxpayers or private individuals will be requested to provide information about their contracting partners.

(b) Cross-border exchange of information

Please see Section IV. International exchange of information.

8. Burden of proof

The burden of proof is on the tax authority to establish all the elements of a tax claim. However, the tax authority is also obligated to consider evidence in favor of the taxpayer. There are certain exceptions where the burden of proof is on the taxpayer. For instance, in the event of a tax...
assessment by estimation, the taxpayer has the burden to prove that the estimation is inaccurate. This exculpation, however, must be "credible."

9. Potential consequences

If the tax authority concludes during an audit that the taxpayer’s declared tax base is lower than the taxpayer’s actual taxable earnings, it may adjust the tax base to reflect a more accurate figure. If, however, the tax authority is unable to accurately assess the taxpayer’s tax base (due to incomplete tax returns or the lack of tax returns, etc.), then the taxable income is estimated. This estimation may be based on the following:

- Gross income
- Gross or net value of assets
- Visible assets
- Estimated income

The burden of proof regarding the necessity and the appropriateness of the estimation is on the tax authority. Nevertheless, the taxpayer has a right of exculpation, i.e., it may provide evidence that its actual tax base is different from the estimated tax base.

(a) Normal tax rate

If the tax authority finds that the taxpayer’s taxable income is higher than indicated in the tax return, the tax base will be adjusted and the spread will be subject to normal tax rates.

(b) Late payment interest

Late payment interest is due on any unpaid tax. The daily rate of interest is calculated according to the following formula:

(Prime rate of the National Bank of Hungary plus five percentage points)/365
(c) **Self-revision interest**

As mentioned above, until the beginning of an audit, tax returns may be corrected by the taxpayer. The daily self-revision interest is the equivalent of the prime rate of the National Bank of Hungary/365. In the event of repeated self-revision, the self-revision interest is 150% of the above. By paying the unpaid tax and self-revision interest in due time, the taxpayer will avoid late payment interest, tax penalty and default penalty.

(d) **Tax penalty**

The most severe consequence of tax underpayment is tax penalty. The amount of the payable tax penalty is based on the amount of tax shortfall. The maximum rate of the penalty is 50% of the tax shortfall (in the event that the tax shortfall is related to concealing taxable income, utilizing or producing false documents or falsifying accounting records, the maximum rate of the penalty is 200% of the tax shortfall).

As a new rule of the Taxation Procedure Act, if the taxpayer waives its right to appeal and pays in a timely manner the unpaid taxes, then the taxpayer must only pay 50% of the tax penalty amount assessed by the tax authority.

(e) **Default penalty**

A default penalty is payable if procedural rules are breached (e.g., a delay in filing a tax return, the tax return is incomplete, no tax return is filed or a withholding or reporting obligation is violated). Generally, the maximum amount of default penalty for legal persons is HUF 500,000 (approximately EUR 1,500 as of November 2019), but it can be higher in certain cases, e.g., in the event of a breach in connection with the transfer pricing documentation, the general maximum amount of default penalty is HUF 4 million (approximately EUR 12,000 as of November 2019).
(f) **Seizure of goods in stocks and closure of commercial premises**

If an entity carries out its activity without court registration, its stocks of goods may be seized to secure the default penalty assessed by the tax authority. Commercial premises may be closed for 12 working days if the taxpayer does one of the following:

- Employs employees without registering them with the competent authorities
- Distributes goods of uncertified origin
- Breaches its receipt obligations for the second time within one year after the first audit
- Breaches the statutory obligations relating to the operation of cash registers

(g) **Prohibition of double audits**

One final primary consequence must be mentioned. The tax authority must adhere to the "prohibition of double audits" principle. In the event of general tax audits, as a rule, once a period has been examined in the course of an audit, this period cannot be re-audited. The Taxation Procedure Act allows for certain cases where the tax authority may re-audit an audited period (e.g., upon request of the taxpayer).

10. **Strategies for dealing with tax audits**

(a) **Cooperation or confrontation?**

Generally, a taxpayer should cooperate with and assist in a tax audit. Repeated failures to cooperate will raise the tax auditor’s suspicions. Clearly, cooperation should not mean the taxpayer’s waiver of the procedural guaranties designed to protect the taxpayer (see above). The tax authority should respect the taxpayer's rights at all stages of the audit.
The atmosphere during the audit should never become too informal, thus negatively affecting the taxpayer’s rights.

(b) Who should be involved in the audit?

It is advisable to have the local managing director or head of the tax department deal with the audit. Usually the local director has the deepest insight into the taxpayer’s contractual relationships and accounting practices, and has the most experience in dealing with tax auditors. Nevertheless, under the Taxation Procedure Act, tax auditors have the right to interview any and all employees of the taxpayer, even if they have not been exclusively appointed by the taxpayer to participate in the tax audit.

Tax advisers may provide assistance to the work of the director or another person involved in the audit. However, they are usually not present at all stages of the audit. It is more common that they attend only the introductory meeting or other significant phases of the process. However, it is advisable to discuss problematic issues, as often as possible, with a tax adviser.

11. Conversion of a regular tax audit into a criminal investigation

Budget fraud charges may be alleged if the budget is reduced and the taxpayer willfully induced another person to hold false beliefs or make false statements or conceal facts regarding budget payment obligations or refunds from the budget. Furthermore, budget fraud charges may be alleged in one of the following circumstances:

- If the budget is reduced and the taxpayer willfully applied for tax exemption without a legal basis or used up funds from the budget for non-authorized purposes
- If the budget is reduced and the taxpayer willfully created or distributed excise products without a legal basis or authorization
If the taxpayer willfully did not properly account for funds from the budget or did not provide information regarding thereof or used false documents regarding thereof

Violation of accounting obligations charges may be alleged if the taxpayer violated invoicing, reporting or bookkeeping obligations and induced an error, materially effecting the true and fair view, or obstructed the transparency or the audit of the financial situation of the taxpayer.

If the tax auditor suspects that the taxpayer is involved in willful budget fraud, the tax authority may file a report against the taxpayer with the competent department of the tax authority. As a result, the tax authority will initiate an investigation against the suspected taxpayer. The criminal procedure will be initiated, upon the evidence gathered by the tax authority, by the public prosecutor.

If a director, member or employee of a company with authority to exercise control or supervision fails to fulfill their supervisory obligation, and as a result makes it possible for a member or employee of a company to commit budget fraud, the person with supervisory powers may be punished by up to three years of imprisonment.
II. Resolution procedures

1. Administrative level

(a) During the audit

Once the auditors believe that they have gathered all the information necessary for the tax assessment, or if the period open for the audit has elapsed, the auditors will summarize their findings in the closing minutes of the audit. The taxpayer has the right to make comments on the closing minutes within 30 days after their delivery. In this case, the audit may be continued for an additional 30 days to examine the taxpayer’s comments. The audit ends with the delivery of the closing minutes or the additional minutes, while a resolution marks the end of the audit procedure as such.

(b) After the release of tax assessment notices

If the taxpayer disagrees with the decision of the tax authority, there are two options to have the decision reviewed.

The tax authority that issued the decision has the right to review and amend or withdraw any of its decisions if it discovers an infringement of the law.

This review can only be initiated *ex officio*. The decision may be reviewed within one year to the detriment of the taxpayer or beyond one year within the statute of limitations to the benefit of the taxpayer. The one-year limit does not apply in the following situations:

- A binding court decision declares the taxpayer guilty of tax fraud.
- A binding court decision declares that the tax authority has violated its obligations.
- The taxpayer acted in bad faith.
A taxpayer that disagrees with the tax authority’s decision has the right to file an appeal that will challenge the decision. The appeal must be filed with the tax authority of first instance and addressed to the tax authority of second instance. The deadline for filing the appeal is 15 days from the date of the delivery of the decision. In the event of tax assessment, the appeal shall be filed within 30 days from the date of the delivery of the decision. The appeal is not subject to any formal requirements. A significant restriction of the Taxation Procedure Act is that the taxpayer may not refer to any new facts and circumstances that the taxpayer had been aware of already during the tax audit. Practically, this means that the last point in time where the taxpayer can freely present new facts and circumstances is during the comments to the minutes. The appeal suspends the enforceability of the decision of the tax authority of first instance. The tax authority of second instance is not bound by the appeal, i.e., it may review the whole decision irrespective of whether the appeal has been filed against the whole decision or just a part of it. It may sustain, modify or annul the decision of the tax authority of first instance. If the tax authority of second instance concludes that the tax authority of first instance failed to sufficiently examine the background of the case, then the tax authority of second instance may order the tax authority of first instance to review the case or it may review the case itself.

2. Judicial tax litigation

(a) Appeal to the administrative and labor court ("Administrative Court") / Regional Court

The taxpayer has 30 days upon receipt of the final decision of the tax authority of second instance to file an appeal with the competent Administrative Court/Regional Court. The appeal must be submitted to the tax authority that made the decision against which the appeal is made. The appeal is possible only if the taxpayer has exhausted all administrative

157 A recently adopted bill will see separate administrative and labor courts abolished from 1 April 2020. Regional Courts will be responsible for administrative matters from this date.
instances. In Hungary, the Administrative Court deals with administrative appeals until 1 April 2020. Starting from this date, Regional Courts will deal with administrative appeals. The court appeal, unlike the appeal filed in an administrative procedure, is subject to the formal and material requirements set forth in the Administrative Litigation Code and may only be based on a breach of law. In contrast to the case of an appeal filed in the administrative procedure, the Administrative Court/Regional Court is bound by the appeal, i.e., it may review the decision of the tax authority of second instance only to the extent of the filed appeal. The filing of the court appeal does not suspend the enforceability of the decision of the tax authority of second instance.

However, the Administrative Court/Regional Court may suspend enforceability upon the request of the taxpayer. According to the Administrative Litigation Code, taxpayers can only refer to facts and evidence in the judicial tax litigation that were already evaluated in the administrative procedure. The taxpayer may also refer to new facts and evidence if the taxpayer already referred to such evidence but the tax authority did not consider it in the administrative procedure or the taxpayer was not aware of or did not refer to such evidence because of reasons beyond the taxpayer’s control. The Administrative Court/Regional Court has the right to sustain, modify or set aside the decision of the tax authority of second instance or to order the tax authority to review the case.

As a rule, the judgment of the Administrative Court/Regional Court is non-appealable, that is, no ordinary appeal can be filed against the judgment of the Administrative Court/Regional Court. If the decision of the tax authority of second instance has been sustained, modified or set aside by the Administrative Court/Regional Court, then this judgment is final and no procedure may be carried out regarding the same case (either at an administration or at a litigation level). If the court orders the tax authority to review the case, then the tax authority is bound to the findings of the court.
There are two extraordinary remedies against the judgment of the Administrative Court/Regional Court. The taxpayer may file a request for judicial review with the Supreme Court or the taxpayer may file a request for "novation" with the Administrative Court/Regional Court that handed down the contested judgment.

(b) **Extraordinary novation by the Administrative Court/Regional Court**

A novation can be requested within six months after the judgment of the Administrative Court/Regional Court becomes final if the taxpayer presents new facts or any evidence that was not taken into account in the administrative procedure or if it was beyond the taxpayer's control to present such facts or evidence in the administrative procedure. A different judge in the same Administrative Court/Regional Court will review the request for novation. If this judge approves the novation, the court will have to hear the case again.

(c) **Extraordinary judicial review by the Supreme Court**

The taxpayer may challenge the judgment of the Administrative Court/Regional Court by filing a request for judicial review with the Supreme Court. Under the Administrative Litigation Code, the request may be based only on a breach of law or on a derogation from a published decision of the Supreme Court in a legal question, and must be filed within 30 days after the judgment of the Administrative Court/Regional Court has been delivered. A lawyer must represent the taxpayer before the Supreme Court. Under the new rules applicable as of 1 January 2018, the Supreme Court only admits the case for review in very limited cases, e.g., if the review by the Supreme Court is needed to ensure or develop a comprehensive jurisprudence, or the legal matter is significant or socially important, or the preliminary procedure of the Court of Justice of the European Union (CJEU) is needed, or a procedural right of the applicant was infringed upon with an effect to the merits of the decision, or the Supreme Court would like to diverge from its previous jurisprudence. The
Supreme Court may sustain or set aside the judgment of the Administrative Court/Regional Court, potentially ordering a new procedure.

(d) Court of Justice of the European Union

The CJEU has jurisdiction to give preliminary rulings on the interpretation of the law of the EU. Since Hungary’s accession to the EU, Hungarian courts may request the CJEU to give a preliminary ruling if they consider that a preliminary decision on the question is necessary to give a judgment. However, this is not an option but an obligation for courts against whose decisions there is no judicial remedy under Hungarian law. If a court refers a question for preliminary ruling to the CJEU, the domestic procedure is suspended for the duration of the preliminary ruling procedure.
III. Competent authority/Arbitration Convention

To avoid double taxation generated by a reallocation of income by a foreign tax authority or by the NAV, Hungary has entered into double tax agreements (DTAs) with many countries all over the world. These DTAs most often align with the OECD Model Convention. A taxpayer that is of the opinion that the taxation of one or both of the contracting states would lead to double taxation may request the competent authority of their state to initiate competent authority proceedings. The request must be filed within three years after the taxpayer is first notified of the action, giving rise to taxation that is not in accordance with the DTA. The competent authorities of the concerned states must try to find a solution within the framework of competent authority proceedings, but there is no guarantee that the competent authorities will actually find a solution under these proceedings.

Furthermore, under the DTAs, there is no time limit within which the competent authorities must act under the competent authority proceedings. The taxpayer does not have a right to be heard during the procedure. Time limits under Hungarian law will not apply. For instance, if the competent authorities reach a solution, they must implement the solution notwithstanding the Hungarian time limits.

As far as a procedure with other Member States of the EU is concerned, Hungary has ratified the 90/436/EEC Convention on the elimination of double taxation in connection with the adjustment of profits of affiliated enterprises ("Arbitration Convention").

The Arbitration Convention applies if the tax authority of a Member State taxes or takes measures that would lead to taxing profits of a company resulting from cross-border intra-group transactions, provided that the same profits are also taxed or planned to be taxed by another Member State. This is the case, for example, if a Member State’s tax authority makes transfer pricing adjustments.
The procedure under the Arbitration Convention starts with a unilateral relief procedure. If the competent authority of a Member State intends to adjust the profits of an enterprise, it is obligated to inform this enterprise in due time. This enterprise may inform the other party of the transfer pricing relationship. This other party, at this point, may inform the competent authorities of its state of residence.

The procedure continues with a mutual agreement procedure between the Member States’ competent authorities. If the competent authorities do not reach a solution within two years, they must set up an advisory commission. This advisory commission must deliver an opinion within six months and the competent authorities must reach a solution within six months after the delivery of the opinion of the advisory commission.

The competent authorities may deviate from the opinion, but double taxation is deemed to have been eliminated only if the profits of the taxpayer are included in the taxable profit of one Member State or if the tax chargeable on the profits in one Member State is reduced by an amount equal to the tax chargeable on the profits in the other Member State.

Hungary has implemented Council Directive 2017/1852 on tax dispute resolution mechanisms in the EU in a bid to resolve disputes between Member States when those disputes arise from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and capital. The affected person (resident in an EU Member State and directly affected by the dispute in question) must file a complaint within three years of the receipt of the tax authority resolution resulting in, or that will result in, the question in dispute, while upon the acceptance of the complaint, the mutual agreement procedure would take two years.
In certain cases, the affected person can turn to the Advisory Commission. This is possible if:

- The complaint was rejected by at least one, but not all, of the competent authorities of the Member States concerned
- The complaint was rejected by all of the competent authorities of the Member States concerned, but this decision was overturned by at least one, but not all, of the competent courts of the Member States concerned
- The competent authorities of the Member States concerned had accepted the complaint but failed to reach an agreement within the two-year deadline

As an alternative, the competent authorities can opt to refer the question in dispute to the Alternative Dispute Resolution Commission. In any case, a six-month deadline (extendable by three months) applies for the procedure before the Advisory Commission or the Alternative Dispute Resolution Commission.

The competent authorities must reach a final decision within six months of the notification of the opinion of the Advisory Commission or Alternative Dispute Resolution Commission. The final decision can deviate from such opinion. However, if the competent authorities fail to reach an agreement within the above six-month deadline, they will be bound by the opinion.

Apart from the tax dispute resolution mechanism in the EU, Hungary has also introduced new rules regarding dispute resolution in the case of tax treaties. The complaint can be filed by:

- A Hungarian resident
- A foreign resident through a competent foreign authority
The complaint needs to be filed within three years from the receipt of the tax authority resolution resulting in, or that will result in, the question in dispute. The complaint is dealt with in a mutual agreement procedure.
IV. International exchange of information

Given that an increasing number of taxpayers are engaged in cross-border activities, the tax authority requires an effective legal mechanism for obtaining information from their treaty partners to ensure compliance with the tax laws.

There are three ways by which cross-border information is exchanged: the exchange of information on request; the voluntary submission of information; and the mutual exchange of information. The request for the exchange of information from another country’s authority must at least include the data of the client and the purpose of the request. The Hungarian authority will reject the request in any of the following cases:

- The requesting authority has not yet taken all measures provided to gather the necessary information.
- The procurement of the requested information is prohibited under Hungarian law.

The Hungarian authority may reject the request in any of the following cases:

- The requesting authority or another authority of the requesting state cannot provide similar information due to legal reasons.
- The requested information would disclose certain business, industrial or professional secrets or commercial procedures, which are not allowed to be disclosed under Hungarian law.
- The requested information covers tax period(s) prior to 1 January 2011.
- If the request was made prior to 11 March 2011, it should have been rejected based on the prohibition by law.
Information may be submitted voluntarily if the Hungarian authority suspects that another country suffers tax loss due to transactions discovered in Hungary. Further, VAT information regarding transactions within the EU is also provided voluntarily.

The mutual exchange of information is based on double taxation treaties and other multilateral and bilateral agreements, and it is regulated in secondary EU sources. Such EU sources are as follows:


Although the EU regulation is aimed at facilitating the work of the authorities of the community, cooperation is not always entirely free of discrepancy.

Article 10 of the 2010 regulation sets forth a deadline of three months for the provision of information and a deadline of one month if the requesting authority is already in possession of the information. The regulation does not provide for sanctions if the requested information is not provided in a timely manner.

Council Directive 2011/16/EU was amended by extending the cooperation between tax authorities to the automatic exchange of financial account information. The implementation of this rule in Hungary has been in effect since 1 January 2016.

Hungary has entered into agreements with more than 100 countries regarding the automatic exchange of financial account information ("CRS"). These countries include the Netherlands, Belgium, Luxembourg, Ireland, Switzerland, the UK, etc. Hungary has also entered into a Foreign Account
Tax Compliance Act (FATCA) agreement with the US to mutually exchange financial account information.

Hungary has also implemented the CBCR regime as stipulated in Council Directive 2011/16/EU. A Hungarian entity is subject to CBCR and a notification obligation if: (i) the MNE group’s total consolidated revenue reached EUR 750 million or HUF 235.5 billion in the previous financial year; and (ii) the Hungarian entity qualifies as a constituent entity of the MNE group (i.e., it is part of the consolidated group). If, based on the above, the Hungarian entity is subject to the CBCR and a notification obligation, then the Hungarian entity must notify the Hungarian tax authority on whether the Hungarian entity will complete the CBCR in Hungary or another entity from the MNE group will complete the CBCR in its resident state. This notification must be filed with the Hungarian tax authority electronically using the required electronic form.

In line with Council Directive 2018/822 amending Directive 2011/16/EU with regard to mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC 6 Directive), Hungary will transpose reporting obligations with respect to cross-border arrangements having specific hallmark(s). Although the rule will come into effect on 1 July 2020, the reporting obligation has applied since 25 June 2018. An arrangement has to meet a series of criteria to qualify as a reportable cross-border arrangement (i.e., concerns a Member State and another country, not all of the participants in the arrangement are resident for tax purposes in the same jurisdiction, the main benefit or one of the main benefits is tax advantage, confidentiality clause for the intermediary, etc.).
The reporting obligation primarily falls on intermediaries. An intermediary can be:

- Any person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border arrangement

- Any person that, having regard to the relevant facts and circumstances, and based on available information and the relevant expertise and understanding required to provide such services, knows or could be reasonably expected to know that they have undertaken to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organizing, making available for implementation or managing the implementation of a reportable cross-border arrangement (it can be evidenced that such person did not know and could not reasonably be expected to know that that person was involved in a reportable cross-border arrangement)

This is provided that the person fulfills any of the following criteria:

- They are resident for tax purposes in a Member State
- They have a permanent establishment in a Member State through which the services with respect to the arrangement are provided
- They are incorporated in or governed by the laws of a Member State
- They are registered with a professional association related to legal, taxation or consultancy services in a Member State

Intermediaries will be required to report the cross-border arrangements unless an exemption applies, in which case they will be required to inform other intermediaries or, ultimately, their clients.
A two-step penalty regime applies in case of non-compliance. The tax authority can at first levy a penalty of HUF 500,000 (approximately EUR 1,500 as of November 2019) and, as a second step, if non-compliance persists in spite of the tax authority’s call, a penalty of HUF 5 million (approximately EUR 15,000 as of November 2019) may be levied.
Handling Tax Disputes in Italy

Barbara Faini

Barbara Faini’s practice mostly involves the resolution of tax controversies, including assistance during tax audits, alternative dispute resolution techniques and all administrative phases of a controversy through litigation. She has participated in cases involving a variety of domestic and international issues, including intercompany pricing, management fees, disallowance of tax credits, permanent establishment issues and VAT. She defends cases before the Italian Supreme Court of Cassation and the Court of Justice of the European Union. She was recommended as the top tax litigator in the Guide to the World’s Leading Tax Controversy Advisers and was named in 2017 and 2020 as one of the women tax leaders in Italy by International Tax Review.

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I. Managing the tax audit process

1. General

Tax audits normally cause a high degree of concern for the management of Italian companies, not only because of the risks that come with being assessed for violations of tax legislation, with frequent criminal ramifications, but also due to the lengthy and demanding procedure carried out by tax auditors during such an audit.

Another reason is that tax audits may be conducted at the taxpayers’ premises without any advance notice and are normally of a general nature, that is, for the purpose of reviewing the entire tax position of the selected taxpayer with particular attention to corporate income tax (Imposta sul Reddito delle Società — "IRES") and local income tax (Imposta Regionale sulle Attività Produttive — "IRAP"), VAT and withholding tax. The audit may be carried out by a section of the police specializing in taxation (i.e., Guardia di Finanza) or by the tax office competent for the specific district (i.e., tax auditors). It is regular practice for tax audits to be carried out by the police because they normally support investigative activities that are conducted by the tax offices.

As a result, no negative significance should be attributed to the fact that the police, instead of the tax office, conduct tax audits. During the audit, tax auditors review the taxpayers’ corporate ledgers (such as that of shareholders and ledgers with the minutes of the directors’ meetings) and the accounting books, as well as interrogate the taxpayers' employees. Tax auditors may also inspect all of the company’s premises and ask for any kind of documentation, including a chart of the group, the corporate organizational chart, financial statements, and agreements and

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158 The corporate income tax (Imposta sul Reddito delle Società or IRES) rate as of 1 January 2019 is 24%. The local income tax (Imposta Regionale sulle Attività Produttive or IRAP) is levied at the regular rate of 3.9%. Different rates are provided for special business activities and the rate may be subject to changes over time.
correspondence. In theory, tax audits should not affect the business activity of the company under investigation. However, the continuous presence of the tax auditors at the taxpayer’s premises, with their consequent need for assistance and the collection of documents, certainly slows down the taxpayer’s business activity.

On 4 December 2017, the Tax Police published a new and very detailed set of instructions on how to manage and handle tax investigations, which include specific analyses on several topics, such as the criteria for the selection of taxpayers to be audited; a description of the powers of the tax auditors and the right of the taxpayers; the coordination of audits among different offices of the tax administration; and the notion of privilege.

(a) Expected periodicity

At the beginning of each fiscal year, the Ministry of Finance prepares and circulates operating instructions to its offices, which, among others, will provide guidelines for the auditing activity. The audits should strengthen the fight against tax fraud and evasion, prevent possible tax-abusive behavior and intensify the perception of taxpayers that they are constantly monitored by the tax administration, thus increasing the collection of evaded or unpaid taxes. The instructions identify areas where there is a major risk of tax evasion, as well as the type of taxpayers requiring continual and intense control. In particular, tax auditors are normally required to concentrate their attention on detecting abusive practices, stressing the need for coordination among all the offices of the tax authorities that are empowered to conduct tax audits (such as customs offices, employment offices, etc.). Particular attention will always be given to VAT and VAT fraud, to corporations belonging to a tax unit or involved in business restructuring transactions, and to taxpayers that concluded transactions with companies based in jurisdictions with privileged tax regimes that are identified for not ensuring an adequate exchange of

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159 Circular letter 1/2018 — operating manual to combat tax evasion and tax frauds.
The most recent set of instructions tries to balance the need for implementing a more transparent relationship with the taxpayers (like the Cooperative Compliance Program) to prevent tax evasion or aggressive tax-planning schemes by taxpayers, including multinational companies. For instance, transfer pricing adjustments should be limited to situations where there is clear intent from the taxpayers to reduce the Italian taxable basis, trying to avoid situations where a double imposition may occur.

Enterprises with a turnover higher than EUR 100 million ("Large Taxpayers") have been assigned to special offices to take care of all tax functions. As a result, tax audits, collection of taxes, tax refunds, etc., with regard to Large Taxpayers have been concentrated on such offices formed at the regional level (i.e., they depend on the Regional Directorate), which should offer more specialized and professional assistance. These large enterprises should be audited regularly, possibly on a yearly basis, to establish a "tutorship" aimed at increasing the level of collaboration between the taxpayers and the tax authorities. With regard to smaller enterprises, the previous rules remain in place, with the consequence that enterprises with a fiscal year turnover higher than EUR 25.8 million would generally be subject to a tax audit every two years (which does not mean that they will necessarily be inspected every fiscal year), while enterprises with a fiscal year turnover ranging from EUR 5.1 million to EUR 25.8 million would generally be subject to a tax audit every four years. However, the current practice is different, as the tax offices and the Tax Police do not

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160 The list of jurisdictions that do not ensure adequate exchange of information is included in the Decree dated 23 January 2002 (as modified by the Decree of 3 April 2002, as recently amended by the Decree of 27 April 2015). The legislation regarding the deduction of costs paid to blacklist jurisdictions has been subject to profound change with Legislative Decree No. 147 of 2015, effective as of 8 October 2015.

161 Guidelines 16/E of 28 April 2016 and the Central Directorate Instructions dated 13 December 2016. See also the more recent Act for the Direction of Fiscal Policy issued by the Minister of Finance dated 7 December 2017.

162 The Tax Police are still entitled to launch tax raids against Large Taxpayers.

163 Although, this has not yet been applied in practice.

164 Article 42 of Law No. 388 of 12 December 2000.
have a sufficient number of auditors to carry out this kind of auditing program, especially in certain areas of Italy where the concentration of enterprises is more dense (such as the Milan area). As a result, the periodicity provided by the law is not normally respected.

(b) Selection of tax audit targets

The selection of companies to be audited is generally made with special lists based on criteria decided on each year by the Ministry of Finance. The selection criteria take into consideration a number of facts and elements that have been considered by the tax authorities as signs of possible tax evasion or tax avoidance, such as: (i) the request for the reimbursement of tax receivables; (ii) the specific sector of business activity in which the taxpayer is involved; (iii) the completion of extraordinary transactions listed among those targeted by anti-abusive tax provisions (i.e., mergers, de-mergers, contribution in kind, transfer of receivables, etc.); and (iv) the endemic loss situation.  

Moreover, a tax audit may be initiated based on information collected by the tax authorities during their investigations or auditing activity (for instance, an exchange of information or cross-selling activity) or through questionnaires addressed directly to the taxpayer and aimed at obtaining certain types of information.

(c) The outcome of the tax audits

In general terms, upon conclusion of a tax audit, the taxpayer is delivered with a report aimed at summarizing the initial challenges raised against the taxpayer and indicating the higher taxable income allegedly connected with said violations ("Tax Audit Report").

The Tax Audit Report can be viewed as the first step of a tax assessment procedure, since it generally sets out the arguments on which the competent tax office then grounds the formal notice of tax adjustments.

165 See Guidelines 16/E of 28 April 2016.
The Tax Assessment is in fact aimed at raising the final challenges against the taxpayer and, therefore, at determining the actual amount of higher taxable income and higher tax(es) assessed, along with the relevant penalties.

(d) Statute of limitations

The rules regarding the statute of limitations for Tax Assessments have been subject to significant changes over the years.

Until 1 September 2015, as a rule, the ordinary statute of limitations for notifying a Tax Assessment with respect to corporate income tax and VAT was four years, computed as of the end of the fiscal year in which the tax return was filed. This term was extended by one year in the event of failure to file the tax return.

The statute of limitations was doubled if the tax auditors envisaged, in the course of a tax audit, a violation punishable under criminal law, for which they were entitled to send a criminal notice to the public prosecutor, who then decided whether to start a criminal investigation.

The statute of limitations rules, applicable until 1 September 2015, gave rise to a tough debate due to the fact that the possibility for tax auditors to re-open fiscal years already closed was considered disrespectful to the taxpayers’ rights and in breach of the general principles of transparency of the relationships between the tax administration and taxpayers and of the principle of legal certainty. As a result, the Italian legislator revised them through Legislative Decree No. 128/2015.

According to the revised rules (applicable from 2 September 2015), the tax authorities were not allowed to assess the fiscal years for which the ordinary statute of limitations had already expired at the time the criminal
allegation was notified (which is different from what the previous legislation allowed).

Such new rules were applicable to prior years (due to the principle that law with a favorable effect for the taxpayer can be applied retroactively).

As of 1 January 2016, the statute of limitations rules were subject to further modifications, which apply to the fiscal years following that which was running on 31 December 2016. According to the new set of rules, which are currently in place, the doubling of the statute of limitations is no longer possible and the new deadlines within which to serve Tax Assessments are: (i) five years in cases of unfaithful tax returns; and (ii) seven years in cases of omitted filings of tax returns. Both terms are computed as of the end of the fiscal year in which the tax return was filed.

The statute of limitations is not interrupted by a tax audit or by a request for information or a questionnaire. As a result, the tax office shall serve the taxpayer with the Tax Assessment before the statute of limitations has expired.

In certain cases, the tax office that has already served a Tax Assessment may still be entitled — within the ordinary statutory term — to conduct a new Tax Assessment. This is possible if the initial assessment was "partial" (because it was based only on the limited information in the hands of the tax office) or if new information and facts that were not known at the time of the notification of the initial Tax Assessment are discovered by the tax administration.

In 2014, a new pilot project named the Cooperative Compliance Program for Large Business Taxpayers in Italy was launched to create a new form of relationship between large business taxpayers and the tax administration (Section 27, paras. 9-12 of Law Decree No. 185/2008, as converted by Section 1 of Law 2/2009) to allow current risk management monitoring activities to evolve into more advanced programs, consistent with the
recent recommendations by the Organization for Economic Cooperation and Development (OECD).

2. **Anticipation of and preparation for the tax audit**

Any enterprise located in Italy (i.e., a corporation, an individual enterprise or a branch) is obligated to keep accounting ledgers. In particular, corporations are required to maintain the following accounting books: (i) daily book; (ii) inventory book; (iii) asset book; and (iv) VAT books.

For statutory purposes, pursuant to Article 2220, paras. 1 and 2 of the Italian Civil Code, companies must retain the accounting books for at least 10 years from the record date of the last entry. The same 10-year term applies to the retention of any commercial documents. For tax purposes, pursuant to Article 22 of Presidential Decree No. 600/1973, any book, information or document that may be relevant to assess an Italian company’s tax position and/or may have a tax impact (for example, agreements, contracts, etc.), including accounting books, records and electronic recording/storage means, must be kept until the relevant fiscal year is time-barred for assessment purposes, or up to the exhausting of any pending proceedings with the tax authorities, or in case they last longer than the 10-year period pursuant to Article 2220 of the Italian Civil Code. In the event that accounting and tax records, as well as ledgers, are maintained on a centralized basis (see below), the Italian taxpayer should be able to prove that the records are duly updated if requested to do so by the Italian tax authorities during a tax audit, by printing out the accounting entries from the accounting soft records in the presence of the tax auditors. If the taxpayer is unable to provide the accounting records, under certain conditions, the tax authorities may be entitled to assess the relevant income tax on a presumptive basis without considering these records. The taxpayer is obligated to maintain all the documentation needed to prove the correctness of its behavior in relation to the tax authorities at its offices in an audit. In particular, any information, data, books or records that the taxpayer refuses to show to the tax auditors
upon specific request cannot be used by the taxpayer to defend its position during tax litigation.

However, information, documents and data not produced upon the tax authorities’ request may still be taken into account before the tax courts when a tax court proceeding is initiated, on the condition that the taxpayer declares that there were reasons beyond its control for not previously producing the information.

3. Areas of tax auditors’ special attention

(a) Procedure and form

Tax audits are normally conducted on-site (i.e., at the taxpayers’ offices) without advance notice. Indeed, there are no provisions obligating the tax authorities to notify a taxpayer in advance that they are initiating the auditing process. Tax auditors tend to avoid giving any prior notification to the taxpayer of the programmed tax audit to prevent the taxpayer from preparing for the auditing process and amending possible violations in anticipation.

However, if the tax office, rather than the Tax Police, carries out the tax audit, the start of the tax audit is normally made known in advance.

A tax audit can be "general" if it is aimed at reviewing and analyzing the taxpayer’s overall position with regard to corporate income tax, local tax, withholding tax and VAT for the fiscal year(s) under audit. It can also be "special" when its objective is to scrutinize only specific types of taxes (such as custom duties, intra-community VAT and excise duties).  

The reasons for gaining access to the taxpayer’s offices, the names of the tax auditors who will carry out the audit and the type of tax audit to be carried out should all be reported in a formal document to be given to the

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166 In addition to tax audits, there are a number of formal controls carried out by the tax office on a routine basis, the analysis of which is out of the scope of the present work.
taxpayer before any type of inspection or audit commences. Indeed, according to law, access to the taxpayer’s office should be justified by the need to collect documents or make inspections on-site.\textsuperscript{167} Rather, the tax auditors are not obligated to communicate the information they collected from their investigations before starting the tax audit. On the other hand, the taxpayer may be assisted by a tax consultant and may require that the review of the relevant documentation be made at the tax authority’s offices or at the offices of the tax consultants.

Tax auditors, however, usually carry out their inspections at the offices of the enterprise,\textsuperscript{168} which means that there will be a corresponding slowdown in daily work, as the inspection by the tax auditors at the taxpayer’s premises may take quite a long time. The Taxpayers’ Charter\textsuperscript{169} establishes the period for tax audits (which, in the past, could last for six months) by providing that the presence of the tax auditors at the taxpayer’s premises may not exceed 30 working days, which can be extended by an additional 30 working days if the inspection proves to be particularly complex or difficult.

Although the physical presence of tax auditors at the taxpayer’s office may not lawfully exceed this number of days, the common practice is that tax auditors will collect the required documentation during their visit, which will then be reviewed at their offices. This means that the tax audit will only conclude after a number of months, depending on the scope of the taxpayer’s business activity. Minutes of daily activities should be prepared

\textsuperscript{167} Article 12 of Law No. 212 of 27 July 2000, known as the Taxpayers’ Charter. The Taxpayers’ Charter is a list of rights and obligations of taxpayers in relation to their tax affairs, which is an attempt to make the knowledge of said rights and obligations much more widely accessible and understandable.

\textsuperscript{168} Tax audits can also be conducted at the premises of the Tax Police or the tax office under certain circumstances.

\textsuperscript{169} Law No. 212 of 27 July 2000.
and signed by both the tax auditors and the taxpayer at the end of each day the tax auditors are in the taxpayer’s offices.

As mentioned above, at the end of the tax audit, the tax auditors draft a final report (already referred to above as "Tax Audit Report") summarizing the violations assessed during the tax audit and indicating the proposed tax adjustments and applicable administrative sanctions. The Tax Audit Report is served to the taxpayer and forwarded to the tax office competent for the assessment activity, which will review the tax auditors’ proposed tax adjustments as illustrated in the Tax Audit Report and issue the tax adjustment notice (already referred to above as "Tax Assessment").

Within 60 days from the notification of the Tax Audit Report, the taxpayer has the right to draft and submit to the tax office a brief, with some observations and comments on the proposed tax adjustments indicated in the Tax Audit Report, which can prevent the tax office from including in the Tax Assessment any challenges that appear to be manifestly wrong. The tax office cannot issue the Tax Assessment before the above-mentioned 60-day term has elapsed, unless a case of urgency occurs that is particularly justified in the Tax Assessment.

(1) Financial and accounting

The preliminary work of the tax auditors is to check whether the mandatory books and ledgers are being duly and regularly maintained, as well as updated according to Italian law (i.e., through a formal audit process). Indeed, if there are no regularly kept accounting books, the tax auditors are entitled to adjust the taxpayer’s income for corporate income tax, local tax and VAT purposes based on certain assumptions (i.e., without taking into account the transaction actually performed by the taxpayer, but based on general parameters regarding the business activity exercised). The tax auditors already have the taxpayer’s financial statements and relevant tax returns, as these documents are in their database and normally reviewed and analyzed before the start of the tax

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audit to identify the potential areas of tax evasion by the taxpayer's business.

(2) Formal requirements

The tax auditors will review sample sale and purchase invoices to check if they were recorded in line with the corporate income tax and VAT legislation principles (in a substantive audit process). With regard to corporate income tax, the tax auditors will take revenue and costs into account to verify that they were correctly recorded on an accrual basis and that costs were deductible from the revenue in line with the principles and restrictions of Italian law. With regard to VAT, randomly selected transactions will be reviewed from a formal and substantive viewpoint, with particular emphasis on input VAT, to look for possible improper and unlawful VAT deductions.

(3) Documentation of intra-group transactions

Legislation introducing documentation requirements for transfer pricing purposes was issued in 2010 (Law Decree No. 78/2010, converted into Law No. 122/2010, as well as the Documentation Regulation of 29 September 2010).

According to this legislation, enterprises that conclude transactions with foreign companies belonging to the same group may prepare adequate transfer pricing documentation and file a notice thereof to the tax administration (at the time of the filing of the tax return). No contemporaneous filing of the documentation is required, since the same should be handed over to the tax auditors within 10 days from the request made by them in the context of an audit. The documentation is qualified as "adequate" if it meets the requirements provided by Italian regulations (which mirror the format recommended by the Code of Conduct issued by the European Joint Transfer Pricing Forum) and if a description of all the intercompany transactions concluded by the company is provided. A master file should be prepared only if the Italian company is a holding or a
sub-holding company, while, in the event of an Italian subsidiary belonging to a foreign group, the preparation of the country file will satisfy the requirements of the legislation. The documentation should be written in Italian, while agreements should be left in English.

The preparation of adequate documentation in the meaning indicate above, together with the filing of the relevant notice with the tax administration, will entitle the taxpayer to obtain administrative penalty relief, which otherwise would range from 90% to 180% of the higher tax applied to the adjusted revenue.

(b) Substantive issues

In Italy, certain upward or downward adjustments need to be made to corporate revenues/costs/income to calculate taxable income at the time of the preparation of the tax return. As a result, tax audits are aimed at verifying that all the transactions carried out by the taxpayers are correctly recorded in the accounting ledgers (to prevent tax fraud or evasion deriving from the omitted or incorrect registration of input or output invoices), that tax returns have been prepared in line with the tax provisions and, thus, the upward/downward adjustments required by law have been made correctly.

Depending on the type of taxpayer that is subject to a tax audit, certain key areas are subject to scrutiny and an in-depth investigation. With regard to companies belonging to multinational groups, the areas of interest for the tax auditors are normally as follows.

(1) Transfer pricing

Intra-group relationships will be deeply scrutinized. Tax auditors will normally request a copy of all intra-group agreements and any additional documentation proving that intra-group transactions are concluded at arm’s length. Tax auditors will concentrate on transfer pricing issues concerning the cost of goods and will focus more and more on agreements regarding the license of intangibles and payment of management fees, as
well as scrutinize in detail the year’s downward adjustments, since they could potentially be aimed at illegally transferring revenues out of Italy.

For this reason, tax auditors are not satisfied with the mere review of the relevant agreements, but will ask to be given evidence of the services supplied and the benefits obtained by the taxpayers.

As far as agreements about management fees are specifically concerned, if there is a lack of evidence regarding the actual service rendered (either for a quantitative or from a qualitative point of view), or in respect to the actual benefit that the service had for the Italian company, the relevant costs will normally be disallowed entirely, resulting in the necessity for the taxpayer to prove the correctness of its tax behavior also before tax courts.

(2) Restructuring/business reengineering

Extraordinary transactions carried out for the purpose of restructuring or business reengineering (such as mergers, de-mergers, transfers of ongoing business, contribution in kind in exchange for shares and share-for-share exchange) that have an impact on Italian companies are subject to deep scrutiny from tax auditors on the grounds of being potentially abusive. The above-mentioned transactions might be challenged pursuant to the anti-abusive provision. Recently, the General Anti-Avoidance Rule (GAAR) was introduced to provide taxpayers with a more certain legal framework on the topic. Unlike in the past, where the anti-abusive rule in place applied only to corporate income tax (although tax authorities tried to expand the scope of the provision), the new provision covers all taxes, both direct and indirect, with the exclusion of customs duties. Under the GAAR, transactions qualify as abusive when one or more of them are "lacking any

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economic substance which, despite being formally compliant with the tax rules, achieve essentially undue tax advantages.”

According to the GAAR, a transaction may qualify as "abusive" when, apart from the tax purposes, there are no or negligible business purposes that justifies the same, recognizing that transactions aimed at improving the organizational and managerial structure of the business should not be seen as abusive.

The GAAR specifies an important concept, that is, it acknowledges that the taxpayers have the liberty to choose among different optional tax regimes provided by the law or between alternative transactions.

(3) Transactions concluded with low-tax jurisdictions.

Another important area on which tax auditors will focus is that of transactions concluded with enterprises based in low-tax jurisdictions, to verify whether anti-tax haven provisions are applicable. According to the provisions in force until 7 October 2015, the deduction of the costs incurred by an Italian enterprise in transactions with companies located in a low-tax jurisdiction was disregarded unless the Italian enterprise could prove that the transaction was actually carried out (by providing the tax auditors with all the relevant documentation) or that they were justified by a business purpose.

Tax haven jurisdictions, as determined by the Ministry of Finance, are countries that are exempt from corporate income tax or apply, to the income produced therein, corporate income taxes at a rate considerably lower than the rate applied in Italy.

172 The tax haven countries are listed in the Decree dated 23 January 2002 (as modified by the Decree of 3 April 2002, as amended by the Decree of 27 April 2015).
The law was significantly amended\textsuperscript{173} and eventually repealed.\textsuperscript{174}

(4) **Permanent establishment**

The permanent establishment issue is currently one of the reasons for concern for entrepreneurs because tax authorities have started to focus on permanent establishments even more following the approval of the BEPS Actions. Based on our experience, the most critical aspect is the case of Italian subsidiaries acting as marketing and sales support services providers for the principal entity, which are remunerated with a fee based on a cost-plus approach. Indeed, such entities, in most cases, are considered to be actively intervening in the sales process and qualified as permanent establishment of the foreign principal with significant ramifications from both an administrative and a criminal standpoint. Tax auditors will adopt the principle of prevalence of substance over form, which was used in the *Philip Morris* case.\textsuperscript{175}

(5) **Consolidated tax returns (fiscal unit)**

Italian companies are entitled to consolidate the incomes and losses of their subsidiaries. This consolidation can be limited to the Italian resident subsidiaries (domestic consolidation) or extended to (all) non-resident subsidiaries (worldwide consolidation). The above-mentioned topic is the subject of a deep analysis by the tax inspector for the purpose of verifying the correct application of the above rules and the absence of abusive intentions on the part of the taxpayer.

\textsuperscript{173} Legislative Decree No. 147 of 2015, effective as of 7 October 2015.

\textsuperscript{174} Law No. 209 of 2015 became effective as from the fiscal year following that running on from 31 December 2015 for subsequent fiscal years (i.e., from fiscal year 2016 for companies whose tax period was the calendar year).

\textsuperscript{175} See Supreme Court Decision No. 3367 and No. 3368 of 7 March 2002; No. 7682 of 25 May 2002; and No. 10925 of 25 July 2002.
(6) Withholding taxes

The proper application of withholding taxes to both domestic and cross-border payments is also subject to tough scrutiny to identify possible violations. In this respect, tax auditors will analyze the real nature of the payments to verify whether the taxpayer has correctly qualified them for the purpose of the application of withholding taxes. Tax auditors will verify whether the conditions for the possible application of reduced withholding tax rates are present, concentrating on the concept of beneficial owner or anti-abusive legislation.

4. Special tax audits

Special tax audits can be performed to examine specific areas of tax law. For instance, audits to ascertain the correct application of intra-community VAT (to prevent fraud, which commonly affects EU transactions) to assess the status of inventory and the correct maintenance of the inventory book, as well as to verify the correct treatment of importations for customs duty purposes, are more frequently conducted.

The procedure and the methodology adopted in the performance of a special tax audit do not differ from those conducted in general tax audits. The sole difference with respect to general audits is that "special" audits are aimed at verifying a particular aspect of the tax position of the taxpayer, such as VAT, custom duties or wages tax. The offices authorized to conduct special audits may also be different. Officers working for the customs office carry out customs duties audits, while the social security office (which is not part of the tax administration) carries out wage tax audits.

5. Electronic data processing (EDP) access during audit

Domestic legislation does not contain any provision identifying the power of the taxpayers regarding, and/or the rights of the tax auditors to gain access to, the EDP system during the tax audit. It is possible, however, to draw conclusions from the general provisions governing the maintenance
of accounting ledgers and from the general provisions on tax audits. In particular, a taxpayer maintaining its accounting through an EDP system is obligated to print out the entry made in the accounting ledgers within the date of approval of the annual financial statements. In the case of tax audits, if said formality has not already been complied with, the tax auditors are entitled to require the immediate printout of the registration made during the fiscal year current at the date of the tax audit. Moreover, tax auditors are entitled to look for information to verify that the taxpayer had maintained accounting ledgers in line with the formalities provided by the law and that these ledgers reflect the real economic status of the company, proving that no fictitious or fraudulent transactions were made. This information can be acquired from any type of document maintained by the taxpayer at their offices or at the offices of third parties, including business correspondence, extra-accounting correspondence, budget reports, etc. As a result, the tax auditors can take into account any information contained in the EDP system (including email correspondence) when they finalize their assessment.

In principle, a party other than the taxpayer may keep the accounting and tax records/ledgers on the condition that this taxpayer provides the competent tax authorities with a declaration released by the keeper of the record that certifies it possesses said accounting records.

According to this principle, the accounting records may be centralized, for instance, at the level of the non-Italian resident service company of a group rendering the accounting services to all the companies of the same group. In such a case, however, the Italian company should be able to print out all the records, duly updated, if so requested by the Italian tax authorities during a tax audit. If the company is not able to provide the accounting records, under certain conditions, the tax authorities could be entitled to disregard the accounting records and assess the income on a presumptive basis.
6. Information-gathering powers

(a) Production of foreign-based information/information obtained from unrelated parties

Under the general principles, tax auditors are empowered to ask the taxpayer under audit for any information or documents that may help them understand the transactions carried out, including any possible foreign-based information that is available. A special domestic provision entitles tax auditors to ask "any person" to provide the competent tax office with specific documents or information concerning specific transactions with the taxpayer under audit, or to provide additional clarification. However, this provision of documents cannot be seen as a tool to force the provision of foreign-based information by foreign entities or third parties. Indeed, there is no obligation for the requested foreign-based or unrelated party to provide the tax administration with the requested documents/information, apart from a fine ranging from EUR 258 to EUR 2,065, which will be due in the event of a failure to answer within 15 days after the notification of a specific written request (Article 11 of Decree 471/97). The fine is levied on each request served by the tax administration that has not been answered by the taxpayer.

As mentioned above, although there is no obligation to provide documents that are located outside of Italy to tax auditors, it is advisable for the Italian taxpayer to be able to collect said documentation and provide these to tax auditors as a means of giving the tax administration all of the facts to prove the correctness of their business behavior.

(b) Exchange of information/confidentiality of information

Tax authorities are empowered to exchange information that is relevant to taxpayers’ assessments of taxes with the tax authorities of other EU countries as a result of the implementation in Italy of EU directives. In particular, the new EU Council Directive 2016/881 of 25 May 2016, amending Council Directive 2011/16/EU on administrative cooperation
relevant to tax matters between Member States, was formally implemented in Italy. The law provides for the regular mechanisms of information exchange (on request, automatic and spontaneous) and, at the same time, gives different rules for the actual applications of the same. This power, which had not been widely exercised before, is being exercised more and more often, especially by tax authorities of foreign countries performing on-site tax audits of companies belonging to multinational groups.

Moreover, most of Italy’s tax treaties contain a provision based on the OECD Model Treaty that allows the tax authorities of different countries to exchange the information necessary for the application of the treaty provisions. Although the OECD Model Treaty (Article 26) seems to refer only to the application of the tax treaty provisions, it could also be considered a general rule applicable to cases in which the Italian tax authorities need information about companies that reside in countries where no tax treaty exists.

Tax authorities are required to maintain the confidentiality of all taxpayer information, except for data contained in income tax returns. Any other taxpayer information may only be disclosed to third parties on the basis of a judicial decision.

7. **Multijurisdictional tax audits**

Italy seldom gets involved in multijurisdictional tax audits in which Italian tax authorities cooperate with tax auditors of other jurisdictions to carry out a simultaneous audit relating to a certain group of taxpayers, such as subsidiaries belonging to the same group. This is mainly due to the scant attention given to cross-border transactions, until recently. However, it is becoming more frequent that tax audits of Italian taxpayers are initiated on the request of a foreign tax administration that needs to verify whether certain specific transactions carried out by taxpayers located in their country have been correctly reported by the Italian taxpayer.
Furthermore, recently, we have seen multijurisdictional audits conducted on Italian companies.

8. Burden of proof

Burden of proof for the unlawful behavior of the taxpayer that allegedly committed the violations challenged during the audit falls on the tax authorities. However, the burden of proof may be transferred to the taxpayer when, during the tax audit, the taxpayer is not in the position to provide sufficient documentation, proving the correctness of their behavior. The most obvious case is management fees. If the taxpayer is not able to provide evidence that the costs paid to the company of the group acting as a service provider correspond to services actually provided, and that these actions brought actual benefits to the recipient, the attitude of the tax auditors will be to disallow the cost amount to be deducted entirely, so that the taxpayer will be obligated to prove the legitimacy of the cost deduction before the tax court.

9. Potential consequences

As mentioned in the preceding sections, audit activity concludes with a Tax Audit Report, which constitutes the preliminary document through which the tax auditors notify the taxpayer of the violations allegedly committed. From a corporate income tax perspective, the consequence of the alleged violations may be a re-adjustment of the profits (including a disallowance of certain costs), with the consequence of a re-determination of the final corporate income. From a VAT perspective, this may be an adjustment of either output VAT applied to sales invoices or input VAT applied to purchase invoices that have been offset against output VAT.

The Tax Audit Report usually provides a preliminary determination of a higher (not lower) taxable income or a higher (not lower) amount of VAT due, with the resulting indication of the fines applicable for both corporate income tax and VAT purposes.
10. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

The attitude of the tax auditors over the last few years has changed significantly. While in the past tax auditors conducted their audits on the assumption that any taxpayer was a potential tax evader, with the consequence that they transformed the audit into a kind of accusatorial process where the taxpayer was presumed to hide documents and information, the situation has now improved. In particular, tax auditors have become more aware of the complexity of the economic environment, as well as that of tax legislation, and are better inclined to understand the position of the taxpayer. Subsequently, they are less inclined to view the taxpayer’s behavior as tax-driven and are more inclined to constructively discuss the decisions taken by the taxpayer, from a tax perspective.

The reason for the change in attitude is partially due to the fact that the Taxpayers’ Charter clearly lists all the rights that the taxpayer may exercise during an audit, with the consequence that tax auditors are necessarily obligated to comply with the principles indicated in the said charter for the benefit of the taxpayer.

At any rate, to show cooperation during an audit, it is highly recommendable to maintain at the offices of the company any documents that may successfully prove the correctness of its behavior from a tax perspective and to ensure that the accounting records are printable at any time on request.

(b) Who should be there?

It is advisable for tax auditors to receive the continual assistance of a director, manager or employee who is fully aware of the accounting and tax issues, as well as of the tax implications of certain transactions or relationships carried out by the company.
The presence of independent tax consultants, who may be able to monitor the lawfulness of the behavior of the tax auditors and explain to them the legal basis of certain tax issues, is highly recommended, especially as a means of reducing the number of controversial issues. There are very few cases where the presence of managers from other companies in the group is recommended. One should also bear in mind the problems in the communication they may have with the tax auditors.

(c) Settlement or litigation?

The decision between settlement and litigation (as explained in more detail below) cannot be made during the audit process, but only once the audit is completed and the Tax Audit Report is issued. During audits, however, some controversial issues may be discussed and (possibly) negotiated to convince tax auditors that the behavior of the taxpayer was correct and, therefore, no challenges should be raised in the Tax Audit Report.

Once the Tax Audit Report is completed, the taxpayer may take into consideration the possibilities offered by domestic legislation to start formal negotiations with the tax administration and seek a settlement, which will also involve the legal interpretation of the law. The beneficial effect of the settlement, as mentioned below, would be to noticeably reduce the amount of the administrative penalties that would otherwise be applicable if the case is litigated (and lost) before the tax courts.

11. Conversion of a regular tax audit into a criminal investigation

The tax auditors may complete their Tax Audit Report by remarking that specific violations of the taxpayer represent criminal violations punishable by criminal penalties under special tax legislation. In this situation, tax auditors are obligated to give notice of the assessed criminal violation to the competent prosecutor and provide them with a copy of the Tax Audit Report. The prosecutor will have to evaluate if a criminal violation actually exists and then proceed according to the criminal tax law provisions.
II. Resolution procedures

1. Administrative level

(a) During the audit

During the tax audit, no resolution procedures are available, in the sense that the taxpayer can only request that comments and observations on the inspection activity carried out by the tax auditors be included in the Tax Audit Report. Indeed, once the Tax Audit Report is issued and served to the taxpayer, tax auditors will deliver it to the competent tax office, which is the tax authority entitled to issue the tax adjustment notice. At this stage, the taxpayer is entitled to file written comments with the competent tax office within 60 days starting from the day in which the Tax Audit Report was served. Such comments are intended to provide the tax office with the preliminary arguments of the defense against the alleged violations contained in the Tax Audit Report. The purpose is to prevent the tax office from automatically including the violations in the final tax adjustment notice without first evaluating their reasonableness. The actual usefulness of such option is, however, disputable and mainly depends on the reasonableness of the individual tax office to which the written comments are addressed. On the other hand, the downside of the written comments is that they will offer the tax office the chance to see the defense strategy of the taxpayer in advance. As a result, the propriety of filing these comments should be evaluated on a case-by-case basis.

Recently, new rules and deadlines for voluntary amendments to tax returns or mistakes made in past years have been approved so that taxpayers may take advantage of the related reduction of penalties.176

In particular, for taxes administered by the Italian Revenue Agency, the possibility of proceeding with the amendments even when an audit has already closed, until a notice of assessment or a notice of liquidation is

176 Article 1, para. 637 of Law No. 190 of 23 December 2014.
served, has been introduced. The consequence will be that even in case of audit or challenge included in a Tax Audit Report, the taxpayer could still self-cure previously made violations, contrary to what it was provided under the previous rules. In this case, the penalty is reduced to one-fifth of the minimum.

There is no specific deadline for self-curing previously made violations after the issuance of a Tax Audit Report. However, it is reasonable to assume that no correction can be made after the service of a Tax Assessment.

(b) Period after the release of tax adjustment/tax collection notices

The tax adjustment notice will set down final accusations against the taxpayer and establish the tax liability, as well as the type and amount of penalties. The taxpayer is entitled to appeal this notice before the competent tax court to dispute the legitimacy of the accusations. The tax adjustment notice cannot be served to the taxpayer prior to the expiration of the 60-day term provided by the law for the written comments. The actual length of time that normally intervenes from the day on which the Tax Audit Report is served and the day on which the tax office issues (and notifies) the tax adjustment notice may vary greatly on a case-by-case basis. Sometimes, it may happen that the tax adjustment notice is served to the taxpayer more than one year after the notification of the Tax Audit Report. This is because the competent tax office often issues the tax adjustment notice just before the expiration of the statute of limitations provided by the law.

Generally speaking, when a tax adjustment notice is served, the assessed higher taxes (plus related interest and penalties, if any) will become final and due after 60 days. Before the expiration of the 60-day term, the taxpayer can do the following:

- Pay the requested amount
• File an appeal with the competent tax court
• File a settlement proposal with the competent tax office

If the taxpayer pays the (requested) higher taxes within the 60-day period, they will be obligated to pay the higher taxes assessed in their entirety, plus the related interest, and part of (one-third only) the penalties, if any. If the taxpayer appeals against the tax adjustment notice before the competent tax court within the above 60-day period, they may be obligated to pay in advance one-third of the higher taxes assessed plus the related interest (no penalties). However, the taxpayer may ask that the request of advance payment be suspended by filing an appeal before the same tax court competent to decide on the legitimacy of the Tax Assessment.

As a third alternative, the taxpayer can file a settlement proposal with the competent tax office. The settlement proposal suspends for 90 days the 60-day term for filing an appeal with the competent tax court against the assessment. In such a case, if the parties reach a settlement on the amount of the (higher) tax base, the new tax (plus interests) will be calculated on the (higher) settled value. The penalties, if any, will be reduced to one-third of the minimum applicable amount.

The negotiation for a possible settlement with the tax authorities during the 60+ 90-day period will not jeopardize the position of the taxpayer (the tax authorities cannot raise higher requests if a settlement is not reached in the end), which will still be entitled to appeal the tax adjustment notice before the tax court (Article 6 (3) of Legislative Decree No. 218/97).

In addition to the above, Italian tax legislation allows the tax authorities and the taxpayer in a tax court case to settle the dispute by a negotiated settlement. In the settlement procedure, both the taxpayer and the tax authorities may take the initiative of proposing an agreement to settle the dispute pending before the tax court. In the event of settlement, the taxpayer is obligated to pay the amount of taxes agreed on with the tax

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authorities, as well as the interest that had accrued on the relevant amount, plus 40% of the tax penalties due on the agreed-on amount if the settlement is reached before the provincial tax court or 50% of the tax penalties due on the agreed-on amount if the settlement is reached before the regional tax court. The possibility of reaching an in-court settlement before the regional tax court was introduced on 1 January 2016. The payment can be made either in one single installment at the time of the settlement or in no more than eight quarterly installments (12 if the total amount due is higher than EUR 51,645.69), subject to interest.

The settlement folds the tax case and may have an impact on the criminal law consequences (if there are any) of the accusations raised against the taxpayer, in that it may represent a mitigating circumstance.

2. Judicial tax litigation

(a) Provincial and regional tax courts

The tax adjustment notice, which is served to the taxpayer by the competent tax office, must be appealed before the tax court of first instance (i.e., the provincial tax court), in the province where the competent tax office is located, by the taxpayer within 60 days after its notification. The appeal has to be served to the tax administration within the deadline provided by law and then filed with the tax court of first instance. The tax office, as the opposing party, has to file a counter-brief within 60 days from the notification of the appeal brief made by the taxpayer. The taxpayer’s appeal should explain all the reasons for the appeal and list all the motions to the court. Documents giving evidence of the taxpayers’ grounds can be filed. Contrary to what is allowed in civil and criminal courts, witnesses are not admitted before tax courts and the judges will take their decisions only based on documents provided by the parties.

177 Legislative Decree No. 156 of 24 September 2015.
The tax court will then schedule a hearing for the discussion of the case, and supplementary documents and briefs can be filed within 21 and 11 days, respectively, prior to the date scheduled for the hearing. The hearing will be held in chambers unless one of the parties applies for it to be held in the form of a public hearing. During the public hearing, the discussion of the case is normally very concise and, within 30 days, the judge should hand down their decision.

Any decision of the tax court of first instance can be appealed before the tax court of second instance (i.e., the regional tax court) within 60 days from the date in which the decision has been served to the opposing party or, in the event that no notification is made, within six months from the date of the filing of the decision with the tax court’s secretary.

The Supreme Court in Rome is competent for any appeal against the appellate tax court’s decision, but only under certain conditions and for specific objections, being a court of legitimacy.

(b) European Court of Justice (ECJ)

The tax courts of first or second instance are allowed to suspend the proceedings and remit the case to the ECJ, to ask for its opinion on whether the domestic legislation relevant for deciding a given case submitted to their attention is in line with the EU provision or whether said legislation should be considered non-applicable because of its non-compliance with EU law. In principle, the suspension of the domestic proceedings and the remittance of the case to the ECJ do not depend on a specific request from the taxpayer, but are left to the discretionary judgment and awareness of the court. However, if taxpayers identify the reasons and arguments for asking for the remittance of the case to the court of judgment, arguments supporting these grounds in the defensive briefs and a specific request raised by the taxpayer may be advisable.

Non-compliance of the Italian legislation with the EU provisions could be acknowledged by the tax authorities themselves, which would be entitled
to directly apply the EU legislation (for instance, in a case of precedents from the ECJ). However, it is highly unlikely that this will happen and taxpayers will normally start a proceeding before the tax courts have their rights recognized through the direct application of the EU legislation made by the judge of the local tax court.

Normally, the tax authorities will only agree to acknowledge the taxpayers' rights without the need to start a tax proceeding if the decisions of the tax courts are considered indisputable precedents. In principle, the taxpayers could ask that the Italian government be ordered to pay for the damages caused by the delay in the application of the EU legislation.

(c) **Application for a suspension of payment demand**

Prior to the issuance of the decision of first instance, tax authorities can collect one-third of the claimed additional income taxes plus interest. If the Tax Assessment is confirmed by the tax court of first instance, tax authorities can collect up to two-thirds of the assessed additional taxes (plus interest) and penalties (without interest).

The remaining amount of taxes, interests and penalties can be collected after the decision of the appellate court is handed down. Taxpayers can request the suspension of the payment demand before the tax courts of first instance if the following conditions are met:

- The Tax Assessment may cause serious and irreparable damage to the taxpayer.

- Upon an initial analysis, the arguments raised by the taxpayer against the Tax Assessment are deemed to be founded.

- The suspension may only be partial or may be subject to the provision of a guarantee.
Recently, the possibility to request the suspension of the payment was extended before the tax court of second instance. Furthermore, it is now possible to ask for the payment suspension in case a litigation proceedings is moved before the Supreme Court.

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178 See Article 52 of Legislative Decree No. 546/1992.
III. Competent authority/Arbitration Convention

All Italian double taxation treaties contain the competent authority process clause under Article 25 of the OECD Model Treaty (the so-called mutual agreement procedure). However, no procedural rules have been implemented in domestic legislation and only a few competent authority agreement procedures have been carried out. Their findings are secret and are not public knowledge.\(^{180}\)

Should the agreements concluded following the amicable procedures provided for by the double taxation treaties\(^{181}\) provide for positive adjustments to the non-resident taxpayer’s income, negative corresponding adjustments to the Italian taxpayer’s income are allowed under Article 31-\textit{quater} of Presidential Decree No. 600 of 1973.\(^{182}\)

As far as Italy is concerned, the level of enforcement of the competent authority process has, for many years, been rather low due to the circumstance that no official explanations existed with respect to procedural aspects and the Mutual Agreement Procedure (MAP) is, in any event, a facultative procedure that does not require the tax authorities to

\(^{180}\) Section 10 of Presidential Decree No. 287 of 27 March 1992, which sets forth the guidelines of the tax service re-organization, introduced by the Ministry of Finance’s office for the study of comparative tax law and international relationships. Among other things, this office is entitled to deal with tax authorities of other countries to apply the provisions under the Italian tax treaties.

\(^{181}\) This also applies in cases of agreements concluded with the competent authorities of foreign states following the amicable procedures provided for by the EU Arbitration Convention.

\(^{182}\) Article 31-\textit{quater} of Presidential Decree No. 600 of 1973 allows making corresponding negative adjustments to the Italian taxpayer’s income as a consequence of: (i) agreements concluded with the competent authorities of foreign states following the amicable procedures provided for by the international conventions against double taxation or by the EU Arbitration Convention; (ii) the conclusion of the audits carried out as part of international cooperation activities, the outcomes of which are shared by the participating states; and (iii) a request filed by the taxpayer following an adjustment carried out by a state where a convention against double taxation is in force.
reach the agreement aimed at preventing double taxation, which is not appealing to taxpayers. The Arbitration Convention was a way to eliminate double taxation at the EU level. However, the involvement of a competent authority in the resolution of tax disputes involving transactions that took place with foreign entities is becoming more and more frequent and is seen as a way to avoid double taxation, especially with respect to transfer pricing audits and assessments when penalties are not applied for having the taxpayer prepare the relevant transfer pricing documentation.

On 5 June 2012, the Italian Revenue Agency issued Circular Letter No. 21/E of 2012, which has improved the recourse to the MAP or the Arbitration Convention as a possible remedy to eliminate double taxation. Indeed, the circular letter clarifies some relevant aspects of the MAP or Arbitration Convention procedure (i.e., the object and possible requests; formal aspects regarding the filing and documentation to be provided; the procedure for the suspension from the payment of taxes and penalties; and the relationship between the MAP/Arbitration Convention and domestic remedies (i.e., litigation and settlement)).

In the event that the taxpayer has initiated litigation proceedings before the tax courts, as of 1 January 2016, the filing of the MAP/Arbitration Convention suspends litigation on request of both parties waiting for the competent authority’s decision.\(^\text{183}\)

\(^{183}\) Legislative Decree No. 156 of 24 September 2015.
IV. International exchange of information

In general, the exchange of information for tax purposes between Italy and other countries could take place: (i) upon request of the tax authority of a country to the tax authority of another country; (ii) on an automatic basis, with specific deadlines; and (iii) on a spontaneous basis, without any specific request.

The rules on the exchange of information are mainly contained in conventions against double taxation, in EU directives and other specific agreements stipulated by Italy at an international level.

As far as the exchange of information within the EU is concerned, this topic is regulated domestically by Article 31-bis of Presidential Decree No. 600/1973, which has implemented in Italy Council Directive 2011/16/EU of 15 February 2011 (lately amended and supplemented). According to such rule, the Italian tax authority exchanges, with the other competent authorities of the Member States of the EU, the information necessary to ensure the correct assessment of taxes, operating in compliance with the terms indicated in Articles 7, 8, 8-bis and 10 of Council Directive 2011/16/EU of 15 February 2011. In particular, for these purposes, the Italian tax authority collects the information to be forwarded to the aforementioned authorities in the manner and within the limits set for the assessment of income tax in Italy.

When one or more taxpayers present a common or complementary interest between Italy and other Member State(s), the tax authority may decide to carry out simultaneous audits with the tax authority of the other Member State(s), each in its own territory, to exchange the information thus obtained, when such audits appear more effective than an audit carried out by a single Member State.
Handling Tax Disputes in Luxembourg

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I. Managing the tax audit process

1. General

Under the Luxembourg tax system, three tax authorities are involved in the assessment and collection of taxes.

Income tax matters are handled by the Direct Taxes Authority (DTA or Administration des contributions directes), which assesses and collects direct taxes, such as individual income tax from individual taxpayers, corporate income tax (CIT or impôt sur le revenu des collectivités), municipal business tax (MBT or impôt commercial communal) and net wealth tax (NWT or impôt sur la fortune) from corporate income taxpayers, as well as withholding taxes on wages and salaries and other taxes. The DTA also determines the basis of collection for property tax (tax valuation on all real estate in the country).

VAT, registration duties, stamp duties and other indirect tax matters are handled by the Indirect Taxes Authority (Administration de l’enregistrement, des domaines et de la TVA). Excise duties and certain other specific matters (such as consumption taxes on alcohol and vehicle tax) are handled by the Customs and Excise Administration (Administration des douanes et accises).

On 1 January 1997, an important reform was implemented to reorganize the judicial system concerning administrative matters. This reform impacted and amended the tax dispute resolution process, which is still applicable today. In addition, a circular was published on 28 August 2017 to give clarification on how to implement the mutual agreement procedure provided for in bilateral tax treaties concluded by Luxembourg. More recently, the bill of Law 7431 introduced by the Luxembourg Government on 11 April 2019 will implement the EU Directive 2017/1852 of 17 October 2017 on tax dispute resolution mechanisms in the EU, which will be a subsidiary to the mandatory binding arbitration clause of the multilateral instrument. The DTA represents the government of Luxembourg during
workshops held by the EU and the Organization for Economic Co-operation and Development (OECD). The DTA is also active in developing its network of double tax treaties (DTTs), and responsible for advance pricing agreements (APA) as well as the advance tax agreement (ATA).

The DTA is divided into 14 divisions of management, three revenue offices and 44 services of taxation dealing separately with individuals and companies. Regarding APA procedures, a permanent commission has been created with the aim of discussing and reviewing all APA requests, seeking to have a harmonized criterion for taxpayers.

2. Statute of limitations

(a) Principles and exceptions/extensions

According to Luxembourg law, the statute of limitations with respect to CIT, MBT and NWT is five years from the year following that when the tax debt was incurred. In other words, with respect to CIT, MBT and NWT, the statute of limitations starts with the taxable event (i.e., the event or action that renders the tax assessable) irrespective of whether or not a tax assessment has been issued by the tax authorities. The statute of limitations can be extended by five additional years (i.e., 10 years in total) in case: (i) incomplete tax returns are filed; (ii) inaccurate tax returns are filed; or (iii) no tax returns are filed.

The 10-year limitation period applies when tax returns are not filed or in the case tax charges are increased due to the filing of an inaccurate or incomplete tax return (it is irrelevant whether it was intentional or not). For instance, regarding the tax charge for 2015, the (ordinary) five-year limitation period will start on 1 January 2016 and will expire on 31 December 2020.

However, a reassessment of the 2015 tax assessment is still possible for a 10-year period starting on the following year succeeding that during which
the tax debt is due. In other words, the statute of limitations will start on 1 January 2016 and will expire on 31 December 2026.

From a VAT standpoint, the statute of limitations is five years from December of the year during which the VAT becomes due.

With respect to municipal taxes, the statute of limitations is five years following the year when the first reminder occurs; while for customs duties, the statute of limitations is three years from the year following that during which the tax debt is incurred. Finally, for registration duties, the statute of limitations is generally 30 years. In practice it can be two years from the date of registration.

The statute of limitations applies not only to the principal amount of debt but also to ancillary income (e.g., interest for late payment, penalties).

In certain circumstances, the extinctive prescription can be interrupted or suspended. Under Section 222 of the Luxembourg General Tax Law (Abgabenordnung), the DTA has the possibility to amend the tax assessment issued on previous years to the extent the statute of limitations has not yet expired. This is only possible if the DTA becomes aware of a new fact or other new means of proof (neue Tatsachen oder Beweismittel) justifying the increase of the tax previously assessed. The facts must be proven, ignored initially by the DTA, established with certainty and relevant from a tax perspective.

(b) Causes of suspension

Statutory limitations may be suspended if the creditors are unable to recover their claim (e.g., the Revenue Department's suspension of an income tax claim of a taxpayer as a result of a claim by the latter against tax assessments). In the case of suspension, the statute of limitations is not canceled. The remaining statutory limitations period will only be on hold as long as the creditor is unable to act.
If a taxpayer files a claim against a tax assessment (see the judicial tax litigation section of this document), the statute of limitations is suspended as long as the head of the DTA (Directeur des Contributions Directes) or the courts’ decisions are still pending. In any case, the suspension of the statute of limitations will not prevent the taxpayer from paying the debt that is still due.

The statutory limitations may also be suspended if the taxpayer benefits from a suspension of payments.

(c) Causes of interruption

The specific causes of interruption (e.g., coercive measures from the Revenue Department (Trésorerie de l’Etat) imposed on the taxpayer or the taxpayer’s voluntary renunciation of a prescription that has already passed) are included in civil law.

Once a statute of limitations is interrupted, the period that has run is canceled and a (full) new period will be started.

3. Rights and obligations

(a) Obligation to maintain proper documentation

In accordance with Luxembourg accounting legislation, all book entries must be backed by supporting documentation, which must be kept in chronological order. These documents could be kept in the form of copies and they must be true copies of the original documents.

Furthermore, as an EU Member State, and thus party to the intra-community VAT system, Luxembourg businesses are subject to specific requirements regarding evidence of transactions carried out. It is necessary to keep all documents that can be used to review intra-community flows of goods and services, including invoices issued and received, notes of goods deliveries, or the contracts/agreements under which purchases and sales have been conducted. The Luxembourg VAT law requires that the
taxpayer has to keep its invoices for a period of 10 years. In theory, the invoices can be stored outside Luxembourg without restriction. In practice, the Luxembourg VAT authorities do not accept their storage outside the EU.

These various requirements ensure that when Luxembourg enterprises are required to keep accounting data, this data is backed by the necessary documentation on the transactions performed.¹⁸⁴

The obligation to maintain regular and accurate accounts is also foreseen by the General Tax Law¹⁸⁵ from both formal and substantial perspectives.

Accounting is deemed regular from a formal point of view when arranged in a clear and orderly manner, so as to facilitate any research and control. It is regular in substance when it gives a true and complete picture of the financial situation of the company. To this end, it must comply with general accounting principles, such as the principle of continuity, consistency, specificity exercises, no compensation, and accounting value of expenses and products, as well as prudence.


For example, and without limitation, it is worth mentioning some negative consequences, for tax purposes, of a storekeeper’s breach of its duty to hold complete and regular accounting, such as the impossibility of having a divergent fiscal year or the impossibility of incurring carryforward losses.

When accounting is not regularly done, the tax authorities will be automatically allowed to reassess the accounting profits generated by the company. In the event the irregularity of accounting results in tax fraud,

¹⁸⁴ OECD Peer Review Report - Phase 1: Legal and Regulatory Framework (Luxembourg), paras. 146 to 148.
¹⁸⁵ Paragraphs 160 to 162.
administrative sanctions will be applicable. In the event the irregularity of accounting results in tax swindling, criminal sanctions will apply.

The administration may require the payment of taxes as long as the statute of limitations remains valid. It is therefore important that the taxpayer keeps its books for 10 years following the year to which these books refer.

The General Tax Law is aligned with the provisions of the Commercial Code and it generally sets out guidelines that inform taxpayers of their obligation to keep 10-year records of their accounting documents (although there are shorter time frames in respect of tax matters).

Business people or entities that do not keep regular and complete accounts for 10-year periods may be further considered guilty of simple or fraudulent bankruptcy.

(b) Transfer pricing documentation

Article 56 of the Luxembourg Income Tax Law, amended under Chapter 9 of the Law of 19 December 2014, enforced on 1 January 2015, provides for the arm’s-length principle as a general rule:

"(a) une entreprise participe directement ou indirectement à la direction, au contrôle ou au capital d’une autre entreprise, ou que (b) les mêmes personnes participent directement ou indirectement à la direction, au contrôle ou au capital de deux entreprises, et que, dans l’un ou l’autre cas, les deux entreprises sont, dans leurs relations commerciales ou financières, liées par des conditions convenues ou imposées, qui diffèrent de celles qui seraient convenues entre des entreprises indépendantes, les bénéfices de ces entreprises seront déterminés aux conditions qui prévalent entre entreprises indépendantes et imposés en conséquence."
The English translation of this provision is:

"(a) an enterprise participates directly or indirectly in the management, control or capital of another enterprise, or (b) the same persons participate directly or indirectly in the management, control or capital of two enterprises, and that, in either case, the two companies are, in their commercial or financial relations, bound by agreed or imposed conditions, which differ from those which would be agreed between independent enterprises, the profits of these enterprises will be determined by the conditions prevailing between independent enterprises and imposed accordingly."

To this end, Luxembourg transfer pricing legislation applies the arm’s-length principle to associated enterprises, as set forth in the OECD Transfer Pricing Guidelines.

The arm’s-length principle is set out in Article 9 of the OECD Model Tax Convention, which states that where:

"conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

The arm’s-length standard is generally applied by members of the OECD and many non-members as well.186

The law of 22 December 2016 introduced Article 56-bis into the Luxembourg Income Tax Law.

186 Please refer to http://www.oecd.org/.
Article 56-bis provides that Luxembourg companies have to determine, within the context of their transfer pricing documentation, an arm’s-length price for all transactions between related parties. For this purpose, companies have to determine their pricing on the basis of a comparability analysis (i.e., comparison with market transactions with similar economic characteristics). In this respect, the comparison method to be used should be the one that will achieve the more precise arm's-length price.

Moreover, where a transaction contains elements that do not have a valid commercial rationale and that negatively impact the determination of the arm's-length price, such transaction should be ignored in full or in part for the purpose of the determination of said arm's-length price.

Furthermore, Luxembourg entities falling under the scope of the law of 13 December 2016 related to country-by-country reporting (CbCR) obligations (i.e., ultimate parent entities controlling a multinational enterprise group whose total consolidated turnover exceeds EUR 750 million) have to file a report including economic, financial and tax information to the Luxembourg tax authorities. If a Luxembourg resident reporting entity fails to file the report, files it late or files false or incomplete information, or even fails to inform the Luxembourg tax authorities that the ultimate parent refuses to provide the relevant information requested for the filing, the entity could be subject to a fine up to EUR 250,000.

(c) Other obligations

As a preliminary remark, one should note that under Luxembourg tax law, economic reality prevails over "legal" reality. In principle, the legal owner of goods is also considered the economic owner for tax purposes. However, civil law may, at times, not match economic reality. In this case, tax law will not follow civil law.

Taxpayers (either individuals or businesses) must file a tax return annually when they are subject to direct taxes. Indirect taxes, such as VAT or
subscription taxes, which derive from specific transactions, are generally due on a periodical basis.

Due to the Luxembourg tax compliance system (filing of tax returns), the taxation process by Luxembourg tax authorities mainly consists of checking the accuracy of such returns. The tax assessment process can only be achieved through information, communication and justification.

(1) Information

In the event the taxpayer refuses to cooperate, the tax authorities are allowed to obtain the requested information from third parties (the taxpayer being liable for any fees due in this respect). If this is not possible, the tax office may proceed to the tax assessment arbitrarily.

Two types of obligations to inform exist: the general and the occasional. The general obligation to inform concerns both direct and indirect taxes.

Under this obligation, taxpayers and third parties are obligated to provide the Luxembourg tax authorities with any information requested by the latter. No specific conditions (e.g., tax audits or suspicion of fraud) need to exist in this respect. This obligation derives from the principle of cooperation of the taxpayers with the tax authorities.

On the other hand, occasional information requests occur when the tax authorities need additional information in the frame of a specific tax assessment (e.g., information/tax returns provided by the taxpayer do not match the information held by the tax authorities).

The behavior of the taxpayers is taken into account by the tax authorities when they decide on the following: the amount of tax penalty to impose; applying a coercive measure; or proceeding to perform an arbitrary tax assessment.
(2) Communication

Only relevant documents can be requested by the tax authorities (i.e., professional documents such as bank statements or book entries). Any document relating to the taxpayer’s privacy should not be supplied.

Any person subject to the obligation to inform generally holds relevant information for tax assessment purposes. However, the tax authorities cannot override professional secrecy, which allows specific persons not to disclose information.

(3) Burden of proof

Tax compliance obligations require positive faithfulness from the taxpayer. In case the tax authorities still doubt the accuracy of the information disclosed by the taxpayer, they may request evidence, either in writing or verbally.

Adequate documentation is required from corporate taxpayers that have transfer pricing operations and transactions with associated enterprises. The law dated 19 December 2014, which clarified this issue, specifically states that the taxpayer must provide evidence upon the tax authorities’ request as regards the adjustment of profits of associated enterprises. This clarification led to a reversal of the burden of proof in the sense that, when the tax authorities can reasonably assume the transfer of profits to foreign associated enterprises, the corporate taxpayer must prove, under reasonable conditions, that the applied adjustments of profits are compliant with the law. Determining the method that will be used to adjust profits must be settled before the tax audit, not when questions have been raised in this respect.

In spite of these specific requirements, the Luxembourg regime of burden of proof is actually rather fair, in the sense that both the taxpayer and the

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187 Paragraphs 171 al. 1 and 205 al. 2 of the General Tax Law.
tax authorities must cooperate so that, at the end, the tax authorities may obtain all relevant information needed to perform the tax assessment.

As a result, the tax authorities have the burden of proof with regard to facts likely to increase or generate a tax burden (i.e., proof that items are taxable) while the taxpayer is responsible for proof that will support facts likely to decrease their tax liability (i.e., proof that items are deductible from the taxable basis).

Contrary to judicial litigation, all sorts of evidence is admissible (i.e., writings, witnesses and assumptions).

(d) Types of control

As tax audits are generally based on information, communication and proof obligations, they can be conducted at the tax authorities' workplace.

In exceptional cases, the tax authorities may decide to conduct a thorough audit of the financial statements of a taxpayer at the taxpayer's workplace. The Revision Board (Division Révision), which is a division relating to the DTA, is in charge of such specific tax audits. It is important to note that the purpose of a thorough audit is only to check the accuracy of the tax return filed by the taxpayer and in no case will information on third parties be collected.

A thorough tax audit may last several weeks and is performed during "normal" working times. A draft of the report will be sent to the taxpayer at the closing of the audit so that the taxpayer will have the option to provide additional comments/information in this respect. The draft of the report is admissible until no evidence to the contrary arises.

The tax audits performed by the Revision Board, which are routine audits, should be held every three years for so-called "large companies." In contrast, occasional audits may be conducted in the event that

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188 Paragraph 162 al. 10 of the General Tax Law.
mismanagement, which should be controlled, is suspected, or when tax fraud or tax avoidance is alleged.

Tax fines can be imposed, if necessary, on the occasion of these tax audits. In addition, amended tax assessment notices can be reissued and the tax authorities may also conduct a tax assessment arbitrarily if they suspect irregular accounting practices.

Based on the DTA 2018 activity report, 189 54 tax audits were performed and closed during 2017 and 44 were still open for the same year. Twenty of these gave rise to further claims transmitted to the state prosecutor.

(e) Tax assessments

Theoretically, once the general and exceptional tax audits are finished, the tax authorities will issue a tax assessment notice to the taxpayer.

There are two types of tax assessment notices: those that will establish directly the amount of tax debt due of the taxpayer, and those that are preliminary to the final tax assessment, which will be issued later.

(1) Tax assessment notices to be interpreted narrowly

These tax assessment notices do not generate tax debt, but reveal to or notify the taxpayer of such information.

This category includes the following:

- Those that notify the taxpayer that they are liable for advance payments (generally on a quarterly basis).

- Temporary notices in case there are uncertainties remaining as regards the conditions of a tax debt’s existence.

189 Finance Ministry activity report, tax year 2018, p.120-121
• Call for guarantee notices, where a third party is liable (jointly or instead of the taxpayer), for a tax debt.

(2) **Tax assessment notices to be interpreted in a broad way**

This category includes the following:

• Separate tax assessment notices that establish several taxable bases prior to a final assessment (e.g., several partners realize profits in common and have to reallocate such between each other – the tax rate must be fixed based on the global profits, not on an individual basis).

• Taxable basis notices that only relate to MBT and property taxes, whose establishment is shared by both the tax authorities and the taxpayer’s city of residence (or at least the place of residence of the enterprise).

With respect to separate tax assessment notices, it is important to note that, even if they are considered preliminary to the final notices issued thereafter with the amount of the tax liability, only the claim against the preliminary notice will be admissible. The statute of limitations for filing a claim against such a specific notice is similar to that which is applicable to "ordinary" tax assessment notices that should be interpreted in a narrow way (please see the judicial tax litigation section). In practice, taxpayers are commonly misled and they challenge the final notice rather than the preliminary one. In this case, they will be considered automatically inadmissible.

In case an administrative act is deemed illegal, the taxpayer can either challenge such an act through a judicial claim, or ask the tax office to amend the act directly.

An administrative act can be withdrawn or abolished. Both events have the same result (i.e., they render the act unenforceable). However, there is a difference between these two events with respect to the date of effect. A
withdrawal has a retrospective effect as from its date of issuance, while an abolishment has a prospective effect. Most administrative acts are subject to abolishment rather than withdrawal.

Taxes are due at different dates, depending on the type. The non-payment of taxes may lead to penalties for late payment, unless the taxpayer benefits from a suspension of payments.

In principle, tax due is payable within the month of notification of the tax assessment, with advance payments due quarterly in respect of direct taxes.

4. Tax offenses

As a general rule, a taxpayer in Luxembourg is usually free to choose the method by which it structures its affairs, even with a view to minimizing its tax liability.

In certain circumstances, a taxpayer may have acted in a way that is compliant with the law (whatever the area it concerns), but with a purpose to solely avoid/reduce its tax liability; this is the concept of "abuse of law" (abus de droit).

Traditionally, Luxembourg tax law does not contain many specific anti-abuse provisions. In Luxembourg, "abuse" or "avoidance" in tax matters is therefore a matter of general anti-abuse provisions and principles.

As a result, in this case, tax authorities are allowed to dismiss certain operations/qualifications of operations made by a taxpayer even if, in itself, such operations did not infringe the law.

Since 1 January 2017, Luxembourg law distinguishes between three types of tax offenses: simple tax fraud, aggravated tax fraud and tax swindling (or tax evasion). Both aggravated tax fraud and tax swindling are defined as criminal offenses, whereas the simple tax fraud remains a non-criminal offense.
(a) Simulation and anti-abuse provisions

Luxembourg's general tax rules contain two types of general anti-abuse provisions:

- The "simulation" or "sham transaction" doctrine
- The "abuse of law" or "abuse of legal form" doctrine

A sham transaction is embodied in Section 5 of the Tax Adaptation Law and can be defined as a situation where parties have concluded a legal act or series of legal acts, but do not, as such, respect the legal (and economic) consequences of such an act or series of acts. In such a case, the Luxembourg tax authorities could disregard the fictitious transaction, requalify the transaction based on the real operation entered by the parties, and apply the proper tax treatment.

Under Luxembourg tax law, "abuse of law" or "abuse of legal form" can be defined as a situation where a taxpayer wishes to obtain a certain economic result, but circumvents the law by not using the legal forms that are generally used to obtain or achieve such a given goal. Rather, they utilize legal forms that are generally not meant to achieve such a given economic goal, and with a purpose (intention) of avoiding or minimizing tax.

The general anti-abuse provision under Section 6 of the Tax Adaptation Law will thus result in a "recharacterization" of a given transaction for tax purposes. Such a recharacterization would imply drawing a parallel between the tax charge effectively borne by the taxpayer that is abusing the legal form or law and that which it would normally have borne using the typical legal form.
According to one of the rare Luxembourg case laws that refers to abuse of law: (i) the use of forms or of institutions offered by private law; (ii) a reduction of the tax burden; (iii) an inappropriate "path"; and (iv) the absence of valid non-tax reasons justifying the path chosen, might be considered the four cumulative conditions that need to be met in order to classify an operation as abuse of law.

As an example, the signing of a share purchase/contribution agreement ("use of forms or of institutions offered by private law") by a loss-making Luxembourg company, in view of transferring, to an affiliated profit-making Luxembourg company, a receivable against a company in default for a price equal to its principal amount, may be considered abuse of law when: (i) the (profit-making) buying company waived the receivable after its acquisition (whereas such receivable could have been waived by the (loss-making) selling company – referring to the "inappropriate path" concept); (ii) it allows the profit-making company to substantially reduce its taxable basis ("reduction in the tax burden"); and (iii) no economic/business reasons or risks justify such transfer ("absence of valid non-tax reasons").

In addition, the new version of the parent subsidiary directive was implemented in Luxembourg with effect as from 1 January 2016 and it introduced specific anti-abuse rules applicable in case of dividend distribution to or from a Luxembourg entity.

Finally, the Law of 21 December 2018 which transposes the anti-tax avoidance directive (ATAD), introduces a general anti-abuse rule. The new general anti-abuse rule maintains the principal criteria of the abuse of law as defined above. The ATAD considers as an abuse of law the legal route that, having been used for the main purpose, or one of the main purposes, of circumventing or reducing tax contrary to the object or purpose of the

190 Administrative court, 7 February 2013, 31230C (confirming Tribunal Administratif, 12 July 2012, 28815).

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tax law, is not genuine, having regard to all relevant facts and circumstances. The legal route, which may comprise more than one step or part, shall be regarded as non-genuine to the extent that it was not used for valid commercial reasons that reflect economic reality. The provisions of the ATAD are applicable as of 1 January 2019.

(b) Simple tax fraud

A taxpayer’s operation may qualify as simple tax fraud if the latter benefits from unjustified tax advantages or puts itself in a position where it reduces its tax liability in an unlawful manner.\textsuperscript{191} An (unsuccessful) attempt at tax fraud is subject to the same penalties as an executed case of such.

As previously mentioned, simple tax fraud does not fall within the category of tax crime, unlike aggravated tax fraud and tax swindling. However, all three must satisfy the same “grounds” to be deemed to exist. An operation will fall within the category of aggravated tax fraud when the amount of eluded or unduly refunded tax exceeds certain thresholds, and within the category of tax swindling if additional (more serious) conditions are present. Tax fraud (simple or aggravated) and tax swindling have identical characteristics. One of these is that they both contravene the law (élément matériel), either through action or omission. The result of such a breach of law is the procurement of a reduced tax rate or of any other tax benefits not foreseen by the law.

Most of the time, fraud will consist of hiding taxable income or increasing deductible expenses through counterfeit accounts of an enterprise.

In addition to a breach of the law, the element of intention, considered by most a guilty mind, is required (élément intentionnel).

This condition implies that the taxpayer, by acting in a certain way, was trying to achieve a certain objective (e.g., avoid taxes or obtain a reduction in its taxes through unlawful means). When considering whether an act

\textsuperscript{191} Paragraph 396 al. 1 of the General Tax Law.
falls within the category of tax fraud or tax swindling, the tax authorities disregard the ground(s) of the taxpayer. However, such ground(s) may be taken into account by the judge (in the case of aggravated tax fraud or tax swindling) when deciding on the penalty.

(c) Aggravated tax fraud

Aggravated tax fraud is characterized when the conditions of simple tax fraud are met and when the eluded (or unduly refunded) tax exceeds 25% of the annual tax due while amounting to at least EUR 10,000 or when the eluded (or unduly refunded) tax exceeds EUR 200,000.

Aggravated tax fraud is considered a criminal offense (i.e., dealt with by the Luxembourg criminal court only).

Aggravated tax fraud attempts will be subject to the same sanctions as actual aggravated tax fraud.

With respect to VAT, aggravated tax fraud is foreseen by the Luxembourg VAT law when the amount of the infraction exceeds a quarter of the VAT avoided or unduly reimbursed that is not lower than EUR 10,000, or when the VAT avoided or unduly reimbursed exceeds EUR 200,000 per reporting period. In that case, a prison sentence between one and three months and a fine between EUR 25,000 and six times the amount of the VAT avoided or unduly reimbursed can be imposed.

(d) Tax swindling (escroquerie fiscale)

In Luxembourg, from a criminal and tax perspective, tax swindling, just like aggravated tax fraud, is not only a tax-related offense (which the Luxembourg tax authorities may handle), but is also a criminal infraction.

The elements of tax swindling are similar to those of tax fraud; that is, there is: (i) an active or passive breach of the tax law, resulting in a decrease of the tax charge or the granting of a tax benefit not provided by the tax law; and (ii) a guilty mind.
More specifically, tax evasion applies in case the payment of a significant (in relative terms, compared to the annual tax due) amount is being avoided via the systematic use of fraudulent maneuvers in order to conceal relevant facts from the tax authorities or to convince the tax authorities of incorrect facts.

Tax swindle attempts will be subject to the same sanctions as actual tax swindles.

With respect to VAT, if fraudulent tactics are used, or the taxpayer belongs to an organized gang and the fraud involves a significant VAT amount for a reporting period, a prison sentence between one month and five years and a fine between EUR 25,000 and 10 times the amount of the VAT avoided or unduly reimbursed can be imposed.

(e) Tax penalties

In the case of late payments or missing payments of tax due, the DTA may impose a monthly 0.6% late interest on the tax due from the taxpayer.

In the event of late filing or if filing of the tax returns is missed, the taxpayer may be subject to a penalty of up to 10% of the tax due, as well as a tax fine of up to EUR 25,000.

In the event of the voluntary filing of incomplete or incorrect tax returns, or if filing of the tax returns is missed, the taxpayer may be subject to a tax penalty for an amount between 5% and 25% of the eluded tax or tax unduly reimbursed.

The tax authorities may also impose a penalty ranging between 10% and half of the amount of the eluded tax (or of the unduly reimbursed tax) in the case of a proven simple tax fraud.

In aggravated tax fraud cases, the penalty can range between EUR 25,000 to six times the amount eluded (or unduly reimbursed) together with imprisonment from one month to three years.
In case of tax swindling (or tax evasion), the penalty can range between EUR 25,000 to 10 times the amount eluded (or unduly reimbursed) together with imprisonment from one month to five years.

As regards VAT, lump-sum taxation and fines can be cumulative. Fines range between EUR 250 and EUR 10,000. Default interest can amount to up to EUR 25,000 per day of delay. Non-payment within the deadline of the partial or total VAT due can trigger a fine not exceeding 10% of the VAT due for the year concerned.

A fine between 10% and 50% of the VAT avoided or unduly reimbursed is also foreseen under certain circumstances (minimum EUR 125).

Amounts arising from lump-sum taxations and fines are payable within one month of the notification.

5. Tax audits in practice

One of the unique business traits of Luxembourg is that a large number of companies incorporated in the country are holding companies (e.g., so-called société de participations financières or Soparfis) that do not perform activities other than typical holding or financing undertakings.

As a result and for practical reasons, tax audits performed on these type of companies generally rely on information, communication and proof rather than on control at the registered seat of such companies (please see Section (d) Types of control). In other words, tax audits of such companies usually take the form of information requests sent by the tax authorities based on the tax returns filed and the supporting information provided (which are mainly annual accounts and other accounting documents).

Routine payroll audits occur, on average, every three years and generally follow the same route as that described above.

On-site audits are the exception, rather than the rule.
6. Tax audits from an international perspective

The Luxembourg tax authorities benefit from increasing mutual collaboration in the tax field with other Member States of the EU. They have significantly developed the DTT network, covering the OECD-compliant exchange of information process.

Within the EU and under certain other tax treaties, Luxembourg's competent authorities can request an exchange of information with a foreign competent authority. The foreign country involved can begin an administrative examination in order to gather necessary information.

Tax authorities are also empowered to initiate simultaneous tax audits that involve one or more taxpayers in different countries.

Exchange of information requires a legal basis. There is an increasing number of international legal instruments, on the basis of which exchanges of information for tax purposes may take place, such as DTTs, FATCA (i.e., the intergovernmental agreement signed between Luxembourg and the US), the OECD Common Reporting Standard, as well as the EU directives on mandatory exchange of information in the field of taxation.

The main forms of information exchange are: (i) upon request; (ii) automatic; and (iii) spontaneous.

(1) Exchanges of information upon request

Law of 25 November 2014 ("2014 Law") amended the law of 31 March 2010 implementing DTTs as well as the procedure related to the exchange of information upon request. The 2014 Law applies to any request for exchange of information from a foreign tax authority based on either a relevant DTT, the EU Directive of 16 March 2010 on mutual assistance for the recovery of claims relating to taxes, duties and other measures, the Directive on Administrative Cooperation in the Field of Taxation or the OECD Convention on Mutual Assistance in Tax Matters. In practice, exchange of information upon request happens when the competent
authority of one country asks for particular information from the competent authority of another country. In Luxembourg, a taxpayer will not be necessarily informed of an exchange of information involving them. Indeed, in the case that the Luxembourg tax authorities have the information requested in their files, the Luxembourg taxpayer will not be informed of such a request. Further to the Berlioz case (C-682/15) ruled on by the Court of Justice of the European Union (CJEU) on 16 May 2017, the Luxembourg government introduced, through the law of 1 March 2019 amending the 2014 Law, a full judicial remedy for the information holder not limited to the possibility of an appeal against the quantum of the fine imposed by the tax authorities on non-communication of the information requested. This new judicial remedy entitles the judges to annul partially or fully the request for information, if it does not meet the principle of foreseeable relevance.

(2) Automatic exchanges of information on financial accounts

Information that is exchanged automatically is typically information comprising many individual cases of the same type, usually consisting of details of income arising from sources in the source country.

This information is obtained routinely (generally through a reporting of payments by the taxpayer) by the sending country and is thus available for transmission to its treaty partners. Normally, competent authorities interested in automatic exchanges will agree in advance as to what type of information they wish to exchange on this basis. Information is often exchanged in bulk and the taxpayers involved are not specifically informed of the fact that information is exchanged with another country.

Following the development by the OECD of a common reporting standard (CRS) to achieve a comprehensive and multilateral automatic exchange of information (AEOI) in the future on a global basis, Directive 2014/107/EU amending Directive 2011/16/EU as regards mandatory AEOI in the field of taxation (“CRS Directive” or ”DAC 2”) was adopted on 9 December 2014 in order to implement the CRS among the EU Member States. Council

Under the CRS Directive, effective since 1 January 2016, EU Member States are required to implement an AEOI. The CRS Directive was implemented into Luxembourg legislation by the law of 18 December 2015 on the automatic exchange of financial account information in the field of taxation ("CRS Law").

The CRS Law requires Luxembourg financial institutions to identify financial asset holders and establish if they are fiscally resident in countries with which Luxembourg has a tax information-sharing agreement.

Luxembourg financial institutions, under the CRS Law, have to report financial account information of the asset holder to the Luxembourg tax authorities, which will thereafter automatically transfer this information to the competent foreign tax authorities on a yearly basis.

By application of the CRS Law, the first exchange of information started on 30 September 2017 for information related to the 2016 calendar year.

In addition, Luxembourg signed the OECD’s multilateral competent authority agreement ("Multilateral Agreement") to automatically exchange information under the CRS. The Multilateral Agreement aims to implement the CRS among non-Member States; it requires agreements on a country-by-country basis.
The Council Directive 2015/2376 ("DAC 3") dated 8 December 2015, providing on automatic exchange of information on ATAs and APAs, entered into force in Luxembourg on 1 January 2017. The law provides for an exchange of information on ATAs and APAs concluded between the Luxembourg tax authorities and taxpayers.

Per this law, information on ATAs and APAs granted since 1 January 2017 has been exchanged since 1 January 2017. In addition, in some cases, information on ATAs and APAs issued before 1 January 2017 is also exchanged in the following circumstances:

- ATAs and APAs were issued, amended or renewed between 1 January 2012 and 31 December 2013, provided they were still valid on 1 January 2014

- ATAs and APAs were issued, amended or renewed between 1 January 2014 and 31 December 2016, irrespective of whether they are currently still valid

Luxembourg has used the option provided for in DAC 3 to exclude from the information exchange ATAs and APAs that were issued to companies with annual net turnovers that are below EUR 40 million at group level, if such ATAs and APAs were issued, amended or renewed before 1 April 2016. However, this exemption does not apply to companies mainly involved in financial or investment activities.

The Council Directive 2016/881/EU of 25 May 2016 ("DAC 4") implemented by the law of 13 December 2016 introduced private CbCR for multinational companies. As previously mentioned, entities falling under the scope of the DAC 4 (i.e., whether headquartered in the EU or outside with turnover of more than EUR 750 million) have to disclose on a yearly basis financial

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192 Based on Action 13 of the OECD Base Erosion and Profit Shifting (BEPS), one should note that information can be retroactively exchanged from 1 January 2010, provided such information is still valid on 1 January 2014.
information such as revenues, profits, taxes paid and accrued, accumulated earnings, number of employees and the disclosure of certain assets they have worldwide. The notification is due on the last calendar day of the relevant fiscal year and the electronic filing is due 12 months after the last day of the fiscal year covered by the report.

The Council Directive 2016/2258/EU ("DAC 5") dated 6 December 2016, on access to anti-money laundering information by tax authorities, has been applicable in Luxembourg since 1 January 2018. It ensures that tax authorities are able to access anti-money laundering information, procedures, documents and mechanisms for the performance of their monitoring in compliance with the various forms of administrative cooperation provided in Directive 2011/16/EU as amended. DAC 5 also refers to the 4th AML Directive (EU) 2015/849 ("AMLD") of 5 June 2015, which requires obliged entities, such as credit institutions, financial institutions, natural or legal persons acting in the exercise of their professional activities, to identify beneficial owners, notably via the creation of a central beneficial ownership register. In case of violation of the provisions, administrative sanctions and fines may be imposed. The range of administrative fines is broad:

- A warning
- A blame
- A public declaration providing the identity of the individual or company and the nature of the violation
- When subject to approval from an empowered monitoring institution, the withdrawal or suspension of this approval
- The possible pronouncement of a temporary interdiction to perform activities for a period, not exceeding five years, by the Luxembourg financial monitoring commission (Commision de Surveillance du Secteur Financier) and Insurance Commission (Commissariat aux Assurances)
• Administrative fines up to two times the amount of the benefit received from the violation when it is possible to assess it or a maximum amount of EUR 1 million

• Increase in fines up to EUR 5 million or 10% of the turnover in case of company and EUR 5 million for individuals when the professional is a credit institution or a financial institution

• The possible imposition of other fines ranging from EUR 250 to EUR 250,000 in case no cooperation is offered to the tax authorities

The Council Directive 2017/0138/EU ("DAC 6") dated 21 June 2016 implementing obligation for intermediaries to report potentially aggressive tax planning arrangements is being implemented in Luxembourg under Bill of Law 7465. Lawyers, tax advisers, accountants and other services providers should communicate information on cross-border arrangements falling under at least one hallmark, as listed in the annex of the Bill of Law 7465 (very similar to the DAC 6). The specific provision of Article 8ab Section 5 of the DAC 6, under which Member States were entitled to waive this obligation for professionals subject to professional privilege, has been partially implemented. Based on the text of the Bill of Law 7465 still subject to changes, lawyers subject to professional privilege would have to comply with a limited and anonymous reporting (i.e., the lawyers should not communicate the name of the clients).

Luxembourg lawyers, tax advisers, accountants and other service providers are all bound by professional secrecy. Non-compliance with professional secrecy may, in accordance with Article 458 of the Luxembourg Penal Code, be punished with imprisonment (up to six months) and a fine (up to EUR 5,000). The legislator will have to clarify these when implementing the directive into Luxembourg law.

The failure to comply with the new DAC 6 requirements would trigger a fine up to EUR 250,000. The first report has to be made by 31 August 2020, covering reportable arrangements as from 25 June 2018 (the date of entry...
into force of the directive). It follows that tax intermediaries are required to track potentially reportable advice from 25 June 2018.

Finally, the intergovernmental agreement between the US and Luxembourg, to improve international tax compliance and to implement FATCA, was signed on 28 March 2014 between Luxembourg and the US. This agreement strengthens exchange of information obligations between foreign financial institutions and US tax authorities and aims at submitting information on income perceived by US citizens to the US tax authorities. The agreement has been implemented into Luxembourg legislation by the law of 24 July 2015.

(3) **Spontaneous exchanges of information**

Information is exchanged spontaneously when one country, having obtained information in the course of administering its own tax laws, which it believes will be of interest to one of its treaty partners for tax purposes, passes on this information without the latter having asked for it. Whether this information could be relevant or not is mostly determined by the local tax administration on a case-by-case basis. In Luxembourg, the taxpayer involved is normally not notified of the exchange of information.

(4) **Restrictions on exchanges of information**

The competent authorities are allowed to exchange such information as is foreseeably relevant to ensure the correct application of a tax treaty or of domestic tax laws. “Fishing expeditions” or requests for information that are unlikely to be relevant to the tax affairs of a given taxpayer are not admissible.

Before sending a request for information, the relevant competent authority should use all means available in its own territory to obtain the information, except where those would give rise to disproportionate difficulties. These efforts should include attempts to obtain information by, for example, the use of the internet and other publicly available information. This basically means that if a tax authority would like to
receive information from another country pertaining to a specific taxpayer, an attempt should first be made to obtain this information directly (from the relevant taxpayer) before asking the foreign authority for assistance. Other general restrictions to consider are as follows:

(i) Countries are not obligated to exchange information at variance with their own laws and administrative practice.

(ii) Information that is not obtainable under the laws or in the normal course of the administration of a country does not have to be exchanged.

Information that would disclose a trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (public order), does not have to be exchanged.

(5) Country-by-country reporting


The directive is in line with the 2015 Final Report on Action 13 of the OECD BEPS Project, which resulted in a set of recommendations and standards for providing information to MNE Groups, including the master file, the local file and the CbC report (master file and local file recommendations have not been implemented in Luxembourg).

The CbCR Law, as adopted, foresees that Luxembourg tax resident entities ("Reporting Entities") have to comply with the CbCR requirements for financial years starting 1 January 2016 and onward.

According to the CbCR Law, an "ultimate parent entity" of an MNE Group that is a Luxembourg resident for tax purposes, qualifies as a Reporting
Entity and is thus required to file a CbC report with the Luxembourg tax authorities, if the consolidated annual group turnover amounts to at least EUR 750 million (or an equivalent amount in local currency as of January 2015).

However, under certain circumstances, a "surrogate parent entity" or any "constituent entity" that is not the ultimate parent company (such as a Luxembourg subsidiary or a branch of the ultimate parent company) may be designated as a Reporting Entity and, as such, become subject to CbCR obligations.

Additionally, Luxembourg tax-resident entities that are not the ultimate parent entity of an MNE Group also fall within the scope of the CbC Law ("Secondary mechanism") if certain criteria are satisfied.

A Luxembourg entity of the MNE Group will need to notify the Luxembourg tax authorities about whether it will file a CbC report as the ultimate/surrogate parent entity, or if it will do so under the secondary mechanism. If it does neither, it will have to inform the Luxembourg tax authorities of the identity of the ultimate parent entity or surrogate parent entity (as well as identify its tax residency). The DTA had, in addition to the CbCR Law, indicated that such notifications need to be done on a yearly basis by each entity concerned. Entities that do not comply with this requirement will be subject to a penalty of up to EUR 250,000.

The CbC report should, for each tax jurisdiction where the group operates, provide information on the following items: gross income, profit (or loss) before tax, income tax accrued and paid (e.g., withholding taxes), stated capital, accumulated earnings, number of employees, tangible assets (excluding cash and cash equivalents) and the nature of the activities of the involved entities, as well as any other additional information that could be relevant.
The CbC report must be accurate, and completed and filed annually within 12 months of the fiscal year-end of the MNE Group; otherwise, the Reporting Entity will be subject to a penalty of up to EUR 250,000.

The CbC reports can solely be used by the Luxembourg tax authorities as "risk indicators," i.e., for the purpose of assessing high-level transfer pricing risks and other risks related to BEPS. The Luxembourg tax authorities are thus not authorized to perform any potential transfer pricing adjustments on the basis of such reports. However, the CbCR Law does not exclude further investigations (i.e., potential tax audits) in this respect, which may result in appropriate adjustments to the taxable income of a constituent entity.
II. Resolution procedures

At the judicial level, direct tax matters are handled by the administrative court while indirect tax matters are handled by civil courts. There is no tax procedure code at this stage harmonizing the procedural rules for the direct and indirect taxes.

1. Administrative level

A taxpayer can file a claim against a tax assessment with the DTA. This is the start of the pre-dispute phase, which is a compulsory step that needs to be taken in order to gain access to the judicial level, if necessary. There are no particular filing costs or other associated expenses when filing this type of claim.

(a) Formal requirements in an objection procedure

Unless declared "provisional" and unless a claim is filed by the taxpayer within the appeal period, a tax assessment is deemed final after the lapse of three months as from receipt of the assessment notice by the taxpayer. "Final" means that, as a matter of principle, the assessment is no longer subject to appeal or change. Any claim filed after the prescribed period will be considered inadmissible, even if the grounds of the taxpayer are relevant. For situations where the DTA could come back on final tax assessments within the statute of limitation period, please also refer to Section I.2.(a).

Claims against a tax assessment can be filed with the tax office that originally issued the tax assessment notice, or directly with the head of DTA. It can be made either verbally or in writing. In the case of writing, the claim letter may be drafted in French, German or Luxembourgish.

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193 Paragraph 100 of the General Tax Law.
194 Paragraph 249 al. 1 of the General Tax Law.
language.\textsuperscript{195} As a matter of consistency, judicial decisions are always in French.

At this stage, provided the statute of limitations has not passed, the claim is admissible even if the taxpayer simply challenges a tax assessment (i.e., without bringing any specific grounds). Once the claim is made, the tax inspector/office has the opportunity to reconsider the initial tax assessment. In the event the tax office rules in favor of the taxpayer, it will issue a corrective tax assessment notice.\textsuperscript{196} Otherwise, the head of DTA will have to consider the claim.

In the event the claim is considered by the head of DTA, there will be a complete review of the taxpayer’s situation. In this respect, the head of DTA will replace the tax office and will have full powers to reassess the taxpayer’s situation, even aspects that were not originally challenged by the latter. As a result, the head of DTA may amend the tax assessment. In the event the head of DTA intends to deviate by taking a position less favorable than the position taken in the tax return filed by the taxpayer, the latter should be informed and should be given the option of providing the head of DTA with any relevant facts or information. This is based on the principle of the right to a fair hearing.

As regards VAT, the taxpayer can first submit a claim to the head of the VAT office against the lump-sum taxation issued by the VAT inspector within three months after notification. The claim should be duly reasoned. If the claim is totally or partially rejected, the claim is referred to the director of the VAT and a new decision confirming or partially amending the previous one is issued.

The Luxembourg VAT authorities sometimes issue, as a preliminary step, a report (\textit{Procès-verbal}) where some transactions are challenged and additional VAT liability is triggered. The taxpayer is invited to clarify and

\textsuperscript{195} Article 3 of Law of 24 February 1984 on the languages regime.

\textsuperscript{196} Paragraph 94 of the General Tax Law.
challenge the report of the VAT authorities within the 15 days following the issue of the report. Otherwise, the Luxembourg VAT authorities issue a lump-sum taxation in a very short time period.

(b) Suspension of payments

Once the tax office has issued a tax assessment notice, taxes are normally due and payable as from the receipt of the notice (or upon due time when the notice indicates advance payments need to be made on a quarterly basis) by the taxpayer or at the date determined by the tax office. Except as discussed below, these taxes must be paid even if an appeal is filed against the assessment. In order to avoid paying taxes once an appeal has been filed, the taxpayer has the right to request, when certain prerequisites (e.g., financial hardship, serious disease) are present, a suspension of the execution of the payment demand, either from the tax office or from the administrative court.

The suspension of payments should not prevent late interest payment from accruing. However, due to the financial situation of the taxpayer, the applied interest rates are lower than those applied in the case of late payment of taxes.

The tax due will bear no interest if the suspension period does not exceed four months; the monthly interest rate will reach 0.1% if the suspension period exceeds four months and does not exceed 12 months; meanwhile, the interest rate will reach 0.2% if the suspension period exceeds 12 months, but does not exceed three years.

2. Judicial tax litigation

In the event the claim does not result in a solution acceptable to all, the taxpayer may file an appeal against the decision of the head of DTA with the lower administrative court (Tribunal Administratif). The appeal must be filed within three months following the notification of the decision of the head of DTA. It is important that to be admissible, the decision by the head
of DTA must contain legal remedies available to the taxpayer. Moreover, the taxpayer is allowed to file an appeal against the tax assessment notice in the event the head of DTA does not render a decision within a six-month period after the tax assessment notice claim has been filed.

The absence of a decision from the head of DTA does not constitute a dismissal by itself. As a result of such, if the taxpayer wants to file an appeal with the lower administrative court, it will have to refer to the initial tax assessment notice.

Alternatively, the taxpayer may also wait for a decision from the head of DTA even if the six-month period has elapsed. In any case, as long as no decision is taken by the head of DTA, no statute of limitations applies and the taxpayer can file an appeal against a tax assessment notice with the lower administrative court at any time.

When lodging an appeal with the lower administrative court, the taxpayer may be represented by counsel performing a regulated profession, the scope of which is limited to lawyers and certified public accountants/auditors.

The taxpayer may lodge an appeal against the decision of the lower administrative court with the higher administrative court (Cour Administrative). The appeal must be filed with the administrative court within 40 days following the announcement of the decision of the lower court.

When lodging an appeal with the administrative court, the taxpayer should be represented by a qualified lawyer.

During the period when the taxpayer can lodge an appeal with the higher administrative court and the appeal process, the enforcement of the decision of the lower administrative court that canceled or amended the tax assessment notice is deferred. Consequently, all tax assessment notices likely to be issued during this period will be void.
Decisions of the higher administrative court are final and cannot be challenged.

The administrative courts will impose legal costs to be borne by the unsuccessful party, either the Luxembourg State or the taxpayer. Such an indemnity may also be shared or allocated differently if both parties have been partly unsuccessful. Generally, each party has to pay its own lawyer’s fees. Upon request, in certain circumstances, parties may also be granted a lump sum procedural indemnity as a matter of “fairness.”

At any stage of the judicial procedure, the taxpayer may ask the competent jurisdiction to request a preliminary ruling from the Luxembourg Constitutional Court or the Court of Justice of the European Union regarding the compatibility of a disposition of Luxembourg law, or of an interpretation of such disposition with respect to the Luxembourg Constitution or EU law.

In terms of figures, the number of claims introduced was stable between 2015 and 2017 after an increase of over 70% between 2010 and 2015. In 2018, the numbers rose considerably to reach 1,478 claims against approximately 1,200 claims in 2017, which represents an 18% increase. As mentioned above, VAT litigation differs from that to be followed for direct tax matters. An appeal can be lodged with the Luxembourg Civil Court (Tribunal d’arrondissement) against the decision issued by the director of the VAT authorities within three months after receipt of the decision or within six months if the taxpayer does not receive any feedback on the claim filed with the director of the VAT authorities. In the event that the judgment issued by the Luxembourg Civil Court is not in favor of the taxpayer, the latter can lodge an appeal in front of the Luxembourg Court of Appeal within 40 days following the notification of the judgment.

The complexity of the VAT litigations is steadily growing. It triggers more and larger exchanges of statements.
3. **Upfront confirmations as an alternative to audit**

Upfront confirmations of the tax treatment applicable to specific transactions could be obtained from the Luxembourg tax authorities by filing an ATA. This ATA has to provide all the facts and background information of the transaction in an accurate and complete manner. This tax clearance letter will be binding to the tax authorities for a period of five years.

APAs may be filed with the Luxembourg tax authorities and may provide assistance to multinational groups in resolving complex transfer pricing issues. A taxpayer may apply for clarification by agreement with regard to the effect of the statutory transfer pricing provisions on the taxpayer’s transactions.

The procedure by which to obtain ATAs and APAs has been modernized and explicitly formalized into Luxembourg domestic law, following the current global trend toward increased transparency.

The request must be introduced in writing to the tax inspector of the tax office in charge. It must be duly reasoned and must contain at least the following details:

- Precise identification of the applicant
- Detailed description of the operation(s) that is seriously and effectively under consideration and which has not yet produced effects
- Detailed analysis of the tax issues arising from this operation, with the motivated tax position of the applicant
- A confirmation by the applicant that the facts and analysis given are complete and true
An ATA or APA is binding for a period of five years, unless the description of the situation/operations for which the ATA/APA was introduced is incomplete, inexact, has changed, or is no longer in line with domestic, European or international laws.

Nevertheless, Circular L.I.R. No. 56/1 – 56-bis/1\(^{197}\) indicates that all APAs concluded before 2017 are no longer binding for the tax authorities as from 1 January 2017. The same circular also clarifies which information and documentation should accompany each new APA request.

Corporate taxpayers that wish to obtain an ATA or APA have to pay an administrative fee ranging from EUR 3,000 to EUR 10,000 per request, depending on the complexity of the request and the workload of the tax authorities.

Recently, the Luxembourg government introduced a new provision in the 2020 draft Budget law according to which an ATA granted by the Luxembourg tax authorities before 1 January 2015 will cease to be applicable as of the end of the 2019 fiscal year. The taxpayer impacted by such provision should be able to request a new ATA/APA as described above.

\(^{197}\) Circular L.I.R. n° 56/1 – 56 bis/1 of 27 December 2016.
III. Competent authority

In order to prevent double taxation resulting from changes in income allocation, effected either by Luxembourg or by foreign tax authorities, the taxpayer is entitled to apply for a competent authority procedure, as set forth in the relevant treaty. In most cases, the wording of the respective provisions is similar to that in Article 25 of the OECD Model Convention. On 28 August 2017, the DTA published a circular (“Circular No. 60”) on how to implement the mutual agreement procedure provided for in bilateral tax treaties concluded by Luxembourg. Moreover, the multilateral instrument resulting from the OECD action plan on BEPS (MLI) includes two parts dedicated to such matters: Part V, Improving Dispute Resolution, which includes the mutual agreement procedure (minimum standard) and corresponding adjustments, and Part VI on Arbitration (optional). According to the law of 7 March 2019 implementing the MLI, Luxembourg has chosen to apply Part VI (i.e., the arbitration clause). However, to benefit from the arbitration procedure, it is required that the other contracting state to the DTT signed with Luxembourg applies a similar option. The effective application date of the MLI in Luxembourg will depend on the type of taxes and the ratification timing and process in other jurisdictions.

As far as the EU is concerned, double taxation issues can be addressed on the basis of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, which has been in force since 24 April 1993. In addition, a directive on Tax Dispute Resolution Mechanisms in the EU was adopted on 10 October 2017. The purpose of the Bill of law 7431, implementing the EU Directive on Tax Dispute Resolution Mechanisms, is to establish the rules applicable in case of tax disputes arising from the interpretation and the application of the conventions concluded by Luxembourg with one or more EU Member States and therefore close the loophole which may exist when the other EU Member State do not opt for the arbitration clause under the Multilateral Instrument. It shall apply to any case introduced as from 1 July
2019 regarding disputes pertaining to income or capital received during the fiscal year beginning on 1 January 2018 or after.

In principle, the taxpayer must file a claim with the tax authorities of their state of residence. However, in exceptional cases, one should file a claim with the authorities of their state of citizenship. In line with Circular No.°60, when filing takes place in Luxembourg, the competent authority is the finance minister or their authorized representative. In practice, the claim must be filed with the steering committee for all MAPs, or with the economic division for transfer pricing cases, or with the International relations division for all other cases (all three being part of the DTA). Specific elements and information must be included in the claim to be admissible (detailed in Circular No.°60) — the competent authority may also require additional information if necessary (in which case, additional information must be provided within two months following the request). The claim must be filed within three years of the first notification of the measure resulting in the non-compliant taxation (to be interpreted in the least restrictive way for the taxpayer), bearing in mind that the delay may vary, depending on the DTT, so that one should refer to the DTT concerned. The Luxembourg competent authority must meet specific requirements when informing the other competent authority.

The Luxembourg taxpayer has a great deal of flexibility, as the request to initiate competent authority proceedings may already be filed even if there is the mere possibility of double taxation. It is therefore not necessary that the alleged double taxation has already occurred, nor is it necessary that the taxpayer has already filed an appeal in Luxembourg. It may request the initiation of competent authority proceedings prior to filing an appeal, especially as the countries involved are not forced by law to come to an agreement and the proceedings may take several years. For these reasons, it would thus be advisable, in most instances, to simultaneously file a domestic appeal against the decision.
Prior to the opening of competent authority proceedings, the Luxembourg tax authorities will determine if, and to what extent, the taxpayer’s claim can be satisfied domestically (i.e., without involving the other states). If this is not possible, the Luxembourg tax authorities will approach the competent authorities of the other country involved and initiate competent authority proceedings. The taxpayer will not take part in such discussions.

Once the taxpayer has filed a claim with the tax authorities, the authorities have the obligation to note and decide on this demand (as long as it is admissible). However, there are no compulsory periods for treating such a demand and the only purpose of this procedure is to negotiate with the foreign authorities, not to obtain an agreement or solution convenient for the taxpayer.
Handling Tax Disputes in the Netherlands

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I. Managing the tax audit process

1. Tax audits

(a) Reasons for a tax audit

The Dutch Tax and Customs Administration (the Dutch tax authorities — Belastingdienst) can audit any taxpayer or (legal) person suspected to be liable to tax. An audit may be carried out simply to check for compliance or if there is a suspicion that certain rules have been violated. An audit does not have to be directed at a company itself; it can also focus on a person or company, such as a customer or a supplier. Information requests from foreign tax authorities can also give rise to a tax audit by the Dutch tax authorities.

(b) Preparation for a tax audit

In the event of a tax audit, it is generally recommended that taxpayers adopt a cooperative attitude. However, there are limits to the investigative powers of the Dutch tax authorities. Sometimes, the respective opinions on certain matters of a taxpayer and the tax authorities may simply differ. It is recommended that the services of a professional who is knowledgeable on tax matters be retained, so that when audits and disputes occur, risks can be reduced, possible disputes can be handled in time and (international) issues can be resolved.

If subjected to a tax audit, a company should be aware that under Dutch law, a taxpayer has several obligations toward the tax inspector. The legal obligation of taxpayers to cooperate in an audit is not limited to merely answering questions or placing records at the disposal of the Dutch tax authorities. Also note that a tax inspector can verify the tax returns or the administration of a taxpayer "on location."

In general, a tax inspector will contact a company first and announce the tax audit. The taxpayer and the tax inspector will agree on a date and if necessary, on a location for the investigation. The tax inspector will
confirm the "appointment" in writing and indicate the scope of the tax audit (i.e., the taxes and the time period to be covered). A tax inspector is not obligated to announce an investigation. It is possible for inspections to be made unannounced if this serves the purpose of an investigation.

Tax audits never come at a convenient moment and are generally demanding and time consuming. It should be noted that proper preparation all depends on having an accessible administration that meets all legal requirements. In addition, not all audits are executed in the same manner. As tax audits are not always announced, it is recommended that a taxpayer take note of its rights and obligations ahead of time.

Consideration should be given to the following:

- The tax inspector will have prepared the tax audit and will be aware of matters that need further investigation during the tax audit. In turn, by being prepared for a tax audit, a company can approach the tax audit in a strategic manner.

- The tax audit will run more smoothly if the person who will be authorized to answer the questions of the tax inspector is determined beforehand. Start the tax audit by informing the tax auditor about this contact person. It is also possible to appoint external counsel to serve as a point of contact for the audit.

- Keep correspondence with and advice from notaries, attorneys-at-law and tax consultants separate from other documentation and financial administration. Correspondence with and advice from civil law notaries (notarissen) and attorneys-at-law (advocaten) are covered by attorney-client privilege and do not have to be disclosed. Correspondence with tax consultants, on the other hand, is not covered by this legal privilege. However, under the circumstances, this correspondence does not have to be disclosed, going by the principle of fair play. A clear separation of this information will preclude granting the tax authorities any right of inspection.
2. Statute of limitations

In principle, the tax authorities can make adjustments to tax years that are still open. With respect to years for which a final tax assessment has already been imposed, an adjustment can be made if certain requirements are met.

(a) Assessment taxes

With respect to taxes that are levied by means of assessment, such as Dutch corporate income tax and Dutch personal income tax, a tax assessment can be imposed on a taxpayer within three years after the taxable year has ended.

If a (final) tax assessment has been imposed, the tax inspector can impose an adjustment to this tax assessment (i.e., an additional tax assessment — navorderingsaanslag) if there is a qualifying "new fact" or if the taxpayer has acted in bad faith. The time period for imposing an additional tax assessment is limited to five years after the relevant taxable year has ended. This term is extended with any extensions granted for the filing of the tax return. Regarding income from a foreign source, an extended period of 12 years applies to imposing additional tax assessments. If an incorrect inheritance tax return is filed, there is no time limit for the tax inspector to impose an additional tax assessment. Errors in the assessment of tax that are or should have been reasonably apparent to the taxpayer can be adjusted by the tax inspector within two years after the incorrect tax assessment.

(b) Remittance-based taxes

With respect to remittance-based taxes, such as VAT, dividend withholding tax and wage withholding tax, no assessment is imposed. Taxes are paid directly by the taxpayer without a formalization of the amount of tax due in the form of a tax assessment. An adjustment for an underpayment of tax can be made by the tax inspector in the form of an additional tax assessment (naheffingsaanslag) within a five-year period after the tax year.
in which the tax liability has arisen. A 12-year period is applicable in the event of an acquisition of beneficial ownership of real estate.

3. Rights and obligations

(a) Obligation to maintain a proper administration

A company is obligated by law to maintain proper administration from which its financial position and everything else concerning its business or activities can be derived. This administration, including relevant books, documents and other data carriers, must be preserved in such a way that it can be determined, at all times, what the rights and obligations of the company are and so that any other information relevant to the taxation of the company is shown. The administration must be organized and preserved in such a manner that a tax inspector should be able to audit these records within a reasonable period. Pursuant to Dutch law, records must be kept for seven years for audit purposes. Records regarding real estate transactions must be kept for nine years.

(b) Transfer pricing documentation

Dutch law contains special rules on the documentation of intercompany transactions. Any company that engages in intercompany transactions is required to maintain and keep documentation demonstrating: (i) how the price paid on the intercompany transaction was established; and (ii) that the terms and conditions of the intercompany transaction are at arm’s length. The law does not provide for a list of mandatory information to be provided, as this depends on the facts and circumstances of the transaction. The documentation should be available from the time of the transaction. If the information is not available on request, in practice, the taxpayer will be given the chance to remedy this default and to submit the requested information within a certain period. This additional period will depend on the complexity of the transactions.
Transfer pricing documentation requirements apply to multinational enterprises (MNEs) with one or more entities located in the Netherlands:

- MNEs with consolidated revenues of EUR 750 million or more should prepare transfer pricing documentation that consists of a master file, a local file and country-by-country report.

- MNEs with consolidated revenues of EUR 50 million or more, but less than EUR 750 million, should prepare transfer pricing documentation that consists of a master file and local file.

- For MNEs with consolidated revenues of less than EUR 50 million, the current transfer pricing documentation requirements in the Netherlands remain applicable.

If a company in the Netherlands is part of an MNE that has the obligation to prepare a country-by-country report, the company needs to notify the Dutch tax authorities before the end of its financial year and the country-by-country report needs to be submitted to the Dutch tax authorities within 12 months after the financial year.

(c) **Obligation to cooperate**

A company subject to an audit is obligated to cooperate all throughout the process. The obligation rests on the board of directors of the company, as they are the legal representatives of the company. Employees are only allowed to fulfill the obligations of the company if they have been authorized to represent the company. Non-compliance is punishable by law.

(d) **The obligation to provide information**

Upon request, any person is obligated to provide information if the requested information can be of importance for the levying of taxes of the person (or of a third party in the case of third-party investigations) and
the requested information does not fall under the scope of the attorney-client privilege/principle of fair play.

The tax inspector can only request to be provided with information that will help them determine the facts. The opinions or views of a person (or the advisor of this person) do not fall within the scope of the information obligation.

A tax inspector may examine an automated administration system. Data from an automated administration system must be made accessible for inspection and evaluation by a tax inspector, both at the taxpayer’s premises or by means of a data carrier. Similar to the operation of a "primary" paper administration system, operating an automated system must be clarified and explained to the tax inspector.

A tax inspector has the right to make or request copies, printouts and extracts of any information. It is advisable for the company to make its own copies and make a list of everything the tax inspector gathers.

The general principles of proper administration require the tax inspector to demonstrate that the requested information could be relevant with regard to the levying of taxes. This implies that, in the event the tax inspector fails to (successfully) substantiate the information request, no information has to be produced.

On 25 May 2018, the EU Council adopted a directive regarding the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements.198 This EU Directive aims to provide an obligation for intermediaries such as tax advisers, accountants and lawyers to report certain cross-border arrangements that could potentially be used for aggressive tax planning. In cases where

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professional privilege rules apply, or where the intermediary is not based in the EU, the reporting obligation may shift to the taxpayer.

Member States are required to introduce legislation that complies with this Directive by 31 December 2019 at the latest. Such legislation shall apply from 1 July 2020. However, the first reporting period includes reportable transactions implemented between 25 June 2018 and 1 July 2020. As a result, information on potentially reportable arrangements that have occurred from 25 June 2018 onwards should currently already be kept.

(e) Right of entry

A tax inspector carrying out an audit inspection is allowed to inspect the premises used for business purposes. Access must be allowed on weekdays during normal working hours. A tax inspector is not authorized to physically search the offices of a company for documents stored in filing cabinets and/or information on computers against the taxpayer’s will. The tax inspector is authorized to take note of everything that is readily available. Therefore, it is important for a taxpayer to file all documentation and/or files that they have, and not have information/documents lying around during a tax audit.

(f) Attorney-client privilege/Principle of fair play

Attorneys-at-law admitted to the bar in the Netherlands (advocaten) have an obligation to secrecy and a corresponding privilege of non-disclosure. Dutch civil law notaries and in-house lawyers admitted to the bar have the same privilege, subject to certain conditions. The right of non-disclosure (hereafter "legal privilege") is based on the principle that a person should be free to consult a Dutch lawyer or civil law notary (notaris) without fearing that confidential information will later be disclosed. Under legal privilege, a lawyer or civil law notary may refuse to answer any questions or produce any written information when questioned as a witness.

The privilege of non-disclosure is not protected as such under Dutch law, but is available under certain specific provisions of civil, criminal and
administrative law (including tax law). The disclosure of confidential information by a lawyer is punishable under criminal law.

The scope of legal privilege is restricted to information entrusted to the lawyer in their professional capacity, regardless of its form.

Correspondence between a client and an attorney-at-law is therefore covered by the pledge of secrecy and, as a rule, also cannot be seized in a conducted search.

Communications between a client and a tax adviser are not protected by law. However, on 23 September 2005, the Dutch Supreme Court (Hoge Raad der Nederlanden) ruled that pursuant to the fair play principle, the Dutch tax authorities may not have access to the analysis of external advisers made to elucidate the taxpayer’s position and to give them advice in the matter.

In relation to cross-border arrangements that have to be reported based on the DAC 6 Directive, the current Dutch legislative proposal respects attorney-client privilege.199 However, tax advisers cannot rely on the fair play principle and are obligated to report arrangements that fall under the reporting obligation.

(g) Sanctions

Failure to comply with the information and documentation obligations mentioned above can result in sanctions.

(1) Reversal of the burden of proof

If a person or company fails to provide requested and relevant data and information, fails to provide books and documents for inspection, fails to keep proper administrative records and/or fails to comply with documentation obligations, a tax inspector can impose a so-called information notification (informatiebeschikking). If this information

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notification becomes final (i.e., the taxpayer does not contest the information notification or a judge decides the information notification is binding), the taxpayer will be confronted with a reversal of the burden of proof. In that case, the taxpayer has to demonstrate that the assumptions of the tax inspector and the corrections made by the tax inspector are incorrect.

If a company engaging in intercompany transactions has not maintained and kept the required transfer pricing documentation, the burden of proof may also be reversed. The tax authorities can determine the taxpayer’s profit to what they deem to be at arm’s length (within reasonable limitations) and incorporate these arm’s length corrections in the tax assessment. It will then be up to the taxpayer to provide evidence that the assumptions of the tax authorities are incorrect.

Not filing the required tax return may also result in a reversal of the burden of proof.

(2) Administrative fines

The tax inspector can impose administrative fines on a taxpayer that does not fulfill its information obligations.

A default penalty (verzuimboete) can be imposed in the following cases (amounts are for 2019):

<p>| Failing to (timely) file a tax return regarding Dutch corporate income tax or Dutch personal income tax | EUR 5,278 (maximum) |
| Failure to (timely) file a tax return regarding remittance-based taxes (such as VAT and dividend withholding tax) | EUR 131 (maximum) |</p>
<table>
<thead>
<tr>
<th>Failure to (timely) file a tax return regarding payroll taxes</th>
<th>EUR 1,319 (maximum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to (timely) pay remittance-based taxes, or failure to pay remittance-based taxes in time</td>
<td>EUR 5,278 (maximum)</td>
</tr>
</tbody>
</table>

An offense penalty (vergrijpboete) can be imposed in the following cases:

<table>
<thead>
<tr>
<th>Information and/or documentation are intentionally not, or incorrectly, provided to the tax inspector by a taxpayer in connection with a request for a preliminary tax assessment or a request for the revision of a preliminary tax assessment.</th>
<th>100% of the amount erroneously not paid (maximum)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A tax return is intentionally not, incorrectly or incompletely filed by a taxpayer.</td>
<td>100% of the amount of the tax assessment (maximum) or 300% of the tax due in specific cases involving tax evasion by individuals (maximum)</td>
</tr>
<tr>
<td>The tax assessment is set too low, which is attributable to willful misconduct or gross negligence of the taxpayer.</td>
<td>100% of the amount of the additional tax assessment (maximum)</td>
</tr>
</tbody>
</table>
### Section One: Country Analysis

**Handling Tax Disputes in the Netherlands**

<table>
<thead>
<tr>
<th><strong>A remittance-based tax is (partially) not paid, or not paid in time, due to willful misconduct or gross negligence of the taxpayer.</strong></th>
<th><strong>100% of the amount not paid or the amount not paid in time (maximum)</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Not complying with notification and/or reporting obligations in relation to country-by-country reporting.</td>
<td>EUR 830,000 (maximum)</td>
</tr>
<tr>
<td>Not complying with the obligation to report reportable cross-border arrangements (<em>legislative proposal</em>)</td>
<td>EUR 830,000 (maximum)</td>
</tr>
</tbody>
</table>

(h) **Criminal sanctions**

The tax authorities can always proceed to criminal prosecution. Criminal law is invoked whenever certain tax laws need to be enforced. It is the ultimate recourse, which demands that a person meet their obligations relating to the provision of information. A distinction is made between misdemeanors, to which a fine applies as a sanction, and criminal acts for which a jail sentence or a fine can be imposed.

4. **The tax audit from an international perspective**

The Dutch tax authorities benefit from the increasing mutual collaboration in the tax field with other Member States of the EU, as well as with countries that the Netherlands has concluded treaties covering the exchange of information. International cooperation among various tax authorities is not only effective, but is also necessary to enable the gathering of sufficient and accurate information. It helps with making sound decisions regarding the overall acceptability of a tax return and the
transfer prices used in international transactions in particular. Within this framework, European cooperation in the area of mutual tax audits has developed rapidly in recent years. Within the EU and under certain tax treaties, the Netherlands’ competent authorities can request a foreign competent authority to exchange information, and vice versa. The foreign country involved can begin an administrative examination in order to gather the necessary information. Tax authorities are also empowered to initiate simultaneous tax audits that involve one or more taxpayers in different countries. In addition, in the field of VAT, the number of multijurisdictional tax audits and the (automatic) exchange of information between Member States have increased. This is the result of additional European legislation enabling or even requiring Member States to cooperate more intensively in the field of VAT.

(a) Exchange of information

Exchange of information requires a legal basis. There are a number of international legal instruments on the basis of which exchanges of information for tax purposes may take place. The instruments include bilateral tax conventions, the Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters, Tax Information Exchange Agreements (designed specifically for administrative assistance purposes in tax matters), the introduction of country-by-country reporting, or, within the European Community, the EC Directive on Mutual Assistance Directive 2011/16/EU as amended by Directive (EU) 2016/881. Procedures for providing assistance to foreign jurisdictions may also be established in domestic law based on which information may be exchanged even if there is no treaty. The main forms of information exchange are: (a) on request; (b) automatic; and (c) spontaneous.

(1) Exchange of information on request

Exchange of information on request refers to a situation where the competent authority of one country asks for particular information from the competent authority of another country. In the Netherlands, a
taxpayer will not be informed of an exchange of information. This does not mean that one cannot become aware of a request for exchange of information, because a request for information from abroad is often the starting point of a tax audit.

(2) Automatic exchange of information

Information that is exchanged automatically is typically information comprising many individual cases of the same type, usually consisting of details of income arising from sources in the source country, e.g., interest, dividends, royalties, but also income from real estate. This information is obtained routinely (generally through reporting the payments by the taxpayer) by the sending country and is thus available for transmission to its treaty partners. Normally, competent authorities interested in automatic exchanges will agree in advance as to what type of information they wish to exchange on this basis. Information is often exchanged in bulk and the taxpayers involved are not informed of the fact that information is exchanged with another country.

EU Member States are required to exchange information automatically in advance cross-border tax rulings, advance pricing arrangements and reportable cross-border arrangements. EU Member States receiving information will be able to request further information where appropriate.

(3) Spontaneous exchange of information

Information is exchanged spontaneously when one country, having obtained information in the course of administering its own tax laws that it believes will be of interest to one of its treaty partners for tax purposes, passes on this information without the latter having asked for it. Whether information could be relevant or not is mostly determined by the local tax

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200 The first information regarding reportable cross-border arrangements shall automatically be exchanged by 31 October 2020. The first reporting period does however include reportable cross-border arrangements implemented between 25 June 2018 and 1 July 2020.
administration on a case-by-case basis. In the Netherlands, the taxpayer(s) involved is/are normally not notified of the exchange of information.

(b) Restrictions to exchange of information

The competent authorities are allowed to exchange such information as is foreseeably relevant to secure the correct application of a tax treaty or of domestic tax laws. Countries are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

Before sending a request for information, the relevant competent authority should use all means available in its own territory to obtain the information, except where those would give rise to disproportionate difficulties. These efforts should include attempts to obtain information by, for example, the use of the internet and other publicly available information. This basically means that if a tax authority would like to receive information from another country pertaining to a specific taxpayer, an attempt should first be made to obtain this information directly (from the relevant taxpayer) before asking the foreign authority for assistance.

Other general restrictions to consider are as follows:

(i) Countries are not obligated to exchange information at variance with their own laws and administrative practice.

(ii) Information that is not obtainable under the laws or in the normal course of the administration of a country does not have to be exchanged.

(iii) Information that would disclose a trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (public order), does not have to be exchanged.
(c) Multijurisdictional tax audits

Multijurisdictional tax audits come in two forms: simultaneous audits and joint audits. In simultaneous audits, the tax authorities of several countries each perform their own audit on their side of the border, exchange information, and then meet to try to settle the case. In the past, the Netherlands has initiated these kinds of multilateral audits. In a joint audit, there is one single audit team with the same information, and this team has to come to one conclusion. The Netherlands also participates in joint audits of multinational taxpayers. The Netherlands actively invites other countries to join in conducting joint transfer pricing audits.

5. Adjustments with respect to a tax audit

(a) Adjustments to assessment taxes

If a final tax assessment has already been imposed and a tax inspector wishes to levy additional tax, the tax inspector can impose an adjustment to the tax assessment, a so-called additional tax assessment (navorderingsaanslag), if the following conditions are fulfilled:

(i) The tax inspector came across a "new fact." The additional assessment must be based on a fact the tax inspector previously had no knowledge of, nor should have had knowledge of, when the original assessment was issued; or

(ii) The taxpayer acted in bad faith. No "new fact" is necessary in the event information regarding this fact was deliberately withheld or falsely supplied to the tax authorities by the taxpayer; and

(iii) The additional assessment must be issued on time:

a. With respect to Dutch-sourced income: The tax inspector will be limited to a time period of five years after the taxable year has ended.
b. With respect to income arising from foreign sources: A period of 12 years after the taxable year has ended is applicable. Aforementioned periods are extended with any extension that was granted for the filing of the tax return.

Obvious writing and typing errors can be corrected by the tax inspector on the condition that the taxpayer: (i) is aware of or should be aware of the error(s); and (ii) recognizes or should recognize the error(s). Additional tax assessments may also be issued in the event a tax assessment was erroneously determined at a too-low amount or if erroneously, no tax assessment was issued at all, and this, within reason, should have been recognizable to the taxpayer. Based on Dutch law, such a mistake is deemed to have been recognizable to the taxpayer if the amount of tax that was not levied is at least 30% of the tax due by law.

(b) Adjustment to remittance-based taxes

Remittance-based taxes such as VAT, dividend withholding tax and wage withholding tax are not subject to the "new fact" or the bad faith conditions. If, following a tax audit, the tax inspector wishes to levy additional tax, they are limited by a five-year period in which they can impose an additional tax assessment (naheffingsaanslag). A 12-year period may be applicable in the event beneficial ownership of real estate was acquired.

6. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

In the Netherlands, undergoing a tax audit is a fact of business life, and must be handled in a calm and responsible manner. Although the taxpayer is normally burdened with numerous requests for information, which may impair the running of the taxpayer’s day-to-day business, a tax audit should be dealt with cooperatively and preferably settled on an amicable
basis if possible. The taxpayer's rights and obligations should, of course, always be observed.

(b) Who should run the show?

In general, the local people (i.e., the managing director, the responsible tax manager and/or the tax counsel) have the most detailed knowledge about the facts and circumstances of the company and the most experience in dealing with Dutch tax officials. They know the rules of conduct best and should be expected to have sufficient expertise and creativeness to bring even a difficult tax audit to a successful end. Generally, it is not advisable to have people from foreign affiliates directly participating and meeting with the tax officials.

(c) Settlement or litigation?

Litigation is one of the ways to resolve a dispute. Disputes can often be resolved without the intervention of a judge. Nevertheless, experience shows that the most favorable settlements are reached when the tax authorities know that a taxpayer is willing to litigate if necessary. Potential tax disputes may be settled during an audit, thus preventing litigation. It is generally preferred to settle tax disputes at the administrative level if possible, if only because of the potential duration of tax litigation proceedings, during which the taxpayer may not have the comfort of knowing whether or not the contested (bookkeeping) practices will eventually be accepted. In addition, in certain situations, a specific dispute should be viewed as a bigger picture, which may strategically demand a settlement of an issue that is open for litigation, but will achieve a favorable settlement of another issue that is less suitable for litigation.

In the following events, litigation should be seriously considered or is simply unavoidable:

- If settlement at court level is expected to be more favorable than at the administrative level
• If questions of principal importance for the taxpayer or for the tax administration are at stake

• If certain practices may be, or have been, qualified by tax officials as tax evasion

• If constitutional issues are at stake, such as a conflict between domestic law and EC law, and an incorrect or untimely implementation of EC Directives into domestic law

(d) What information should be provided?

As discussed before, the tax inspector is allowed to ask the taxpayer to provide information. The powers of the Dutch tax authorities are far-reaching, but constrained by the law and by the general principles of proper administration. The law provides that only information relevant to the levying of taxes may be requested by the tax inspector. Moreover, the general principles of proper administration mark the boundaries that the tax inspector has to comply with if requesting information.

7. Conversion of a regular tax audit into a criminal investigation

A tax audit usually starts as an administrative investigation. However, during a tax audit, facts and circumstances that are covered by fiscal sanctions may surface. The audit may then shift from the administrative field to the criminal field (i.e., from a regular tax audit to a criminal investigation).

The distinction between a tax audit and a criminal investigation is important because different rights and obligations are applicable. In the Netherlands, a tax audit is assigned to the tax inspector of the Dutch tax authorities, whereas the investigation of tax offenses is assigned to the Fiscal Intelligence and Investigation Service (fiscale inlichtingen- en opsporingsdienst or FIOD).
If a taxpayer is subject to a criminal investigation, or the administrative tax audit is converted into a criminal investigation, the following should be taken into consideration:

(a) **Right not to incriminate oneself (cautie)**

As previously discussed, the taxpayer is obligated to cooperate with the tax inspector during a tax audit. However, from the moment a (legal) person is suspected of criminal behavior, the "suspect" is not obligated to cooperate in the examination nor are they compelled to make any incriminating statement with respect hereto. The investigator should inform the taxpayer of the suspicion and inform the taxpayer of their right to remain silent once they have officially been declared a suspect.

(b) **Entering premises and residences/searches**

Investigating agents in an examination of criminal tax offenses have the right to access any location, insofar as this is reasonably necessary in the fulfillment of their tasks, without requiring any special permission to do so.

An investigating agent should identify themselves in advance and inform those present of the purpose for entering the premises. The taxpayer should always demand proof of identity and make a copy or write down the relevant information. Special rules apply regarding entry into homes or residential properties.

Within the scope of an investigation of criminal tax offenses, a search can be initiated. Searches are a part of the investigation in which a search is specifically and systematically conducted regarding items and documents that can be legally confiscated.

(c) **Confiscation of documents and demanding that documents be surrendered**

During a regular tax audit, the taxpayer is obligated to provide (copies of) documents for inspection upon the request of the tax inspector. However, the tax inspector is not allowed to confiscate any documents. In criminal tax cases, written evidence fulfills an important function.
documents that may reveal the facts may be confiscated during an investigation of tax offenses. All other documents that may involve future sanctions must be kept secure. Given that documents are not always readily at hand, the investigator can demand that documents be turned over. The suspect is obligated to comply with such a demand.
II. Resolution procedures

1. Alternative dispute resolution

In recent years, the tax authorities experimented with mediation in tax cases. External mediators interceded between the tax authorities and taxpayers in administrative appeals. Participation in the experiment was on a voluntary basis.

2. Administrative level

A taxpayer can lodge an objection with the Dutch tax authorities against a tax assessment. There are no filing costs regarding an administrative objection.

(a) Formal requirements in an objection procedure

During the objection procedure, strict procedural requirements are applicable. An objection letter has to be lodged with the competent tax inspector within six weeks after the date of the tax assessment. An objection filed after the prescribed period will be considered inadmissible.

The objection letter is required to be in the Dutch language and the objection must be substantiated (i.e., the letter must contain the grounds of the objection). Before the tax inspector decides on the objection, a taxpayer should be given the opportunity to verbally explain the objection during a hearing. The hearing must be held by a tax inspector other than the inspector who made the initial decision or who imposed the tax assessment. The final decision on the objection must also be taken by a tax inspector other than the one who has made the initial decision or the one who imposed the tax assessment.

The tax inspector should make a decision within six weeks from the moment the objection period expired (i.e., six weeks after the six-week period for lodging the objection has expired). The tax inspector will be allowed to extend this period with an additional six weeks and a further
extension can be agreed upon by both parties. In practice, an objection procedure may take much longer. If the tax authorities do not reach a decision within the aforementioned period, formal steps can be taken against the tax inspector and, ultimately, an appeal can be lodged with the district court, provided certain requirements are met.

(b) Suspension of payments

Payment of the contested tax assessment is not suspended automatically during the objection phase. If the taxpayer wishes to be granted a suspension of payment, they are required to submit a request to the tax collector (the department within the Dutch tax authorities that deals with the collection of taxes). The tax collector will grant the request if the collection risk is low.

The tax collector may request security for the amount of unpaid tax (e.g., a bank guarantee or a pledge on certain assets). If the tax assessment involves an undisputed amount, this amount has to be paid according to the original stipulated term in the tax assessment.

Interest is calculated on the unpaid amount of tax. If the disputed amount of tax was paid and the taxpayer wins the case, no interest will be compensated.

If the tax inspector decides favorably on the objection, the costs of the administrative objection, such as costs for legal assistance, can be reclaimed. However, the amount of this compensation is limited by law, and in practice, not more than a fraction of the actual costs involved are reimbursed.

3. Judicial tax litigation

(a) Tax litigation

If the decision of the tax inspector during the objection phase is wholly or partially unfavorable, an appeal can be lodged with the district court.
against this decision. If the decision of the district court is wholly or partially unfavorable to the taxpayer or for the tax inspector, an appeal against this can be lodged with the court of appeal and, ultimately, with the Netherlands Supreme Court.

(b) Formal requirements in a court procedure

The notice of appeal against the decision by the tax inspector has to be filed with the district court within six weeks from the date of the decision of the tax inspector. A notice of appeal filed after the prescribed period will be considered inadmissible.

The notice of appeal has to be in the Dutch language and must be fully substantiated. It should be clear from the notice of appeal what the issue is and what the dispute amounts to. In addition, the district court has to be furnished with a copy of the decision on the objection by the tax inspector.

During the appeal procedure, it is not required that the taxpayer is represented by an attorney or tax adviser. Instead, the taxpayer itself or a representative can appear before the district court.

A court fee is required when lodging an appeal to the lower court. The court fee (griffierecht) ranges from EUR 47 to EUR 174 for individual taxpayers and EUR 338 for legal entities (amounts applicable for 2019).

(c) The court procedure

Upon receipt of the notice of appeal and the court fee, the district court will provide a copy of the notice of appeal to the tax inspector. Subsequently, the tax inspector will respond to the appeal. This response will be forwarded to the taxpayer by the district court. The district court has the authority to initiate its own investigations, for example, by requesting additional documentation. However, at this stage of the procedure, the active involvement of the district court is the exception.
The taxpayer can either end the written procedure and wait for the summons for the court hearing or respond to the positions taken by the tax authorities by filing a replication (Conclusie van Repliek). For their part, the tax authorities have the right to reply to a possible replication by preparing a rejoinder (Conclusie van Dupliek).

In general, the district court will give the parties the opportunity to attend a court hearing. Depending on the case, the degree of difficulty and/or the amount involved, one or three judges will rule on the case. The taxpayer and/or its attorney/adviser are not obligated to attend the court hearing, but the tax inspector will always attend a hearing due to the internal guidelines of the Dutch tax authorities. For this reason, attendance at the hearing will be important in order to be able to reply to questions from the court and respond to statements from the tax inspector.

Although parties have the right to present new facts and/or arguments during the court hearing, one should observe caution when doing so. The court hearing will usually be adjourned for the court to review the new facts/materials or arguments. More importantly, the tax inspector should be given time to respond to these new facts. Since it could frustrate the court’s agenda, new facts and/or arguments should be presented to the court and the opposite party prior to the court session, unless presentation during the hearing cannot be avoided.

During the court hearing, it is possible to hear witnesses or experts. From a practical perspective, it is advisable to announce in advance that a witness and/or expert will be brought in.

Tax court hearings are not open to the public; the hearing is held behind closed doors. Although the ruling of the court is public, the written ruling will usually be published without the names of the parties. The taxpayer, thus, does not have to be concerned about negative publicity or the disclosure of confidential information.
After the court hearing, and unless the court has further questions, the district court will rule within six weeks from the date of the session. In practice, depending on the case, this term can be much longer. If the district court is not able to render a ruling within six weeks, parties will be informed.

If the district court rules wholly or partially in favor of the taxpayer, the court fee will be refunded. Upon application, the district court may also rule that the tax authorities have to reimburse the taxpayer for its expenses relating to the procedure. The reimbursement is limited by law and is usually just a fraction of the actual costs of a procedure. A reimbursement for costs has to be explicitly requested by the taxpayer in the appeal.

An appeal with the court of appeal can be lodged against the ruling of the district court.

(d) Suspension of payments

Lodging an appeal with the district court (and other courts) will not automatically result in a suspension of payment of the disputed amount.

During the appeal procedure before the district court (as well as before the court of appeal and the Supreme Court), a request for a suspension of payment can be lodged with the tax collector. If the tax collector grants a suspension of payment and the appeal is unsuccessful, the disputed amount, including interest on underpaid taxes, must be paid.

(e) Court of appeal

The notice of appeal has to be lodged with the court of appeal within six weeks from the date of the ruling of the district court and rules similar to those for the initial appeal with the district court apply. If a notice of appeal is filed after the prescribed period, this constitutes an inadmissible appeal.
The notice of appeal has to be in the Dutch language and must be fully substantiated. In addition, a copy of the ruling of the district court must be provided to the court of appeal. A court fee is due in connection with the appeal to the court of appeal. The court fees range from EUR 128 to EUR 259 for individual taxpayers and EUR 519 for legal entities (amounts applicable for 2019).

A new request for suspension of payment has to be lodged with the tax collector.

As in the case of the district court, the court of appeal will rule on the facts and the legal questions. It can be expected that, in addition to the arguments against the position of the tax authorities, arguments against the district court ruling are required for an admissible appeal.

(f) The Supreme Court

An appeal to the Netherlands Supreme Court (Hoge Raad) can be lodged against the decision of the court of appeal. The Supreme Court accepts the facts as established by the court of appeal and limits its ruling to the formal aspects of the procedure and the legal questions. A court fee is required in these proceedings as well. Legal fees range from EUR 128 to EUR 259 for individual taxpayers and EUR 519 for legal entities (amounts applicable for 2019).

During an oral hearing of the case, which is the exception before the Supreme Court, or when the taxpayer wants to file a written pleading, the taxpayer must be represented by an attorney-at-law (advocaat).

A new request for suspension of payment has to be lodged with the tax collector.

Finally, the Supreme Court can ask for a preliminary ruling by the Court of Justice of the EU for fundamental EU law-related questions.
(g) Criminal procedure

The public prosecutor may initiate separate criminal proceedings for crimes such as tax fraud. This procedure follows the general rules of the criminal procedure. In principle, the so-called *una via* doctrine applies. This means that the same criminal action cannot be penalized more than once. As a result, if a tax assessment was imposed including penalties, it is no longer possible for the public prosecutor to prosecute the same issue in a separate criminal procedure.
III. Competent authority procedures

In the event a person or a company faces or is likely to face double taxation, and no provision for the prevention of double taxation is applicable, the person or the company may apply for the elimination of double taxation by way of a competent authority procedure under a bilateral tax treaty. Within the EU, a company that is a resident of an EU Member State can also apply for the EU Arbitration Convention, provided that both states involved are signatories to this convention.201

The Dutch government actively promotes the effectiveness of both procedures and is generally willing to resolve double taxation issues.

1. Bilateral tax treaties

A person residing in the Netherlands for tax treaty purposes and subject to economical or juridical double taxation is allowed to invoke a competent authority proceeding under the applicable bilateral tax treaty. All bilateral tax treaties for the avoidance of double taxation concluded by the Netherlands contain a provision similar to Article 25 of the OECD Model Convention.

The OECD has recognized the obstacles relating to the competent authority proceedings of Article 25 of the OECD Model Convention. It therefore launched a project to improve the effectiveness of this procedure. Attention is hereby focused on operational and substantive issues, as well as on ways to ensure that the competent authority

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201 Convention of 23 July 1990 on the elimination of double taxation in Connection with the Adjustment of Profits of associated Enterprises (90/436/EEC). In 1995, 2005 and 2008, the EU Member States entered into a convention for the accession of new EU Member States to the EU Arbitration Convention.
proceedings will reach a satisfactory conclusion within a reasonable time frame.\textsuperscript{202}

On 30 January 2007, the OECD Committee on Fiscal Affairs adopted a report regarding the inclusion of a new para. 5 in Article 25 of the OECD Model Convention.\textsuperscript{203} This paragraph provides for a possibility that a case may be referred to a binding arbitration procedure, upon the request of the taxpayer and/or one of the competent authorities, or by mutual agreement between both competent authorities. Such a binding arbitration procedure follows the failure of competent authorities to eliminate double taxation within two years after Article 25 of the OECD Model Convention was invoked. The OECD Manual on Effective Mutual Agreement Procedures (MEMAP) is endorsed by the Netherlands.

As of 1992, the Netherlands, as a general policy, has been in favor of including an arbitration clause in a competent authority article when concluding a bilateral tax treaty.\textsuperscript{204} The Netherlands has included an arbitration clause in tax treaties with the following countries: Albania, Armenia, Bahrain, Barbados, Bermuda, Brazil, Canada, Croatia, Curacao, Egypt, Estonia, Ethiopia, Georgia, Germany, Ghana, Hong Kong, Iceland, Japan, Jordan, Kazakhstan, Kenya, Kuwait, Latvia, Lithuania, Macedonia, Malawi, Moldavia, Mexico,\textsuperscript{205} Norway, Poland, Qatar, Russia, Sint Maarten,

\textsuperscript{202} OECD, Improving the Process for Resolving International Tax disputes, 27 July 2004. An organized overview of country profiles is now available at the OECD website.
\textsuperscript{203} OECD, Report on Improving the Resolution of Tax Treaty Disputes (February 2007).
\textsuperscript{204} For example, the tax treaty with the US concluded on 18 December 1992. As regards the implementation of Article 29 (competent authority proceedings) of the US-Netherlands tax treaty, an administrative agreement was published on 7 October 2003.
\textsuperscript{205} The double tax convention itself does not include an arbitration clause. However, the Protocol annex to the double tax convention includes a provision that conveys, if, after 11 October 2007, in a double tax convention concluded between Mexico and a third state, an arbitration clause is included, which is essentially equal to the provision on arbitration in the OECD Model Tax Convention, such provision will apply between the Netherlands and Mexico from the date on which the Agreement between Mexico and the third state takes effect.
Slovenia, South Africa, Switzerland, Uganda, Ukraine, United Arab Emirates, the UK, the USA, Uzbekistan and Zambia.

On 7 June 2017, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") was signed, covering 68 jurisdictions. The MLI will modify a large number of existing tax treaties with anti-tax avoidance measures developed in the OECD BEPS project. The provisions of the MLI will only apply between countries that made matching choices. One of the measures included in the MLI relates to the mutual agreement procedure (MAP). The MLI intends to strengthen the effectiveness and efficiency of the MAP. Whether the MLI will affect the bilateral tax treaties concluded by the Netherlands depends on whether the Netherlands and the country with which the Netherlands has concluded a tax treaty make matching choices in relation to the MAP provision of the MLI.

2. EU Arbitration Convention/EU Directive

Within the EU, double taxation can be eliminated, separate and apart from the applicable treaties for the avoidance of double taxation, under the EU Arbitration Convention.

The Arbitration Convention has a significant advantage over regular treaties for the avoidance of double taxation, in that it applies to situations, including permanent establishments of EU companies in other EU states. The EU Arbitration Convention guarantees the removal of double taxation within a certain period. However, the scope of the EU Arbitration Convention is narrower than the scope of competent authority procedure under treaties for the avoidance of double taxation. Whereas the EU Arbitration Convention solely relates to transfer pricing disputes, the competent authority procedure under tax treaties is applicable to all double taxation cases that are not in accordance with the provisions of that specific tax treaty.
Under the EU Arbitration Convention, Member States are given two years to resolve the double taxation through the competent authority procedure. The Dutch position regarding the commencement of the two-year period is that this term is deemed to begin at the date on which these occur:206

- The competent authority receives the request.
- The tax assessment incorporating the adjustments is irrevocably determined.

If the conditions of an early MAP207 are met, the two-year term starts, in principle, earlier (i.e., at the moment the final assessment is imposed) or at the time the full request has been received.

If EU Member States have not reached an agreement to eliminate double taxation within this two-year period, the case must be referred to an arbitration committee. This committee has to present its advice within six months. After the arbitration committee has given its advice, the competent authorities of the Member States are obligated to resolve the double taxation within six months. If they fail to resolve this within this period, the advice of the arbitration committee becomes final.

In addition to the European Arbitration Convention, the EU Council adopted a directive on tax dispute resolution mechanisms in the EU.208 This directive was adopted to ensure an effective resolution of disputes concerning the interpretation and application of bilateral tax treaties and the European Arbitration Convention. In general, the scope of the directive is broader than the scope of the European Arbitration Convention and should provide taxpayers with a time limit for the duration of procedures and increase conclusive and enforceable decisions. The laws of the Member

206 MAP Decree, Sec. 5.1 (Decree of 29 September 2008, nr. IFZ2008/248M).
207 MAP Decree, Sec. 3.1.2.1. further explained on page 33.
State should comply with the directive by 30 June 2019 at the latest. At the time of writing, the legislative procedure in the Netherlands is still pending.

For additional information on the European Arbitration Convention and the EU Directive, we kindly refer to Section Four: Tax Dispute Resolution Mechanisms within the EU.

3. Dutch standard policy for the competent authority procedure

A request for competent authority assistance must be submitted within three years after the first notification from which double taxation may result.

Individual bilateral tax treaties may contain other terms, however. The Dutch position is that the request of a taxpayer will be deemed to have been submitted in a timely manner if the request is received within three years (but note that this period could differ in specific tax treaties) after the date of the issuance of the tax assessment in which the adjustment is reflected, or the moment the grounds for the adjustment are explained, if this is made at a later time.\(^{209}\)

As the competent authority procedure involves more than one jurisdiction, the taxpayer must ascertain the position of the other jurisdiction with respect to the commencement of the three-year term, within which a request ought to be filed to get access to the competent authority phase. A deviating position of another jurisdiction regarding the three-year term may lead to an earlier commencement of the three-year term than would be the case from the Dutch position, thus barring access to competent authority proceedings if the taxpayer files its request too late.

If a competent authority request is filed with the competent authorities in a timely manner, the Netherlands, in principle, allows for a corresponding

\(^{209}\) MAP Decree Sec. 2.2.
adjustment or a withdrawal of their adjustment, even if the statute of limitations has expired in the Netherlands. \(^{210}\) Other jurisdictions may take a different view, however, depending on their domestic laws and the applicable competent authority treaty provision (whether or not this includes an override position if the domestic statute of limitations has expired). It is therefore recommended that a taxpayer review in the other jurisdictions whether the statute of limitations can be suspended (e.g., by filing an additional tax return). This depends on the domestic law of the other jurisdictions.

The Netherlands encourages early access to the mutual agreement process (i.e., the MAP procedure), which may take place before the actual adjustment is proposed or an assessment containing an adjustment is issued. \(^{211}\) Furthermore, the target period for resolving double taxation issues is two years, based on a chess clock principle, meaning that for the two-year term, only the time during which the Dutch competent authority is required to take action is considered.

The MAP process commences through the filing of a formal request. This request can be filed when a reasonable assumption exists that taxation will result not in conformity with the applicable treaty to which the Netherlands is a party. \(^{212}\) The request must be filed within a three-year period after the first notification that double taxation may result. No special form is required to file a competent authority request in the Netherlands. However, the website of the Dutch Ministry of Finance contains a sample request that can be downloaded and printed for use. \(^{213}\)

\(^{210}\) MAP Decree Sec. 2.2, the new para. 5 to Article 25 of the OECD Model Convention follows the same format; a solution will be implemented notwithstanding any time limits under domestic law. A similar format is also enclosed in Article 13 of the EU Arbitration Convention.

\(^{211}\) MAP Decree, Sec. 1.

\(^{212}\) MAP Decree, Sec. 2.1.

\(^{213}\) The sample request is available online and only in the Dutch language.
A MAP request to be filed in the Netherlands should be forwarded to the following address and with this subject line:  

Ministry of Finance  
Directorate International Fiscal Affairs  
P.O. Box 20201  
2500 EE The Hague  
The Netherlands  

Re: Competent Authority Procedure  

This also applies to requests for corresponding adjustments in the event of (foreign) transfer pricing adjustments. These are coordinated with the Coordination Group Transfer Pricing for advice.  

User fees are not charged in the Netherlands. Upon the request of the taxpayer, a deferral of tax collection will be granted until the date on which both the domestic and international procedures have been completed.  

A penalty will be reduced if the amount of the adjustment is waived as a consequence of the competent authority proceedings.  
Furthermore, the Dutch government will seek to ensure congruence between the assessment and collection of interest charged and paid by the other states.  

214 MAP Decree, Sec. 2.4.  
215 MAP Decree, Sec. 8.1.  
216 MAP Decree, Sec. 8.2.  
217 MAP Decree, Sec. 8.2.
The contents of the MAP request must follow the recommendation of the OECD Manual on Effective Competent Authority Procedures, and consist of the following:218

a. Information of the taxpayer submitting the request and the involved foreign parties (name, address, taxpayer identification number)

b. Information on the relevant facts and circumstances of the issue presented (including the relationship between the taxpayer and other parties)

c. The (other) countries to which the request relates

d. An explanation of the reason (possible) double taxation occurs or why the principles of Article 4 of the EU Arbitration Convention are not observed (if this pertains to a request under the Arbitration Convention)

e. The chosen treaty basis for the request (bilateral treaty or EU Arbitration Convention)

f. A choice in relation to whether a regular or accelerated MAP process is preferred

g. Information on the tax years involved

h. Information on the competent tax authorities with jurisdiction over the matter

i. Copies of assessments, reports of audits from the revenue service or other measures that (may) result in double taxation

j. Information on the rights that the taxpayer or other parties have invoked with respect to the relevant transactions and information on the procedures that are still available in the Netherlands or other

218 MAP Decree, Sec. 2.5.
countries with respect to the relevant tax assessments; information regarding judicial decisions relating to the matter

k. A commitment from the taxpayer that it will comply with all reasonable requests from the competent authority as soon as possible and will make all documents available for the competent authorities

l. In the event of an accelerated MAP process, a duly signed letter by the taxpayer in which a request is made to the competent tax inspector to postpone a decision on the letter of objection for the term of the MAP and possible subsequent arbitration procedures

The same information should be provided to the competent authorities of the other jurisdiction involved. Taxpayers are granted the possibility to verbally present their case and should request such in their filing if they want to avail themselves of that possibility.

Early MAP is possible, but only if these three requirements are met:219

a. The taxpayer must agree with the postponement of the decision on the letter of objection sent to the tax inspector for the term of the MAP process and possible subsequent arbitration in writing.

b. The request for accelerated MAP must have been filed prior to the tax inspector’s decision on the letter of objection to an assessment.

c. If the filing is based on the Arbitration Convention, agreement with the contents of a standardized determination agreement that provides that domestic legal remedies should not have been availed of.

The Dutch authorities strive to keep the taxpayer informed by sending a notice of receipt of the filing, plus a possible request for additional information within five working days after the receipt of the MAP filing. Within two months after the filing, additional information will be

219 MAP Decree, Sec. 3.1.2.1.

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requested, if required. The Dutch authorities will inform the treaty partner and provide them with a copy of the request and a confirmation that the request was submitted within the requisite time.\textsuperscript{220} In the case of the EU Arbitration Convention, it will be provided when the two-year term (Article 7-1, Arbitration Convention) commences. The competent tax inspector will also receive a copy of the request, all within one month after the receipt of the filing for MAP.

If an MAP filing is based on a situation that is deemed to not result in double taxation or taxation in violation of the treaty, the request may be denied. The request will be denied as well if the filing is made too late, so that it is no longer likely that an MAP can be successfully commenced.

The Dutch authorities strive to inform their treaty partners of their position with a position paper within four months after the two-year term within which resolving the issue has commenced.\textsuperscript{221}

Once resolution is obtained, the taxpayer is requested to agree on the outcome in writing. Implementation of the agreement can be done by way of a discretionary reduction of the assessment in the Netherlands, if the outcome results in a reduction in Dutch taxes. The applicable five-year statute of limitations can be extended for this purpose.\textsuperscript{222} If no resolution is obtained, the taxpayer can avail itself of other legal measures or arbitration, if such is provided for under the applicable treaty. Arbitration under the EU Arbitration Convention is discussed in Section Four.

In the event double taxation is caused by an adjustment originating in the Netherlands, an extension can be granted to pay taxes due upon the request of the taxpayer. It should be noted that the sample request provided by the Ministry of Finance does not contain a provision for

\textsuperscript{220} MAP Decree, Sec. 4.2.
\textsuperscript{221} MAP Decree, Sec. 5.4.
\textsuperscript{222} MAP Decree, Sec 6 and Sec. 6.1.
extension of payment, however. In the event of an accelerated MAP, the extension is granted automatically.

Interest obligations due can be made part of the MAP process. The Netherlands has entered, for example, into an agreement regarding interest payments with France.\(^{223}\)

The filing of an MAP request is deemed to constitute an approval of the exchange of relevant information. No separate acknowledgement will be provided by the Dutch tax authorities pursuant to Article 5(2) and Article 7(2) of the Act on International Assistance within the Levying of Taxes.\(^{224}\)

The MAP outcome constitutes a one-time assessment of facts and circumstances in certain years. The outcome therefore constitutes no precedent for subsequent years.

\(^{223}\)http://www.minfin.nl.

\(^{224}\)MAP Decree, Sec. 8.3.
Handling Tax Disputes in Poland

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I. Managing the Tax Audit Process

1. The Polish binding rulings regime

Poland has been implementing the binding rulings ("Individual Interpretations") regime since 2003. This was significantly amended on 1 July 2007. A binding ruling is an interpretation of particular tax law provisions made by the competent tax authority based on the circumstances described by the taxpayer. Such an interpretation is binding on the competent tax authorities, but is not binding on the taxpayer (or other persons submitting the motion for a binding ruling). In practice, taxpayers tend to follow the binding rulings issued by the tax authorities or try to challenge these in appeal proceedings. Binding rulings are issued upon the submission of a motion, which may be submitted by any person interested in receiving a binding ruling (e.g., a taxpayer, a tax remitter or a potential investor who plans to start business activities in Poland).

The observance of a binding ruling by the taxpayer (or another applicant) prior to the change to the same binding ruling must not be detrimental to the taxpayer. However, in some cases, a binding ruling will not protect the taxpayer from the payment of due tax, but exempt it from the payment of penalty interest and other sanctions in cases where the interpretation of the relevant tax authority is different from that given in the binding ruling obtained by the taxpayer.

The person applying for the binding ruling is obligated to describe exhaustively the factual background of the case or future event, as well as its position concerning the legal evaluation of the case. A binding ruling cannot be issued with respect to cases that are presently the subject matter of pending tax proceedings or tax audits, or if the case has been settled in a decision or ruling of a tax office or tax and customs office (these are two different types of offices). The fee for a motion for a binding ruling is PLN 40 (approximately EUR 8) for one issue that has been resolved by the authorities. It must be paid within seven days from the...
day on which the motion was filed. If the fee is not paid, or if the taxpayer (or another applicant) fails to exhaustively describe the state of affairs or future events, the application will not be processed.

Individual Interpretations contain an evaluation, with legal grounds, of the taxpayer’s standpoint. In situations where the binding ruling is detrimental for the taxpayer, exhaustive justification of the tax authority’s position must be included in the binding ruling. However, if the taxpayer’s standpoint is correct (in the view of the tax authority), the binding ruling may only confirm the position of the taxpayer and a detailed justification is not needed.

The time limit for issuing a binding ruling is three months from the day on which the motion was submitted. If the binding ruling is not issued within this period, the taxpayer’s standpoint, which is outlined in the motion, will be considered binding on the tax authorities, following the day on which the three-month period ends.

The taxpayer, who has a right to file a complaint against the binding ruling with the voivodeship administrative court, can challenge negative binding rulings.

From 1 November 2019, a taxpayer may also apply for binding information on VAT rates applicable to goods or services on or after 1 April 2020. The process of obtaining such information is in many ways similar to binding tax rulings. The main difference is that the binding information on VAT rates is issued in the form of a decision, which can be challenged first at the administrative level — by way of an appeal to the same authority — and then at the administrative court level — by way of a complaint with the voivodeship administrative court.
2. Tax audits

(a) Selection of tax audit targets

There have always been tax audits in Poland and it has been hard to maintain calm during such audits. However, it is possible to deliberate over their intensity, the scope of matters to which they apply and the group of entities subject to the audits, as well as, unfortunately, the political undercurrent, since these items have been subject to change over the last few years. The hypothesis can easily be made that, although in the early years (after the systemic transformations in Poland in the early 1990s), the quantity (or number) of audits was decidedly greater than their quality (i.e., understanding of the business processes taking place in the market economy and the technical knowledge of the auditors). The trend has now gone the opposite way. Audits are held less frequently (relatively speaking), but these are decidedly more intensive in both documentary and technical terms since, together with the development of the market economy, the knowledge of the auditors on the mechanisms of the economy and activities of the entities in the market economy have progressed.

This means that the audits are no longer oriented purely toward finding errors and other shortcomings in the documentation, but they also seek to understand the technicalities of the business processes taking place in the taxpayer’s business and the resulting tax problems, together with verifying the taxpayer’s adherence to and alignment with the legal requirements.

A separate issue that taxpayers and authorities conducting the audit must face is the quality of established tax law. It could be argued that the current tax law is a set of poorly thought-out regulations that are often in conflict with each other (a series of contradictory provisions can be found in a single legal act) and they fail to reflect the movements of the developing market economy. Such a state of affairs means that the taxpayer will try to resolve disputable matters on its own and, furthermore, it will often follow the opinion presented by the tax
authorities, a move that will not always be beneficial. That is why it is highly recommended that taxpayers ask tax advisers for assistance when they are not sure if they are properly abiding by Polish tax regulations or if they are presenting an opinion that is different from that of the tax authorities.

Qualified tax advisers could help the taxpayer properly interpret unclear tax regulations, which should decrease the risk of potential disputes.

It is not possible to rely on court judgments with respect to all decisions issued by the tax authorities. This can be confirmed on many grounds. First, the specific court opinion is binding only on the parties in the dispute. In other cases, such an opinion may only be treated as an argument supporting the taxpayer’s view. Second, it is common practice for two different judgments to be issued in two similar cases. Thus, the argument that a court has issued a positive judgment in a case similar to the taxpayer’s case may be weakened by another contrary judgment issued by a different court. Finally, two main disadvantages of the court proceedings are the long process in the court system — since it is sometimes necessary to wait up to two years for a decision — and the often insufficient technical knowledge of the judges presiding over the given cases.

Despite the issues and problems mentioned above, it must be emphasized that court opinions in general and the opinions of the Supreme Administrative Court in particular are highly respected by practitioners and widely commented on among taxpayers and the tax authorities.

From the beginning of 2009, significant changes have been introduced to the Polish Tax Code. In particular, a non-final decision is no longer enforceable, unless the decision has been rendered immediately enforceable. This is possible under the following circumstances: a tax authority has information from which it follows that enforcement proceedings are pending against the party with respect to other receivables; a party does not have assets of the value corresponding to the
amount of tax arrears with default interest on which it is possible to establish compulsory mortgage or fiscal pledge, which would have the priority of satisfaction; a party performs an act consisting of the transfer of assets of significant value; or a period until the lapse of the period of limitation of the tax obligation is shorter than three months.

However, a final decision is generally enforceable, unless its enforcement was suspended. A tax authority of the first instance may suspend enforcement of such decision in the event a complaint is filed with the administrative court until the ruling of the court becomes valid.

3. **Advance preparation for tax audits**

The audits may be performed by two types of authorities: the tax authorities (e.g., the head of the Tax Office), which are also responsible for, among other things, the collection of taxes; or by the special authority specializing in conducting audits — the tax and custom authorities (i.e., the head of the Tax and Customs Office). All activities are actually performed by tax or customs and fiscal inspectors in the name of the appropriate authority.\footnote{There are some differences between the procedure before the tax authorities and that before the tax and customs authorities. For example, since 1 March 2017, an appeal against a decision issued by the head of the Tax and Customs Office is verified by the same body, i.e., by the head of the Tax and Customs Office, whereas, appeals against decisions issued by the head of the Tax Office are still verified by the director of the Tax Chamber. These differences will not be discussed in detail.}

A tax audit starts with the delivery of authorization to perform a tax audit. In this authorization, the tax authority specifies elements, which are as follows:

- The addressee; the extent of the audit that tax liabilities are to be audited (e.g., corporate income tax (CIT) and VAT, among others)
- The period to which the audit applies
The people conducting the audit

As already mentioned, such an authorization must be delivered to the taxpayer in accordance with the applicable procedure. In actual practice, the auditors will most frequently go to the taxpayer’s registered office and deliver the decision to the people authorized to represent the given taxpayer. The tax audit usually starts in this manner.

Tax authorities generally should notify the taxpayer of the intention to initiate the audit with a seven-day notice (to initiate the audit before the lapse of a seven-day period, the taxpayer’s consent is required). If the audit is not initiated within 30 days following the date indicated in the notification, the initiation of the audit will require another notification. The notification is not necessary when the tax and customs authorities initiate the audit.

Another important issue related to this method of starting the audit is that Polish tax law provides for specific and related voluntary disclosures. If a taxpayer "discovers" irregularities in tax settlements as a result of an internal audit (which, for example, may be performed by a taxpayer in the period between a delivery of the above-mentioned notification and the actual date of the initiation of the tax audit), it has the opportunity to correct the tax returns submitted earlier and pay the tax due together with default interest. Such a correction should be supported by an explanation of the reasons why such irregularities have occurred and what actions have been taken to correct the previous mistakes in the tax returns. Such an explanation should be prepared in writing and it is highly recommended that a tax adviser be asked for assistance in preparing these documents.

It is worth emphasizing that sometimes these activities are insufficient to exempt individuals who are responsible for the tax settlements of a given taxpayer from liability for tax crimes. In practice, these will be the members of the management board who held these posts during the period in which the tax arrears arose (however, please see our comments...
regarding the correction of tax returns after the protocol from the tax audit in Section II. 1.). To be exempt from personal liability, a member of the management board (sometimes all members of the management board) must submit an official document prepared according to strictly defined principles in which they admit to the act committed, namely to the commission of the tax arrears, and in which they disclose the amount of the arrears and then state, in practice, that the tax arrears have been paid, together with the default interest due (active repentance).

It should be re-emphasized that it is only possible to be exempted from liability for tax crimes exclusively by submitting this formalized document, which should satisfy all the requirements provided for by law. In addition, it is worth noting that the criminal sanctions on the people responsible for the tax liability of a given taxpayer for the failure to meet the duties arising from the tax laws are very strict, since these people are subject to a maximum penalty of approximately EUR 5.8 million (from 1 January 2020) and/or five years of imprisonment.

We would like to point out that the legal consequences arising from the voluntary disclosure letter will only occur if this document is submitted before the date on which the tax authority learned of the given irregularity in the tax settlements. Consequently, submission after the date of the commencement of the audit of such a document for the period covered by the audit will not be legally valid and will not prevent the initiation of a criminal investigation against the individual in question. On the other hand, there were several cases in which, after the completion of the tax audit by the tax authorities, it was possible to correct a tax return without any criminal sanctions.

The findings of a tax audit must contain a legal assessment of facts determined during the tax audit. If a taxpayer agrees with the findings, in some cases (related mainly to taxes other than VAT) the taxpayer will have the right to correct a tax return and pay the due tax together with interest, and potential criminal sanctions will be not be imposed. This right
is limited to a relatively short period between the date of delivery of the findings and the day of institution of the tax proceedings against the taxpayer (in the case of a tax and customs audit conducted by the tax and customs authorities under a slightly different procedure, this right is limited by the deadline, which is 14 days from the delivery to a taxpayer of the results of the audit). After such time, the audit automatically transforms into assessment proceedings. Therefore, after receiving the findings from the tax authorities, it is important to decide whether it would be justifiable to agree with the findings of the auditors and correct the tax return or to challenge the position taken by the auditors.

The applicable tax law in Poland does not prescribe any fundamental restrictions on the documentation the auditors may demand. Clearly, the scope of the documentation that the tax audit demands differs according to the scope of the audit and the type of taxes audited, although an attempt can be made to present the following list of documents that are usually of interest:

- Accounting ledgers and financial statements for the years covered by the audit and the financial reports of registered auditors (taxpayers are not obligated to disclose correspondence with tax or legal advisers, although they may show the opinions received if they believe that this could help)

- Commercial documentation, namely, agreements with trading partners, commercial correspondence, invoices, bank transfers, etc.

- Tax returns and copies of bank transfers documenting the payment of taxes and all tax registers that the taxpayer keeps

- So-called unified audit files, that is, information from tax registers, bank account records, etc. (depending on the particular type of unified audit file), compiled in a specified electronic format
Apart from the examples of documentation presented above, which, as a rule, are of interest, the auditors may demand the presentation of any other evidence or documents that they believe the taxpayer should present.

As a rule, taxpayers will designate a person or persons who are responsible for communicating with the auditors, who will be responsible for providing the so-called administrative support of the demands presented by the auditors. In practice, auditors will want to talk about the substance of the matters with people holding responsible functions for the taxpayer (i.e., members of the management board, the head accountant, managers responsible for the individual departments, etc.). The auditors' right to question any person employed by a given taxpayer is in no way legally limited.

The taxpayer subject to the audit has the duty to provide the auditors with an appropriate, separate workplace where they can review the documentation without being hindered and where they can freely talk to the taxpayer's staff. During the audit, the taxpayer should appoint one or two people who will be responsible for communicating with the tax auditors. There are no legal obstacles to appointing a tax adviser as one of the people responsible for communicating with tax auditors and if the taxpayer does so, it may be assured that its interests are best protected.

Other employees should not have any contact with tax auditors and should not answer informal questions. Despite the fact that the information gained by the tax authorities in that manner does not constitute evidence in the tax proceedings, it may be used against the taxpayer during further proceedings. Tax auditors may question all of the taxpayer's employees (as witnesses), but any examination of this kind should be made in accordance with the formal rules established in the Polish Tax Code. This examination is confirmed by a formal protocol signed by the auditors and a witness.
4. Areas of tax auditors’ special attention

(a) Procedure and form

(1) Financial and accounting

The methodology used in conducting an audit that is usually utilized by the tax authorities essentially involves, first, a review of the correctness of the tax returns filed by the taxpayer and then a comparison of such with the taxpayer’s tax records, or, as a rule, the financial ledgers. These steps should account for differences existing between accounting law and tax law with respect to principles of recognition of certain expenses and incomes. This is the norm for the start of an audit. Based on these findings, the auditors can, and will, delve deeper into the commercial documentation. As mentioned earlier, there are no legal restrictions on the scope or type of documentation that the auditors may demand to be presented. It is the taxpayer’s duty to provide the requested documents in a reasonably quick manner.

Poland has specific rules relating to the duty of businesses to maintain ledgers and records and to produce financial statements. These rules largely mirror international accounting standards, but there are also some greater restrictions and requirements that are specific to local Polish purposes. Such ledgers, records and financial statements must be kept for tax purposes and should be retained for a specified duration. Accounting ledgers and supporting source documentation must be in the Polish language. There are also specific requirements for the electronic storage of documents and the use of electronic facilities for the purpose of keeping accounting records.

As a rule, and particularly in the case of major taxpayers, auditors will assume a specific threshold level of materiality for testing and will conduct the audit through sampling, since it is not possible to audit everything.
In view of the practice with regard to audits that have already been conducted, it is possible to try to define the issues that are usually of greater interest to the auditors.

(2) Formal requirements

i) Commercial agreements

The practice of tax auditors indicates that it is extremely important for taxpayers to have correctly executed agreements regarding their commercial ties. The auditors generally do not recognize expenditures that have actually been made by the taxpayer as deductible expenses if these have not been sufficiently documented (e.g., those in the form of commercial agreements). This requirement applies not only to related parties, as defined by the transfer pricing (TP) regulations, but also, in principle, to every transaction undertaken by the taxpayer. It is worth drawing attention to the fact that, regardless of the auditor’s demand that agreements documenting commercial transactions be disclosed, having appropriate agreements can be and is important to the taxpayer itself for reasons of evidence. Naturally, every commercial transaction gives rise to specific tax consequences, whether this is with regard to taxable income or deductible costs. Thus, if the taxpayer experiences specific tax consequences from a given transaction, attention must be paid, in the event of a possible audit, to proving that the transaction took place, that the parties agreed on certain financial conditions and that people empowered to act on behalf of the taxpayer correctly executed it. Consequently, having commercial agreements could significantly simplify tax proceedings and release the taxpayer from the obligation to provide lengthy evidence with other forms of proof that the transaction took place. Documentation in the form of commercial agreements is particularly important in transactions with related parties and this will be discussed in detail below.
ii) Substance over form

Polish tax law specifies that the requirement that transactions conducted by the taxpayer from which specific tax consequences arise should be assessed primarily in terms of their nature and not in terms of the name of the given transaction, thus establishing the principle of "substance over form." Consequently, the conduct of tax audits follows this doctrine and it will so frequently occur in tax practice that the tax authorities will not make reclassifications but, rather, will specify the tax consequences that take the nature and type of the given transaction, but not the name accepted by the parties, into consideration. Even so, attention should be paid to the fact that this so-called "reclassification" does take place in practice and applies, in particular, to lease agreements. The regulations on the tax consequences of leasing are so complicated and unclear that the taxpayer can easily make a mistake and erroneously qualify a given agreement under one of the two categories of "operational leasing" or "financial leasing," which automatically results in different tax consequences.

The best way to avoid the potential problems connected with reclassification and its influence on the tax aspects of the transaction is to ask tax advisers to assess all the tax risks associated with an agreement prior to its conclusion. The parties to the agreement should take into consideration all of the comments presented by the tax adviser with respect to the envisaged transaction. The alternative solution is the so-called "health check," i.e., a short tax review of the current agreements concluded by a taxpayer, followed by a brief summary of any tax risk related to the current business transactions of a particular taxpayer. Such

226 We use the concepts "financial leasing" and "operational leasing," which are not officially referenced in any legal document although these are commonly used in Poland, to differentiate between the two forms of leasing that differ in terms of tax consequences. The fundamental difference applies to the tax depreciation of the subject of the lease: the lessee records the depreciation in financial leasing, whereas the lessor records the depreciation in operational leasing.
action assures a taxpayer that all its actions have been made in accordance with current tax regulations.

iii) Withholding tax

A frequent item of interest to auditors is the duty of taxpayers to calculate, collect and remit the withholding tax to the tax authority when making payments to entities with registered offices outside Poland for items such as interest, license fees, dividends, etc. Polish tax regulations specify the rates on the amounts paid abroad for various kinds of receivables and simultaneously provide that the basic tax rates are to be applied unless otherwise specified in the respective double taxation treaties. However, it is only possible to apply the rates arising from the agreement if the taxpayer has a residence certificate issued by the appropriate tax authorities to the recipient of the receivables on the date of transfer of the receivables. It is not uncommon for taxpayers to forget this requirement or to receive the appropriate document too late, which will enable the tax authorities to impose negative sanctions on the taxpayer.

(3) Documentation of intra-group transactions

As emphasized above, one of the issues deserving particular attention is the documentation of transactions between related parties as defined by Polish tax regulations on TP. Following Poland’s accession to the EU, taxpayers have been indicating that the tax authorities have started to pay particular attention to the subject of TP. A penalty is imposed on the taxpayer in the event that the tax authorities make an assessment of the taxpayer’s tax liabilities that differs from what has been declared and when the taxpayer has not presented the required tax documentation (in accordance with the regulations). The difference between the taxable income declared by the taxpayer and the taxable income assessed by the tax authorities is subject to taxation at a rate of 50% (for comparison, the standard tax rate is 19%). From 1 January 2019, the TP regime was significantly amended. One of the changes is the elimination of the
increased 50% tax rate. Instead, the taxpayer is obliged to pay an additional 10-20% sanction on the difference between the taxable income declared by the taxpayer and the taxable income assessed by the tax authorities.

In recent years, there have been a number of significant changes to the tax regulations on TP, each with their own specific intertemporal provisions, delimiting which regulations apply to transactions made in a particular time. We strongly urge taxpayers to seek advice from professional tax advisers in this respect to make sure that their TP documentation is up to date and includes all required information.

We have included below a description of the documentation requirements regarding TP, in accordance with the rules implemented on 1 January 2019.227

Polish tax authorities adhere in general to the OECD Transfer Pricing Guidelines and apply the arm’s-length approach. The application of the Polish TP regime is related to the determination and assessment of the taxable income earned as a result of transactions that could be recognized as arising in Poland and, in the case of domestic entities, of income earned abroad if this income can be attributed to them. The tax authorities review transactions between related parties. If the terms and conditions of these transactions differ from what would have been agreed between unrelated parties because of the relationship between these parties, and this results in a lower taxable income than what would have been reported in the case of unrelated parties, the tax due will be levied without consideration to the terms and conditions agreed upon between related parties. The tax authorities may also levy tax based on an appropriate transaction that

227 These regulations are specified in Chapter 1a of the Polish Corporate Income Tax Act, Articles 11a-11t. Previously, they were specified in Articles 9a, 11 and 19 (4) of the Polish Corporate Income Tax Act and a regulation of the Minister of Finance of 10 September 2009, Tax Journal of 2014 item 1186 (unified text).
unrelated parties would have justifiably concluded in place of the controlled transaction.

With regard to the TP methodology, if the taxpayer defines the market value of the transaction by using one of five methods, provides the tax authorities with the appropriate data, and the credibility and objectivity of the submitted data does not give any grounds for reasonable doubt, the tax authorities must set the market value of the transaction using the method applied by the taxpayer unless another method is more appropriate in light of the information provided.

Beginning in tax year 2017, the Polish requirements as to the scope of the obligatory TP documentation follows the latest OECD developments. A local file is obligatory with respect to a homogenous transaction exceeding in a given financial year a threshold of either PLN 2 million or PLN 10 million, depending on the type of transaction. A master file is obligatory for a taxpayer where the consolidated revenues of the taxpayer’s group exceeds PLN 200 million and provided that: (i) the taxpayer is obligated to prepare the local transfer pricing documentation; (ii) the taxpayer is consolidated using a full or proportional method for accounting purposes; and (iii) a consolidated financial statement is prepared for the taxpayer's group.

Transfer pricing documentation has to be filed upon the request of the tax authorities within seven days of such request. A shorter version of the local file (so-called information on transfer prices) needs to be submitted on a yearly basis, without request from the tax authorities and within nine months of the end of tax year.

The required documentation must include the following information.

228 The five methods are: (i) the comparable uncontrolled price method; (ii) the resale price method; (iii) the reasonable margin (“cost-plus”) method; (iv) the net transactional margin method; and (v) the profit split method.
Local file

1) Information of the taxpayer

2) Description of transactions/other events between the taxpayer and related parties, including analysis of functions, risk and assets

3) Analysis of transfer prices, including analysis of comparables or analysis of compliance, updated at least every three years

4) Financial information

Master file

1) Description of the taxpayer's capital group

2) Description of material intangible assets and property rights of the group

3) Description of material financial transactions of the group

4) Financial and tax information on the group

(4) Others

The tax authorities in Poland pay particular attention to transactions with foreign-related parties, such as shareholders, and will pay special attention to transactions related to knowhow and management services, royalties and all forms of license payments. These issues are some of the most important for the tax authorities and are usually the focus of tax audits, since the transfer of profits out of Poland is a major concern for the Polish tax authorities. For this reason, Polish taxpayers with foreign capital participation are facing an increasing number of tax audits compared to those in other EU countries.
(b) Substantive issues

(1) Deductible expenses

The most popular issue in terms of the extent of the audit is the subject of the so-called deductible expenses in income tax. Polish regulations on the principle of recognizing expenditures as deductible expenses that can be treated as deductible expenses for tax purposes are, first, not worded precisely, thus leaving the tax authorities excessive room for free interpretation. Second, it is excessively deceptive in terms of the extent of the exclusions under which expenses will not be recognized as tax-deductible expenses. Tax advisers will be able to assess whether expenses borne by a taxpayer can be classified as tax-deductible costs and, in the event of a potential tax dispute, they will be able to defend its tax classification before the tax authorities and before administrative courts if necessary.

In ordinary business, the problem of deductible expenses does not create many difficulties for taxpayers, but this problem arises in advanced business structures and, in particular, in complicated transactions and financial structures, such as securitization, factoring, etc., where, unfortunately, tax laws lag behind the development of market solutions. This situation means that, in many cases, it is not possible to find a response in the provisions of the law and it is possible to encounter many different (and often contradictory) interpretations from the tax authorities that apply on the same business issues.

(2) Restructuring/business reengineering

In recent years, there has been a noticeable rise in the popularity of all types of transformations of business entities, such as mergers and splits, etc. The presence of multinational corporations in Poland and the transformations they undergo have meant that the business entities belonging to these corporations that have registered offices in Poland have also undergone such transformations. All types of transformations give rise to specific tax consequences.

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The tax regulations on these issues are extremely complicated and, when an analysis of some of their provisions is made, the conclusion can be drawn that the proposed assumptions on transformations of an international scope are uneconomical from a Polish tax standpoint and require certain modifications in some cases. However, in terms of tax audits, it should be generally understood that every transformation affecting Polish taxpayers has the potential to become the subject of a tax audit. This is because the tax authorities recognize that, in many cases, one of the main reasons for the transformations is the obtainment of tax optimization to reduce tax burdens in a given tax jurisdiction.

### (3) Transfer pricing

We have already mentioned that one of the issues that deserves particular attention is the documentation of transactions between related parties. Before the Polish accession to the EU, tax audits concentrating on TP issues were relatively rare. However, since the accession, we have been noting that Polish tax authorities have become more and more interested in a detailed examination of the transactions between related parties. Moreover, beginning in 2016, there has been a significant increase in the quantity of audits run by the tax authorities (mainly by the former tax control offices) focused solely on TP issues, during which tax inspectors prepare their own benchmark analysis and try to question the general level of the reported margin, for example, by the Polish subsidiaries of a multinational enterprise.

### (c) VAT

VAT has always been a topic that tax auditors in Poland love. Auditors pay particular attention to both formal errors and substantive issues, of which the most popular are the offset of tax on purchases made and the correct application of complicated principles specifying the moment when the tax liability becomes due. This has been the case for many years now, due to constantly evolving, "liquid" legislation on VAT, often self-contradicting and unclear, leaving too much room for free interpretation from the tax
authorities. Moreover, since Poland’s accession to the EU, another level of sophistication of VAT provisions has been added, as Poland needs to adjust its regulations on VAT to those of the EU.\textsuperscript{229} Consequently, tax audits on VAT have resulted in a large number of problems with which the taxpayers have been left to cope. In view of the fact that VAT plays a significant part in the Polish budget and the transparency of Polish regulations on VAT continues to deteriorate due to the substantial amount of changes over the years, which creates problems for taxpayers to adjust swiftly to the new VAT environment, it can be clearly stated that tax audits on VAT will be intensified over the coming years.

Recently, tax authorities have been examining compliance with the law governing the deductions of input VAT connected with intra-community supplies and exportation of goods and services. In addition, tax officials often review whether the conditions for applying the 0% VAT rate to intra-community supplies and export of goods have been fulfilled.

Taxpayers often have problems with the proper implementation of those regulations in their day-to-day business practice. The common practice in Poland is for taxpayers to ask their advisers to do the following:

- Review the current business structure of the company.
- Verify whether this structure conforms to current VAT rules.
- Adjust the structure to the new VAT system.

It is highly recommended to ask local tax advisers for help in the adjustment of business activities to new VAT standards. Taxpayers should also contact their tax adviser on a regular basis to apply a "VAT check" to every important business transaction.

Finally, over the last few years there has been an intensification of both VAT fraud (through domestic and intra-community structures) and complex interdisciplinary audits aimed at fighting the problem. Although fighting fraudulent activity by the tax authorities is generally a good thing, normal taxpayers may be caught in the crossfire and denied the right to offset input VAT or to use the 0% tax rate on intra-community transactions. Given that these types of tax audits are becoming more frequent and the nature of such disputes is complicated, asking for the help of local tax advisers is recommended.

(1) Others

Of the remaining issues covered by tax audits, it is certainly possible to mention liabilities arising from customs duties and the duties of taxpayers as remitters obligated to collect tax from the salaries paid to employees (audits have also been directed here to check the correctness of the settlements of the obligatory social insurance contributions). Other tax liabilities, such as transfer tax and real estate tax, etc., have not been subject to spectacular or intensified tax audits, a situation that does not mean that such audits have not taken place.

5. Multijurisdictional tax audits

Tax audits that were part of an international tax audit of a given taxpayer are exceptionally rare in tax practice. This has been the case for many reasons, one of which is the lack of taxpayers that have a presence in several tax jurisdictions and the lack of legal frameworks allowing the tax authorities to conduct this type of audit (it is true that there is a convention\textsuperscript{230} on the basis of which cooperation between the tax authorities of the convention’s signatories is theoretically possible but, in practice, these are redundant regulations.) At present, however, it cannot be ruled out that, together with the growing presence in Poland of a large

\textsuperscript{230} Convention on Mutual Administrative Assistance in Tax Matters, executed in Strasbourg in 1988, signed by the Polish authorities in 1997.
number of multinational corporations, and primarily with Poland's accession to the EU, the problem of international cooperation between tax authorities from various jurisdictions will become an ongoing and practical issue that Polish taxpayers will need to face.

6. Burden of proof

A highly important issue when conducting the tax audit is the principle regarding "burden of proof." According to the Polish tax law on the principles of conducting tax audits, the burden of proof regarding irregularities on tax liabilities rests with the tax authorities performing the audit. This principle, which is supported by many other principles of a general nature, such as the principle of the rule of law, the principle of proportionality, the principle of equal treatment under the law and the principle of the right of appeal, etc., means that the tax authority must conduct the audit in a manner that takes account of all actual and legal circumstances and allows the taxpayer to participate in the proceedings, and that it must prove a breach of the tax law, if this has taken place.

In many court opinions, administrative courts have held that the burden of proof lies with the tax authorities: "Tax authorities are obligated to determine precisely the factual background of the case. This requires verification of all evidence that may affect the outcome of the case." This is a legal theory but, as is generally the case, practice can vary and it often happens that the taxpayer must prove its "tax innocence." Several court opinions confirmed that the obligation of tax authorities to determine the factual background of the case is not unlimited. In many cases (e.g., regarding tax-deductible costs), the taxpayer must be active

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232 Judgment of the voivodeship administrative court in Warsaw of 3 August 2006, ref. III SA/Wa 187/05.
and, in fact, sometimes provide evidence to help determine the facts or to present its position.\textsuperscript{233}

Furthermore, such active participation of the taxpayer at this stage in the proceedings when the tax authority has not yet issued a negative decision for the taxpayer can enable the tax authority to clarify the doubts that arise and can often lead to a significant simplification of the proceedings and the avoidance of charges being pressed for a breach of tax law if it transpires that, after the clarifications are provided, the given business structures are understood by the tax authorities.

It is worth emphasizing that in recent judgments,\textsuperscript{234} the administrative courts have stated that a taxpayer was obligated to prove that marketing, advisory and other non-material services were actually performed. Thus, taxpayers and their advisers should be prepared for a more detailed review of marketing transactions. To safeguard its position during a potential audit focused on non-material services, a taxpayer should possess documentation (e.g., time statements, reports and opinions) confirming that the non-material services were actually rendered. If a taxpayer possesses this kind of documentation, it would be difficult for the tax authorities to question the treatment of payment for such services as a tax-deductible cost of the taxpayer.

7. Potential consequences

(a) Adjustment of income and additional tax payment

If the tax authorities find irregularities in the tax settlements of a taxpayer, the tax audit normally ends with the issuance of a tax decision that specifies the level of tax arrears and, as a rule, the level of default interest

\textsuperscript{233} See, for example, the judgment of the Supreme Administrative Court of 6 June 2000, ref. III SA 1252/99.

\textsuperscript{234} Judgment of the Supreme Administrative Court of 18 August 2004, ref. FSK 356/04.
The taxpayer has a duty to pay the amount arising from the tax decision, together with interest on the tax arrears up to the date of payment of the amount of tax due. The submission of an appeal against a negative decision for the taxpayer, in principle, does not suspend the accrual of default interest. Therefore, although such a decision is, as a rule, not yet enforceable, the taxpayers often contemplate paying the amount of the tax assessment to avoid further accrual of interest.

In certain situations, such as a TP assessment decision or VAT assessment decision, the tax authorities may impose additional sanctions payable alongside default interest, calculated as a percentage of the difference between the amounts declared by the taxpayer and the amounts assessed by the tax authorities.

(b) Penalties for individuals

Should a negative tax decision be issued, specifying the duty to pay tax arrears, this could mean, and as a rule generally does mean, the threat of the initiation of a tax crime investigation of the members of the management board and/or the people responsible for the discovered tax shortcomings. This is described in detail in Section 9 below.

8. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

In principle, the answer to this question should be divided into two stages. The first stage is the "tax audit," where a confrontation with the tax authority conducting the audit cannot be justified. It is appropriate to cooperate to the highest extent possible, while observing the rules arising from the specific provisions of the law governing the principles of tax proceedings. Cooperation with the auditors at this stage may bring the

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235 At present, the default interest is 8% per annum. The rate of the default interest is 200% of the basic Lombard interest rate set by the National Bank of Poland (NBP). Thus, it changes with the base rate applied by the NBP.

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taxpayer positive results if, for instance, it is able to explain and clarify some issues that may have further consequences, such as a negative tax decision, which, if left without clarification, could be the subject of further proceedings. The second stage is "further proceedings," which refers to the appeal against the decision and the complaint to the competent administrative court of first instance, i.e., voivodeship administrative court or the cassation petition to the Supreme Administrative Court. In principle, there is no cooperation at this stage because the taxpayer must present arguments to undermine the negative decision it received from the tax authorities.

(b) Who should run the show?

The first stage of the proceedings, namely the "tax audit," will generally be the exclusive domain of the taxpayer and the employees who can provide explanations to the auditing officials. It is relatively rare for the legal/tax adviser to take part at this stage. However, the participation of experienced tax advisers at this stage may become common practice in the near future. Tax advisers know what tax auditors are allowed to do during the audit and, thus, may easily protect taxpayers from the potential abuse of the tax auditors' authority. If tax advisers take part in the tax proceedings from the very beginning, they will be able to identify some strong procedural arguments in favor of the taxpayer that are based on their participation in the audit. Additionally, they can easily identify potential issues that may be raised by the tax auditors and help solve these in the most beneficial way.

Usually, the first moment in which taxpayers use the help of qualified advisers is when they need to submit clarifications to the audit report. However, further stages of the proceedings, namely the appeal against the decision, the complaint to the voivodeship administrative court and the cassation petition to the Supreme Administrative Court, as well as the related participation in court hearings, are the domain of specialized legal and tax advisers, but with the active participation of the taxpayer. The
participation of specialized advisers is necessary for at least two reasons. First, the advisers have extensive technical knowledge, as well as knowledge of other cases, namely of resolved court cases with a similar factual background. Although Poland does not have a common law system, as a rule, the courts usually respect earlier resolutions in similar cases. Second, the participation of specialized advisers is necessary, particularly at the stage of court proceedings where a number of issues of importance to the taxpayer will depend on the observance of the rigid rules of court proceedings and the observance of formal rules regarding the submitted procedural writs.

Furthermore, the so-called compulsory barrister’s counseling exists at the stage of filing the cassation petition to the Supreme Administrative Court, which means that there is a requirement for the complaint to be prepared by an authorized specialized adviser, such as a barrister, legal counsel or tax adviser. Unless such a person prepares the complaint, the court will not initiate the proceedings.

9. Conversion of a regular tax audit into a criminal investigation

(a) Regular tax proceedings versus criminal investigation of the individual parties

(1) General issues

As a rule, a negative completion of the first stage of the regular tax proceedings for the taxpayer means that the respective tax authorities have issued a negative decision. "Negative" means that the tax authorities have acknowledged that the taxpayer has made specific errors that resulted in tax arrears arising, and this is stated in the issued decision. Such a completion of the first stage of the tax proceedings could mean, and as a rule generally does mean, the threat of the initiation of a tax criminal investigation of the members of the management board and/or the people responsible for the discovered tax shortcomings. Poland has separate
provisions of the law,236 which specify the principles of liability of individuals237 for crimes and infringements committed with respect, for example, to the duties arising from the tax regulations, provisions of accounting law, provisions of customs law and provisions of foreign exchange law, among others. In principle, a tax crime investigation is conducted separately from a tax investigation of a taxpayer, whereby the results of the tax investigation and its progress affect the progress of the tax crime investigation.

If, for instance, it transpires that — following an appeal against the decision — the tax authority of the higher instance finds that there was no breach of the tax law and, thus, the decision of the authority of the first instance is overruled, then, in principle, the tax crime investigation against the given person should be considered irrelevant and ended.

(2) Risk of criminal liability

Irregularities in the calculation and payment of tax liabilities, as well as irregularities in accounting duties (i.e., keeping the accounting ledgers and preparing the financial statements) and other non-tax-related irregularities referred to in the cited provisions may result in the criminal liability of the people (individuals) responsible for these issues for the taxpayer. The respective authorities may primarily charge the managers (members of the management board of the given taxpayer) or other employees who were personally liable for these irregularities. In certain cases, all members of the management board may be charged and found liable.

Three different regimes of criminal liability may apply:

- Tax crime liability under the Fiscal Criminal Code

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236 See, i.e., the Fiscal Criminal Code of September 1999; in certain cases, the Criminal Code of June 1997; and other acts that provide for criminal liability, i.e., the Accounting Act, etc.
237 Neither a tax crime investigation nor a criminal investigation can be conducted against legal persons; tax crime liability and criminal liability are always the liability of natural persons.
• Criminal liability under the Criminal Code

• Criminal liability under separate provisions (e.g., the Accounting Act, banking law and other laws concerning particular business sectors)

Tax crimes are prosecutable by the tax office and tax and customs office (in practice, by specialized units within these offices), while general criminal prosecution lies within the responsibility of the Public Prosecutor’s Office and with the police. Proceedings under the Fiscal Criminal Code have certain distinguishing features, including the availability of the active repentance procedure (which prevents the initiation of an investigation against a person who submitted a confession before the authorities became aware of their offense) and voluntary submission to liability (which protects the defendant from having a criminal record, despite having pleaded guilty).

(3) Tax and criminal fines

There are many specific cases and numerous offenses and their corresponding fines, although we will only be commenting on a few as examples.

• Article 56, Section 1 of the Fiscal Criminal Code: filing of false tax returns, which results in the tax not being paid, or there was a danger of non-payment of taxes
  
  o This is a fiscal criminal offense, prosecutable by a tax office, which is punishable by a fine and/or imprisonment for up to five years; if the value of the unpaid (endangered) tax is low, the punishment is limited to a fine only.

This fiscal criminal offense is subject to a fine of up to 720 "daily rates" or imprisonment for up to five years. A statute of limitations of 10 years

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238 The maximum amount of a "daily rate" refers to the minimum monthly salary applied to employment contracts equal to 400/30 of such a monthly salary at the time the case is
applies to this offense (measured from the end of the year in which the unpaid tax was due).

Low value means that the maximum penalty is limited to a fine of up to 720 daily rates "only." A statute of limitations of three years applies to such an offense (calculated from the end of the year in which the unpaid tax was due). The low value of unpaid tax, as referred to in the applicable provisions, is defined by reference to the minimum monthly salary applied to employment contracts, multiplied by 200.

If the value of unpaid (or endangered) taxes is lower than the "statutory threshold," the liability is limited to a petty offense. A petty offense is punishable by a fine of up to the minimum monthly salary applied to employment contracts, multiplied by 20. The statute of limitations that applies to petty offenses is much shorter (one year from the end of the year in which the tax was due). The statutory threshold for unpaid tax is defined by reference to the minimum monthly salary applied to employment contracts, multiplied by five.

Please note that individuals may also be accused of committing several crimes under other provisions of the law, some of which are:

- Breach of the Accounting Act by failing to prepare financial statements
  - This is a criminal offense prosecutable by the public prosecutor and the police, which is punishable by a fine or imprisonment for up to two years.
• Failure by any person to keep records of their business activity or the keeping of unreliable records, as stipulated in the Criminal Code
  
  o This is a criminal offense prosecutable by the public prosecutor or the police, which is punishable by imprisonment for up to three years.

(b) Presence of counsel

In the event that a fiscal criminal or criminal investigation (as referred above) is initiated, an attorney specializing in criminal law should be notified immediately and it is advisable that this attorney handles each case from the beginning. The presence of the attorney is required and advisable, as the regulations on criminal proceedings are complicated and, if not followed properly, may result in an even worse position for the individual in the case.
II. Resolution procedures

1. Administrative level

(a) During the audit

During the tax audit, the taxpayer is obligated to nominate a person (or persons) who will be responsible for communicating with the auditors and will provide them with documents that will enable the auditors to determine the correctness of the taxpayer’s tax settlements. Most frequently, the tax audit takes place at the taxpayer’s registered office or at the place where the taxpayer’s tax documentation is located (e.g., the registered office of an external accounting office that services the taxpayer). During the tax audit, the auditors often hold meetings with the taxpayer’s representatives, who are authorized to communicate with the tax authority to clarify any possible doubts that emerge in connection with the audit activities conducted.

Sometimes, the auditors demand the submission of clarifications on individual matters that, in the opinion of the auditors, require clarification. The auditors do not hold formal meetings with the taxpayer to agree on a common position or to agree on certain issues through negotiation.

The fundamental objective of the audit is to check whether the audited parties are performing the duties arising under the provisions of tax law. As such, the auditors act as investigators rather than negotiators. They have the following rights:

- To gain access to the land or the buildings, premises and other facilities of the audited party
- To gain access to residential property (in strictly defined cases)
- To demand the presentation of the property of the entity subject to the audit and to examine this property
• To demand the presentation of files, ledgers and all types of documents related to the audit and to prepare transcripts, copies, excerpts, notes, printouts and documented collection of data in electronic form

• To gather other required materials regarding the audit

• To secure the evidence gathered

• To demand proof of the identity of people if this is necessary for the purposes of the audit

• To demand that a physical count be conducted

• To question witnesses, the audited party and other persons

• To consult experts 239

The tax audit ends with a resolution in the form of an audit report (protocol). Should the taxpayer disagree with the findings in the audit report, it may present its reservations or clarifications within 14 days of the date of receipt of the report, simultaneously providing evidence in support of its position. It is advisable that experienced tax advisers prepare these reservations. The auditors are obligated to review the reservations and motions, and notify the taxpayer of the method of their resolution within 14 days of the date of their receipt.240 The audit report does not contain any resolutions regarding changes in the tax base, the tax assessment or the amount of the tax arrears.

In addition, until 31 December 2006, the report did not contain a legal evaluation of the matters that are the subject of the audit. It only contained the actual findings and the documentation on the evidence reviewed. As a result of amendments to the Tax Code, as of 1 January 2007,

239 Article 286 of the Tax Code.
240 Article 291 of the Tax Code.
every audit report has to contain a legal evaluation of the matters that are the subject of the audit. Thus, as of 1 January 2007, it is possible for taxpayers to determine the risk connected with the findings of the tax audit, and decide whether the correction of the tax return is possible and justified or whether it is necessary to argue with the tax authorities during the tax proceedings.

A slightly different procedure applies with respect to the tax and customs audit. The tax and customs audit ends with the result of the audit. The taxpayer may then correct its tax returns in line with the findings of the audit within 14 days from receipt of the results. After that time, the audit automatically transforms into tax assessment proceedings.

(b) After the release of the tax assessment decision

The tax proceedings conducted by the appropriate tax authorities may end with a decision being issued and delivered to the taxpayer specifying the level of the tax liability. The decision is issued on the basis of the findings included in the audit report (findings of the tax audit) and additional proceedings aimed at gathering further evidence necessary to issue the decision. Before the decision is issued, the tax authority sets a seven-day deadline for the taxpayer to respond to the matter of the evidence gathered.\textsuperscript{241} It should be emphasized that in one of its judgments, the Supreme Administrative Court in Poland stated that:

\begin{quote}
The failure of the application of Article 200 Section 1 of the Tax Code by the appeal authority or authority conducting the investigation to find the decision invalid is a significant procedural infringement and results in the need for the administrative court to overrule the decision issued as a result of the investigation that is subject to this defect.\textsuperscript{242}
\end{quote}

This means that taxpayers whom the tax authority prevented from responding to the evidence have procedural arguments that cause the

\textsuperscript{241} Article 200 of the Tax Code.
\textsuperscript{242} Judgment of the Supreme Administrative Court of 15 September 2004, 43f. FSK 467/04.
decision of the tax authority to be overruled in the appeals procedure or before the administrative court.

A taxpayer that disagrees with the resolution of the tax authority has the right to file an appeal against the decision issued by the tax authority of the first instance (most frequently the head of the tax office or the head of the tax and customs office). The deadline for filing such an appeal is 14 days from the date of delivery of the decision that is issued by the tax authority of the first instance. The appeal must be submitted to the tax authority of the first instance and then transferred to the authority of the second instance (usually the director of the Tax Chamber), which conducts a repeat review of the case (the exception to this rule concerns a situation where the decision of the first instance is issued by the Tax and Customs Office. In such a case the Tax and Customs Office also settles the appeal). It may also gather additional evidence on the case. Just like the tax authority of the first instance, the director of the Tax Chamber should set a seven-day deadline for the taxpayer to respond to the evidence gathered (even if no new evidence has been gathered).243

It is worth emphasizing that, as of 1 January 2007, it is possible to ask for a commencement of formal hearings before the representatives of the authority of the second instance. The hearings may take place at the request of the taxpayer or ex officio. The aim of the hearings is to clarify the factual background of the case. During the hearings, new evidence (e.g., experts' opinions, visual inspection and examination of witnesses) may be gathered/performed and additional explanations may be submitted.

If the decision issued by the tax authority in the appeals procedure is detrimental to the taxpayer, it may enforce its rights in the proceedings before the administrative courts by filing complaints.

243 Judgment of the Supreme Administrative Court of 4 August 2004, ref. FSK 156/04.
2. Judicial tax litigation

(a) Voivodeship administrative court

A taxpayer that is dissatisfied with the resolution of the tax authority in the appeals procedure may file a complaint with the voivodeship administrative court. It has 30 days to do so from the date of delivery of the decision by the tax authority.244 It should be remembered that taxpayers submit complaints through the authority whose activities are the subject of the complaint. This means that, in fact, the complaint needs to be addressed to the voivodeship administrative court, even though all documents should be filed with the tax authority that issued the negative decision. The complaint should contain a brief description of the situation, specifying the decision that is the subject of the complaint and the authority that issued the decision, and should show the breach of the law or legal interests. Furthermore, it must satisfy certain formal requirements specified in the act.

The tax authority with which the taxpayer filed the complaint has the duty to file it with the court within 30 days of the date the complaint was filed, as well as to respond to the charges raised in the complaint. It may also agree with the arguments and accept the demands in their entirety.

The court then reviews the complaint filed by the taxpayer. According to current practice, it usually takes the court between five and eight months to review the case and issue a verdict.

(b) Supreme Administrative Court

The taxpayer may file a cassation petition against the resolution of the voivodeship administrative court. Due to the rank of the Supreme Administrative Court and the many formal requirements, a cassation petition on tax matters must be prepared exclusively by a barrister, legal

244 Article 52 of the Act on Proceedings Before Administrative Courts.
counsel or tax adviser (with certain exceptions). The petition can only be based on either of the following grounds:

- A breach of substantive law or its erroneous interpretation or inappropriate application
- A breach of the provisions of the proceedings, if the infringement could have a significant impact on the result of the case

The cassation petition is filed with the court that issued the challenged judgment or decision within 30 days from the date the transcript of the judgment with its justification was delivered to the taxpayer. The petition is addressed to the Supreme Administrative Court but is filed with the voivodeship administrative court whose decision the taxpayer is challenging.

The Supreme Administrative Court reviews the case within the limits of the cassation petition. However, the taxpayer may cite new arguments justifying one of the cassation grounds. After reviewing the petition, the Supreme Administrative Court may accept the taxpayer’s arguments and overrule the resolution of the voivodeship administrative court or dismiss the taxpayer’s petition.
Here is a simplified chart of the appeal proceedings:\(^{245}\)

![Diagram of appeal proceedings]

(c) The Court of Justice of the European Union

The Court of Justice of the European Union (CJEU) has been authorized since 1 May 2004 to resolve issues connected with the potentially improper implementation of EU law in the Polish legal system. Since then, many "Polish cases" have been brought before the CJEU.

Taxpayers cannot file a complaint directly with the CJEU, but if the taxpayer submits a complaint to the voivodeship administrative court and the court has certain doubts with respect to the interpretation of Polish tax regulations in light of the EU tax law, it may forward a question to the CJEU. In such a case, the proceedings before the court are suspended until the CJEU answers the question raised by the voivodeship administrative court. It is worth emphasizing that the voivodeship administrative court is not obligated to pass the question to the CJEU, even if a taxpayer argues in its claim that local regulations are not in line with EU law.

\(^{245}\) Since 1 March 2017, appeals against a decision issued by the head of the Customs and Fiscal Office have been verified by the same body (i.e., by the head of the Customs and Fiscal Office).
The obligation to refer a question to the CJEU, if the answer of the court is necessary to issue a final verdict, is imposed on the Supreme Administrative Court.
III. Competent authority/arbitration convention

Article 26 of the OECD Model Tax Convention introduced the competent authority proceedings with which to avoid double taxation arising from the activities of the tax authorities of states from various jurisdictions. The competent authority proceedings are contained in the majority of double taxation treaties executed by Poland, which has not introduced any specific local laws on these matters. The detailed principles of applying this procedure are regulated differently in various double taxation treaties, so the respective provisions of the agreement should be analyzed in detail each time. However, one may raise the following question: What happens if the bilateral procedure is started between the competent authorities but the domestic tax proceeding is pending in the meantime? There is only one provision in the Polish tax law provisions that directly refers to such situation and it states that the statute of limitations for tax obligations (i.e., five consecutive calendar years) will be suspended, but not for more than three years. However, if the given tax case and its results depend on the conclusions of the competent authority proceedings, one may argue on the basis of the provisions determining the rules of the tax proceedings and court proceedings that either the tax authority or the court should suspend the tax proceeding or tax case until the competent authority proceedings are finished. This depends on the arguments used by the taxpayer in its dealings with the tax authorities. In our opinion, it is advisable to seek professional assistance in such cases.

Moreover, as of 1 February 2007, Poland has been bound by the Arbitration Convention, as published in the Journal of Law at the end of August 2007.
Handling Tax Disputes in Russia

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III. Competent authority .................................................................................... 492
I. Managing the tax audit process

1. General

(a) Applicable law

The major legal principles and fundamentals of the Russian tax system are set forth in Part One of the Russian Federation Tax Code ("Tax Code").

These major principles include the following: the types of taxes imposed in the Russian Federation, the rights and obligations of taxpayers and the tax authorities, the procedures for a tax audit, the nature of tax violations and related sanctions and the procedure to appeal tax authority decisions and actions. Part Two of the Tax Code contains the substantive provisions on the application of particular taxes. The Tax Code is the controlling part of Russian tax legislation.

(b) Relevant government body

Tax enforcement under Part One of the Tax Code is the responsibility of the Federal Tax Service and its subdivisions in the Russian Federation. The Federal Tax Service is located in Moscow. Each administrative unit of the Russian Federation has a regional tax inspectorate directly subordinate to the Federal Tax Service. Finally, most municipalities or districts have their own local tax inspectorates, which are directly subordinated to the appropriate regional tax inspectorates. For example, in Moscow there is a local tax inspectorate in each municipal district that is subordinated to the Tax Inspectorate of the City of Moscow. As such, in most cases a taxpayer deals with and is audited by the local tax inspectorate of the municipality or district where the taxpayer is located.

Large taxpayers with a high level of income and tax payments are registered separately at the federal or regional level in inter-district tax inspectorates according to their location. Once they reach a certain threshold in income and tax payments, they are further transferred to the
federal level to interregional tax inspectorates according to industry sectors.

The Federal Tax Service is a federal government body under the supervision of the Ministry of Finance. In contrast to the Federal Tax Service, the Ministry of Finance sets tax policy and negotiates tax treaties, as well as acting as a competent authority for tax treaty purposes. However, it is not directly involved in tax enforcement.

(c) Types of tax audits

Chapter 14 of the Tax Code sets forth the major legal principles for conducting audits by the tax authorities. It provides for four principal types of tax audits: (i) chamber audits; (ii) on-site audits; (iii) follow-up on-site audits; and (iv) transfer pricing tax audits.

(1) Chamber tax audits

The tax authorities may conduct an audit in the local offices of the tax inspectorate based on tax returns and other documents related to the calculation and payment of taxes. Tax inspectors do not need any special permission from their superiors to conduct a chamber audit. Generally, a chamber tax audit can be conducted within three months (two months with regard to VAT returns) of the date when the audited tax returns and other documents were filed.

If the tax authorities discover inconsistencies or mistakes in the course of their documentary review, they should inform the taxpayer and request explanations and/or additional documents. The taxpayer, in turn, should explain and present additional documents, as well as make necessary amendments to the relevant documents within five business days.

If upon the analysis of the documents presented by the taxpayer the tax authorities discover violations of tax legislation, they issue an act ("Tax Audit Act"), indicating all properly documented violations, within 10 business days of the end of the chamber tax audit. The Tax Audit Act must...
be delivered to an authorized representative of the taxpayer. After that, following the procedural requirements described in the resolution procedures section, the tax authorities must issue a decision concerning the results of the tax audit showing the amount of additional tax, tax penalties and late payment interest due from the taxpayer ("Tax Audit Decision").

(2) On-site tax audits

An on-site tax audit may be conducted only based on a formal decision made by the head of a tax inspectorate (or their deputy). It may cover one or several taxes and may not be conducted more than twice a year with respect to a particular taxpayer.

Generally, an on-site tax audit may not last more than two months, with those months calculated as a number of days actually spent by tax inspectors at the site of a taxpayer. The term of an on-site tax audit includes the period of time from the date of the decision on the appointment of an on-site tax audit until the date when the notice of the completion of the on-site tax audit is delivered. In certain cases established by the Federal Tax Service, a higher supervisory level within the Federal Tax Service may extend the period of the tax audit up to four months and, in exceptional cases, up to six months.

During an on-site tax audit, tax inspectors may:

- Take an inventory of goods and assets
- Seize documents, gain access to and examine a taxpayer's industrial and commercial premises
- Request information on the audited taxpayer from third parties through the tax authorities where these third parties are registered

If the tax authorities demand documents from a taxpayer, the taxpayer must provide the requested documents within 10 business days. If the
requested documents cannot be provided within this term, the taxpayer must inform the tax authorities in writing about the reasons for this non-provision and request an extension of time to present the documents. The tax authorities must issue a decision on the extension of (or refusal to extend) the time to provide the documents within two days from the day they receive the taxpayer’s request.

An on-site tax audit may be suspended by a special decision of the head (deputy head) of the tax inspectorate for up to six months (up to a maximum of nine months if information from foreign state authorities needs to be requested) in the following cases: (i) information on the audited taxpayer is requested from third parties; (ii) information is requested from foreign state bodies under international agreements of the Russian Federation; (iii) an expert examination is conducted in the course of the audit; and (iv) translation of documents is required.

Within two months of the date when a notice of completion of the on-site tax audit is issued, the tax authorities must issue a Tax Audit Act. After that, following the procedural requirements described in the resolution procedures section, they issue a Tax Audit Decision showing the amount of additional tax, tax penalties and late payment interest assessed on the taxpayer.

(3) Follow-up on-site tax audits

As a general rule, follow-up on-site tax audits on the same periods and taxes are prohibited by Russian tax laws, except in the following cases: (i) a follow-up on-site tax audit is appointed by the higher tax authority as a means of control over a lower-level tax authority; (ii) a taxpayer files an amended tax return with the amount of tax due lower than that in the initial tax return – then the local tax authority may conduct a follow-up on-site tax audit of the tax period covered by the amended tax return (within the scope of amendments in the tax return); and (iii) the taxpayer undergoes a liquidation or corporate reorganization. A follow-up on-site
A tax audit is governed by the same rules and procedures as a regular on-site tax audit.

(4) Transfer pricing tax audits

In 2012, Russia introduced new transfer pricing rules that contain special procedures for transfer pricing audits. Transfer pricing audits are performed separately from regular tax audits.

Transfer pricing audits may be performed by a special department of the Federal Tax Service only and may not be performed on-site as a part of regular tax audits of the taxpayer. Local tax inspectorates do not have the authority to conduct transfer pricing audits.

A transfer pricing audit may cover the three calendar years immediately preceding the year when the decision on the tax audit is made. If one of the parties to a particular controlled transaction has been audited and no transfer pricing adjustment has been made, the other parties to the same transaction may not be separately audited in connection with the same transaction.

The maximum period for conducting a transfer pricing audit is six months, with the possibility of an extension of up to 12 months in extraordinary cases. In the event that information from tax authorities of a foreign state and/or the translation of such information into Russian is needed, the maximum period may be extended for another six months. In the event the information requested from a foreign state is not received within six months, the maximum period may be extended for another three months. Thus, in total, the maximum period of a transfer pricing audit may be one year and nine months.

The Federal Tax Service must prepare a Tax Audit Act and present it to the taxpayer within two months of the completion of the transfer pricing audit. The taxpayer may provide written objections to the Federal Tax Service within 20 business days after the receipt of the Act. After that,
following the procedural requirements described in the resolution procedures section, a Tax Audit Decision is issued. The period for delivery of the Tax Audit Decision on the results of a transfer pricing audit may be extended for one month.

2. Tax audits

(a) Expected periodicity

The expected periodicity depends on the particular type of tax audit. For example, an on-site tax audit may generally not be conducted more than twice a year. A chamber tax audit may be conducted each time a taxpayer files a tax return.

(b) Selection of the tax audit targets

In 2007, the Russian Federal Tax Service issued a list of criteria for selecting tax audit targets, such as reporting losses during several tax periods, declaring a significant amount (89%) of input VAT deductions within 12 months, declaring taxes in an amount lower than the average tax burden level for legal entities in a particular industry, and failing to present explanations at the request of the tax authorities. However, these criteria are not binding. In practice, Russian tax authorities also focus on taxpayers that operate in highly profitable industries, such as the energy and power sectors, the metals industry, the production and sale of gasoline and other oil-based products, wholesale trade, and banking and financial services.

The Russian tax authorities have developed a risk-oriented approach in the selection of targets for a tax audit. In particular, they evaluate taxpayers based on typical risk factors and the existence of potential high-risk transactions based on information gathered through pre-audit control procedures, including document and information requests and interrogations of employees.
3. Advance preparation for tax audits

In preparation for an anticipated tax audit, the best strategy for a taxpayer is to conduct a comprehensive internal audit with the purpose of identifying the major tax risks related to its operations and existing accounting documentation, based on tax returns for the respective periods, and to pay an additional amount of tax and corresponding late payment interest. Generally, no tax penalties will apply if the taxpayer files an amended tax return and pays the tax and late payment interest before the commencement of a tax audit.

As described in more detail below, currently the areas that attract tax inspectors’ special attention in Russia are business purpose and economic justification of various operations and expenses, permanent establishments of foreign companies, thin capitalization, beneficial ownership cases, deduction of interest, royalties and intra-group services, as well as various issues related to VAT refunds. Accordingly, the primary focus of internal audits should be on these issues as well as on other matters that could be of importance, taking into account the nature of the taxpayer’s business.

Preparing for tax audits is an important process. In our experience, taxpayers that have properly reviewed their risk issues and have organized their backup documentation in advance are better able to manage the audit process.

In addition, under the Tax Code a taxpayer may request a written explanation from the tax authorities on a particular issue. Please note, however, that the Federal Tax Service frequently declines to provide explanations on issues that it believes are hypothetical. In the event that the tax authorities later change their position, at best, such a written explanation will protect the taxpayer from the imposition of tax penalties and late payment interest. As a practical matter, a local tax inspector will rarely question the conclusions set forth in a written explanation obtained at the level of the Federal Tax Service or the Ministry of Finance.
4. Limitations period for assessments

The Tax Code provides that in an on-site tax audit, the tax authorities may only audit the three calendar years immediately preceding the year in which the decision on the appointment of the on-site tax audit is issued. The exception is established for cases when a taxpayer files an amended tax return, which allows the tax inspectorate to perform an on-site tax audit of positions amended in the return outside the three-year limitations period.

Chamber tax audits do not have a statute of limitations (other than the three-month period from when the tax return is filed).

Under the Tax Code, the statute of limitations with respect to the application of tax penalties is three years. Depending on the nature of a particular tax violation, the statute of limitations starts running from the day the tax violation is committed or from the day following the end of the tax period during which the tax violation is committed.

There is no formally established statute of limitations with respect to underpaid taxes and related interest for late payment of taxes. As a practical matter, however, the risk that the tax authorities will assess additional tax and late payment interest for periods earlier than three years preceding the year of the tax audit is limited due to the three-year restriction on conducting on-site tax audits. Such a risk largely depends on whether the tax authorities may assess taxes independently of a tax audit (e.g., an error in the tax returns showing an underpayment of taxes without requiring further documents).

5. Areas of tax authorities' special attention

(a) Procedure and form

During a tax audit, the tax authorities may check the taxpayer’s compliance with financial and tax accounting rules. Under the Tax Code, a gross violation of financial and tax accounting rules is considered a tax
violation and may be subject to a tax penalty of up to 20% of the amount of tax underpaid because of this violation. For the purpose of applying this provision, a gross violation of financial and tax accounting rules is defined as the absence of supporting documents, VAT invoices or accounting books. In addition, a gross violation may arise as a result of systematically (two or more times within a calendar year) late or incorrect input into accounting records and reports of the taxpayer’s economic operations, monetary resources, tangible assets, intangible assets and financial investments.

(b) Substantive issues

(1) Business purpose/Economic justification

In case of a tax dispute, Russian courts will likely apply a business purpose concept when scrutinizing the actions of the taxpayer. Historically, this concept was introduced by the Supreme Arbitrazh Court Resolution No. 53 dated 12 October 2006. According to this concept, a tax benefit (broadly defined, including tax deductions and tax exemptions) can be deemed unjustified, in situations where for the purposes of taxation particular transactions were not accounted in accordance with their real economic purpose, or where the transactions were not justified by economic or other reasonable causes (business purpose). The tax benefit cannot be the main purpose of a transaction.

On the other hand, the possibility of achieving the same economic result by engaging in other operations that provide a lower amount of tax benefit cannot be a ground for treatment of the tax benefit as unjustified.

In this area, tax authorities have always taken a very aggressive position.

Therefore, a taxpayer should be able to demonstrate and explain the peculiarities and non-tax business purposes of their activities, as well as to prove the economic justification of a specific operation in question.
Russian tax authorities also often assert that a taxpayer received an unjustified tax benefit if they were involved in transactions with so-called "bad faith suppliers" — i.e., legal entities that fail to duly discharge their tax liabilities and have features of so-called "one day companies." On this basis, they often disallow the deductibility of expenses and input VAT. In order to defend their right to a tax deduction in this case, a taxpayer must show that the transaction had real economic substance, and that the taxpayer demonstrated a certain level of due diligence when choosing the supplier (including, but not limited to, requesting the counterparty’s statutory documents along with the documents confirming the fact of its state and tax registration, contract signatory’s authority and identity, the existence of the company’s office and facilities, etc.).

The business purpose concept was codified under Article 54.1 of the Tax Code, which applies to the tax audits initiated starting from 19 August 2018. Under the new rules, there is a two-step approach when determining whether a transaction meets the business purpose test and a tax benefit can be considered as justified:

- There is no evidence of intentional misstatement of information on actual business activities of the taxpayer.
- The following two conditions are simultaneously met:
  - Gaining tax benefit is not the main goal of the transaction.
  - The transaction was actually performed by the relevant counterparty.

(2) Deductibility of intercompany expenses

Russian tax authorities often challenge the deductibility of expenses incurred under contracts between companies of the group as economically unjustified and documentarily unsupported.
Particularly, Russian tax authorities from time to time refuse to recognize documents issued in accordance with foreign legislation and business practice as sufficient documentary support for the deduction of expenses in Russia. Russian tax authorities also question the justification of expenses and do not always accept certain documents, such as cost-sharing agreements, as sufficient justification. Taxpayers normally defend their right to the deduction of intercompany expenses in court if they demonstrate the real nature and business purpose of expenses and provide documents issued in accordance with Russian and/or foreign legislation and business practice. The court practice also sets forth requirements for the documents supporting intercompany expenses to demonstrate what particular services were provided, the cost of these services, and how the services are connected with the taxpayer’s business activities.

(3) VAT refund

Russian tax authorities usually pay special attention to the use of input VAT, especially if a taxpayer requests a tax refund. In this connection, a number of circumstances attract the special attention of the tax authorities, including the performance of export operations by the taxpayer, the performance of leasing operations, the loss-making status of the company, intercompany operations, and violation of law by the taxpayer’s contractors, among others. Quite often Russian tax authorities deny input VAT by claiming that the operations performed by a taxpayer are economically unjustified (for a detailed description, please see above).

In order to prove its right to input VAT or a VAT refund, a taxpayer should properly document all operations performed and be able to demonstrate the business purpose and economic justification of its activities as described above, as well as run due diligence on their counterparties.

(4) Beneficial ownership

Over recent years, during tax audits Russian tax authorities started paying special attention to the determination of beneficial owners of income paid
by Russian companies to foreign entities (e.g., in the form of dividends, interest and royalties). The tax authorities analyze whether the DTT benefits should apply and actively refer to the international exchange of information procedure to support their claims.

6. **Special tax audits**

Generally, the tax audit procedures established by the Tax Code, as described above, apply to all kinds of taxpayers and all taxes.

At the same time, the Tax Code establishes certain peculiarities of tax audit procedures applicable to the participants of Production Sharing Agreements (the three-year limitation period is not applied and the term of the tax audit may exceed six months if a participant company has branches or representative offices); participants of a consolidated group of taxpayers (the term of the tax audit may be increased by the amount of months equal to the amount of participants of the group of taxpayers); participants of regional investment projects (on-site tax audit of such taxpayers can cover five years preceding the year when the audit started); and participants of tax monitoring regime (e.g., they have the opportunity to discuss with Russian tax authorities the tax implications of proposed transactions in addition to past transactions and to obtain a tax ruling that is binding for both the taxpayer and Russian tax authorities). Furthermore, there are certain peculiarities established for audits of transactions between related entities (transfer pricing audits). However, the overall procedure of tax audits is the same for all companies and taxes.

7. **Electronic data processing (EDP) access during audit**

In more complex tax audits, tax authorities may request access to EDP and bring in appropriate specialists. However, this is not commonly the case for most tax audits.
8. Information-gathering powers

As noted above, tax authorities may request information about the audited taxpayer from third parties. In this case, the tax inspectorate conducting the audit (either chamber or on-site) sends a request to the tax inspectorate where the company possessing necessary information is registered, and this tax inspectorate will forward this request to the company. The company must present the requested documents (information) within five days of the date when the request is received, or inform the tax inspectorate about the absence of these documents (information).

Russian tax treaties with other countries contain provisions for the exchange of information and in practice Russian tax authorities start using this tool more and more often. Thus, there have been a number of tax disputes won by the tax authorities over the recent years due to information about ultimate beneficial owners of income (e.g., dividends and royalties) paid by Russian companies, which was obtained via an international exchange of information.

Moreover, in 2015, the OECD Convention on mutual administrative assistance in tax matters came into force in Russia. On 12 May 2016, the Russian Federation became a signatory to the Common Reporting Standard (CRS) Multilateral Competent Authority Agreement (MCAA) for the automatic exchange of information. As of 2020, Russia exchanges information with 75 countries and 13 territories using this standard. In 2017, Russia started the implementation of Action 13 of BEPS. On 26 January 2017, the Federal Tax Service signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports. The list of jurisdictions that exchange CbC reports was adopted by the Federal Tax Service and includes 53 jurisdictions and four territories. Thus, Russia is taking a significant step forward in global tax cooperation.
9. Multijurisdictional tax audits

The Tax Code provides a possibility to conduct tax audits with a participation of foreign tax administrations. However, so far Russia is not yet ordinarily engaged in multijurisdictional tax audits with other countries.

10. Burden of proof

Under the Tax Code, a taxpayer may not be held liable for a tax violation and consequently be subject to tax penalties unless the tax authorities prove that the taxpayer is at fault. However, in practice, taxpayers often have to defend their position in courts where they are required to prove their good faith and the business purpose of their activities.

In transfer pricing tax audits, the price applied by the parties to a transaction is deemed to be at market level unless the tax authorities prove otherwise, or the taxpayer performs a voluntary transfer pricing adjustment.

If a taxpayer prepares and submits to the tax authorities, upon request, transfer pricing documentation justifying the application of a particular transfer pricing method, the tax authorities may apply a transfer pricing method different from the one used by the taxpayer only if they can prove that the method used by the taxpayer does not allow the establishment of comparability between the terms of the controlled transactions and those of the comparable transactions.

11. Potential consequences

(a) Adjustment of income and assessment of additional tax

Based on the findings revealed in the course of a tax audit, tax authorities assess additional taxes due from the taxpayer. If certain expenses are deemed economically unjustified and/or documentarily unsupported, the
tax authorities disallow the deduction of such expenses and make corresponding assessments of additional tax.

(b) Tax penalties

The Tax Code sets forth the following principal tax penalties:

- Failure to pay or underpayment of tax — 20% of the underpaid tax or 40% for intentional underpayments.

- Failure to pay tax on controlled foreign company's profits — 20% of the underpaid tax, but no less than RUB 100,000 (approximately EUR 1,400).

- Failure to withhold — 20% of the tax that should have been withheld.

- Failure to register for tax purposes — 10% of the income generated over the period that the taxpayer avoided tax registration, but no less than RUB 40,000 (approximately EUR 570).

- Failure to file tax returns in a timely manner — 5% of the tax due for each month of delay, but no more than 30% of the total amount of tax due.

- Gross violations of rules governing accounting of income, expenditures, or objects of taxation, which result in a reduction of the tax base — 20% of the underpaid tax, but no less than RUB 40,000 (approximately EUR 570).

- Underpayment of tax as a result of violation of transfer pricing rules — 20% of the underpaid tax starting from 2014 and 40% of the underpaid tax starting from 2017 (if the required transfer pricing documentation is properly prepared and submitted in a timely manner, there will be an exemption from tax penalties in the event the special transfer pricing tax audit results in a tax assessment).
• Failure to submit transfer pricing notification — RUB 5,000 (approximately EUR 70).

In addition, the Tax Code establishes a number of other minor fines for a variety of other less significant tax violations.

(c) Interest for late payment of tax

In addition to tax penalties, a taxpayer is subject to late payment interest, which is charged on the amount of the underlying tax at the rate of 1/300 of the Russian Central Bank key (refinancing) rate, currently at 6.25% per annum (for the tax periods prior 1 October 2017).

In respect to tax underpayment that was committed after 1 October 2017, late payment interest for organizations shall be determined as 1/300 and 1/150 of the Russian Central Bank key (refinancing) rate for the first 30 days and for the period beyond 30 days of the tax payment delay, respectively.

Please note that the total amount of penalties and interest for late payment charged for tax violations have no upper limits and may exceed the amount of the underlying tax.

(d) Collection procedures

Under the Tax Code, after issuing a demand notice, tax authorities may collect from corporate taxpayers and individual entrepreneurs outstanding taxes, penalties and interest on late tax payments without a court decision.

Courts may grant provisional measures, upon motion by the taxpayer, by suspending the collection of taxes, penalties and late payment interest where the taxpayer is challenging the tax assessment in court.

12. Strategies for dealing with tax audits

(a) Interpretation of ambiguities in tax legislation

Any ambiguities in tax laws must be interpreted in favor of the taxpayer in accordance with Article 3 of the Tax Code.
(b) Mitigating, exempting and aggravating circumstances

A taxpayer is exempt from liability for a tax violation if it was committed as a result of: (i) force majeure; (ii) the taxpayer's mental or physical incapacity; or (iii) the taxpayer's reliance on official instructions or rulings issued by tax authorities or other competent authorities. For a corporate taxpayer, the third circumstance is most important, as it exempts the taxpayer from liability for a tax violation and from the accrual of late payment interests if the taxpayer obtained and followed an advance ruling from tax authorities on a disputed issue.

The Russian Ministry of Finance and its territorial subdivisions must respond to an official ruling request filed by a taxpayer within two months, and local tax authorities must respond to requests filed by taxpayers within 30 days. A tax ruling does not exempt a taxpayer from tax liability if it is based on incomplete and/or incorrect information presented by a taxpayer. Therefore, the Russian tax authorities often try to claim that a taxpayer did not present all the details of the case in their request, and therefore a tax ruling does not provide an exemption.

In addition, under several mitigating circumstances, the amount of tax penalty must be reduced by at least 50%. These mitigating circumstances include: (i) personal or family hardship; (ii) threat, compulsion, or personal or material dependence; (iii) the difficult financial position of an individual taxpayer; or (iv) other circumstances within the court’s discretion. On an important note, the tax liability will automatically increase by 100% in the event that a taxpayer committed the same tax violation within the preceding 12-month period.

13. Conversion of a regular tax audit into a criminal investigation

In addition to the regular penalties for tax violations, individual taxpayers and responsible persons in a company may be subject to criminal liability.
Under Russian law, criminal liability applies to individuals only and not to legal entities. Tax authorities may engage Russian law enforcement authorities for on-site audits. Also, if the taxpayer fails to pay the assessed taxes within two months after the expiration of the term for payment of tax assessment as a result of a tax audit, the amount of which may suggest that the responsible persons employed by the company of the taxpayer committed criminal law violations, the tax authorities must notify the Investigative Committee (one of the Russian criminal investigation authorities), which will then decide whether to initiate a criminal case investigation.

The Russian Criminal Procedure Code allows the Investigative Committee to initiate criminal proceedings and establish factual circumstances of tax evasion without an obligatory tax audit.

The Investigative Committee may decide whether elements of a crime are present in the actions of an individual without the need for confirmation from the tax authorities that there was a violation of the tax laws.

Recently, the Federal Tax Service and the Investigative Committee issued Guidelines on identifying intentional tax underpayment (Joint Letter No. ED- 4-2/13650@, dated 13 July 2017) (“Guidelines”). The Guidelines put a strong emphasis on establishing intent to underpay tax in tax audits and presentation of results of tax audits in a tax audit acts as intentional tax underpayment. The Guidelines encourage tax inspectors to actively use special measures of tax control (e.g., interrogation of former and present employees, search of premises, and seizure of documents) and closer cooperation with police in tax audits. The Guidelines lack sophistication in the analysis of what might be complex business structures and provide examples on re-qualification of business transactions, thus leaving plenty of space for broad interpretations.
14. Disclosure of Russian tax law violations without conducting tax audits

If tax authorities discover tax violations indicated in the Tax Code (except for failure to pay or withhold taxes and gross violations of rules governing accounting of income, expenditures or objects of taxation) without conducting tax audits, they must issue a Tax Audit Act indicating the documentarily confirmed violations and present it to the taxpayer.

A taxpayer may present objections to this act within one month of the day it is received. Within 10 business days after the deadline for filing such objections expires, the head (deputy head) of the tax inspectorate shall hold a meeting with the taxpayer’s representative to consider the act and materials presented by the taxpayer. Based on the results of this meeting, the tax authorities may issue a Tax Audit Decision to either impose tax penalties for tax law violation, or refuse to impose penalties for tax law violation. This decision may be challenged by a taxpayer with a higher-level tax authority within one year. The Tax Audit Decision may be challenged in court only after the administrative stage of appeal and only within the three months after the decision of the higher-level tax authority is received by the taxpayer.
II. Dispute resolution procedures

1. Administrative level

(a) During audit

As was noted above, within 10 business days after completion of a chamber tax audit or within two months after completion of an on-site tax audit, an authorized tax officer must draw up a Tax Audit Act and present it to the taxpayer. This act must indicate all properly documented tax violations (if any) and be handed over to an authorized representative of the taxpayer within five business days.

If the taxpayer disagrees with the conclusions contained in the act, the taxpayer may provide written objections to the tax inspectorate within one month after the act is received. Within 10 business days after the expiration of this one-month period, the head of the tax inspectorate (or their deputy) must hold a meeting to consider the tax audit materials and issue a Tax Audit Decision. A taxpayer must be informed about the place and time of this meeting and may attend and provide comments even if no objections are filed. The decision must be presented to an authorized representative of the taxpayer within five business days. When issuing a Tax Audit Decision, tax authorities may issue provisional measures in the form of: (i) a prohibition against alienating property without the consent of tax authorities; or (ii) a suspension of the taxpayer’s bank account. These provisional measures may be substituted by a bank or third-party guarantee, or pledge of property provided by a taxpayer.

Prior to issuing a Tax Audit Decision, the head of the tax inspectorate may issue a decision to conduct additional measures of tax control. These measures may comprise only: (i) requests to provide documents; (ii) examination of witnesses; and (iii) an expert determination. Such additional measures may only cover a collection of additional evidence and cannot be aimed at the identification of new tax violations conducted by the taxpayer. The term for conducting additional measures of tax control
should not exceed one month. The information on the commencement and the end of conduct of additional measures of tax control and their scope should be documented and annexed to the Tax Audit Act within 15 days of the tax authorities finishing their conduct. The Tax Audit Decision comes into force one month from the date when it is received by a taxpayer. During this period, a taxpayer may file an administrative appeal with a higher tax authority, as described below. In this case, the Tax Audit Decision does not come into force and may not be fulfilled. A taxpayer also has further options for challenging the Tax Audit Decision, as described below.

(b) Administrative appeal

There are two levels of appeal against an adverse Tax Audit Decision that a taxpayer may consequently have recourse to: (1) an administrative appeal to a higher level within the tax inspectorate; and (2) an appeal to the arbitrazh court.

The administrative appeal is an obligatory pre-trial procedure that must be accomplished before a court claim challenging a Tax Audit Decision can be filed.

Under the administrative appellate procedure, a taxpayer may challenge a decision of a particular tax inspectorate or tax official at a higher-level tax authority, including the level of the Federal Tax Service. The Tax Code does not establish any special form for such an appeal, but there is a list of certain formal requirements that an administrative appeal must meet. Thus, it must contain all contact information of the taxpayer and the tax authority, as well as outline the grounds on which the appeal is filed and the demands of the taxpayer, etc.

A taxpayer may challenge a Tax Audit Decision either before it comes into force (within one month from the date it is received by the taxpayer) or after it comes into force (within one year from the date it is issued). In the first case, the decision does not come into force and may not be enforced.
until a higher tax authority issues a decision. In the second case, the decision may be suspended only upon special instructions from the higher tax authority, which is normally an exception rather than the rule.

The higher-level tax authority must review the taxpayer’s appeal and issue a decision within one month from its receipt. This term may be extended for another month. Based on the results of the review, the superior tax body must take one of the following actions: (i) dismiss the appeal; (ii) cancel the challenged Tax Audit Decision in part or in whole; (iii) cancel the challenged Tax Audit Decision in whole and issue a new decision; (iv) recognize the actions or inactions of tax officials as illegal and issue a decision on the merits of the appeal.

In practice, the likelihood of obtaining a positive decision from an administrative appeal is limited. To summarize, the administrative appeal process is quite bureaucratic and rarely results in the reversal of the initial claims brought by the tax authorities in the Tax Audit Decision. This is not surprising because the local tax inspectorates base most of their decisions on policies adopted at higher levels.

2. Judicial tax litigation

In 2014, a significant reform of the Russian judicial system was implemented. On 6 August 2014, the Russian Supreme Arbitrazh Court (which was the highest judicial body that reviews commercial and administrative, including tax, disputes involving legal entities) ceased to exist. Its functions were transferred to the Russian Supreme Court, which previously reviewed decisions issued by general jurisdiction courts and did not review commercial disputes and administrative disputes involving legal entities.

As a result, the system of appealing against the decisions of the lower arbitrazh courts has changed, and an additional level of judicial appeal was introduced.
(a) Appeal in the arbitrazh court

The system of arbitrazh courts in Russia is separate from the system of general jurisdiction courts. Arbitrazh courts hear cases involving economic disputes between legal entities, as well as disputes between legal entities and governmental agencies (e.g., the tax authorities). Generally, they may not hear disputes involving individuals, except economic disputes involving individuals registered as individual entrepreneurs and some special categories of cases involving individuals, such as shareholders’ disputes. In contrast, general jurisdiction courts primarily hear cases involving individuals. The Russian Federation Arbitrazh Procedural Code ("Arbitrazh Code") regulates the structure of arbitrazh courts, as well as the trial and appeal procedures in arbitrazh courts and the Supreme Court. The system of courts reviewing tax disputes consists of five major levels: (i) regional arbitrazh courts; (ii) appellate courts; (iii) circuit arbitrazh courts; (iv) judicial panel of the Supreme Court; and (v) Presidium of the Supreme Court.

Under the Arbitrazh Code, a taxpayer may challenge the legality of a decision of the tax authorities and may file any other lawsuit against the tax authorities (for example, contesting the illegitimate withdrawal of funds from its bank account by the tax authorities).

In practice, taxpayers mostly prefer to contest the validity of decisions by the tax authorities. This approach has a number of advantages:

- Firstly, to file a case in court, a taxpayer need not bring any property claims against the tax authorities and, therefore, needs only to pay a nominal state fee of RUB 3,000 (approximately EUR 43). Where a taxpayer files a lawsuit containing property claims, the state fee is calculated as a percentage of the amount in dispute.

- Secondly, such lawsuits challenging a decision of the tax authorities may be filed regardless of whether any funds have already been withdrawn from the taxpayer’s account. The taxpayer may also apply for provisional measures prohibiting the tax inspectorate from forcibly
collecting outstanding tax, penalties and late payment interest amounts before the arbitrazh court procedure is completed, which, of course, is not an option if the funds have already been taken from the taxpayer.

- Thirdly, statistically, judges appear to be more willing to address the first type of lawsuit, primarily because they do not have to confront the issue of whether the state budget will be required to return any funds.

If a taxpayer decides to bring a lawsuit against the tax inspectorate, it must file a case with the local arbitrazh court where the tax inspectorate is located. If the taxpayer decides to challenge normative acts of the Federal Tax Service, it must file a suit directly with the Supreme Court.

As mentioned above, administrative appeal is the obligatory pre-trial procedure. Generally, a taxpayer may file a lawsuit contesting the legality of a decision of the tax authorities within three months, starting on the day the taxpayer learns about such a decision. In this respect, it is important to note that although the Tax Code establishes the possible maximum period of one year for filing an administrative appeal against a Tax Audit Decision that came into force, the deadline of three months for filing a court claim starts running from the date the decision comes into force. Therefore, a taxpayer should file an administrative appeal beforehand in order to preserve its right to challenge the Tax Audit Decision in court.

In practice, before a taxpayer decides to file a lawsuit, they must carefully examine whether any similar cases have ever been heard by the Supreme Arbitrazh Court or Supreme Court. Although prior decisions of the Supreme Arbitrazh Court and Supreme Court are not automatically binding

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246 On 6 August 2014, the Supreme Arbitrazh Court ceased to exist and the Russian Supreme Court became the highest judicial body responsible for the unification of court practice on commercial and tax disputes.
on lower courts, in practice, lower arbitrazh courts will follow a decision of the Supreme Arbitrazh Court and the Supreme Court when considering any substantially similar dispute. Therefore, a taxpayer may reasonably expect a favorable outcome of their dispute if there has already been a positive decision on a similar case decided by the Supreme Arbitrazh Court or Supreme Court. Theoretically, through the appeal process, a taxpayer may take their dispute all the way to the Supreme Court, in the hope that the latter will reverse the prior decision of the Supreme Arbitrazh Court. In practice, however, this may be quite difficult to do, unless the substantive law on which the Supreme Arbitrazh Court based its original decision has changed.

The procedure of challenging a Tax Audit Decision in arbitrazh court is as follows. After a Tax Audit Decision has been a subject of an appeal at the administrative level, the taxpayer may file a lawsuit with the arbitrazh court where the tax inspectorate is located within three months after receipt of the higher-level tax authority decision on the results of the administrative appeal.

The taxpayer may also submit a substantiated petition for provisional measures prohibiting the tax inspectorate from imposing any fines before the arbitrazh court procedure is completed. The court must consider an application for provisional measures within one day after it is filed. The court is not obligated to grant provisional measures unless the taxpayer presents a bank guarantee for an amount no less than 50% of the disputed amount.

Within three months after the lawsuit contesting the legality of a decision of the tax authorities is filed with the court, the arbitrazh court should try the case. However, in practice such term may be much longer.

The first instance court may either reject the claims or satisfy them in whole or in part. The court judgment is subject to immediate enforcement,
but comes into force within one month of the date of its issuance in writing, unless the judgment is appealed.

If the taxpayer or the tax authorities are not satisfied with the first instance court judgment, they may file an appeal with the appellate (2nd instance) court within one month after the issuance of the lower court’s decision. In turn, the appellate court should consider the case within two months after it receives the appeal. This period of time may be extended.

The appellate court may: (i) confirm the initial decision of the first instance arbitrazh court; (ii) repeal or change it in whole or in part and issue a new decision on the case; or (iii) repeal it in whole or in part and decide to cease the legal proceedings of the case or leave the claim without examination either in whole or in part. The decision of the appellate court becomes effective immediately on the date it is issued.

Within two months after the decision is issued by the appellate court, it may be challenged in a circuit (third instance) arbitrazh court. The circuit arbitrazh court should try the case within two months after it receives the appeal, although such time period may be extended. Like the decision of the appellate court, the decision of the circuit arbitrazh court becomes effective immediately on the date it is issued.

Within the two months after the decision is issued by the circuit arbitrazh court, it may be challenged in a judicial panel of the Supreme Court. A Supreme Court judge must review the appeal and within two months (three months if the case file materials are requested from the lower courts) decide whether the appeal should be taken for consideration on the merits by the judicial panel of the Supreme Court. If the appeal is transferred to the judicial panel, the decision of the judicial panel of the Supreme Court on the merits of the case should be issued within two months. This decision also becomes effective immediately.

As a final resort, within three months after the decision of the judicial panel of the Supreme Court is issued, both the taxpayer and tax authorities
may try to initiate a judicial review by the Presidium of the Supreme Court. The standard for this review is that the lower courts decisions violate the public interests or interests of an unlimited circle of persons, or the constitutional rights and freedom of individuals and citizens, or the decision violates unified court practice. Therefore, similar to the judicial panel of the Supreme Court, the Presidium of the Supreme Court is free to decide whether to take the case for consideration or not.

At first glance, the arbitrazh court appeal process may appear rather cumbersome. In practice, however, it is more effective than the administrative appeal procedure. Normally, it takes about six to eight months to go through all of the stages up to the circuit arbitrazh court; however, the process may take longer, depending on the substance of the case. There are specialized tax sections within the Russian arbitrazh courts with judges hearing only tax cases. They are not under the same political pressure as the tax officials. Furthermore, judges more readily refer to tax legislation rather than to internal regulations issued by tax authorities. Since most tax disputes arise from different constructions of the tax laws by taxpayers and the tax inspectors, the judges are often at least willing to interpret the tax laws themselves in order to decide on a proper interpretation. Moreover, the Russian Constitution, the Tax Code and the Arbitrazh Code lay out an important principle, under which the courts must disregard the provisions of any normative act or letter issued by a governmental agency if such provisions contradict the federal laws. At the same time, recent court practice on tax cases shows that a taxpayer must have very persuasive and economically substantiated arguments in order to prevail in court; it is usually not enough to have only legal arguments in order to win the case.

(b) Constitutional court

It is worth mentioning that taxpayers could also bring some of their disputes in the tax area to the Russian Federation Constitutional Court if they are seeking to oppose the validity of a federal law or a normative act.
for being in conflict with the constitution. The constitutional court has, in several cases, ruled that certain tax laws and normative acts were unconstitutional, either because a local tax law went beyond the taxes that federal law permitted a local jurisdiction to impose, or because a normative act went beyond the scope of the tax law it purported to clarify.

(c) EU Court of Justice

Please note that since Russia is not a member of the European Union, the EU Court of Justice has no jurisdiction over Russian tax disputes. Accordingly, the practice of the EU Court of Justice in the tax area is not applicable to Russia.
III. Competent authority

In cases covered by double taxation treaties, competent authorities of foreign countries may initiate competent authority procedures with the Russian competent authority, which is the Russian Ministry of Finance. However, there is no special procedure established by Russian legislation for such cases, and it is not quite clear how they should correspond with Russian court proceedings. One of the major practical problems is that the initiation of MAP is not regarded as a ground for the suspension of the administrative and court proceedings and does not prevent the suspension of the terms for enforcement of tax audit decisions or the collection of tax assessments.

In practice, competent authority procedures are not used very often in Russia, but there have been some situations where the initiation of such procedures has helped taxpayers positively in resolving a tax dispute with the tax authorities.

In September 2019, several provisions on MAP were introduced to the Russian Tax Code (effective as of 1 January 2020). Under the new rules, the procedure and deadlines for submitting an application for MAP, as well as the time for consideration of this application must be adopted by the Russian Ministry of Finance. In case of a tax refund or offset as a result of MAP, such a refund or offset is not limited by the general three-year limitation period established under the Russian Tax Code.

On 30 January 2019, the Russian Ministry of Finance issued guidance on MAP that provides general "framework" rules.

However, still neither the Tax Code, nor the guidance resolve the existing practical issues, mainly the interrelation of MAP and other administrative and judicial remedies.

Please note that since Russia is not a member of the EU, the EU Arbitration Convention is not applicable to Russia.
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I. Managing the tax audit process

1. General

There are three levels of taxation within the Spanish tax system: local, regional and national. This means there are also three levels of tax authorities and collection, and of tax auditing.

The most important taxes (including corporate income tax (CIT), non-resident income tax, personal income tax (PIT), VAT, customs duties or excises), however, are audited by the National Tax Agency, which is an autonomous agency similar to the Inland Revenue Service in the US, although the agency is part of the Ministry of Finance.

Additionally, it should be taken into account that País Vasco and Navarra, due to their unique tax regime, have their own respective tax authority organizations, which are different from the general administration.

There are three levels in the organization:

- *Unidades de Inspección* ("Inspection Units"). These audit small taxpayers, both individuals and corporations. Usually, these units are composed of an auditor, one or two deputy auditors, and an agent. These units are not specialized according to area or economic sector, but assume the task of auditing all taxes.

- *Unidades Regionales de Inspección* ("Regional Inspection Units"). The Regional Units are in charge of auditing corporations with a sales volume greater than EUR 6 million, as well as some small consolidated groups. These units are also composed of a chief auditor, two deputy auditors and a team of assistants. In some situations, they also audit individuals related to companies within their competency (executives, shareholders). In the biggest cities (i.e., Madrid, Barcelona, Valencia), these units are organized according to sector, such as real estate, finance, insurance, food and beverage, and software, to ensure that
the auditors are familiar with the kinds of transactions, market prices, etc., in the audited company’s sector.

- **Equipos de la Delegación Central de Grandes Contribuyentes** ("Central Tax Office Teams"). These teams are deployed nationwide to taxpayers whose respective turnovers exceed EUR 100 million. Traditionally, these teams have been located in Madrid and Barcelona, although they have recently been set up in some other cities such as Bilbao, Burgos, Málaga, Murcia, Oviedo, Palma de Mallorca, Pamplona, Las Palmas de Gran Canaria, Santa Cruz de Tenerife, Santander, Valladolid, Vigo, Zaragoza, Valencia, Sevilla and La Coruña. They check on major companies that operate nationwide and are leaders in their business sectors, as well as serve consolidated groups.

They focus on specific sectors, such as banking, real estate, retail, food and beverage, and software.

This tri-level organization mirrors the auditing of taxes related to customs duties, VAT on imports and excises. These taxes are audited by special bodies within the National Tax Agency, which are also organized into units, regional units and national teams.

In that sense, the utilization of specialists when carrying out a tax audit by Spanish tax authorities is becoming more and more common in recent years. For example, in relation to tax audits focused on transfer pricing (TP) adjustments, the Central Tax Office has created a team of economists and valuators who specialize in TP issues. Additionally, this team is in charge of negotiations of advance pricing agreements (APAs) for TP purposes with multinational groups.

Further, this specialization of tax audit units can also be observed nowadays in regional and even local offices when dealing with TP audits.

Besides, in line with the "Base Erosion and Profit Shifting" Project ("BEPS Project") and other initiatives promoted by international organizations like
the Organization for Economic Co-operation and Development (OECD), the Spanish Tax Agency established in 2013 the National Office of International Taxation (ONFI). The aim of this organization is to strengthen and centralize the control of cross-border transactions carried out by Spanish taxpayers overseas, as well as those by foreign investors in Spain, to prevent the erosion of taxable bases subject to tax in Spain and the use of alleged aggressive tax planning.

For this reason, it is becoming common for auditors from the ONFI to support regular regional and central tax teams when auditing multinational companies, especially in cases of potential undeclared permanent establishments (PE), complex TP matters or, in general, relevant international structures.

The ONFI is also frequently involved in APA handling and in mutual assistance procedures dealing with TP matters.

In particular, it has been announced in the 2019 tax control plan — the report that covers the tax risk areas and the main structures/operations that will be under the control of the Spanish tax authorities during that year (published on 17 January 2019) — that special attention will be given to the following:

- Regarding compliance with tax obligations, the trend is to strengthen the assistance systems through electronic means. For example, the Spanish Tax Administration has designed a procedure of the VAT virtual assistant to help taxable persons. In addition, the tax administration has promoted taxpayers assistance by electronic and telephone channels.

- Within the investigation and control activities related to the prevention of tax fraud, there has been an enhancement of voluntary compliance through new technologies and the improvement of the efficiency of use of the information available to the tax agency (new data analysis and fraud detection models will be developed).
• We have faced the incorporation of information to the database of the tax agency, since the immediate information supply came into force and the incorporation of information due to the exchange of foreign financial accounts of Spanish residents, with the insertion to the CRS project (common reporting standard).

• Internal tax control of multinationals will be done through anti-circumvention measures and monitoring topics such as transfer pricing, permanent establishment, tax havens and preferential regimes.

• The Spanish Tax Administration will enhance actions of patrimonial analysis and investigation as well as the concealment of business or professional activities and abusive use of societies and new business models (especially e-commerce).

• The constant growth of electronic commerce (and its taxation) that drives the growth of companies is once again center stage (new activities have arisen, such as "triangulation of shipments," in which sales made by one company are delivered by others).

• The administration will focus on the study of ways of payment (like blockchain, cryptocurrencies or bitcoin) and will analyze the information proportioned from their use in previous years.

• VAT will be subject to a specific control. As an example, intra-community operations, fraud or VAT evasion throughout tax warehouses will be analyzed.

• Regarding the Corporate Income Tax, the combination of extensive controls of the management areas with those of a more intensive nature, are still typical analysis of the audit area. There would be a control of tax groups and taxable entities, updating the census information and controlling the actions within the framework of relations with the regional treasuries.
• There would be a control of fraud in the collection phase, raising risk evaluation, responsibility derivation, precautionary measures, fraud prosecution, control of apparent insolvencies and cooperation between public administration institutions.

2. Tax audits

(a) Expected periodicity

As we will have the opportunity to mention below, the statute of limitations under the Spanish General Tax Law (GTL) is four years. This means that when the four-year period from the last date for submitting the correspondent tax return has expired, the tax authorities may no longer audit the taxpayers’ obligations.

For this reason, large companies and other taxpayers with certain special characteristics are normally subject to a tax audit every four years comprising the previous four in order to prevent a situation in which the statute of limitations of a fiscal year elapses without their being audited. Companies assigned to the Central Tax Office are therefore audited every four years.

This also applies to large companies assigned to the Regional Inspection Units, although in this case, the frequency of the audits could vary significantly between regions and activity sectors.

Additionally, if a company has passed a recent audit that ends with a considerable assessment, that company will be under close control in the future.

(b) Selection of tax audit targets

The criteria followed by the tax authorities are not always the same and may change, depending on the economic or social environment of the specific period. Normally, large companies fall within the scope of a tax audit every four years for principal taxes: CIT, VAT and wage taxes, etc.
This may also be applicable to companies that develop specific activities or attract the special attention of tax authorities.

Since the implementation of Law 58/2003 of 17 December 2003, which approved a new GTL that came into force on 1 July 2004, the tax authorities have been annually publishing the specific activities and/or operations that they specifically and carefully scrutinize.

The mentioned activities can be summarized as follows:

(i) Informal economy, especially with scrutiny of double accounting methods or partial omission of the activity

(ii) Exploitation of information gathered through the automatic provision of VAT-relevant information

(iii) Aggressive international tax planning schemes

(iv) Digital economy: conduct research on the internet to find information that will disclose hidden activities; control the holders of web pages that continuously sell advertising; and control manufacturers or renderers of services that operate through the internet.

(v) High-value personal services

(vi) Fraud prevention: Tax authorities will focus on organized fraud, especially VAT fraud schemes and asset analysis.

(vii) Investigation and actions of verification of tax and customs fraud; control in the customs precincts

Additionally, the perseverance of the tax agency in its efforts against smuggling, drug trafficking and money laundering is mentioned, in particular.

In addition to the activities/sectors mentioned above, in the latest anti-fraud plan published by Spanish tax authorities, they have included, among
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others, control of imports, the situation of taxpayers subject to taxation through the objective estimation regime, control of customs procedures and premises, and acts of fraud in collection procedures, etc.

In this sense, although it is usually public and known which economic sectors are under special consideration by the tax authorities, the tax administration is not obligated to show in public the so-called "inspection plans." This issue is expressly introduced in a new tax regulation developing the GTL, which came into force 1 January 2008.

However, this does not mean that every taxpayer carrying out that specific activity will necessarily be subject to a tax audit, or that a taxpayer that does not engage in that activity or has not performed the specific operation will not be subject to a tax audit. The tax authorities may initiate a tax audit procedure for any other potential reason.

Aside from the above, a general tax audit may begin if, in the course of a minor verification of data (mismatches in regular information provided by the taxpayer) in the course of a regular tax audit related to negative VAT returns, for instance, the tax auditor perceives that the company has committed irregularities.

3. Advance preparation for tax audits

A tax audit procedure focuses mainly on taking action to investigate and on verifying the tax status of the taxpayer.

According to Spanish tax legislation, a tax audit may begin either with a direct visit of the tax auditor to the company or by a prior notification informing the taxpayer in advance of the audit. This second alternative is normally practiced.

The tax audit thus begins with a written notification issued by the tax authorities informing the taxpayer of the tax audit’s scope (taxes and years) and asking the taxpayer to appear before the tax authorities in at
least 10 days or be prepared for the tax auditor’s visit. The notification may also indicate that the tax auditor will visit the taxpayer’s office.

This means the taxpayer normally has enough time to prepare for the tax audit and to have meetings with its tax adviser in order to analyze its documents. It is highly recommended that the company, with the assistance of the tax adviser, take advantage of this period between the notification and the effective start of the audit to "self-audit" the company and fulfill formal obligations in order to identify possible problems, amend, if possible, any deficient or defective fulfillment of formal obligations, and obtain as well as organize properly all the information that may be relevant to the audit, etc.

However, in recent times, it has become common to start a tax audit with a "tax raid" or an unannounced visit and inspection of the premises of the company, with a judicial warrant. During such tax raids, relevant documents are seized, electronic information (including emails) is downloaded and copied, and employees are interviewed. It is particularly true in cases where tax authorities suspect that an undeclared PE exists, based either on internal information or information received from other tax authorities that followed a similar approach, the "unofficial" collaboration and exchange of information among tax authorities having become common practice.

For this reason, properly educating local employees and preparing them for possible raids is highly advisable.

Aside from this, however the audit is initiated, it is important to prepare the strategy to be followed regarding key or hot topics identified as problematic from the very beginning, and to decide whether it is convenient to focus directly on issues that will surely be the subject of the tax audit or, on the contrary, to provide the tax auditor excess information in an attempt to keep their attention on other issues. This strategy will depend on the character of the tax auditor in charge of the tax audit, so it
is important to discuss this issue with the tax adviser, who will normally be more familiar with the auditors' personal characters and areas of specialization.

In this sense, it is also advisable to analyze and decide beforehand who will attend the meetings with the tax authorities: a person from the company (for example, the financial director), the tax adviser or both together. Sometimes, it is advisable that the person who attends the meetings with the tax authorities is someone who is not from the company (for example, the tax adviser) in order to avoid having to give direct answers to the tax authorities during the meetings. In other words, from a strategic point of view, it is better to collect all the questions and documentation requirements of the tax authorities during the meetings and then provide the answers and documentation in a subsequent meeting. This way, there is enough time to duly prepare and analyze the tax authorities' requests and the taxpayer's answers. Conversely, at other times, it is advisable to have someone belonging to the company act as the direct link with the tax auditors while keeping the tax adviser from appearing in the meetings in order to keep the tax audit less "aggressive."

Additionally, in cases where the tax audit is carried out in the taxpayer's premises, it is very important to hold the meetings in a location where the tax auditors cannot have direct contact with personnel who possess relevant information about the company, but do not know how the tax audit is developing or what the tax auditors are looking for or want to hear. This is important to bear in mind to prevent the tax authorities from obtaining information besides that which is provided directly by the taxpayer's representative in the tax audit and to avoid potential misunderstandings, among others.

Another issue to be considered before submitting the information and documentation requested by tax auditors during a tax audit is the amount of information and how it is to be provided. In Spain, the tax authorities customarily request a great volume of information that the taxpayer has
to provide, duly ordered and classified, in order to facilitate analysis by the tax authorities. Again, this is something that the taxpayer has to balance because there are situations in which the tax authorities delegate their work to the taxpayer, and even demand, with no legal basis, that the taxpayer provide them with certain information in a particular way.

In summary, it is highly recommended that meetings are held with the tax adviser before and during the tax audit, or even that the tax adviser is appointed as a legal representative in relation to the tax authorities if the complexity of the tax audit so requires. The taxpayer will then be better assisted and defended before the tax authorities.

Another matter worthy of mention is that any payment made once the taxpayer is notified of the commencement date of the tax audit will be considered only as payment on account of the final tax debt. That is, once the initial notification is received, no voluntary disclosure, as discussed below, may be made.

The information obtained will be fundamental to the development of the auditing functions, which are aimed at obtaining data or antecedents of any nature on the part of the taxpayer that could have significance to the application of taxes.

It has to be taken into account that, in general, individuals or legal entities, public or private, will be obligated to provide the tax authorities with all types of data, reports and proof of significance for taxes related to the fulfillment of their own tax obligations or the tax obligations of third parties with which they have economic, professional or financial relations.

The taxpayer has two obligations when it comes to disclosing information to the authorities: (i) the obligation to make a disclosure without being required to do so by the authorities as long as the applicable tax regulations establish that certain information has to be supplied periodically to the tax administration; and (ii) the obligation to disclose
information specifically requested by the tax authorities (as explained below).

It must be taken into account that when the tax authorities decide to audit a taxpayer, they already have in their possession plenty of information the taxpayer has previously provided. In this sense, Spain has exerted significant efforts to demand that taxpayers provide a significant amount of information periodically to the tax authorities. Afterward, this information is processed electronically by the tax authorities.

For instance, businessmen and professionals must notify the tax authorities of all transactions entered into with third parties that are not subject to withholding at source, provided the annual amount of the transactions with a given party exceeds EUR 3,005.06 (such obligation is not required for those taxpayers that must upload the content of the invoices received and issued to the tax authorities by electronic means, as the obligation is fulfilled through that pathway). Withholding agents, both individuals and entities, are obligated to give notice of all income paid that is subject to withholding at source and to identify the recipient individual or entity. Financial institutions, as well as stockbroker corporations and agencies that mediate the issuance, subscription or sale of securities are required to notify the tax authorities of such transfers by filing the relevant tax returns in which they have to include, among other things, the identity of buyers and sellers, etc.

Another example is the obligation to submit electronically VAT books containing all the information registered in them, applicable to the taxpayers that have chosen to request a monthly VAT refund (when these taxpayers are also subject to submit, by electronic means, their CIT and VAT returns).

In this sense, a new system for the automatic provision of information entered into force in 2017. According to this system, certain taxpayers (large businesses, in general terms) are obliged to submit to the tax
authorities by electronic means information related to the invoices issued and received, within four days from the issuance or receipt of the invoices.

This regular provision of information is, in fact, one of the bases of the tax system in Spain. The importance given to this by Spanish legislators explains why the incomplete, false or out-of-date provision of information is sanctioned with penalties that, in some cases, may be even higher than penalties for underpayment.

Because of this, it is necessary that the taxpayer complies regularly with all formal tax obligations. This way, if an audit takes place in the future, the taxpayer will be adequately prepared to contribute all the documentation the authorities require, and will ultimately be prepared to face the tax audit.

In addition, tax authorities usually incorporate into the audit file the taxpayer’s public information, such as information contained in official websites and that supplied to the mercantile registries, the stock markets and the financial, banking and/or regulatory authorities, as well as, in the case of multinationals, information received from other tax authorities. For example, in recent cases, we have seen Spanish tax authorities initiate audits or even request search warrants on the basis of information received from other tax authorities regarding the conclusions and approaches followed in the audits in their respective countries.

Therefore, special attention should be paid to information that is included and its potential tax implications, to prevent misunderstandings due to the way the information is presented for purposes other than taxes. Aside from this, when preparing for the audit, the company has to be aware of the kind of information the tax auditor may have in advance, in order to be prepared to explain mismatches or, even better, to avoid these.

Specifically, in cases where the tax audit could be focused on intra-group transactions, it is advisable to have the following issues already in place
and have these reviewed by the tax adviser before submitting information to the tax authorities:

- Statement in the contract about the benefits obtained by the companies through intra-group services or transactions rendered
- Setup of an internal procedure to ensure the correct allocation of expenses
- Maintenance of all the documentation that justifies expenses incurred (invoices, time sheets, minutes of meetings, accounting records, etc.)
- Requests for a certificate from the auditors of the Spanish company, if any, to demonstrate fulfillment of the requirements to obtain the tax deductibility of these charges

In that sense, in the event of restructuring transactions benefiting from the tax neutrality regime, it is highly important to avoid controversies in the course of the tax audit and, particularly to apply the anti-abuse clause that excludes the application of the special regime to a purely tax-driven transaction. It is also crucial that the companies involved prepare and keep as much contemporary documentation as possible prior to the tax audit in order to prove the existence of a valid economic reason supporting the restructuring. This documentation may include specific minutes of the board of directors’ meetings, independent professional advice, improvements and benefits derived from the reorganization, business plans, etc.

In addition, many formal requirements must be fulfilled to benefit from the special regime of restructuring transactions. Mainly, the transaction must be reflected in the relevant companies’ annual accounts. Moreover, in order to benefit from this regime, the election of that option has to be mentioned and included in the public deed in which the transaction is documented and notified to the Ministry of Finance within the three-month period following the inscription of the public deed in the Mercantile...
Registry. It is therefore important to check whether these requirements have been complied with before the audit.

4. Limitations period for assessments

As mentioned above, the general statute of limitations is four years\textsuperscript{247} from the last day for filing the relevant tax return under the terms of voluntary compliance. This term applies to the rights of the tax authorities to assess tax liability, to collect any tax liability previously assessed, and to impose penalties, as well as to the taxpayer's right to obtain the refund of any excess tax paid.

Only actions taken with the formal knowledge of the taxpayer and designed to enable the tax audit, assessment or collection of the tax liability will interrupt the statute of limitations of four years. Any action taken by the taxpayer in order to enable payment of the tax, appeal against an assessment, or obtain a refund will also interrupt the statute of limitations of four years. This means that the four-year period will begin again from the date of any of these actions.

Some provisions prevent abuses by the tax authorities resulting from actions basically aimed at interrupting the statute of limitations without having the collection or assessment of tax as their actual purpose. These provisions establish that in these cases, the period shall not be deemed interrupted.

\textsuperscript{247} Five years in the event of criminal offenses to the tax administration (as of 2013, 10 years in certain aggravated cases). The difference between the statutes of limitations for pure tax debts versus those for criminal offenses committed against the tax administration has been the cause of several practical problems and controversies.
On 12 October 2015, the most important tax reform of the GTL came into force. It established a new regime of statute of limitations for specific cases. In particular:

- Tax obligations that are related to others

  "Connected tax obligations" are defined in the regulations as those in which one of the elements is affected or determined depending on those of another obligation or a different tax period, provided that both taxes are of the same taxpayer.

  The interruption of the administration’s right to make tax assessments for a given tax obligation will also interrupt the right to assess a related tax obligation.

- Right to audit, verify and investigate (not subject to statutory limitations)

  With the new wording, emphasis is placed on the distinction between the right to audit, verify and investigate, and the right to assess the tax debt. The administration then has the power to audit, verify and investigate the fiscal years and tax items barred by the statute of limitations, provided that it is necessary for issuing tax assessments or ordering refunds related to fiscal years for which the statute of limitations has not run out.

  Notwithstanding the above, some limitations are established for the verification of losses carried forward or tax credits, both to those already applied or pending application:

  - In tax audit procedures with a "general scope," the power to audit, verify and investigate runs out after 10 years from the day following the deadline for filing the tax return for the fiscal year in which the tax credit was generated.
o In other tax audits (with a non-general scope) and other tax procedures, the power to verify losses and other tax credits will also be limited to 10 years, as above, but such investigation must be authorized by express mention of the fiscal years or tax periods in which the losses or tax credit was generated.

o This type of verification can only be done within procedures initiated to verify, investigate and assess tax periods for which the statute of limitations has not run out.

- Statute of limitations for periodic collections

For taxes subject to periodic collection against receipt (and when no tax return is filed for its assessment), the statute of limitations period will begin the day on which the tax is due.

5. Areas of tax auditors’ special attention

(a) Procedure and form

(1) Financials and accounting

The taxpayer needs to pay special attention to ensure that the following formal obligations are met:

- Keep the compulsory accounting books in accordance with the Code of Commerce, which establishes that businessmen should maintain books, correspondence, documentation and proof concerning their business for six years. Because the taxpayer is obligated to keep this documentation while the statute of limitations is running, this obligation could be significantly increased in some cases, but only for tax purposes, especially if tax litigation is initiated. In addition, if the taxpayer has taken a negative tax base into account when filing the tax return, it will be obligated to keep the documentation related to the fiscal year in which a negative tax base was declared. Regarding that, please note that according to the Corporate Income Tax Act ("CIT
Act") recently passed (Law 27/2014, of 27 November), which came into force on 1 January 2015, the offsetting of loss carryforwards will not be subject to a deadline.

- Apart from that, be aware that as a result of a recent ruling from the tax court, the right to offset losses has been restricted in the case of CIT late filing. The tax court considered the right to offset as an option that the taxpayers should execute in a timely fashion; otherwise, they will lose their right.

- Moreover, specific circumstances could increase the time period in which the retention of certain documents is compulsory. In the event of amortization/redemption of real estate, for example, the taxpayer has to retain the documentation related to that real estate property for 50 years (which is the period of amortization of real estate).

- Retain not only the books and registrations, but also the software and computer files that serve as backup, as well as the systems of codification utilized to allow the interpretation of the data when an obligation to use data processing systems exists. Issue invoices and retain copies of these, as well as the documents and invoices relating to the tax obligations. In this sense, Spanish tax authorities passed certain regulations regarding electronic invoicing. These provisions state that the recipient of paper invoices is allowed to store these in a digital format, provided that the digitalizing software and the whole process comply with some formal and technical requirements.

- Provide the authorities, upon their express request, with books, registrations, documents and/or information that the taxpayer should keep in relation to the fulfillment of tax obligations.

- When the information required must be kept in a data processing backup file, supply the information in this backup file when requested.
Our previous comments and considerations regarding the retention periods for the conservation of the documentation also apply to other obligations mentioned above.

A case of special importance relates to companies engaging in banking or credit activities. In these cases, the banking secret may not be invoked against the information duty. These entities will be obligated to provide tax authorities with all types of data, reports or antecedents with tax implications that they know are derived from their economic or financial relations.

These entities will be particularly obligated to provide the movements of current accounts, deposits and loans, among others, that are related to a specific taxpayer upon the request of the tax auditor.

(2) Formal requirements

i) Examination of the documentation required of the taxpayer

The tax authorities are authorized to require that the taxpayer present every piece of tax-relevant information/documentation that the taxpayer is obligated to keep.

Usually, the audit is conducted at the offices of the tax authorities, but when there is a considerable volume of documents to be provided, the tax auditor goes to the company’s premises to check these. In this case, the normal procedure is that a sealed-off area or room is prepared for the auditor and the person within the company handling the audit and the different documents (invoices, accounting entries, details of specific accounts, etc.) requested by the auditor are provided.

When the company uses electronic systems for invoicing, accounting, etc., it is obligated to provide the auditors with copies of the data to be examined at their offices. Most auditors, however, prefer to examine the information in paper form and demand that the taxpayer organize and substantiate the data.
ii) Entry into the taxpayer’s premises

Where the auditing work requires it, the tax auditors may enter business offices and any other establishments or places in which taxable activities are carried out. In the event that the tax authorities need to enter a taxpayer’s constitutionally protected domicile, the taxpayer’s consent or a judicial authorization will be required.

In the event that the person exercising authority over access into the taxpayer’s premises refuses entry to the tax auditors, an express, written authorization from the competent administrative authority will be needed.

iii) Attendance of the taxpayer

The taxpayer should attend the tax audit itself or send its representatives to the place, on the date and at the hours indicated for the audit, and should have the documentation and other elements requested by the tax auditors at their disposal for the tax audit.

iv) Initiation and development of the procedure

The procedure of the tax audit will be initiated in the following circumstances:

- Upon the initiative of the tax authorities
- At the taxpayer’s request

In every case, the taxpayer should be informed of the nature and scope of the tax audit (taxes and fiscal years included), of the action taken within the procedure, and of its rights and obligations in the course of such action.

v) Time limit

In relation to deadlines for tax audit procedures, it is necessary to distinguish between those that started before 12 October 2015 and
procedures beginning as of this date, as a result of Law 34/2015, of 21 September 2015, which partially amended GTL.

- Procedures started before 12 October 2015

In general, the tax audit procedure must be concluded within a maximum period of 12 months computed from the notified starting date. In the event that the actions are of particular complexity or reveal that the taxpayer has concealed information, the time limit may be extended for another 12-month period.

In this regard, a new regulation that was developing the GTL was passed by the Spanish government and came into force on 1 January 2008. It increased significantly the reasons and situations in which the tax authorities could extend the tax audit for the said additional 12-month period.

If this limit is exceeded, the tax audit will not interrupt the statute of limitations. Only the final tax assessment may interrupt it.

When the effective duration of a tax audit is determined, the delays caused by the taxpayer (e.g., by not submitting all the required information on time) are not taken into account. For this reason, diligent fulfillment of the tax auditor’s information requests is advisable.

Aside from this, periods when the tax audit is interrupted because of one of the specific causes established by the regulations (for example, the periods granted by tax auditors in order to collect the information requested) are not taken into account.

Finally, it is worth mentioning that if the tax audit is interrupted for more than six months due to the authority’s inactivity, the statute of limitations of four years will not be deemed to have been interrupted by the start of the tax audit.
In the last several years, the Spanish courts have issued several judgments dealing with the calculation of the effective duration of a tax audit, applying criteria that are very favorable to the taxpayer. Those judgments have implied that in several cases, the taxpayers have succeeded in the appeal due to the "formal" aspects of the tax audit and not by substance or material reasons.

That is the reason why the taxpayer, during the course of a tax audit, has to be diligent in fulfilling the tax authorities' requests and to be careful with all the formal issues — such as the exact calculation of the tax audit’s duration — that surround the procedure, paying special attention to the references included in the minutes of the meetings with the tax auditors.

- Procedures started after 12 October 2015

According to the above-mentioned tax reform of the GTL, the terms for carrying out the tax audit are prolonged:

(i) For general terms: 18 months

(ii) For extended terms: 27 months. It is applicable under the following circumstances:

- The taxpayer's annual sales turnover is equal to or greater than that required to audit accounts.

- The taxpayer forms part of a group of companies under the consolidation special regime in CIT or is a VAT company group subject to tax audit.

- The tax audit is verifying related parties' operations and the "extended" deadline is applicable to one. In this case, the extended term is also applicable to the other related parties.
Moreover, the above-mentioned terms could be extended by three or six months more due to the late submission of the required documentation. If a sanctioning file has been opened, its deadline will be extended similarly.

If this limit is exceeded, the tax audit will not interrupt the statute of limitations. Only tax audit activity following the maximum term will interrupt it. Besides, default interest will not be applicable from the deadline up to the end of the tax audit process.

The computation of cases of undue delays and disruptions not attributable to tax authorities, which usually implies the extension of the initial term of the audit, is no longer done. As an exception, and before the file is presented to the taxpayer for submitting allegations, the said taxpayer may request a "courtesy" period of 60 days in which the tax authorities would not be able to carry out any activity with the taxpayer. But this period will be added to the deadline for the tax audit. Finally, the period of tax audits is significantly reduced to a mere six months in the event of limited reviewing procedures (procedimiento de gestión). In these procedures, the obligation to notify within the deadline will be deemed to have been met when notice is made available electronically, either at the tax administration’s electronic address or at the Available Tax Electronic Address.

(3) Documentation of intra-group transactions

It must be said that for tax periods starting after 1 December 2006,248 of the main novelties introduced in the Spanish tax system deals with the treatment of intra-group transactions aimed at introducing measures for harmonizing related party transactions within the EU — the EU Code of Conduct on TP issues — as well as the recommendations established by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in Spain.

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248 Law 36/2006 on measures for the prevention of tax fraud.
In this regard, on 18 November 2008, the amendment to the Corporate Income Tax Regulations (Royal Decree 1793/2008, dated 3 November) was officially published, introducing specific rules on the documentation requirements for related parties' transactions (apart from the ones related to management fees and contributions to research and development activities that were previously passed).

These documentation requirements focus on TP issues, updating the current legislation in accordance with the OECD Guidelines and developing in detail the documentation regarding intra-group transactions that the companies are obligated to prepare and, obviously, provide to the tax authorities so that they can verify whether the agreed conditions are at arm's length.

Regarding the documentation requirements, the Royal Decree 897/2010 entered into force on 11 July 2010, which modified CIT regulations on related transactions’ documentation issues.

On 28 November 2014, the definitive wording of the Spanish Tax Reform was published in the Spanish Official Gazette. The Spanish Tax Reform basically comprises amendments relating to PIT, non-resident income tax, CIT and VAT. In general terms, these measures came into effect on 1 January 2015. On 11 July 2015, Royal Decree 634/2015 was published in the Spanish Official Gazette, approving the new Spanish Corporate Income Tax Regulations, which complement the provisions included in the Spanish Corporate Income Tax Law, including, among other changes, provisions to be in line with the BEPS approach.

The regulations exempt from the obligation of documentation all transactions not exceeding EUR 250,000, according to the market value, which were made during the tax period with the same related person or entity, regardless of the size of the company, and the domestic or international nature of the transactions.
However, this exemption does not apply to the following transactions:

- Transactions carried out with persons or entities resident in a country or territory qualified as a tax haven (unless residing in a Member State of the EU and if the taxpayer certifies that the operations meet economic justification and that such related persons or entities are engaged in economic activities)

- Transactions, carried out by taxpayers of PIT to whom objective assessment schemes apply, with entities in which they or their spouses, ascendants or descendants, either individually or jointly, have a percentage equal or greater than 25% of the capital share or equity

- Transactions that consist of the transfer of a business or shares of entities not admitted to trading on some of the regulated securities markets, as defined in Directive 2004/39/EC

- Real estate transfer transactions or transactions on intangibles

Finally, it should be noted that the obligation to keep TP documentation will not be required, among others, in: (i) transactions between companies in the same group applying the CIT consolidation regime; (ii) transactions carried out by its members with economic interest grouping entities or temporary consortiums; or (iii) those performed within the scope of public share offerings or takeover bids; or (iv) transactions among certain types of credit institutions through an institutional protection scheme approved by the Bank of Spain.

Leaving aside those exceptions, the taxpayer must, at the request of the tax authorities, submit documentation reflecting the market value on which the transactions with related parties must be based. That documentation is split into two parts: master file and local file.

With regard to the latest developments on TP documentation obligations for fiscal years beginning on or after 1 January 2016, for corporate groups
whose turnover is equal to or greater than EUR 45 million in the previous financial year, new information related to the group activities is now required, including intangible assets and other financial activities, as well as new information regarding the taxpayer, its competitors, any previous agreements in force and the taxpayer's financial information. Therefore, the documentation approach will be more analytical in accordance with the new standard adopted by OECD with this regard.

Since 1 January 2015, TP documentation obligation for entities whose turnover (together with the turnover of related entities) is less than EUR 45 million in the previous year has a simplified content. The documentation must describe: (i) the nature, characteristics and amount of related transactions; (ii) the related entities; (iii) the valuation method implemented; and (iv) comparable data and values. Except in certain operations, specific documentation required from the taxpayer has been significantly reduced.

The specific contents of the TP documentation requirements in Spain closely follow the European Union Transfer Pricing Documentation Model and the OECD Guidelines. Three levels of documentation need to be prepared: one relating to the group containing standardized information, commonly known as "master file"; another one referring specifically to the taxpayer, called "local file"; and the Country-by-Country (CbC) report.

i) Standard information that must be included in the master file

   a) Information on the structure and organization of the group

      1. Overview of the organizational, legal and operational structure of the group, as well as any relevant changes made to it

      2. Identification of the different entities that belong to the group

   b) Information on the activities of the group
1. The group’s principal activities and a description of the principal markets in which the group operates; major sources of profits and supply chain of those goods and services that represent at least 10% of the net turnover of the group for this tax period

2. Overview of the functions performed, risks assumed and main assets used by the various entities of the group, including the changes from the previous tax period

3. Description of the group policy on transfer prices including the pricing method adopted by the group

4. List and brief description of the cost-sharing agreements and relevant contracts for the provision of services among group entities

5. Description of reorganization operations and acquisition or assignment of significant assets made during the tax period

c) Information concerning the intangible assets of the group

1. Overview of the group’s global strategy concerning the development, ownership and operation of intangible assets, including the location of the main facilities where research and development activities are conducted, as well as their management

2. List of relevant intangible assets for TP purposes, indicating the entities holding them, as well as an overview of the TP policy of the group in connection with these assets

3. Amount of related-party transactions relating to the group, from the use of intangible assets, identifying the affected group entities and territories of residence for tax considerations
4. List of agreements between group entities relating to intangibles, including cost-sharing agreements, major research service agreements and licensing agreements

5. Overview of any significant transfers of intangible assets carried in the tax period, including institutions, countries and amounts

d) Information on financial activity

1. Overview of the sources of funding for the group, including major funding arrangements with persons or entities outside the group

2. Identification of the group entities that perform the main financing functions of the group, as well as the country of incorporation and the country where effective management takes place

3. Overview of TP policy of financing arrangements among group entities

e) Financial and fiscal situation of the group

1. Consolidated financial statements of the group, provided these are mandatory or are prepared voluntarily

2. List and a brief description of the APAs in force and any other decisions agreed with any tax authority affecting the distribution of profits of the group among countries

ii) **Standard information that must be included in the local file**

a) Information about the taxpayer

1. Management structure, organizational structure and persons or entities receiving the reports on the development of the
taxpayer’s activities, indicating the countries or territories where such persons or entities reside for tax purposes

2. Description of the taxpayer’s activities, business strategy and, where appropriate, participation in restructuring operations or assignment or transfer of intangible assets in the relevant tax period

3. Main competitors

b) Information about related-party transactions

1. Detailed description of the nature, characteristics and amount of the related-party transactions

2. Name and surname or business name or full name, legal address and identification number of the taxpayer and the persons or entities with which the operation is performed

3. Detailed comparability analysis

4. Explanation regarding the selection of the valuation method chosen, including a description of the reasons for the choice, and its means of application, the comparables obtained and the specification value or range of values derived therefrom

5. Where appropriate, criteria for allocation of expenses for services provided jointly in favor of several related persons or entities, as well as the relevant agreements, if any, and cost-sharing agreements

6. Copies of APAs in force and any other decisions agreed with a tax authority in connection with the related transactions mentioned above
7. Any other relevant information used by the taxpayer to determine the valuation of its related-party operations

c) Financial and economic information about the taxpayer
   1. Taxpayer’s annual financial statements
   2. Reconciliation of the data used to apply the TP methods and the annual financial statements, where applicable and relevant
   3. Financial data of the comparable companies used and the relevant source

This implies that the documentation to be prepared not only consists of a purely economic analysis with financial/economic implications, but may also have other relevant legal and tax implications in the tax authorities’ hands.

In this sense, there have been recent experiences in which the tax authorities concluded that companies had a PE in Spain based, among other issues, on the business model description provided by the company, as reflected in the correspondent TP study.

As a consequence, it is very advisable for the taxpayer to include a tax lawyer in the working group preparing the TP documentation in order to take into account not only the economic perspective, but also other potential tax implications, as well as to avoid ambiguous expressions that may give an erroneous impression of the role played by each company or of the nature of the transactions performed.

In this sense, we understand that the set of TP documentation should obviously be standardized for the whole group of companies, but it must be somehow adapted to and reviewed by the specific country involved in order to prevent controversies like the one mentioned above.
Finally, it must be emphasized that these intra-group transactions currently fall very frequently within the scope of tax audits of: (i) Spanish companies with branches or subsidiaries abroad; and (ii) groups formed exclusively by Spanish companies. For this reason, it is crucial and extremely advisable to have available the correspondent TP studies justifying the conditions and margins applied within the group and to fulfill the aforementioned documentation requirements.

iii) CbC report

On a separate note, the new rules require companies to file a CbC report, as well as create new specific documentation requirements in line with BEPS action 13.

For fiscal years beginning 1 January 2016 and onward, CbC reporting will be compulsory for corporate groups whose turnover exceeds EUR 750 million in the 12 months prior to the information period.

This documentation must be filed with the tax administration within 12 months following the end of the taxpayer’s fiscal year. A specific form is available for this purpose.

The CbC report — with respect to the tax period of the parent company, aggregated (for each country or jurisdiction) and denominated in euros — must include the following information: gross revenues of the group; results before CIT (or similar tax) expense; amount of CIT (paid or accrued) including withholding taxes, turnover of capital and other funds existing at the end of the tax period; average number of employees; tangible assets and investment property other than cash and credit rights; list of resident entities including PEs and the main activities carried out; and any other relevant information.
(b) Substantive issues

(1) Concept of residency/permanent establishment

The concept of tax residency in Spain is regulated by Article 8.1 of the CIT Law. Under this law, legal entities qualify as tax residents in Spain if at least one of the three following criteria is fulfilled:

- They have been incorporated according to Spanish laws.
- They have their corporate domicile in Spain.
- Their effective place of management is within Spanish territory.

For these purposes, it will be understood that a company has its effective place of management in Spain if the seat of the direction and control of its activities is within Spanish territory. In order to defend before the tax auditor that the effective place of management is in Spain, the taxpayer must be able to demonstrate that relevant decisions concerning the company’s activity are taken within Spanish territory.

This may be proved by the minutes of the board of directors’ meetings held in Spain reflecting that such decisions have been taken. This proof is normally accepted by tax auditors as evidence of the existence of the effective place of management within Spanish territory.

However, please note that tax authorities are currently trying to attract to Spain the tax residency of pure holding companies incorporated abroad in low-tax jurisdictions that are the sole shareholders of profitable Spanish-operating entities.

The legal concept of PE in Spanish territory and the consequent taxation of income derived from the economic activities carried out through that PE are governed by several rules.

It is understood that a non-resident entity or an individual acts in Spain through a PE when it has any kind of facilities or places of work
continuously or regularly at its disposal in Spain, in which part of its activity is carried out. In particular, it is understood that places of management, branches and offices, among other things, constitute a PE. As far as representative offices are concerned, it is understood that they will not be deemed to constitute a PE in Spain if the activities carried out are merely auxiliary or preparatory in nature; that is, among others, no transactions with third parties are executed from that office. This is why an office that carries out only marketing activities and compilation of information will normally not be considered a PE in Spain unless, of course, the head office's main activity is marketing or the compilation of information.

Aside from this, an agent authorized to contract in the name and on behalf of the non-resident entity that habitually exercises those powers (in the sense stated in the OECD commentaries to the Model Tax Treaty) will be deemed to be creating a PE of the non-resident entity. If the agent works on a totally independent basis, no PE will be deemed to have been created. On the other hand, if the agent carries out its activity in accordance with the rules set by the head office or has the power to oblige the company it represents when negotiating the details of the agreement, a PE will be deemed to be existing in Spain.

The position of the tax authorities and courts has been very aggressive on the existence of PEs and the attribution of income to such PE in the past in relation to certain structures, such as commissionaires, marketing and sales support activities, combined or not with others, and contract manufacturing.

Under this position, it was considered that a PE existed and all profits generated in Spain were attributed to the PE (see the Roche, Dell, and Borax cases). In the case of commissionaire and warehouses, this controversy can be envisaged as closed in the light of the works that developed under the umbrella of OECD Action 7 concerning the PE.
Notwithstanding the above, a recent decision by the Tax Court must be highlighted. Guided by the position of the OECD, the court states that in situations in which the activities in Spain of a foreign investor are characterized as being carried out through a PE, the income from these activities should be allocated to the PE with respect to the risks and functions assumed by the parties involved (and not fully allocated to the PE, as the tax auditors used to consider).

Other BEPS concepts that have been applied somehow by the tax authorities even before the BEPS Projects were launched are as follows:

- The anti-fragmentation rule (under the Spanish concept of "complex operative settlement")
- A leading role in concluding contracts
- Non-auxiliary warehouses. Even if we are not aware of specific cases where this concept has been specifically applied, relevant officials from the National Office for International Taxation have made public statements regarding their intent to pay special attention to this matter.

In this sense, Spain is one of the countries that have been "applying BEPS before BEPS," with retroactive effects, even. This position has been implicitly supported by the Supreme Court (Tribunal Supremo) in its ruling on the Dell case, upholding a purposive interpretation of Tax Treaties and OECD commentaries:

The foregoing seeks the purpose and aim of fulfilling international taxation regulations, aimed at fairly distributing tax burdens and business profits among states, in a very different scenario from the one that existed at the time Double Taxation Treaties arose: a globalized market where multinationals are trying to transfer the profits obtained in other states towards another country with...
lower tax rates. Consequently, the appellant’s strictly formalist-literal and static interpretation is inadmissible.

Finally, in our experience, although the structures are duly designed from a technical perspective, when these are implemented, frequently: (i) certain functions and activities are not carried out by the parties assigned; or (ii) the formalities with which to prove the real role played by each company involved are not properly complied with. Therefore, it is very advisable that these kinds of structures are reviewed and monitored on a day-to-day basis to ensure that all relevant requirements are fulfilled continuously. In this sense, there is a need to take into account that Spanish tax authorities usually require third parties to disclose information related to the taxpayer being audited in order to prove what particular functions and activities are carried out by each of the parties involved in the structure. It is also crucial that the documents that will be provided to the tax authorities to have been previously analyzed and reviewed from this perspective.

(2) Transfer pricing

As mentioned previously, one of the main amendments to the Spanish CIT Law in recent years focused on related party transactions, with the aim of adapting the law to the EU and OECD Guidelines on TP.

In fact, TP policies are becoming an essential part of the audits, especially in the case of multinational companies. Particular areas of interests are IP, financial transactions (such as cash pooling, management expenses) and other support services from central services.

According to the regulation, Spanish taxpayers are obligated to apply market values to every transaction carried out with related parties.

According to the new wording of the Spanish CIT Law, the following parties are considered related parties:

- Entities and their shareholders/members
• Entities and their directors and managers but with regard to their remuneration

• Entities and the relatives, up to and including those three times removed, of the shareholders, members, directors and managers

• Entities belonging to the same group of companies

• Entities and the relatives of the shareholders/members of another entity, up to and including those three times removed, where both entities belong to the same group of companies

• Entities that indirectly hold at least 25% of the shares of another company

• Two entities in which shareholders/members or their relatives, up to and including those three times removed, either directly or indirectly hold at least 25% of the shares

• Entities established within the territory and its PEs abroad

• Non-resident entities and PEs within the territory

When determining the arm's-length price in a transaction between related parties (for example, a Spanish subsidiary and its foreign parent company, or other companies within the group), the Spanish taxpayer could apply any of the generally accepted TP methods. Namely, the comparable uncontrolled price (CUP) method, the cost-plus method, the resale price method, the profit-split method or the transactional net margin method.

If it is not possible to apply one of the above-mentioned methods, the use of other generally accepted methods and valuation techniques could be accepted, provided they respect the arm's-length principle.

According to the new CIT, which came into force in 2015, several TP rules have been affected, including the introduction of the CbC report that was previously analyzed.
In this sense, entities or groups of entities with a turnover below EUR 45 million are subject to simplified TP documentation obligations. This documentation will not be necessary for certain operations. Small-sized entities (those with a turnover of less than EUR 10 million) are released from preparing a master file and must prepare a simplified local file, which does not need to include a comparability analysis and can be prepared using a template (FOV) provided by the tax administration. The FOV should be filed as an appendix of the CIT return.

In order to fall within the scope of TP rules for related entities, the stake a shareholder must own is raised from 5% to 25% (the 1% stake threshold in listed companies is eliminated).

Besides, the preference for traditional transaction methods with which to determine the market value (arm’s-length principle) of operations between related companies is eliminated. Other valuation methods and techniques are included subsidiarily, provided that they respect the arm’s-length principle. Furthermore, specific rules for valuating operations of the partners in professional partnerships are established.

The penalty regime is amended, reducing the sanctions. Likewise, a relevant improvement is the possibility of APAs having retroactive effects within the statute of limitations period.

Regarding the informative obligation for related transactions, on 30 August 2017, the Order HFP/816/2017, dated 28 August, approved the new informative tax form 232 to declare related transactions and transactions/situations related to countries or territories deemed to be tax havens. Previously, this informative obligation was fulfilled in the informative chart contained in Tax Form 200 — Corporate Income Tax return.

This new informative tax form must be fulfilled for fiscal periods that commence after 1 January 2016. It must be submitted within the month after the 10 months following the end of the tax period.
The taxpayers obliged to file the form are corporate income taxpayers and the non-resident income taxpayers acting through a PE, as well as entities with attributions of income constituted abroad with a presence in a Spanish territory that carry out transactions with related persons or entities, provided that:

- The amount paid as consideration for all the transactions as a whole exceeds EUR 250,000 according to the market value, made during the tax period with the same related person or entity.

- Specific transactions – considered risky transactions, such as a taxpayer applying modules with family companies, transfer of business, transfer of unlisted securities and transactions regarding real state or intangible assets – must be declared, provided that the aggregate amount for each specific type of transaction exceeds EUR 100,000. However, in this case it is not necessary that the same valuation method is used.

- The taxpayer is obliged to disclose transactions of the same nature and methodology when the amount of the transactions as a whole exceeds 50% of the company’s turnover.

The taxpayer shall provide information regarding all the transactions it carried out with the same related person or entity during the fiscal period in question. Essentially, this information is the same as the information provided in CIT returns of previous years. The content of such information is summarized below:

- Tax number
- Corporate/Person/Other
- Surname and name/Company name
- Type of controlled relation
Restructuring/Business re-engineering

Under the Spanish CIT Law, a special regime is established for reorganization transactions, such as mergers, splits, contributions of assets, and the exchange of securities. This regime is based on the tax neutrality of these transactions by a deferral of the taxation of the income/capital gains. Likewise, indirect (VAT, capital duty) and local taxation are avoided under this regime.

The CIT Law contains an anti-abuse clause, under which this special tax regime will not apply if any of the above-mentioned transactions is not made for valid economic reasons (reorganization or rationalization of the activities of the companies involved), but solely for tax reasons (like profiting from the existence of losses or the existence of goodwill that may not be amortized in other cases). It will thus be necessary to justify the transaction carried out from an economic point of view.

The fact that the reorganization allows a reduction of the tax liability does not mean it has been made to avoid taxes if there are other valid economic reasons to justify the reorganization. Hence, in those cases, the tax-neutral regime should apply.

The Spanish doctrine considers this clause to be applicable when the transaction is carried out just to avoid Spanish taxation that otherwise would have been levied on it.
The purpose of the reorganization would therefore constitute the main issue to be discussed during the tax audit. Thus, currently, Spanish tax authorities are carefully scrutinizing the restructuring transactions carried out under the scope of the aforementioned special tax regime.

This is why it is crucial to review in depth the whole transaction prior to its implementation in order to decide whether all the requirements established in the special tax regime have been duly fulfilled, and to prepare and keep an adequate dossier of evidence showing the economic reasons that led to the reorganization before the tax audit.

There is no definition in the CIT Law of what should be considered valid economic reasons, but the tax authorities have stated that the reason for this special regime is that the taxation of these transactions must not be allowed to hinder reorganizations when there is an economic objective.

On the contrary, when the purpose is purely tax saving and there is no valid economic reason behind the transaction, the special regime would not be applicable.

The criteria of tax authorities could be summarized as follows:

- The existence of a valid economic reason has been admitted in the following circumstances:
  - A holding company is created (through the contribution of participants in other group companies) to centralize the planning and decision-making of the group, and to improve the commercial, management and negotiation capacities of the group.
  - Reorganizations are undertaken to adopt, among other things, the organization of economic activities to be more productive, profitable and effective.
The economic reorganization of a company is undertaken to unify the business (such as scale of economies, improvement of solvency and resources, and the coordination of activities).

Certain rulings issued by Spanish tax authorities and the resolutions issued by Spanish tax courts have stated that a merger will have a tax avoidance purpose if its sole objective is tax saving, which uses the accumulated losses of the absorbed companies.

It is highly important to take into account that restructuring operations in which the taxpayer benefits from the existence of tax losses pending carryforwards or from the existence of tax-deductible goodwill, which in other cases may not be depreciated, are thoroughly examined during a tax audit. These two circumstances are subject to many requirements that need to be carefully studied by the company and the competent tax adviser.

(4) Restriction on the deductibility of financial expenses

It is necessary to distinguish between tax periods from 2015 on and those that started before 2015, as a result of new CIT Law.

• Before 2015

In 2012, CIT reform introduced a new restriction on the deductibility of net financial expenses, independent of the origin of the debt. Such reform implies the derogation of the previous “thin capitalization” regime, and determines that net financial expenditure higher than EUR 1 million would not be deductible by the company, when the net financial expenditure exceeds a fixed percentage of the operating profit (30%).

This limitation will not apply to credit entities (unless these entities file consolidated tax returns with non-credit entities), insurance companies or entities not included in a company’s group defined by the mercantile law (with other exceptions).
Financial expenses not deducted as a consequence of this restriction could be set off in years to come (18 years).

- **From 2015 onward**

The 27/2014 CIT Act abolishes the time limit for offsetting financial expenses (which were not deducted because of the restriction). Nevertheless, two quantitative ceiling limits apply. On the one hand, financial expenditure cannot exceed 30% of the operating profit, after deducting net financial expenses from the current period.

On the other hand, in leveraged buyout situations, financial expenditure cannot exceed 30% of the purchaser operating profit minored by other amounts (in particular, operating profits of any other entity merged with the purchaser in the following four years after the acquisition).

Finally, up to now, most enterprises consider levying deductible interest on late payments.

However, in the decision of 7 May 2015, the central tax court (Tribunal Económico-Administrativo Central or TEAC) has come to the following conclusions:

- Financial expenses are deductible because these are considered a necessary expenditure.

- Tax deferrals or tax split interests are deductible as a result of deferral or split payment agreements with the tax administration.

- Interest on late payments is non-deductible. In particular, these interests compensate the tax administration for the failure of the taxpayer to comply with the law. Therefore, these are not necessary expenditures, neither are these the result of an agreement with the tax administration. In addition, the TEAC believes interest on late payments ensue from a breach of law.
In this regard, the CIT Act has banned the deduction of expenses that resulted from any activity contrary to the legal order. Therefore, tax auditors will not allow the deduction of interest on late payments.

(5) **Reinvestment tax credit**

Reinvestment tax credit is one of the most relevant and beneficial tax allowances contemplated in Spanish Law. This has been regulated – with certain modifications – in Spanish tax legislation for a long time. In fact, Spanish legislators introduced it into the tax system for the benefit of Spanish taxpayers that are renewing their assets.

However, in the recent past, Spanish tax authorities have shown a tendency to restrict applications by requesting the fulfillment of certain requirements that are not expressly established in the wording of the regulations. Some of these "new" requirements are related to formal aspects, while others are related to material ones, such as the allocation of assets to business activities, the business purpose of the sale and subsequent reinvestment, etc. In fact, for tax periods after 1 January 2007, the CIT Law was amended to incorporate some of the restrictive criteria proposed by tax authorities.

For these reasons, the application of this tax credit has been quite problematic and special audit plans have been approved in order to specifically audit the application of this tax credit by the companies.

According to the above-mentioned new CIT Act, reinvestment tax credit is suppressed for tax periods that commenced in 2015 onward. It is then established as a new "capitalization reserve." According to that provision, the taxpayer could deduct from the taxable base up to 10% of the increment in the company’s own funds, in a "capitalization reserve" (equity), provided that certain requirements are fulfilled.
According to the said reform, it is more likely than not that a new monitoring campaign on the application of the "capitalization reserve" will be launched by the tax authorities during the next few years.

6. Special tax audits

As a general rule, there are no specialized tax auditors for specific taxes, except those related to customs duties and excises to which we refer below. In any case, because the different regions into which Spain is divided (Comunidades Autónomas) are entitled, under the Spanish regime, to audit and collect some taxes (transfer tax, inheritance tax, etc.), tax audits are carried out by auditors that specialize in these taxes and work for these regional subdivisions. The municipalities in Spain also have the power to levy some taxes (business activity tax, etc.). Due to this fact, they have specialized auditors working for them as well.

Normally, the tax audit’s scope covers every tax and tax period within the statute of limitations, but there are tax cases in which specific tax audits may be carried out. Mainly, these are TP, VAT, wage tax and transfer tax.

The assessment that determines tax liability may be definitive or provisional. As a general rule, it will be definitive when all the substantial aspects of the tax audited are taken into account, and the most important consequence is that it cannot be audited again or amended to the detriment of the taxpayer in the future, except in some very special cases and under special procedures.

(a) Transfer pricing

Tax authorities have recently been carrying out more audits focused on TP issues mainly with multinational companies.
A general upward trend in recent tax audits, focused on multinational cash pooling structures, must be highlighted. The main risk areas regarding these financial structures are as follows:

- Asymmetry in creditor and debtor transactions
- Incorrect agreements' characterization, such as short-term agreements governing long-term transactions
- Incorrect remuneration due to incorrect functional analysis, such as the characterization of the leader company as a credit institution

On 6 March 2019, Spain's National Court of Justice issued an important judgment regarding the transfer pricing adjustments made by tax auditors when taxpayers applied the transactional net margin method (TNMM).

The court held that no adjustment was needed for those years where the operating margin was within the arm's-length range (the interquartile range in this particular case). Additionally, when the taxpayer is below the range the adjustment should be driven by defects in the benchmarking. In the case, the court held that it should be adjusted to the lowest value of the arm's-length range (lower quartile), as the tax auditors had not evidenced any comparability defects in the benchmarking provided by the taxpayers.

(b) VAT

Companies that file a negative VAT return in the last period of the fiscal year and demand a refund or compensation for the difference between the input and output VAT are normally audited and will be asked to present their VAT books and invoices. If there are differences or mismatches in the sales listing according to the VAT information exchange system (VIES) information received by the tax authorities, the company will usually be subject to a tax audit. In this kind of audit, tax auditors tend to pay special attention to formal requirements, so it is highly advisable to review the documentation (mainly, invoices and VAT books) with tax
advisers before submitting these to the tax authorities in the event improvements to the presentation of the information are necessary.

Normally, these tax audits are limited in scope and thus, will not prevent a more general tax audit from being conducted in the future.

(c) Wage tax

The GTL considers any taxpayer a withholding agent when it, in accordance with this condition, may be the subject to tax audits to verify that it has fulfilled its obligations. Wage taxes normally fall within the scope of a special tax audit only if the information checked does not match the information provided by the taxpayer, and the tax audit in these cases usually pays special attention to stock options, expatriates and remunerations in kind. Otherwise, the audit regarding wage taxes is conducted much like a general tax audit.

The Personal Income Tax Law considers the following to be withholding agents:

- Legal entities that pay taxable income
- Individual taxpayers that carry out economic activities
- Non-residents, individuals or legal entities carrying out business in Spain
- Non-residents without a PE that pay salaries and wages to employees

Normally, auditors pay special attention, in the course of general tax audits, to withholding obligations in order to regularize any lack of withholding.

Special areas of interest are stock-based compensation programs and extraordinary bonuses, as well as redundancy or retirement payments that benefit from special tax advantages.
In that regard, these regularizations used to end with the assessment of any lack of withholding applied by the taxpayer plus delay interests and penalties. However, following jurisprudence established by the Spanish Supreme Court, the assessment cannot include the lack of withholding (tax due), but will allow the addition of the correspondent delay interest plus penalties. Such jurisprudence applies, provided that the final taxpayer (i.e., the one that receives the rent to which the lack of withholding was applied) has included such amount in its income tax return and has paid the correspondent taxes so that the lack of withholding implies only a deferral of taxation for the Spanish Treasury.

(d) Transfer tax in real estate transactions

Transfer tax and capital duty are not only an issue of competency but are among the most important incomes of the different regions into which Spain is divided (Comunidades Autónomas). For this reason, these regions are very interested in and follow every transaction, such as real estate transactions, in which one of these two taxes may arise. In principle, no indirect taxation will arise in Spain in the transfer of shares. These transactions therefore fall outside the application of Spanish VAT and transfer tax.

As an exception and in general terms, according to the new wording of the applicable regulations, Transfer Tax and Stamp Duty are applicable when the purchaser directly or indirectly acquires control of a company in which more than 50% of its assets are real estate located in Spain and not assigned to business activities, or after obtaining such control, increase the participation share.

In this case, transfer tax will be levied at a 6% to 11% tax rate (depending on where the real estate is located) on the transfer of the fair market value of the real estate owned by the company, although it is worth mentioning that, due to what we consider to be the unsatisfactory wording of the applicable article, this provision tends to be quite problematic in practice,
as it is applied by the competent tax authorities even when the subject matter of the transaction is a going concern and not merely the real estate.

As stated above, the tax is assessed taking into account the real estate’s fair market value, which is not necessarily the value given by the parties. To determine the fair market value, the tax authorities have to follow a special procedure. It must be noted that courts tend to revoke the value given by the tax authorities when there is a lack of substantiation for these assessments.

This provision tries to prevent the avoidance of indirect taxation on the transfer of real estate when channeled through a legal vehicle – the transfer of shares – rather than by way of the property itself. In other words, it is an anti-avoidance measure that applies when the underlying intention is the transfer of real estate through the nominal transfer of shares.

Nevertheless, due to the incompatibility of transfer tax and capital duty, no transfer tax may be levied if the acquisition of shares is made through a transaction falling within the scope of capital duty (mergers, spin-offs or contributions in kind).

Last, we would like to point out from 10 November 2018, the stamp duty taxpayer, when the document subject is accrued because it reflects loans secured by mortgages, is the creditor (normally a bank) and not the borrower, as it has been understood traditionally. In addition, such cost would not be deductible from a CIT perspective.

(e) Customs duties and excises

As we have mentioned, customs duties and excises are audited by special tax auditors that also audit VAT on imports.
7. Electronic data processing (EDP) access during audit

Article 142 of the GTL establishes that audits will be carried out through the examination of documents, books, main and auxiliary accounting, files, invoices, correspondence with tax significance, computer databases, programs, registrations and data processing files relating to the economic activities carried out by the taxpayer, as well as through the inspection of goods, assets, business premises and any other information that must be given to the tax authorities.

Under this law, the tax authorities are entitled to analyze all the tax documentation, which entails reading computer files or data printouts. They may also make notes of accounting entries and data and even obtain copies of magnetic tape backups. To prevent the disappearance or alteration of the documentation, the tax authorities may adopt preventive measures, like the sealing, deposit or confiscation of merchandise, files, offices and computers, although these measures are certainly unusual and are normally adopted in cases where there is a clear suspicion of tax fraud.

The books and the documentation, including the data processing programs and files on magnetic tape backup, should be examined by the tax authorities in the residence or office of the taxpayer and in its presence or in the presence of the person appointed for this purpose, unless the taxpayer consents to an examination at the offices of the tax authorities.

Currently, the tax administration tends to request information from the taxpayers in electronic format in order to expedite processing and will even request direct access to the files, computer programs and intranets of Spanish taxpayers.

In fact, the tax authorities have the right to analyze and examine, among other information, the databases, programs and computer files with tax implications related to the business activities developed by the taxpayer.
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This regulation needs to be borne in mind because the tax authorities tend to expand the attributions given by legislators in requesting full access to the computers, databases, programs and files utilized by the taxpayers.

Therefore, it is very important from a practical perspective to be aware of the applicable regulations so that access will be given only to information and tools the tax authorities have the right to use, but that no uncontrolled access is provided to other information that may lead to misunderstandings and controversies with the tax authorities.

8. Information-gathering powers

As mentioned above, when tax authorities decide to audit a taxpayer, and before initiating the audit, they already have all the information previously provided by: (i) the businesspeople and professionals who must notify the tax authorities of all transactions entered into with third parties that are not subject to withholding at source, provided the annual amount of transactions with a given party exceeds EUR 3,005.06; (ii) withholding agents, both individuals and entities, who are obligated to give notice of all income paid that is subject to withholding at source and to identify the recipient individual or entity; (iii) financial institutions and stockbroker corporations and agencies acting as intermediaries for the issuance, subscription or sale of securities that, for their part, are required to notify the tax authorities of such transfers by providing the identity of buyers and sellers; and, most recently, (iv) online platforms acting as intermediaries in the provision of accommodation and rent of real estate services when the real estate is located in Spain, with regard to the host providing the accommodation services and the guest staying in the Spanish real estate. The first filing of this new reporting obligation is planned to be between 1 January and 31 January 2019 and will cover all stays related to calendar year 2018. For 2019 and onward, reporting has to be filed on a quarterly basis.

Aside from this, the tax authorities may require third parties to provide more detailed or specific information regarding their transactions with the
taxpayer that is under audit. Usually, although not always, the request for information is issued to third parties when the taxpayer refuses to give relevant information to the tax auditors or they have a clear suspicion that the information provided is incorrect or incomplete. These requests for information have also been traditionally used to check the existence of the PE of nonresident companies, by checking with the third parties the actual role of the Spanish subsidiary within a multinational group.

With regard to information provided by foreign tax authorities, Article 26 of the Model Convention of the OECD, for the avoidance of double taxation, establishes that competent authorities of each state will be in charge of exchanging information necessary to apply the convention’s content or the national legislation of the states relating to taxes levied by them.

As of 12 October 2015 (after the reform of the GTL), in initiating a mutual agreement procedure, any administrative and judicial examination procedure that may have been started before will be suspended until the mutual agreement procedure is finalized.

Information received by a state should then be treated as sensitively as information that is obtained on the basis of the local law of that state. It will be transferred only to people or authorities that are responsible for the management or collection of the taxes to which the convention refers, or that are responsible for the declarative or executive procedures relating to these taxes, or for the resolution of the appeals related to these. This information is likely to be revealed at hearings or under the rules established by courts.

Notwithstanding the convention’s provision, a state may not be obligated: (i) to adopt administrative measures contrary to its national legislation or administrative practice; (ii) to supply information that cannot be obtained

249 Tax auditors must comply with specific requirements when the information requirement is addressed to a bank or financial institution.
on the basis of its own national legislation; and (iii) to supply information revealing secrets related to industrial, professional or commercial activities, or information, the communication of which may be against public policy.

The EU Council has adopted Directive 2004/56/CE concerning mutual assistance between the authorities of the Member States of the EU regarding: (i) indirect taxes; (ii) some expenditure taxes; and (iii) taxes related to insurance. The content of this directive was introduced into Spanish tax regulations by the Royal Decree 161/2005 of 11 February 2005. Taking this regulation into account, the tax authorities should not apply different treatment to requests for information from another state or to those from national bodies. Consequently, the rules for obtaining information should be the same, whether or not information is obtained for internal purposes or as a result of a request from the tax authorities of another state. A regulation developing the GTL, which entered into force on 1 January 2008, establishes the way in which mutual assistance with other tax administrations would be carried out and the value that the documentation obtained under that procedure would have for Spanish tax purposes. This regulation was updated by Royal Decree 1558/2012 of 15 November. This change derives from the need to implement Directive 2011/16/UE of 15 February, regarding the administrative cooperation between different EU tax administrations. The new regulations are focused on the proceedings to supply and request information to other EU tax administrations.\(^{250}\)

The new provisions state that inquiries received about mutual assistance shall not be subject to acts of recognition, addition or substitution.

\(^{250}\) New Articles 198 to 207 of Royal Decree 1065/2005 of 27 July, as amended by Royal Decree 1558/2012 of 15 November.
There are different ways of providing information to the tax authorities:

(i) Upon the mutual assistance request of the competent authority of another state or entity, regardless of the purpose

(ii) Automatically, with regard to some kind of information as stated in the mutual assistance-specific regulations

(iii) Spontaneously, in the event it could be helpful to another state or entity

When the tax administration is requested to provide certain documentation to another state or entity, the Spanish competent authority could refuse to do so, unless it is otherwise stated in the mutual assistance-specific legislation.

If the competent authority wants to release the information received from one state, to other states or to third parties, express authorization must be obtained from that first state.

When, as a consequence of the assistance, it is necessary to provide data, reports, assessments or some kind of document, the competent authority should provide this information within a three-month period (with some exceptions).

If the authorities used information during the tax audit that was not provided by the taxpayer, once the period to file objections commences after the tax auditor has presented its proposal for regulating the audited tax statements, the taxpayer has the right to examine and obtain copies of all the documentation existing in the file, including the information provided by third parties, and to file allegations or new documents that would contradict or qualify this information.

Finally, it is noteworthy that in September 2017, the Spanish government adopted the International Agreement for the Exchange of the CBC Report, required for multinational enterprises (MNEs) under the Spanish tax laws.

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and regulations. This exchange of information will be done automatically on an annual basis. The deadline for submitting the CbC report to the other competent tax authorities is 18 months after the closing of the corresponding fiscal year. The agreement clearly states that no TP adjustment or other tax measures can be taken by the relevant tax authority on the exclusive basis of the information contained in the CbC report.

9. **Burden of proof**

The burden of proof in tax procedures is established in Article 105 of the GTL. According to this provision, the parties of a tax procedure have the burden to prove the event-related circumstances that are favorable to them.

This doctrine, established under case law, states that, in the tax field, the tax authorities have the burden of proving not only the existence of the taxable fact, but also its economic magnitude.

However, the taxpayer is responsible for accrediting facts, such as exemptions and deductions of taxable income, which are favorable to them. This principle is ameliorated sometimes by courts that have deemed that the burden of proof should be attributed to the party that is nearest to the sources of proof and therefore can more easily demonstrate the controversial facts.

However, according to the principle that one is presumed innocent until proven guilty, special rules are applied regarding tax infringements. The tax authorities are thus the ones who have the exclusive burden of proof for the existence of the facts relating to the infraction, the accusation of the involvement of the taxpayer as an offender, and its degree of fault in order to prevent the decision of the tax authorities from being deemed unsubstantiated and thus overturned by the courts.
10. Potential consequences

(a) Adjustment of income

The objective of the tax audit is established in Article 145.1 of the GTL, which states that the tax audit will check and research the accurate fulfillment of the tax obligations and, if necessary, a regulation of the tax situation relating to the taxpayer will be carried out through one or more assessments. This regulation does not necessarily mean that the tax audit will end with a demand that the taxpayer face a tax liability. It may also end with the opposite finding, in which the tax authorities must reimburse taxes that should not have been paid or with the acknowledgment of a tax credit against the authorities. The tax auditor usually needs to remind the taxpayer of this possibility.

It is therefore important to check with the tax adviser if there is any place in the tax return where the taxpayer committed a mistake to its own detriment, as this may be used at the appropriate moment of the tax audit to counteract other possible adjustments made by the tax auditor. The 2015 GTL reform established that once the tax audit has been initiated, the taxpayer cannot modify other previous tax forms that are not being tax audited, in order to make available tax credits to be applied in the tax assessment resulting from the tax audit procedure.

In order to achieve the objective of the tax audit, the tax authorities are allowed to perform different activities that could lead to an adjustment of the income that was previously declared by the taxpayer. Specifically, tax authorities will: (i) research the facts related to tax obligations in order to find those hidden by the taxpayer, if there is any; (ii) check the values related to rights, income, products, companies or assets; (iii) corroborate the tax allowances and deductions applied; and (iv) generally analyze all elements of the tax returns filed by the taxpayer to determine their truthfulness and accuracy.
(b) Estimate

The different methods applied by the tax authorities to determine taxable income are established in Article 50 of the GTL.\(^{251}\) The method of an indirect estimate may only be applied by tax auditors when they cannot obtain the necessary information to determine the real taxable amount because one of the following circumstances occurs:

- Tax returns have not been accurately or fully completed or have not been completed at all.
- There is resistance, obstruction, or refusal to allow the tax audit.
- There has been a significant failure in fulfilling accounting obligations.
- Accounting books or supporting documents have disappeared or have been destroyed; this will also include events falling under force majeure.

When the indirect estimation method is applicable, the tax audit will add a detailed report along with the records made in order to regulate the tax situation of the taxpayer. This report will contain the following:

- The main reasons for the application of the indirect estimation method
- The status of the accounting and the compulsory registries relating to the taxpayer
- The explanation of the chosen methods in order to determine the basis of taxation and taxable incomes
- The amounts calculated by using the chosen methods

\(^{251}\) Other methods of indirect estimation are applicable under a specific tax regime, usually applied to small undertakings. The Tax Reform Bill Draft of the GTL also clarifies that the indirect assessment method may be used partially.
The application of this method does not require previous administrative notice. However, in the appeals and claims against the assessments, the appropriateness of using this method may be discussed. The application of this method does not allow the tax auditor to determine tax liability according to the worst possible scenario from the point of view of the taxpayer, but only allows for a reasonable estimation.

The data, documents or proof related to the application of this method used by the tax auditors may come from the following sources:

- Signs, indexes and modules used in the objective estimation method, which will be primarily used with taxpayers that have waived this estimation method, unless tax auditors justify that they have direct information of higher income

- Economic data related to the economic business directly obtained from the taxpayer. Tax auditors are also entitled to use the data of the FY in which the tax audit is taking place as a valid source of data applicable to the previous periods under tax audit, unless the tax auditor or the taxpayer justifies the need to make adjustments to such data. When the information provided by the taxpayer is incorrect or not significant, tax auditors are entitled to use samples of data to come up with averages.

- Data coming from the taxpayer’s business sector reports that are issued by public entities or private organizations using appropriate public data

- Data from a sample obtained by the tax auditors from companies, activities and goods of an analogous nature to the taxpayer’s one, identifying the sample chosen and justifying its adequateness
(c) General anti-avoidance provisions

The GTL contemplates three general anti-avoidance provisions: (i) the substance over form principle; (ii) simulation; and (iii) conflict in the application of tax law.

Under the substance over form principle, taxes should be paid in accordance with the legal nature of the taxable event, regardless of the form or denomination used by the taxpayer and any flaw that may affect its validity. As established in the second paragraph of Article 115 of the GTL, during the process of checking and researching that is carried out by the tax authorities, facts, acts and transactions will be rated irrespective of any previous qualification that may have been given to them by the taxpayer.

The concept of simulation is not defined in tax law, but it does come from general civil law concepts. Basically, a business or transaction may be considered simulated if the parties create the illusion of entering into a standard legal transaction, although they have no intention of actually entering into this transaction or any transaction whatsoever (absolute simulation) or their intention is to enter into a different transaction that is hidden under the simulated one (relative simulation). The GTL expressly states that, in the regulation of a sham transaction, the tax auditors will request not only the underpaid tax, but also late interest charges and penalties.

The conflict in the application of tax law has replaced the traditional fraud-legis provision, although in our view, they are not substantially different from each other. The current provision refers to the total or partial avoidance of the realization of the taxable event, or the reduction

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252 Article 13 of the GTL.
253 Article 16 of the GTL.
254 Article 15 of the GTL.
of taxable basis or payable tax through acts or activities when the following circumstances occur:

- Either individually or as a whole, they are notoriously artificial or unfit to obtain the consequences pursued.

- No other legal or economically relevant consequences result from those acts or activities apart from the tax savings obtained by comparison with the consequences that would have resulted from more usual or fitted acts or activities (business purpose test).

The law provides for a specific procedure to be followed in cases where a conflict in the application of tax law is applied. The assessment will include default interest, and as of 12 October 2015 (after the GTL’s reform), the assessment may include penalties as well. The tax assessment may trigger penalties when previously announced criteria of the tax authorities on such identical schemes exist at the date of deadline for filing the tax return affected by the controverted transaction. To date, one report of the conflict in the application of tax law has been published in September 2018 and is related to the non-deductibility of interest in certain intra-group debt-push-down structures.

There used to be few cases in which the Spanish courts applied the general anti-avoidance provisions. However, the tax authorities started to be relatively aggressive in reclassifying transactions in accordance with their economic purpose, and the conflict in the application of tax law provision is likely to be applied to sophisticated tax planning schemes. During 2014 and 2015, important case law has been issued regarding so-called "debt-push-down" structures, whereby sales of shares within a multinational group imply a shift in/creation of high financial expenses in the Spanish subsidiary. These judicial decisions are analyzing whether or not economic reasons and benefits were driving such transactions, and in most cases, the Supreme Court and the national court are confirming the existence of tax-driven transactions.
(d) Penalties

The regulation of tax offenses and penalties has undergone important amendments, which were introduced by the GTL of 2003. This regulation categorizes tax offenses into three, depending on the breach committed by the taxpayer: minor offenses, serious offenses and very serious offenses.

First, tax offenses may consist of the breach of formal duties, such as registration, provision of the tax identification number in transactions with third parties, or failure to meet accounting requirements or submit information to the tax authorities. This failure to comply with procedural obligations may be subject to a fixed fine ranging from EUR 100 to EUR 20,000 or to fines consisting of a percentage applied to different amounts.\(^\text{255}\)

Also considered a very serious offense is the reporting of false information in order to obtain a fiscal identification number (Número de Identificación Fiscal or NIF), which is subject to a fixed fine of EUR 30,000.

As of October 2012, failure to report owned assets that are not in Spain is also considered a very serious offense and may be subject to a fine ranging from EUR 1,500 to EUR 10,000 for each undeclared data or group of data. However, the tax offenses related to the above-mentioned report are currently being challenged by the European Commission as an alleged breach of European laws. Therefore, penalties might be lowered in the future.

Also as of October 2012, negative obstruction or excuses not to cooperate with tax authorities when the taxpayer is being audited will lead to higher penalties, which may increase up to EUR 100,000 (for nonbusiness taxpayers) and up to EUR 600,000 (for business taxpayers).

\(^{255}\) Articles 198 to 206 of the GTL.
Second, tax offenses may consist of underpayment of the tax due. This offense is subject to a penalty ranging between 50% and 150% of the tax underpaid. Improper claims for reductions in taxable income or for the carry-over of losses are subject to a penalty of 15% of the taxable base improperly reported, while improper claims for tax credits are subject to a penalty of 50% of the tax credit. These two penalties are considered to be on account of the penalty that could be imposed for the underpayment of tax, provided that the underpayment occurred before the penalty on the excess of tax reduction or credits was imposed.

The GTL establishes several reductions of the imposed penalty, depending on the agreement or conformity of the taxpayer to the conclusions of the tax audit and, additionally, depending on whether there has been payment of the debt during the voluntary period of payment.256

The procedure of imposing penalties will be developed separately from the tax audit itself, but it may be developed at the same time if the taxpayer demands it. If the procedure is carried out separately, it must be initiated in the three months following the end of the tax audit and be finished within a six-month period. Once the three-month period for starting the procedure or the six-month period to end it has elapsed, the procedure of imposing penalties may not be continued or initiated again.

Please note that in certain circumstances, it may be advisable to request the simultaneous development of the tax audit procedure and the procedure of imposing penalties in order to deal with both aspects at the same time during discussions with the tax auditor and, eventually, to know the total exposure when deciding whether to agree or not to the regularization proposed by the auditor.

256 These reductions are explained below in Section II, Resolution procedures.
However, this matter should be analyzed on a case-by-case basis with the tax adviser, as this would depend on the tax auditor’s behavior, the tax being audited and the potential areas of risks, etc.

The Spanish specific transfer pricing penalty regime is very much linked to adequate compliance with the documentation requirements. Taxpayers' failure to comply gives the tax administration the power to impose penalties of up to EUR 1,000 for each non-documented "single relevant data," or EUR 10,000 for each non-documented "group of relevant data" if no correction of the valuation of the transaction between related parties results from the lack of documentation. However, the amount of this penalty will have a maximum limit in the lesser of the two following quantities:

- 10% of the amount of the transactions carried out by the company in a given year
- 1% of the net sales of the company

When the tax authorities adjust the transfer price of the transaction, however, the penalty will amount to 15% of the adjustment when transfer pricing documentation is not prepared or inaccurate and in cases in which a company fails to apply the value calculated in accordance with its own transfer pricing documentation.

(e) Default interest charges

Default interest will be calculated on the amount not paid on time or on the amount of the improper tax refund, and it will be due during the period of time comprising the delay on the part of the taxpayer.

However, default interest will not be due if the tax authorities do not observe (due to their fault) the terms established in the GTL for the settlement of a claim or for a procedure until notice of the settlement is given or unless an appeal against this settlement is pending.
The default interest will be calculated according to a special rate approved each year by the budget law. If the budget law does not set the rate, it will be calculated by increasing the statutory interest rate by 25% (for example, if the statutory interest rate is 10%, the default interest will be increased to 12.5%). On the other hand, a reduced rate (i.e., one that is lower than the standard default interest rate) is applicable in cases where the tax debt has been suspended through a bank guarantee.

The default interest has been set up at the following rates in the last few years:

- 2003: 5.5%
- 2004: 4.75%
- 2005: 5%
- 2006: 5%
- 2007: 6.25%
- 2008: 7%
- 2009: 7% until 31 March; 5% from 1 April onward
- 2010: 5%
- 2011: 5%
- 2012: 5%
- 2013: 5%
- 2014: 5%
- 2015: 4.375%
If it is necessary to make a new assessment due to the annulment of a previous one by an administrative or a court decision, the parts of the original assessment that are not affected by the decision will remain in place and the late interest charged will be due on the amount established by the new assessment.

(f) Voluntary disclosure

Voluntary late payment of tax (without a previous demand or request from the tax authorities) prevents the imposition of penalties on the taxpayer, but the taxpayer will be obligated to pay a surcharge for late payment.

Surcharges vary, depending on the time elapsed from the last day of the voluntary compliance period:

- A 5% surcharge will be applicable if the tax is paid within three months following the last day of the voluntary compliance period.

- A 10% surcharge will be applicable if the tax is paid within six months following the last day of the voluntary compliance period.

- A 15% surcharge will be applicable if the tax is paid within a year following the last day of the voluntary compliance period.

- A 20% surcharge will be applicable if the tax is paid once a one-year period has elapsed since the last day of the voluntary compliance
period. Additionally, in this scenario, default interest will be requested on the tax paid.

Moreover, as a tax regulation after 1 December 2006, a reduction amounting up to 25% of the surcharges is applicable, mainly under the following conditions:

- The taxpayer fully pays 75% of the surcharge before the deadline established by the GTL (if notified within the first 15 days of the month, until day 20 of the following month; if notified within the second half of the month, until the fifth of the second month that follows).

- The tax debt has been paid or guaranteed mainly through a bank guarantee.

11. Strategies for dealing with tax audits

First, it is important to be prepared for the tax audit. This means, as we have stated above, it is highly recommended to hold meetings with the tax adviser, both before facing the audit and during the audit in order to be prepared for any question or request that may be raised or made by the tax auditor.

In any tax audit, several meetings with the tax auditor will take place before the tax auditor issues the final assessment. Each meeting will conclude with the signing of the minutes (diligencia) stating the facts and future requests. Minutes are defined in Article 99 of the GTL as public documents that are made to reflect facts and statements agreed upon with the taxpayer or person under audit.

Because minutes are considered public documents, these constitute proof, even against third parties, of the facts they establish and the date on which the facts were established.
If the taxpayer agrees with the facts and statements contained in the minutes, these will be presumed to be correct and may be rectified only if there is proof that an error has in fact been made.

Keeping in mind the nature and value of the minutes as evidence, the taxpayer must be familiar with their content in order to be able to comply with these. If the taxpayer disagrees with the report, this fact must be clearly stated in the minutes.

Aside from this, it is important to mention that the minutes include documents or information that had been requested from the taxpayer and the date on which this information was supplied to the tax auditors. It is therefore advisable to check that the minutes mention the date on which each document or explanation is provided, in order to prevent a delay from being unduly attributed to the taxpayer and from being used as a ground for ordering an extension of the tax audit.

Finally, in the event of a limited review procedure, it is important that the minutes exactly reflect the scope of the revision that has been carried out. In general terms, during the statute-of-limitation period, the tax authorities may carry out a further audit regarding the same tax and years to which that limited review refers, but not regarding the topics that were exhaustively reviewed in the original audit.

**12. Conversion of a regular tax audit into a criminal investigation**

In certain cases, when willfully fraudulent intention is found, the underpayment of tax in excess of EUR 120,000 may constitute a criminal offense, punished with one to five years of imprisonment and by a fine of up to six times the amount of the tax liability. Since 2012, there has been an aggravated offense punished with up to six years of imprisonment when the underpayment of tax exceeds EUR 600,000 and

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257 Criminal Code, Article 305, as amended by Law 7/2012, 27 December.
the criminal offense involves fiduciary instruments that seek to hide the identity of the taxpayer or criminal organizations.

Certain violations of accounting requirements, including the following, may also constitute a criminal offense:258 (i) failure to keep accounting records;259 (ii) keeping more than one set of accounting records for the purpose of disguising the real economic situation of an enterprise; and (iii) failure to register economic transactions in the accounting records or the registration of fictitious transactions in the accounting records if the violation results in an underpayment of tax by more than EUR 240,000. The sanction applicable to these offenses is imprisonment of five to seven months.

As of 24 December 2010 — the date in which the amendments introduced in the Criminal Code by Law 5/2010, and on 22 June entered into force — entities may be found liable from a criminal point of view and therefore can be found guilty of the commission of the mentioned offenses against the Public Treasury. This liability is complementary to the potential liability of the individuals (de jure or de facto directors responsible for the company’s actions).

This is a relevant amendment to the Spanish legal system, since until the mentioned date, only individuals could be found liable from a criminal perspective.

The penalties envisaged for the companies include, apart from economic penalties, other sanctions like the closure of the company or the prohibition to operate during certain years, as well as other less severe ones like the prohibition to enter into agreements with public bodies or receive subsidies during certain years, etc.

258 Criminal Code, new Article 305-bis, introduced by Law 7/2012, 27 December.
Besides, this same legislation regulates the potential mitigation effects on the company for having an adequate "corporate compliance program."

All the information obtained by the tax authorities, as well as the statements made by the taxpayer before the tax auditors (mainly those included in the minutes of the audit meetings), may be used in the criminal procedure. This has not been considered by our Supreme Court as a violation of the right of the defendant to not incriminate himself/herself.

If the tax authorities classify the taxpayer's conduct as a criminal offense against the tax authorities, they are obligated to inform the ordinary courts or send the file to the official prosecutor.

Please note that after 1 December 2006, the tax authorities are allowed to submit the file to the ordinary courts without hearing the taxpayer.

1. The GTL reform has substantially changed the procedures that should be undertaken to convert a regular tax audit into a criminal investigation, introducing a new chapter to regulate this procedure. In line with the 2012 reform of the Penal Code regarding tax criminal offenses, in situations where indications of tax fraud have been detected, the new regulations allow a tax assessment to be made so that the debt can begin to be collected. Thus, the decision on guilt is left to the competent court of law, or the case may be sent to the Public Prosecutor's Office.

2. The general rule, therefore, will be that the Administration will make the tax assessment and initiate the actions to collect the tax, even if criminal proceedings have begun. This is meant to overcome the necessary suspension of the Administration's assessment under the old regulations, which converts the tax debt into something else that, at times, was difficult to collect.
Therefore, we may distinguish between these two types of tax audits:

A. Tax audits initiated before 12 October 2015, in which the tax auditor has already submitted the file to the court or to the public prosecutor

In this case, tax authorities do not proceed with the administrative procedure, which will be suspended until there is a final and absolute judgment from the courts, the charges have been dismissed, or the official prosecutor gives the file back to the tax authorities because it does not consider the taxpayer’s conduct as constituting a criminal offense. In the event that a guilty verdict is handed down by the ordinary courts, the administrative penalty will not be imposed. However, if the courts consider that there has been no criminal offense, the tax authorities will be allowed to begin or continue their administrative procedure, taking into account those facts considered as proven by the courts. In this case, the statute of limitations will recommence at the same point where it was when the suspension took place. In the event any administrative procedure is being conducted during the stay of the criminal proceedings, this will not be taken into account because once the file is submitted to the ordinary courts by the tax authorities, the administrative procedure has to be stopped.

It is worth mentioning that it is common practice for tax auditors (normally those assigned to specialized units) to act as expert witnesses during a criminal procedure.

B. Tax audits initiated after 12 October 2015 or initiated before such date, but in which the tax auditor has not yet submitted the file to the court or the public prosecutor

When the tax auditor sees signs of a possible criminal tax offense, the tax audit procedure will not be suspended, but will continue until a tax assessment is issued. In that case, two different tax assessments will be issued: (i) one regularizing the taxes not affected by a criminal procedure, which will follow its normal course for appealing and debt collection; and
(ii) another regularizing the facts, adjustments and taxes that may constitute a criminal offense. In this case, the tax auditor will first issue a proposal and will open a hearing and allegations period for the taxpayer, after which tax authorities have the option to issue a tax assessment "linked to a criminal offense."

This tax assessment "linked to a criminal offense" will be issued — notwithstanding the remittance of the file — to the court of public prosecutor. Only in certain specific cases will the tax assessment not be issued and the file will be sent to the court or public prosecutor (such as when there is a risk of time barring the criminal offense due to the statutes of limitations period, when the exact amount cannot be determined or when the criminal investigation may be impeded by any means).

In any event, the tax authorities will not remit the file to the criminal court or public prosecutor when the taxpayer wholly regularizes its tax situation voluntarily in a complete manner, and fully pays the taxes due before the tax audit procedures are initiated or before a criminal complaint is filed.

Once this tax assessment is issued, the file will be sent to the criminal court or public prosecutor with a criminal complaint and when such complaint is admitted for processing, the voluntary deadline to pay the tax debt starts and the tax assessment may no longer be appealed to the tax courts. In fact, the tax assessment will then follow all the regulations and procedural rules applicable to criminal cases, losing any link to the ordinary judicial procedures, except for the fact that the tax debt is owed upfront and all collection procedures must start following tax regulations (instead of criminal regulations).

If the complaint is not admitted for processing, the tax audit procedure will be moved back to the administrative stage of the tax proposal. The tax penalty procedure may be reopened or started after the regular tax assessment is issued.
When the verdict of guilt in a tax offense is declared by the criminal court, the tax debt may be subject to the adjustments required to comply with the judicial decision.

All these important changes will likely have a significant impact on how to deal with tax audits, since the new regulations will ensure the tax debt collection, because the tax debt already existed even before the criminal offense was declared.

The new regulations also designate possible persons who may share tax liability arising from the criminal offense (i.e., those causing or actively cooperating in the criminal acts).
II. Resolution procedures

1. Alternative dispute resolution

The so-called "Acta with Agreement" is the only "settlement" procedure contemplated in the Spanish tax legal system, since it reflects a proposal of assessment agreed upon by the tax auditors (with the previous consent of their superior officer, the chief inspector) and the taxpayer. However, this kind of Acta was passed in 2003 for very specific cases and has been used on very few occasions.

Apart from that case, there are no scenarios in which a formal negotiation with Spanish tax authorities is admitted by Spanish tax legislation. However, in practice, there is always a certain level of negotiation with the auditors in charge of the tax audit during its development, but this is not formally reflected as such in the audit documentation; it is more of an informal issue, so the outcome of such negotiation is included only in the assessments issued by the auditors.

Once the assessment is appealed before the tax courts or the "pure" judicial courts, there will be no option for settlements.

As a novelty in this matter, it must be mentioned that a "Code of Good Tax Practices" was recently made public in July 2010 by the so-called "Major Corporation Forum," which comprises representatives of the tax authorities and the Spanish corporate network.

It should first be pointed out that despite having been passed by the Major Corporation Forum, any Spanish entity can voluntarily adhere to the code, irrespective of its size.

The code contains recommendations assumed by tax authorities and corporations that are designed to improve our tax system by increasing legal protection, mutual cooperation and the application of responsible tax policies by companies. The objective of the code is therefore to promote mutual cooperation between the tax authorities and member corporations.
based on principles of transparency, trust and good faith, which is intended to result in greater control by the authorities, more legal protection, and a reduction in litigation.

The "good tax practices" include, with regard to transparency and legal protection in the application and interpretation of tax regulations by the authorities, the following:

- The application of precedents and standard criteria by tax authorities
- The publication of the criteria applied in control proceedings to the extent they are applicable in general
- The establishment of procedures that enable taxpayers to be aware of the criteria observed by the authorities in a particular transaction or operation at the appropriate time
- The possibility of taxpayers filing explanatory schedules together with tax returns that contain information on the facts and criteria used to prepare them, which would be positively taken into consideration by the authorities in applying and calculating tax penalties

Additionally, with regard to reducing litigation and avoiding disputes, "the good tax practices" include the following:

- The mutual objective of reducing the disputes resulting from the interpretation of applicable tax regulations
- Throughout tax inspections, the authorities will: inform the taxpayer as quickly as possible of all events that could require adjustment; specifically assess its allegations; endeavor to discuss the issues and evidence prior to signing reports; and encourage agreements and acceptance, etc.
The reduction of indirect tax liability, in the sense that the authorities will attempt to accurately define the reasons for the requirements and declarations, and limit the duration of inspections and investigations

2. Administrative level

If taxpayers disagree with an assessment made by the tax authorities, two different possibilities for an appeal are available to them. They may appeal an assessment either directly to the tax courts (reclamación económico-administrativa) or to the authorities that issued the assessment (recurso de reposición). Irrespective of their choice, either action must be filed within one month from the date of the assessment notice.

In deciding whether to appeal before the authorities that issued the assessment or to go directly to the tax court, it must be taken into account that the first possibility is recommended only in cases: where the authorities have committed very obvious errors; where the taxpayer has finally obtained decisive proof that could not be submitted before; or where the taxpayer intends to delay a final administrative decision for as long as possible. In other cases, the appeal should be filed directly with the tax court.

If the taxpayer elects to appeal to the same authorities that issued the assessment and they do not respond within one month from the date on which the appeal is filed, the administrative appeal may be considered to have been disregarded and the taxpayer may therefore file an appeal before the tax court. Nevertheless, the taxpayer may opt to wait for an express decision, which may also be appealed before the competent tax court.

It should be pointed out that Spanish tax courts are offices belonging to the Ministry of Finance and Public Administrations and are thus not part of the judicial system. After the GTL’s reform, as of 12 October 2015, all economic-administrative appeals must be filed electronically. Although not yet completely developed, the reform also states that the whole
economic-administrative stage will be handled by electronic means. There are two kinds of tax courts: Regional Tax Courts (or TEARs) and the TEAC. In most cases, appeals must be made to TEARs. However, for assessments coming from tax authorities with jurisdiction over the entire territory of Spain, appeals must be made directly to the TEAC. When matters are valued above a certain threshold, decisions issued by TEARs can be appealed before the TEAC or even appealed directly to the TEAC if this is desired by the taxpayer.\(^{260}\)

In individual cases, if local tax authorities issue the assessments regarding local taxes, the appeal must be filed before the local authorities that issued the assessment or took the action. Thereafter, an appeal may be filed before an ordinary court of justice without the need to appeal to the tax courts.

Since 2004, some local entities (mainly large municipalities) have created their own tax courts, so the assessments of local taxes may also be appealed before them prior to a court of justice.

3. **Judicial tax litigation**

Decisions handed down by the TEAC and those decisions of TEARs that may not be appealed to the TEAC may be appealed to the ordinary courts of justice within two months from the date on which the taxpayer is notified of the tax court’s resolution. If the tax court does not respond to the claim of the taxpayer within one year from the date on which the appeal was filed,\(^{261}\) the taxpayer could deem the decision adverse and could file an appeal with the ordinary court of justice within two months following the one-year period referred to above. The taxpayer could always wait for an express decision. Starting on 12 October 2015, there is no

\(^{260}\) In general matters, the amount must exceed EUR 150,000, whereas in matters concerning the tax base (without the existence of any tax debt), it must exceed EUR 1,800,000.

\(^{261}\) In the event that the tax courts do not issue their resolution within a one-year period and the final resolution is against the taxpayer’s position, no default interest may be requested from the latter in connection with the delay incurred by the tax courts.
deadline to file an appeal with the ordinary court of justice in case of tacit adverse TEARs resolutions (i.e., when there is no express resolution).

When deciding whether to wait for a decision from the tax court or not, the taxpayer should take into account the previous decisions of the tax court and the judgments of the ordinary court of justice deciding the case in similar cases. Another fact to be taken into account is the nature of the legal arguments used by the taxpayer. For example, tax courts could not declare that a regulation violates the law. If this is the main argument of the taxpayer, it is of no use to wait for a decision from a tax court, and it is more convenient to appeal as soon as possible to an ordinary court of justice because this court has the power to declare a regulation null and void.

In evaluating these alternatives, it would be good to know that appeals before the tax courts are usually cheaper and take less time than a procedure before a court of justice. Therefore, in practice, and unless there are no expectations of success before the competent tax court (for example, in cases where the appeal is based on contravention of the law by a regulation, said contravention cannot be declared by a tax court), it is advisable to wait for the tax court’s decision even if the one-year period has elapsed.

The previously mentioned appeals against the tax courts’ resolutions are filed before the regional courts of justice (Tribunal Superior de Justicia) or the national court (Audiencia Nacional), depending on the tax court that heard the appeal and the tax concerning the appeal. As a general rule, a ruling by one of the TEARs could be appealed at the respective regional court of justice, whereas rulings by the TEAC could be appealed at the national court.

Based on Law 7/2015 of 21 July 2015, as of 22 July 2016, the appeals of the judgments of the regional courts of justice and the national court before the Supreme Court are subject to significant changes. Such appeals are not
subject to amount thresholds, but need to have an objective interest in the formation of the jurisprudence. This requirement will likely limit the cases that will reach the Supreme Court. Before 22 July 2016, the judgments of the regional courts of justice and the national court were only appealed by the taxpayer before the Supreme Court in special cases, and when the amount of the tax argued before the court was more than EUR 600,000 or more than EUR 30,000 if the aim of the appeal was to request the Supreme Court to issue a definitive interpretation for similar cases that have been solved differently by the individual courts of justice.

The taxpayer must be represented by a special attorney (procurador) and assisted by a lawyer before the ordinary courts of justice.

In addition, a specific fee must be paid, with the rate depending on the type and amount of the appeal and the court handling the appeal. The maximum amount of this fee is EUR 11,200. As of August 2011, following Constitutional Court Sentence No. 140/2016, parts of these fees payable by legal entities are unconstitutional.

The taxpayer does not have the right to lodge an appeal at the Court of Justice of the EU. In Spain, the general rule is that a petition for a judgment by the Court of Justice of the EU must be made by the court, the highest court in Spain, through the filing of a "prejudicial question." The Spanish Supreme Court used to be very reluctant to involve the Court of Justice of the European Union when solving its cases, although in the last few years, such tendency has slightly changed and the Supreme Court has filed several "prejudicial questions" regarding specific tax issues.

(a) During audit

During a tax audit, it is normal for the tax authorities and the taxpayer to have different meetings in order to discuss or, when possible, resolve important and useful points for the tax audit. These agreements will be highly important in preparing the final conclusion of the tax audit.
Once the tax auditors consider that they have obtained all the relevant information and the documents they need to proceed with the verification and, if this is possible, to issue an assessment, a period is granted for the taxpayer to review all the documents incorporated in the records of the tax audit, submit any additional documents it considers relevant, or allege what it considers adequate.

In practice, the taxpayer does not usually use this period to submit allegations, since it does not exactly know at this stage what proposal of assessment the tax auditors will issue. Nevertheless, it is important to check that all the relevant documents justifying or supporting the taxpayer’s position are incorporated in the records and that no documents or information (for example, that obtained from third parties) had been ignored, thus damaging the taxpayer’s position.

Finally, in complex tax audits and although there is no legal basis for it, it is sometimes common to enter into a kind of negotiation between the tax auditor and the taxpayer. For example, in cases that are not clear-cut and where both parties accept the technical arguments put forth by the other party on different issues raised in the course of the tax audit, the audit may end with an Acta with agreement or Acta with conformity (see below for details of these Actas) with the aim of avoiding an appearance before the courts of justice to solve controversial technical issues. It has been our experience that the tax adviser’s role in these cases is crucial.

Once the period for allegations has elapsed, the tax auditors will issue a proposal of assessment called Acta. This Acta is of three different types:

1. **Acta with agreement**

   This kind of Acta is the only "settlement" procedure (of some sort) contemplated in the Spanish tax legal system, since the Acta reflects a proposal of assessment (and, being the case, a proposal of penalty) agreed upon by the tax auditors (with the previous consent of their superior
officer, the chief inspector) and the taxpayer. However, the taxpayer has no legal right to be offered this kind of agreement by the tax auditors.

This kind of Acta has been introduced by the GTL that was approved in 2003 and may be issued only in these situations:

- An assertion about the decisive facts for the correct application of the tax rule turns out to be necessary.
- Uncertain legal concepts are discussed and must be applied.
- Estimations, appraisals or measurements of data or elements are to be carried out.

Recently, we saw an increase of these types of Actas in TP tax audits where arm’s-length principle valuation is difficult.

The assessment will be deemed issued and notified to the taxpayer and, in this case, the penalty will be deemed imposed and notified, once 10 days have elapsed from the date of the Acta without a correction of errors by the competent tax authorities.

The substantive content of the assessment will be understood as having been accepted by the taxpayer and by the tax authorities. The assessment and the penalty derived from the Acta with agreement may be challenged or revised under an administrative process only through a null and void declaration proceeding.

In the event of penalties derived from this kind of Acta, a 50% reduction will apply. In this regard, the GTL has recently been amended in order to maintain the 50% reduction even in those cases in which the taxpayer requests a deferral or a payment of the tax debt in installments.

(2) Acta with conformity

This kind of Acta is issued in the event the taxpayer agrees to the assessment proposed by the tax auditors. Although in theory, the
conformity refers only to facts included in the proposal and not to the application of the law on the basis of these facts, in practice, conformity exists only in cases where the taxpayer agrees to the proposed assessment and has no intention of appealing it.

The assessment will be deemed to have been issued and notified to the taxpayer according to the proposal formulated in the Acta if, after one month since the day following the date of the Acta, a decision of the chief inspector modifying the assessment has not been notified to the taxpayer.

In general, no additional documents will be issued and notified to the taxpayer and, once this month has elapsed, the voluntary period for the payment of the tax debt assessed (if any) will automatically commence.

In the event the taxpayer decides to appeal the assessment derived from the Acta with conformity, the dispute will be limited to the legal rules applied and may not deal with the facts stated in the assessment.

In accordance with Article 188 of the GTL, a 30% reduction will apply to penalties derived from Actas with conformity. An additional 25% reduction will be implemented if the taxpayer pays the penalty on time and does not file an appeal against the penalty’s assessment. The taxpayer will lose its right to obtain this 25% additional reduction if it decides to lodge an appeal.

(b) Acta with disagreement

This kind of Acta is issued when the taxpayer disagrees with the facts considered by the tax auditors and, more generally, when it disagrees with the proposal of assessment.

In these cases, apart from the Acta itself, the tax auditors must draft a more detailed supplementary report explaining in detail the facts taken into account, the rules applicable to the case, and the sense in which these rules have been applied to the specific facts of the case.
After receiving the *Acta* and the supplementary report, the taxpayer will have 15 days to present the grounds of its disagreement.

Afterward, once the proposed assessment (and the complementary report) and the taxpayer’s allegations have been examined, the chief inspector will issue the final assessment. The taxpayer may appeal this assessment upon submitting its grounds for disagreeing with both the facts considered by the tax auditors and the application of the laws to them.

4. **Special review procedures**

The GTL establishes some special and exceptional procedures that the tax authorities may follow in order to revoke their assessments or resolutions that are detrimental to the taxpayer. These special procedures are as follows:

- A special review procedure to declare an act null and void (not merely irregular)

- A declaration of a "detriment" procedure, which is, in fact, a preliminary procedure the tax authorities must follow in order to appeal their own acts before a court of justice, because unless the tax authorities' act is null and void, they may not revoke the act itself if the revocation will result in a worse situation for the taxpayer

- An error rectification procedure to correct merely mathematical mistakes

During the statute of limitations period, the tax authorities may even revoke their own acts through a very simple procedure if this revocation benefits the taxpayer.

Additionally, the GTL regulates the undue payment refund procedure that may be initiated by the tax authorities or by the taxpayer. Finally, if the tax authorities or the decision on the future appeal rules that there has
been an unlawful payment, the amount due to the taxpayer will include the default interest.

5. **Miscellaneous matters: payment of tax**

As a general rule, tax assessments are presumed valid and the obligation to pay them is therefore not directly suspended even if they are appealed.

Nevertheless, at the administrative stages of the litigation procedure (*recurso de reposición* before the same tax authorities that issued the assessment and in the appeal before the tax courts), the payment obligation would be automatically suspended if the taxpayer guarantees the tax liability plus surcharges and default interest.

As an exception, exclusively in the event of appeals against penalties, it is not necessary to guarantee the amount of the penalty while the appeal is before the Spanish tax courts (TEARs or TEAC) in order to obtain its suspension.\(^{262}\) However, if the penalty is appealed before the ordinary courts of justice, it will be necessary to request its suspension. The tax liability may be guaranteed: (i) through a guarantee issued by certain financial institutions (bank guarantee); (ii) a deposit in cash; or (iii) the personal guarantee of two solvent taxpayers.\(^{263}\) If the taxpayer is not able to provide such a guarantee, suspension of the payment obligation may be demanded by offering another kind of guarantee, but in this case, the suspension is not automatic and must be granted by the competent tax court.

Additionally, please note that as of 1 May 2009, the payment obligation will be suspended without the need for the taxpayer to provide a guarantee if the tax debt is lower than EUR 18,000.

As a special case, the GTL establishes the possibility of suspending the payment obligation even if no guarantee is given in cases where the

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\(^{262}\) Article 212 of the GTL.

\(^{263}\) This third method is applicable only if the tax liability is less than EUR 1,500.
payment obligation may result in irreversible damage and the taxpayer cannot offer any kind of guarantee.

The procedure and requirements for obtaining the suspension of a tax assessment before the tax administration is currently regulated by Articles 39 and 47 of the Royal Decree 520/2005, dated 13 May.

Appeals filed before the ordinary court of justice do not suspend the obligation to pay a tax liability unless the court so decides. In this case, the court will also decide on the guarantee to be provided, if any. In practice, if the payment obligation is suspended in the tax court procedure, the ordinary courts usually maintain the suspension under the same terms prevailing at the administrative stage.

Only in the event of penalties has the Supreme Court established in the past that suspension of the payment obligation without offering any kind of guarantee must be upheld in the ordinary courts of justice. This doctrine has been recently modified, and now, the ordinary courts of justice will have to decide whether they will maintain the suspension, and whether they will maintain it without a guarantee from the taxpayer or make the suspension subject to the delivery of the guarantee.

If the authorities that issued the assessment of the TEAR, the TEAC, the ordinary courts of justice or the Supreme Court set aside the appealed assessment, the taxpayer could request compensation from the tax authorities that is equal to the costs resulting from the creation and maintenance of the guarantee provided for the suspension of the payment of the tax liability. The taxpayer would also receive the interest accrued on those costs.
III. Competent authority

The Spanish administration referred to the Code of Conduct, derived from the EU Joint Transfer Pricing Forum, in preparing Royal Decree 1794/2008 of 3 November ("Royal Decree"), which was published on 19 November 2008. By this decree, special procedures that will be used by the Spanish tax administration, with the involvement of the relevant tax authorities of the other country, were passed. These will be used to resolve situations in which double taxation arises for Spanish companies.

In particular, the procedures dealt with in the aforementioned Royal Decree are the following:

- The competent authority proceedings provided in the tax treaties signed by Spain following the OECD Model Tax Treaty
- The procedure of applying the so-called Arbitration Convention (90/436/ECC Convention of 23 July 1990) concerning the elimination of double taxation that may arise in intra-group transactions within companies residing in EU countries

Although the use of these procedures has increased in recent years, the fact is that Spanish domestic legislation did not expressly regulate these procedures until the Royal Decree was published.

In this sense, the Royal Decree regulates the commencement, authentication, application requirements, steps to be taken, termination procedure and eventual enforcement of the agreement reached under the scope of the procedures.

It should be noted that the regulation of the aforementioned procedures establishes that their commencement would not preclude the possible commencement of the internal procedures (administrative or judicial).

In relation to the development of the procedure, it should be highlighted that Spanish regulations, in line with the latest amendments of the OECD
Model Tax Treaty, had ruled that there is a possibility taxpayers will demand that unresolved issues be referred to an arbitration commission, provided that this alternative is expressly contained in the applicable tax treaty.

Additionally, the Royal Decree established that, in general, the General Directorate of Taxes (Dirección General de Tributos) is the competent administrative authority to deal with these procedures. The tax authorities (Agencia Estatal de Administración Tributaria) are the competent authorities when the procedures refer to the application of Convention CEE/90/46 of 23 July, to eliminate double taxation from the amendment of income from associated companies, and when the procedures refer to the application of the articles of the convention to prevent double taxation on income from business profits attributable to a PE and associated companies. The procedures in which both the General Directorate of Taxes and the Spanish tax authorities are competent authorities are coordinated by the General Directorate of Taxes. Last, and in relation to both procedures, Spanish regulations expressly establish the alternatives to obtaining the suspension of the tax due’s execution, its effects and the potential guarantees to be granted by the taxpayer. The Royal Decree mainly refers to Spanish legislation governing the suspension of tax liquidations, with the main relevant issues being (except in very unique cases) the need for granting guarantees (usually a bank guarantee) and the accrual of suspension interests during the suspension period.

From a practical perspective, the Royal Decree lacks any express disposition in respect of cases where the taxpayer has initiated: (i) correspondent internal litigation procedures; and (ii) the above-mentioned proceedings, and the agreements eventually reached by the tax administrations under the scope of the competent authority proceedings differ from the correspondent court of justice’s decision.

Finally, on 10 October 2017, the European Council approved a new system for resolving double taxation disputes between Member States. The
directive strengthens the mechanisms used to resolve disputes that arise from the interpretation of agreements on the elimination of double taxation. The transposition deadline for Member States is 30 June 2019. Spain has not transposed the directive yet.
IV. International exchange of information

As previously mentioned, when the tax authorities decide to audit a taxpayer (but before initiating the audit), they already have all the information previously provided by: (i) the businesspeople and professionals who must notify the tax authorities of all transactions entered into with third parties that are not subject to withholding at source, provided the annual amount of transactions with a given party exceeds EUR 3,005.06; and (ii) withholding agents, both individuals and entities, who are obligated to give notice of all incomes paid that are subject to withholding at source and identify the recipient individual or entity, and financial institutions and stockbroker corporations and agencies acting as intermediaries for the issuance, subscription or sale of securities that, for their part, are required to notify the tax authorities of such transfers by providing the identity of buyers and sellers; and, most recently, (iii) online platforms acting as intermediaries in the provision of accommodation and rent of real estate services when the real estate is located in Spain, with regard to the host providing the accommodation services and the guest staying in the Spanish real estate.

Aside from this, the tax authorities may require third parties to provide more detailed or specific information regarding their transactions with the taxpayer being audited. Usually, although not always, the request for information is issued to third parties when the taxpayer refuses to give relevant information to the tax auditors or they have a clear suspicion that the information provided is incorrect or incomplete.

With regard to information provided by foreign tax authorities, Article 26 of the Model Convention of the OECD, for the avoidance of double taxation, establishes that the competent authorities of each state will be in charge of exchanging the information necessary for applying the convention’s content or the national legislation of the states relating to taxes that they levy.
The information received by a state should then be treated as sensitively as information that is obtained on the basis of the local law of that state. It will be transferred only to people or authorities that are responsible for the management or collection of the taxes to which the convention refers, or that are responsible for the declarative or executive procedures relating to these taxes or for the resolution of the appeals related to these. This information is likely to be revealed at hearings or under the rules established by the courts.

Notwithstanding the convention’s provision, a state may not be obligated: (i) to adopt administrative measures contrary to its national legislation or administrative practice; (ii) to supply information that cannot be obtained on the basis of its own national legislation; and (iii) to supply information revealing secrets related to industrial, professional or commercial activities, or information, the communication of which may be against public policy.

Moreover, the EU Council has adopted Directive 2004/56/EC concerning mutual assistance between the authorities of the Member States of the EU regarding: (i) indirect taxes; (ii) some expenditure taxes; and (iii) taxes related to insurance. The content of this directive was introduced into Spanish tax regulations by Royal Decree 161/2005 of 11 February 2005. Taking into account this regulation, the tax authorities should not apply different treatment to requests for information from another state from those that come from national bodies. Consequently, the rules for obtaining information should be the same, whether or not information is obtained for internal purposes or as a result of a request from the tax authorities of another state.

To this end, a regulation developing the GTL, which entered into force on 1 January 2008, establishes the way in which the mutual assistance with other tax administrations would be carried out and the value that the documentation obtained under that procedure would have for Spanish tax purposes.
If the authorities used information that was not provided by the taxpayer during the tax audit, once the period to file objections commences after the tax auditor has presented their proposal for regulating the audited tax statements, the taxpayer has the right to examine and obtain copies of all the documentation existing in the file, including the information provided by third parties, and to file allegations or new documents that will contradict or qualify this information.

Furthermore, it is interesting to note that on 1 July 2014, the agreement between the United States and the Kingdom of Spain to improve international tax compliance and provide for the implementation of the Foreign Account Tax Compliance Act (FATCA) was published in the Official State Gazette. The parties shall notify each other in writing when their necessary internal procedures for entry into force have been completed. According to the agreement, Spanish financial institutions may exchange information regarding certain accounts maintained by residents of the US in Spain. The financial institutions should register and obtain the Global Intermediary Identification Number (GIIN) before 1 January 2015.

GTL’s reform in 2015 has also implemented information obligations related to financial accounts:

- Financial institutions must identify the tax residence of the bank account holders and provide information to the tax authorities in this regard, according to Directive 2011/16/EU, as modified by Directive 2014/107/EU regarding the compulsory and Automatic Exchange of Financial Account Information and, according to the Multilateral Competent Authority Agreement (MCAA), regarding Automatic Exchange of Financial Account Information.

- The bank account holders are obligated to identify its tax residence before financial institutions, when they open a financial account.
• Failing such obligations or providing incorrect information constitutes a tax infraction and gives rise to penalties of EUR 200 or EUR 300 per account holder.

For the declarations in force as of 1 January 2016, the identification must be made during the 90 days after the financial bank account is opened. The documents related to such obligations must be kept for four years after the financial account is closed.

All financial institutions subject to this obligation will be obligated to communicate to each individual that such information will be provided to the tax authorities and transferred to the corresponding Member State.

This regulation is also applicable to the information and due diligence derived from the Agreement Between the United States of America and the Kingdom of Spain to Improve International Tax Compliance and to Implement FATCA.

Additionally, on 25 May 2016, the EU Council adopted Directive 2016/881/EU, implementing CbC reporting measures recommended in October 2015 as part of the OECD/G20 project targeting BEPS in a legally binding EU instrument ("CbCR Directive"). This directive modifies Directive 2011/16/EU. CbC reporting is a new compliance obligation for large MNEs, which requires the disclosure of financial, tax and other information in a standard format, which will then be made available to the tax authorities of all the countries in which the MNE operates. The measures only apply to MNEs with total consolidated group revenue of at least EUR 750 million (large MNEs).

The competent authority of a Member State where the CbC report was received will, by means of automatic exchange, communicate the CbC report to any other Member State in which, on the basis of the information in the CbC report, one or more constituent entities of the MNE Group of the reporting entity are either residents for tax purposes or subject to tax with respect to the business carried out through a PE. The communication
should take place within 15 months of the last day of the fiscal year of the MNE Group to which the CbC report relates. The first CbC report must be communicated for the fiscal year of the MNE Group commencing on or after 1 January 2016, which must take place within 18 months of the last day of that fiscal year.

Following the OECD’s recommendations, implementation into domestic law of the CbC reporting measures had already begun (and the acronym, CbCR had already become widely used) in several Member States even before the adoption of the CbCR Directive, which includes Spain. However, with the publication of the CbCR Directive, Member States are now obliged to have transposed and published, by 4 June 2017, the laws, regulations and administrative provisions necessary to comply.

As mentioned earlier, the Spanish government implemented in September 2017 in its domestic legislation the International Agreement for the Exchange of the CBC report, which was signed in Paris in January 2016.

Finally, it is also noteworthy that the Spanish government has signed the Multilateral Instrument on 7 June 2017. This convention provides an improvement of the mutual agreement procedures rules and sets out a binding arbitration provision for dealing with tax controversies related to the application of a double tax convention. However, the Multilateral Instrument has not been officially implemented in Spain so far.
Handling Tax Disputes in Sweden

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Linnea Back practices in the areas of tax litigation and tax reorganization for national and international company groups, as well as for small- or medium-sized corporations managed by their owners. She has successfully defended private and corporate clients in Swedish tax courts.

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I. Managing the tax audit process

1. General

A tax audit is primarily an investigation of the information that forms the basis for tax returns and/or income statements of a company, some other type of legal entity or a sole trader. Tax auditors from the Swedish Tax Agency (Skatteverket) carry it out.

A tax audit may also include the collection of information for the investigation of entities other than the audited entity. An audit does not need to be limited to one category of tax. Income tax, VAT, social security contributions and other taxes and fees may all be included in the same audit. The decision to initiate a tax audit is made by the tax authorities and is not subject to appeal.

2. Tax audits

(a) Expected periodicity

A number of factors are important with regard to expected periodicity. In general, larger corporations and multinational companies are more frequently subject to tax audits due to the scope of their transactions than individuals or smaller companies. Although individuals and smaller companies may face a lower risk, they will be subject to an audit if the tax authorities, for instance, initiate a special audit project where attention is focused on a limited number of factors that apply to those companies or individuals. For instance, if the tax authorities decide to initiate a project focusing on transfer pricing issues in small- or medium-sized groups of companies, such companies and groups of companies face a higher risk of being subject to a tax audit. The tax authorities carry out special audit projects on a yearly basis with shifting targets. In general, it is not possible to give an estimate of how often a company should expect to be subject to a tax audit since the audit selection criteria vary and a larger number of factors affect the actual outcome. The time intervals largely depend on the field of business and size of the company, among many other things.
(b) Selection of tax audit targets

The main purposes of tax audits in Sweden are to reinforce the preventative effect of the tax system and to prevent tax evasion, as well as strengthen the credibility of the tax authorities and the tax system in general. All submitted tax returns undergo certain basic controls before being accepted and it is the aim of the tax authorities to have as many automated basic controls as possible. After this initial stage, the tax authorities select a number of individuals and companies each year to be investigated more extensively and also choose companies or individuals to be audited more extensively with respect to a specific field, such as VAT reporting or employers’ social security contributions. These in-depth investigations can be carried out in the form of a so-called desk investigation, a control visit to an individual or a company, or a tax audit. In-depth investigations are mostly aimed at the business sector and the tax audit is the most extensive of these. The tax authorities’ investigations are normally focused on the last submitted tax return, but may be extended to cover previous periods if, for instance, the discovered errors were caused intentionally and have been made systematically or the amounts involved are considerable.

When selecting the companies to audit, the tax authorities will take into consideration a number of factors, such as the probability of the audit correcting intentional errors and contributing to voluntary cooperation, as well as how the audit conforms to the general purpose of strengthening the taxpayers’ compliance with the tax laws and tax system in general.

Tax audits are intended to focus on grave and obvious errors in the tax returns or to aid in the early detection of “new” errors. Audits are also meant to focus on sectors where tax avoidance is considered particularly offensive to the public. Tax audits are further used to continually check on companies or individuals who have been known to commit errors in the past. Factors such as the structure of ownership and anticipated inclination toward tax avoidance, as well as the level of profit of the company, are
assessed before the decision is made to target a specific industry or company for tax audit. In part, the selection is made randomly to map potential areas of risk and to monitor how the tax system as a whole is functioning. The information gathered at this stage is also analyzed using a number of specially designed computer programs.

The tax authorities may, among other things, use the information from the following sources as a basis to decide on which companies to target: i) information from the public, as well as from various databases (both within the tax authorities' and external databases); ii) income statements submitted by employers and self-employed individuals; and iii) information from the Companies Registration Office (Bolagsverket), the Social Insurance Office (Försäkringskassan) or the Swedish Enforcement Authority (Kronofogdemyndigheten). The Swedish Enforcement Authority is an autonomous public authority whose main functions are summary proceedings and collection of debts, supervision of bankruptcies, debt reorganization and preventative action by providing information to certain target groups regarding the risks associated with borrowing and buying on credit.

Information from third parties, as well as from other governmental and municipal authorities, such as the Post Office and Swedish Customs (Tullverket), may also be used to form the basis of a decision to initiate a tax audit.

3. **Advance preparation for tax audits**

A tax audit should be carried out in a spirit of cooperation and in a good atmosphere between the tax auditors and the person or entity being audited. It should also be carried out in such a way that the business of the audited individual or company is not unnecessarily hindered.

A decision to initiate a tax audit must be issued in writing and should include information revealing the scope of the audit, what will and will not
be audited, which periods of time are covered by the audit, and the possibility of exempting certain types of documents from the audit.

Since the audited party should be informed of its rights when an audit is initiated, the tax authorities have issued an information folder (SKV 663) on tax audits in which some of the rights of an audited party are described. This folder should be provided alongside the written decision. A general rule is that the audit should be conducted in cooperation with the audited individual or company and the auditor should be as open and informative as possible, without revealing facts that might be harmful to the audit. The audit should be conducted to affect business activities carried out by the individual or company being audited as little as possible. The decision will generally be sent in advance by mail to the entity subject to the audit. Furthermore, the time and the place of the audit should not be decided until after the consultation between the audited entity and the tax authorities. In some cases, such as if the purpose of the audit may be compromised, the notification to the audited company and the actual audit may take place simultaneously.

A tax audit is normally not carried out within the business premises of the audited entity. However, it may only be done so if the company being audited agrees to this. In these cases, the company should provide, whenever possible, an appropriate workplace within the premises at the auditors’ disposal.

The company being audited is obliged to produce the documents and other information needed for the audit. The audited company is also required to give access to premises primarily used by the company and generally give all necessary assistance to the auditors. If the audited company fails to comply with these provisions, the tax authorities may issue a conditional fine. A conditional fine is a fine that is not final, but will be subject to the fulfillment of certain requirements. Documents that may be audited include bookkeeping accounts and all other documents attributable to the business, including electronic documents, internal
memoranda, etc. In addition, books, records and verifications used in bookkeeping must be maintained for a period of at least seven years. The documents included in the audit should be named in the decision to conduct the audit. Moreover, the audit may include the investigation of cash registers, machines and equipment, as well as that of inventories and the premises and buildings connected to the business. It may also include documents subject to confidentiality.

Certain documents may be exempted from an audit. Documents containing information received by a lawyer, consultant, physician or some other professional in their line of work that are subject to professional confidentiality, in the sense that professionals are not allowed to act as witnesses in court proceedings regarding information received in their work, may be exempted. In addition, other documents of special importance and/or of a confidential nature may be exempted from the audit. Such documents may contain, for example, information on the personal status of employees or client files at a lawyer’s office.

It should be emphasized that the audited company’s own assessment of whether a certain document may be exempted from the audit is to be respected to a high degree by the tax authorities. The administrative court (Förvaltningsrätten) handles the question of whether documents may be exempted from a tax audit. A company that wishes to exempt a certain document from a tax audit should file a petition with the court. The administrative court’s decision in the matter may be appealed to the administrative court of appeal (Kammarrätten).

There are a number of actions a taxpayer ought to consider to successfully prepare for a tax audit, which include:

- Decide whether the audit should take place within the business premises and, in this context, decide whether it is possible to set up an appropriate workplace for the auditors.
• Decide who should interact with the auditors on behalf of the company and, for that purpose, who will be at hand to answer any questions asked and decide in what form answers should be given (i.e., written or oral). As a rule, written answers are usually preferable.

• Decide how the rest of the staff should interact with the auditors. It is advisable to have as few staff members as possible interacting with the auditors.

• Confirm that all financial and other records and accounts, statements, and other information and documents relating to the company, including, for example, minutes from board meetings, are at hand, as these documents and information may be requested by the auditors.

• Investigate what documents and information may or ought to be exempt from an audit and prepare the necessary applications for their exemption.

4. Limitations period for assessments

There is no statute of limitations governing when a tax audit may be initiated for a given year. However, the standard time limit for making a change to a closed tax return to the taxpayer’s disadvantage is two years after the end of the calendar year in which the fiscal year ended. This period may be extended for up to six years from the end of the calendar year in which the fiscal year ended. This is the case if the company has submitted erroneous information in a tax return or during the tax proceedings. The period may be extended further if the company has not filed a tax return or an income statement as required by law, or if a representative of the company is deemed guilty of tax fraud.

The crucial factor for whether the tax authorities may amend a closed tax return to the taxpayer’s disadvantage after the expiry of the two-year period is, thus, whether the taxpayer has submitted erroneous information...
or has merely made an open disclosure and thereby disclosed all relevant information to the matter.

The difference between making an open disclosure and submitting erroneous information is described below, yet the following brief clarification might be useful. If the taxpayer has merely made an open disclosure, then it has fulfilled its obligation to submit correct and sufficient information. In other words, the tax authorities will be able to make a correct assessment of the taxpayer’s income based on the information submitted by the taxpayer. If a taxpayer has claimed a deduction to which the taxpayer, in accordance with tax legislation, is not entitled or if the taxpayer has not fulfilled its obligation to submit correct and sufficient information, the tax authorities may impose tax surcharges and reassess already approved tax returns during a five-year period. However, if a taxpayer has made an open disclosure in its tax return and, for instance, claimed a deduction to which the taxpayer, in accordance with tax legislation, is not entitled, such return may not be subject to tax surcharges. This means that merely claiming a right will not trigger the risk of negative consequences in the form of tax surcharges or reassessment after the expiry of the standard statute of limitations, as opposed to submitting insufficient or false information to support such a claim.

To make a correct tax decision, the tax authorities are obligated to investigate inconsistencies and acquire any generally accessible information, such as income statements. However, this obligation is not overly far-reaching, which is why the taxpayer should always make sure to submit all the information that is or could be relevant to the tax return. If the taxpayer submits lengthy reports as complementary information to the tax return, it is necessary to pinpoint the issue to which the tax authorities should direct their attention. This should be accomplished to prevent a situation where the taxpayer is deemed to have submitted erroneous information. No decision, regardless of whether it is justified, may be deemed erroneous information as long as the taxpayer has submitted sufficient information along with the tax return, so that the tax
authorities are able to make the correct decision based on the submitted information.

5. Areas of tax auditors' special attention

Of special interest for tax audit purposes from the standpoint of the tax authorities are businesses with large amounts of cash in circulation, such as restaurants and other venues that entertain visiting customers, which is where the tax authorities calculate that a large proportion of intentional errors are made.

Generally, the auditors’ focus of interest will vary depending on the reasons for their decision to initiate the audit. For example, if the purpose of the audit is to investigate whether the company has fulfilled its reporting obligations, the auditors will focus on the relevant books and records concerning these items. In addition, a number of specially designed computer programs are used to gather information about the company and give the auditors as complete a view as possible of the company and its operations.

During the audit, the auditors will particularly focus on the following:

(a) Procedure and form

(i) Financials and accounting

According to Chapter 41, Section 7 of the Swedish Tax Procedural Act (Skatteförfarandeslagen SFS 2011:1144), all bookkeeping materials and other documents attributable to the business may be audited. Furthermore, according to a statement by the Parliamentary Ombudsmen (Justitieombudsmannen), the scope of bookkeeping material covers essentially every document that may shed light on the business of the audited party and may be included in a tax audit. The Parliamentary Ombudsmen are officials elected by the Swedish Parliament (Riksdag) to ensure that public authorities and their staff comply with the laws and other statutes governing their actions. The ombudsmen conduct this
supervision by evaluating and investigating complaints from the public, inspecting various public authorities and conducting other forms of inquiries that they themselves initiate.

(2) **Formal requirements**

According to Chapter 7, Section 1 of the Swedish Bookkeeping Act (*Bokföringslagen SFS 1999:1078*), bookkeeping material is to be maintained in the form of documents, microfilm or in a form that may be read using technical devices (“machine-readable media”). Bookkeeping material stored on machine-readable media must be immediately print-ready in either plain documents or documents on microfilm.

According to Chapter 7, Section 2 of the Bookkeeping Act, documents, microfilm and machine-readable media used to store bookkeeping material must be stored safely in a manner that provides easy access for seven years after the expiry of the calendar year in which the financial year in question ended.

A special point of interest to the auditors may be if the company has a permit to retain bookkeeping material on machine-readable media located outside of Sweden, for instance, a server located in another country. To receive such a permit, the company in question must be able to immediately provide the tax authorities and Swedish Customs access to the accounting records placed on the offshore server.

(3) **Documentation of intra-group transactions**

Swedish tax legislation provides for an arm’s-length approach, as stipulated in Chapter 14, Sections 19 and 20 of the Income Tax Act (*Inkomstskattelagen SFS 1999:1129*). Under Chapter 39, Sections 15, 16 and 16 a-f of the Tax Procedural Act, transactions between related companies must be documented. The documentation shall include information needed to make the correct assessment of the taxpayer’s taxable income. The documentation requirements were amended as of 1 March 2017 and are now based on recommendations provided by the Organisation for
Economic Co-operation and Development (OECD) in Base erosion and profit shifting (BEPS) Action 13. For more details, please see below Section (b) (2) Transfer pricing.

An advance pricing arrangement (APA) procedure entered into force on 1 January 2010. The information required to obtain an APA under the APA Act (Lag (2009:1289) om prissättningsbesked vid internationella transaktioner) is more comprehensive than the information covered by the documentation rules in the Tax Procedural Act.

There are no specific requirements regarding the documentation of transactions between related companies in Sweden.

(4) Disclosure of creditors and payees

For practicable purposes, the tax auditors may request all documents and information related to the business under audit. This includes, but is not limited to, the right to request the names of creditors and payees.

However, if the documents and/or other information disclosing the names of certain individuals and businesses are of significant interest to the audited business, measures may be taken to attempt to exempt such documents from the audit process.

The taxpayer has to show sufficient evidence to support any deduction claims regarding costs in the business activities. The Bookkeeping Act states that, with a few exceptions, legal entities are obligated to keep books on their business activities. According to the Tax Procedural Act, anyone who is obligated to submit tax returns should also make sure that, by taking notes, keeping books or through other suitable measures, said obligation or other obligations to submit information are fulfilled.
(5) Coercive measures

An audited company or individual may be subject to coercive measures under the Tax Procedural Act. Coercive measures may be used to accomplish the following:

- To carry out an audit within the business premises regardless of whether the business has given its consent, if there are particular grounds
- To search for documents and other information within the business premises, which may be seized if there is a risk that the audited company will otherwise seek to withhold any information
- To discover documents of relevance with regard to the obligation to submit income statements if there are particular grounds
- To cordon off premises, repositories or other areas if the documents or information stored therein cannot be moved from the location, and there is a risk that such documents or information may be compromised if left on-site

Documents and information that may be exempted from the audit process may also be exempt from the coercive measures described above.

(b) Substantive issues

(1) Permanent establishments/residency

For income tax purpose, Swedish tax law differentiates between resident and non-resident persons. As a rule, the worldwide income of resident individuals and companies is taxable in Sweden ("unlimited tax liability"). On the other hand, only the Swedish-sourced income of non-residents may be taxed in the country ("limited tax liability"). Thus, the question of whether an individual or a company is a resident or a non-resident is highly important during a tax audit because it may potentially result in the
complete transformation of the taxation of the audited individual or company.

To determine the residence status of the audited individual or entity, the tax auditors will thoroughly investigate the specific circumstances of the case at hand, such as the habitual abode in the case of individuals and the place of effective management or registration for companies. A number of factors will affect whether the tax authorities decide that an individual or a company is deemed a resident in Sweden for tax purposes and is, thus, subject to unlimited tax liability.

If a foreign company carries out business in Sweden, the tax auditors will specifically investigate whether the company should be considered to have conducted its business from a permanent establishment in Sweden. A foreign company with a permanent establishment in Sweden is liable to Swedish tax on profits attributable to the permanent establishment. Conversely, a foreign entity pursuing business activities in Sweden without a permanent establishment in the country is not subject to Swedish tax on profits from that business.

A legal presence by way of a permanent establishment may be deemed to exist if: (i) the foreign entity has an office or other premises that may be deemed a "fixed place" from which its business is wholly or partly carried out; or (ii) Swedish employees are authorized to accept orders and have the authority (and habitually use that authority) to conclude contracts in Sweden in the name of the company.

A recent development in this area is that the Swedish Tax Agency published a statement that a permanent establishment arises if a foreign company has one or more servers located in Sweden and the main purpose of the business consists of providing space and data capacity on the server to customers.

Marketing activities, including authorization to accept orders on behalf of the foreign company, might be seen as authorization constituting a
permanent establishment even if the employees are not authorized to negotiate the terms of agreements. However, strictly preparatory and auxiliary work will not create a permanent establishment. Such preparatory and auxiliary activities may be marketing activities conducted by way of providing information only. A permanent establishment will not be deemed to exist where business is carried out through an independent agent, provided that this agent is acting in the course of their ordinary business. Furthermore, holdings such as a foreign legal entity’s participation in a Swedish partnership, depending on the activities carried out by the partnership, may constitute a permanent establishment for the partners.

Income derived from a permanent establishment is taxable in Sweden even if the company as such is not considered resident for income tax purposes. As of yet, the Swedish tax authorities have not been known to regard a commissionaire acting on behalf of a company to constitute a permanent establishment for the company, thereby making the company liable to tax on the income generated by the commissionaire.

(2) Transfer pricing

As of 1 April 2017, Swedish rules regarding transfer pricing and documentation requirements that entered into force on 1 January 2007 are no longer applicable.

Instead, new rules apply to financial years after 31 March 2017. The legislation follows the OECD recommendations stated in BEPS Action 13, where the documentation is divided into two parts: the first part includes a master file where information regarding the multinational group is to be provided and the second part includes a local file, which serves as a complement to the master file. The local file includes information about the specific local entity in question and detailed information regarding the cross-border transactions. In addition, according to Chapter 33 of the Tax Procedural Act, a Swedish parent company of a multinational group must
submit a country-by-country (CbC) report to the Swedish tax authorities, unless exempt by law.

Companies that are part of a group with fewer than 250 employees and a turnover of less than SEK 450 million (approximately EUR 44 million) or a balance sheet total of less than SEK 400 million (approximately EUR 39 million) are exempt from the documentation requirement. Yet, a company that is exempt, still needs to adhere to the arm’s-length principle.

Certain transactions of smaller value do not need to be documented. Transactions with a foreign associated company amounting to less than SEK 5 million (approximately EUR 485,000) are always exempted. However, this exemption does not apply to transactions involving intangible assets, which need to be documented regardless of the transaction amount.

The Swedish CbC report rules apply to financial years starting after 31 March 2017. The legislation includes an obligation for all parent companies of Swedish multinational groups with at least SEK 7 billion (approximately EUR 712 million) in group revenues during the preceding fiscal year, or EUR 750 million for multinationals with a foreign parent company, to submit a CbC report to the Swedish tax authorities. CBC reports should contain information such as business income, EBIT, paid and accumulated income tax, number of employees, share capital, retained earnings and tangible assets for each tax jurisdiction in which the group conducts business.

In addition, a Swedish company that is not a parent company may be obliged to submit a CbC report in three situations: (i) if the parent company of the group is not obligated to submit CbC reports in its country of residence; (ii) if the country of residence does not have a valid agreement with Sweden regarding the automatic exchange of CbC reports; or (iii) if the Swedish Tax Agency has reported to the entity that there are systemic flaws in the country of residence of the parent company.

If the Swedish company is required to file a CbC report, such filing must be made no later than 12 months after the end of the financial year for which

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the reporting is done. Accordingly, for the financial year ending on 31 December 2019, the deadline for filing would expire on 31 December 2020.

A Swedish company or a branch of a foreign company in Sweden that is part of a multinational group is required to submit CbC notifications to the Swedish Tax Agency before the end of the financial year with information regarding which group entity is required to submit a CbC report and in which country (CbC notification form SKV 2382).

In addition, an APA procedure entered into force on 1 January 2010. Under the APA Act, the taxpayer has an obligation to provide the tax authorities with information relevant to the APA, i.e., whether the factual circumstances on which the APA is based have changed or whether the APA is not applied by the taxpayer. Information on applicable APAs shall also be provided in corporate income tax returns and shall be covered by the rules on information submission obligation for partners of a Swedish partnership, for instance.

(3) Restructuring/business reengineering

Where a group of companies has been restructured, tax auditors may show special interest in the manner of the restructure. This may involve, for example, an investigation of how the assets and/or shares of companies involved in the restructuring have changed ownership. The tax authorities may also be interested in whether the assets have been transferred at fair market value and whether the rules on transfers of assets below fair market value may be applied. If the rules on transfers of assets below fair market value are not applicable, but assets have been transferred nonetheless below the fair market value, this may cause withdrawal taxation (uttagsbeskattning) for the selling company. Withdrawal taxation will result in taxation where the selling company is deemed to have received the full market value as consideration for the assets transferred for tax purposes, i.e., the selling company is taxed on a fictitious income amounting to the difference between the price paid for the assets by the buying entity and the fair market value of the assets.
6. **Special tax audits**

(a) **VAT**

Since VAT is one of Sweden’s main sources of tax revenue, there is an advanced system in place for auditing, among other things, submitted VAT returns under the Swedish VAT Act (*Mervärdeaktivitetslagen SFS 1994:200*). The purpose of a VAT audit is typically similar to the purpose of a general income tax audit, as both types of audits are generally aimed at investigating whether a company has fulfilled its obligation to report VAT/income and has submitted the required statements and tax returns correctly. It also ensures that the obligation to submit information will continue to be met in the future. Foreign businesses that register for VAT with the tax authorities may appoint a VAT representative to act on their behalf. The tax authorities may choose to audit the appointed VAT representative acting on behalf of a foreign company. If the same representative represents numerous foreign businesses, the audit may only target information regarding the business that is subject to the audit.

(b) **Miscellaneous**

The tax authorities annually engage in special audit projects in which different business areas are targeted. Such projects may range from a few tax officers targeting certain types of businesses in a narrowly defined part of Sweden to nationwide projects involving multiple tax offices targeting whole areas of business.

7. **Electronic data processing (EDP) access during audit**

During a tax audit, the auditors must be granted access upon request to use terminals or other technical equipment needed to take notes regarding documents and other information that can be obtained by only using such equipment. The auditors may be denied access to the technical equipment if the company produces a copy of the requested information that can be viewed without difficulty by using another available technical device. This kind of information includes written messages, images and other
recordings that may be read or otherwise understood by using technical devices.

The rules regarding exemption of documents from an audit are applicable to machine-readable information. Furthermore, the rules governing the scope of the audit with regard to tangible documents also apply to electronic documents. This means, for instance, that an electronic document must be designated in the decision to audit in order for it to be included in the audit.

8. Information-gathering powers

(a) Information obtained from unrelated parties

(1) Background

The tax authorities have the option to request information from unrelated parties through either an injunction or a third-party audit. The tax authorities may also request information from other agencies as needed for tax purposes, including audits of VAT and employers’ social security contributions. The tax authorities may also send requests for information to private individuals and entities, asking them to voluntarily submit information. However, this method must be used with caution.

(2) Third-party audits

Concerning third-party audits, the tax authorities may initiate an audit of an unrelated company (Company B) to obtain information regarding another company (Company A), even if the scope of the audit does not involve Company B. Tax authorities are not required to know that the specific information or documents regarding Company A are located at Company B, but there must be a certain likelihood that the relevant information is obtainable at Company B. Furthermore, it is not required that any legal transactions take place between the companies.

Third-party audits may also take place as general investigations to gather information in preparation for more in-depth investigations.
investigations are carried out, for instance, when it is unclear if all the companies that have been initially investigated should be subject to an in-depth investigation.

The audited company or individual has the right to be informed of the purpose of the audit. This rule also applies to third-party audits. Thus, if the audit includes an investigation and search for information regarding certain third parties or the search for documents and/or legal acts that have already been targeted by the tax authorities, this information should be disclosed in the decision to initiate the audit sent to the company or individual. However, if the tax authorities can establish that there are particular grounds for doing so, they may withhold information on which companies, persons or legal acts the audit is targeting. The tax authorities decide if there are particular grounds to withhold information in each individual case and there is no possibility of appeal against such a decision.

(3) Injunctions

The tax authorities may request information via injunctions by which someone else (besides the audited company) may be investigated for gathering information on legal acts entered into by the audited company and another party.

The injunction may involve a request for the release of a specific legal act or legal acts, or a request for information regarding legal acts involving a certain individual or entity. The purpose of an injunction may also be to conduct a general investigation to prepare for the investigation of other entities. This may include, for example, the gathering of information on all subcontractors involved in a specific building project. An investigation made in preparation for the launch of an in-depth investigation may result in only some of the targeted companies being subject to further investigations.

A search by injunction may be conducted to find a specific legal act (rättshandling) or legal acts. However, the term "legal act" is not defined in
Swedish law. The Swedish word *rättshandling* can mean both a legal document and a legal act, and in the preparatory works — e.g., the governmental bills (propositions) and other preparatory documents that form part of the parliamentary process when a law is enacted and that form an important source of information for interpreting the laws — it is stated that the term is commonly used in law, which is not meant to have a separate meaning in connection with injunctions against third parties. In legal doctrine, it is suggested that the term involves "most actions and statements of legal importance," for instance, signed contracts, payment of claims, return of loaned assets, etc., between the entity subject to an injunction and the other party.

Either the individual or the company that is subject to an audit, or a third party, can withhold documentation of transactions and other documents. However, by using injunctions, the tax authorities have the option of searching for documents in the possession of an entity that, in itself, is not the subject of a tax audit.

(b) Cross-border exchange of information

The cross-border exchange of information during tax audits is governed by, among other things, the Act on Mutual Assistance in Tax Errands (Lagen om ömsesidig handräckning i skatteärenden SFS 1990:314), the Directive on Administrative Assistance (2011/16/EU of 11 February 2011), the Council Directive (EU) 2016/881 of 25 May 2016, amending Directive 2011/16/EU, and the Council Regulation on administrative cooperation in the field of VAT (EU No. 904/2010 of 7 October 2010). In the Act on Mutual Assistance, mutual assistance means the exchange of information, including participation in tax investigations and in simultaneous tax investigations, assistance during collections (including security measures) and the service of process. Also included is the voluntary and automatic exchange of statements of earnings and income.

the mandatory automatic exchange of information in the field of taxation, by changing the Act of Administrative Cooperation in Tax Matters within the EU (2012:843). The changes state that the Member States' competent authorities, by automatic exchange, may provide information on advance rulings in cross-border tax issues and APAs to other Member States' competent authorities and to the European Commission.

Further, Sweden is part of the automatic information exchange on financial accounts. Foreign Account Tax Compliance Act (FATCA) was implemented in Sweden on 1 January 2015 and Common Reporting Standard (CRS) (DAC2 Directive EU 2014/107) was implemented on 1 July 2016. Just like other EU countries, Sweden will implement Directive EU 2018/822 (DAC6) on mandatory disclosure rules for intermediaries by 31 December 2019.

Further, Sweden has entered into double taxation treaties with more than 80 countries. As a rule, however, only information covered by domestic laws may be requested according to the treaty provisions. The treaty procedure should only be used when all other means of obtaining the sought-after information within the other country have been exhausted.

9. Multijurisdictional tax audits

(a) Simultaneous tax audits

The expression "simultaneous tax audit" is used when two or more states enter into an agreement to conduct a simultaneous investigation. Each state retains responsibility for the investigation in its respective jurisdiction. The target of a simultaneous audit may be one or more individuals or legal entities and the purpose is often to investigate international transactions that extend across several jurisdictions.

Simultaneous tax audits may be carried out in accordance with the Nordic Agreement on Mutual Assistance (Det nordiska handräckningsavtalet SFS 1990:226), the Council Regulation (EU) No. 904/2010 of 7 October 2010 concerning administrative cooperation in the field of VAT and the
Convention by the European Council and the OECD, as well as bilateral double taxation treaties. Simultaneous tax audits are infrequently used, but the method was described in a report from the Swedish tax authorities in 2002 as the "method of investigation of choice for the future" and there is a strong recommendation to increase the number of simultaneous tax audits each year.

A program for so-called multilateral audits within the EU covers direct and indirect taxes. Audits within the EU program are audits of multinational corporations or coordinated audits. Coordinated audits take place when companies in different Member States conclude transactions or enter into agreements with each other and are audited simultaneously, in which case, the tax authorities of several Member States participate in conducting the audit. This kind of coordinated audit may be conducted if it facilitates the auditing of the companies or if the auditing would otherwise be incomplete.

(b) Secondment of auditors

Apart from simultaneous tax audits, Swedish auditors may be present at an audit in another country. This is regulated by the EU regulation mentioned above and the OECD Convention, as well as by bilateral double taxation treaties. During secondments abroad, the Swedish tax auditor may not participate actively in the investigation, and the same applies when a foreign tax auditor is present during a Swedish tax audit. Until now, there have been few secondment cases, but these are expected to increase with the growing integration of the Swedish economy into the European economy.

10. Burden of proof

Matters of taxation are handled by the Swedish tax authorities and the administrative courts, which consist of 12 administrative courts, four administrative courts of appeal and the Supreme Administrative Court. As a rule, the tax authorities and the administrative courts have an obligation to
investigate each matter to the extent necessary with regard to the state, complexity and nature of the matter. The taxpayer has an obligation to provide information within the framework of the regular tax proceedings and must submit information necessary for the assessment of its taxes due to the tax authorities. If the taxpayer fails to fulfill its obligation to provide information, the tax authorities have the right to serve the taxpayer an injunction to submit the information needed to carry out taxation, under penalty of a fine. If the taxpayer does not comply with its obligation to submit sufficient or correct information in its tax return, or other mandatory filings, the tax authorities will make an arbitrary assessment, but must present information in support of the arbitrary assessment. If the tax authorities claim that the taxpayer has had unaccounted revenues, the tax authorities have the burden of proof to present evidence to this end. If the taxpayer wishes to deduct costs, it has the duty to verify the existence and extent of these costs. Both the case law from the administrative courts and various official standpoints and notifications from the tax authorities provide a number of rules on where the burden of proof can be presumed to have been transferred to the opposing party, whereby these presumptions can be refuted if sufficient evidence to the contrary is presented. Generally, the existence of agreements or other documents that are valid from a civil law standpoint is a strong presumption for the validity of a transaction for tax purposes. In such cases, the burden of proof is placed on the tax authorities if the tax authorities wish to question such agreements or documents.

Both the tax authorities and the administrative courts are free to examine any documents submitted as evidence at their own discretion. Furthermore, there are no rules under Swedish law concerning inadmissible evidence.

The European Convention on Human Rights (ECHR) has been incorporated into Swedish law. According to several previous rulings from the European Court of Human Rights, Swedish rules on tax surcharges, which are imposed when a taxpayer is found to have submitted erroneous
information, are in accordance with the presumption of innocence rule as established in the ECHR, provided that the courts apply the tax surcharge rules in a nuanced and nonrestrictive manner. Therefore, an individual could be subject to tax surcharges and face criminal charges on tax fraud regarding the same actions and/or omissions. There was widespread opposition among the lower courts and in legal doctrine to these rulings and the Court of Justice of the European Union (CJEU) requested a preliminary ruling on the issue. Following case law, the Swedish regulation with potential simultaneous liability for tax surcharges and criminal liability was found to breach the principle of *ne bis in idem* or the ban on multiple proceedings for the same crime. Hence, as of 1 January 2016, this case law is interpreted by the Swedish legislator as entailing barring regulation preventing the prosecutor to initiate a tax fraud process if the Swedish Tax Agency previously has taken a decision on tax surcharges in respect of the same action and/or omissions and the same individual. Adversely, the Swedish Tax Agency may not make a decision on tax surcharges if the prosecutor has already initiated a tax fraud process in respect of the same action and/or omissions and the same individual.

Further, a joint procedure for tax surcharges has been implemented and tax surcharges may now also be claimed by the prosecutor in the criminal court proceedings.

Hence, the matter of tax surcharges has been somewhat transferred to the criminal courts in the event that criminal liability is tried.

In the event a tax controversy gives rise to criminal proceedings, the taxpayer has no obligation to provide information to the authorities, since this would be inconsistent with the presumption of innocence, as set forth in the ECHR. For this reason, the taxpayer has the right to refrain from giving information to the tax authorities in a joint tax and criminal investigation. In criminal cases, the public prosecutor must prove beyond reasonable doubt that erroneous information has been submitted.
11. Potential consequences

(a) Adjustment of income

The ordinary annual tax assessment decision is based on information provided in the taxpayer's tax return. If the tax authorities find reason for doing so, they will deviate from the declared information or reassess the taxpayer's income and alter the taxation accordingly. The tax authorities can make such a reassessment before the end of the two-year period following the end of the calendar year in which the fiscal year ended. After that time, the tax authorities cannot reassess unless the taxpayer is found guilty of having submitted faulty or erroneous information and the taxable amount is not insignificant. The reassessment can be made up to six years after the end of the calendar year in which the fiscal year ended. After this, a reassessment may be made if criminal charges for tax fraud are brought against the taxpayer.

(b) Estimate

If the taxpayer submits insufficient information to the tax authorities, an arbitrary assessment will be made. The assessment must be based on what is reasonable and fair in light of what has been established during the tax authorities’ investigation.

(c) Substance over form

In general, the tax authorities and the administrative courts have three methods for disqualifying transactions that are deemed to have been made solely for the purpose of avoiding tax. They may: (i) deem that the relevant statute is not applicable to the transaction and that the transaction is, thus, not subject to a certain tax benefit; (ii) apply the "see-through" principle (genomsyn); or (iii) apply the Tax Avoidance Act (Lag mot skatteflykt SFS 1995:575). The "see-through" principle has been developed in the case law of administrative courts and means that, if applied, some or all of the steps or legal acts in a transaction may be deemed non-existent. However, the Supreme Administrative Court has declared that this...
principle must be applied with great restraint. The Tax Avoidance Act provides that a legal act may not be recognized during the assessment of a taxpayer’s income if the legal act is part of a procedure that grants a substantial tax benefit to the taxpayer, if the taxpayer directly or indirectly has participated in the legal act or legal acts, and if the tax benefit may be deemed the main reason for the legal transaction. A further requirement for the application of the rules on tax evasion in the Tax Avoidance Act is that an assessment based on the legal act or acts must be regarded as contrary to the purpose of the tax laws that apply or are circumvented from applying due to the legal acts in question. If a legal act or acts are not recognized due to the application of the Tax Avoidance Act, the assessment of the taxpayer in question will be carried out as if the legal act or acts had never taken place.

(d) Tax surcharges

If the tax authorities conduct an arbitrary assessment due to a lack of submitted information or reassess due to the submission of erroneous information on the taxpayer’s part, a tax surcharge will be levied in addition to other taxes payable. The tax surcharge varies from 2% to 40% of the amount of tax in addition to the taxable amount, as determined only on the basis of the submitted tax returns or filings. If the company has reported a loss, the tax surcharge is calculated on 25% of the difference in deficit. In practice, this implies that tax surcharges on deficit are higher than revenue, since the basis for calculating the tax surcharge on revenue is the corporate income tax rate of 21.4%. Late payment fees and other fees are levied if a tax-liable person or legal entity does not make payments or submit required tax returns on time. The tax authorities may refrain from levying tax surcharges and fees if submitted erroneous or insufficient information is deemed excusable on the taxpayer’s part or if it would be unreasonable to levy such surcharges or fees. Further, tax surcharges will not be levied if submitted erroneous or insufficient information is caused by an obvious typographical error; if the amount at hand is insignificant; if the taxpayer has voluntarily corrected the
erroneous information; or if the tax authorities have made an assessment that is different from information submitted in a tax return but the reassessment itself does not cover factual data.

(e) Late payment interest

Late payment interest is levied on both preliminary tax and final tax in the case of late payment or with regard to income tax, employer’s contributions, excise duty, payroll tax and VAT. The interest currently ranges from 1.25% to 16.25% of the amount, depending on, among other things, the size of the outstanding amount and the basis on which the tax authorities have levied the interest.

12. Strategies for dealing with tax audits

(a) Cooperation or confrontation?

When the tax authorities decide to perform an audit of the taxpayer, all materially relevant communication will be documented in writing. If the audited taxpayer chooses not to cooperate with the tax authorities and intentionally fails to submit requested information, then this will most likely work to the taxpayer’s disadvantage, as the tax authorities in such a case will make an arbitrary tax assessment based on available facts. The tax authorities are likely to view a lack of cooperation on the part of the taxpayer as a sign of irregularity or unlawful conduct.

(b) Professional assistance in a tax audit

For practical reasons and to safeguard the taxpayer’s interests, a person with a good grasp of the audit process and expertise in Swedish tax law should represent the taxpayer during the audit proceedings. Among other things, this person should be capable of correctly evaluating what documents, which are to the advantage of the taxpayer but which the tax authorities have not requested, should be presented to the auditors.
(c) Settlement or litigation?

The taxpayer does not have the option of settling a matter with the tax authorities. If a tax audit is initiated, the taxpayer will receive an audit memorandum when the audit is finalized. The taxpayer will be given the opportunity to present their views on the matter at hand and the tax authorities will subsequently make a decision based on the memorandum and the views submitted by the taxpayer. The only real choice available to the taxpayer is to decide whether to appeal the tax authorities' decision to the administrative court. In addition, negotiations between an audited taxpayer and the tax authorities regarding the outcome of the audit are very rare.

13. Conversion of regular tax audits to a criminal investigation

The tax authorities have a far-reaching obligation to report suspected crimes discovered during their auditing activities to the public prosecutor. However, the tax authorities are not allowed to independently decide if they will report a suspected crime. Reporting is only non-mandatory if it is likely that it will not result in a punishment or other consequences for the taxpayer under penal law. The tax authorities interpret this to mean that they may refrain from making a report only where small amounts are concerned. The tax authorities may also report crimes other than tax-related crimes, but they are not obligated to do so. Although the reporting right of the tax authorities can be restricted by secrecy regulations, this does not apply where tax-related crimes are concerned.

There are no special procedural rules for converting a tax audit to a criminal investigation. Once a suspected crime is reported to the public prosecutor, two investigations will be carried out: the tax audit, which is carried out by the tax authorities, and the criminal investigation, which is led by the prosecutor.
An important difference between the two investigations is that the taxpayer is under no obligation to voluntarily assist in the criminal investigation, as that would potentially lead to penal consequences for the taxpayer, whereas they have an obligation to submit information regarding their income to the tax authorities.

Under recent legislation on the ban on multiple proceedings for the same crime, excluding criminal liability and tax surcharges for the same act, the tax authorities will need to assess whether tax surcharges should be levied in the event that the authority contemplates reporting a certain act to the public prosecutor.
II. Resolution procedures

1. Administrative level

(a) During an audit

During the audit process, an ongoing discussion as regards the audit process and its possible findings will naturally be conducted between the representative of the audited company and the tax auditor. In general, a draft copy of the audit memorandum will be presented to the audited company before the memorandum is finalized to give the taxpayer the opportunity to express its views. This will also be a good time for the taxpayer to point out discrepancies, inconsistencies and other errors in the draft memorandum and to present, wherever possible, any further documentation in support of its view.

(b) After the release of the tax audit memorandum

After the audit memorandum has been finalized and sent to the taxpayer, the taxpayer will be given the opportunity to express its views on the subject matter of the memorandum. Generally, the taxpayer has up to one month to submit this statement, which should include a critical analysis of the conclusions and estimated tax assessments, if any, proposed in the memorandum.

Based on the memorandum and the statement by the taxpayer, the tax authorities will decide on possible tax reassessments. If this takes place within a year after the tax year in question, the decision will be in the form of a review decision of the tax decision of the tax year in question. After that time, the tax authorities will need to show that the taxpayer has submitted erroneous information to make a reassessment.
2. Judicial tax litigation

(a) Swedish Tax Agency

As stated above, if the tax authorities decide to reassess the taxation of the taxpayer, the taxpayer will have the opportunity to either request a re-appraisal, i.e., that the tax authorities re-examine their decision, or file an appeal to the administrative court. If the taxpayer chooses to file an appeal directly, it must be addressed to the administrative court but sent to the tax authorities. The tax authorities will then examine the appeal to determine if it has been submitted in due time and, if so, on their own accord re-examine their decision and possibly change it. Should the tax authorities change their decision, the appeal will be dropped automatically. If not, the appeal will be passed to the administrative court to be tried by the court.

Both the taxpayer and the tax authorities may initiate a re-appraisal of a decision by the tax authorities. The taxpayer must file its request for a re-appraisal within five years from the end of the year of assessment in question, whereas the tax authorities' limit is set at five years from the end of the year of assessment in the case of a favorable decision for the taxpayer; otherwise, it will be set at one year.

In the event that the tax authorities find that the appeal has not been submitted in due time, the appeal will be rejected. A separate appeal against the decision to reject an appeal may be filed with the administrative court.

(b) Administrative court

In session, the administrative court consists of one presiding judge and three lay judges. The government sets down the number of lay judges for each administrative court. In certain minor matters, the court will only have one judge.
Proceedings in the administrative courts are generally conducted in writing, but the taxpayer has the option to request an oral hearing to better describe the facts and circumstances of their particular case. The court is obliged to sustain a request for an oral hearing in a litigation where the tax agency has levied tax surcharges on the taxpayer. The court has an obligation to investigate the matter at hand as extensively as its nature requires before handing down its ruling. The taxpayer may appeal the judgment of the administrative court within two months to the appropriate administrative court of appeal.

(c) Administrative court of appeal

There are four administrative courts of appeal. In general, judgments by the administrative courts regarding taxation may be appealed to the administrative courts of appeal within two months from the receipt of the lower court’s ruling. The court comprises three presiding judges.

The judgment of the administrative court of appeal may be appealed to the Supreme Administrative Court (*Högsta förvaltningsdomstolen*), provided that leave to appeal is granted.

(d) Supreme Administrative Court

The Supreme Administrative Court is the highest court in the administrative court system. Established in 1909 to handle administrative matters previously dealt with by the government, the court mainly handles matters appealed from the administrative courts of appeal.

The Supreme Administrative Court has to grant leave to appeal before a matter can be handled, unless the administrative court of appeal is the court of first instance. Review permissions will be granted if the matter is important for the development of case law or if there are special reasons for the court to consider the matter. However, leave to appeal is always granted in the event that serious mistakes have been made by the lower courts.
(e) CJEU

If a taxpayer considers a decision to infringe applicable EU law, it may petition the court to submit a request for a preliminary ruling under Article 267 of the Treaty on the Functioning of the European Union to the CJEU. All the three categories of administrative courts in Sweden are authorized to refer a question to the CJEU if they consider it necessary to pass judgment in a case before them. The Supreme Administrative Court has an obligation to refer a question to the CJEU when necessary, but retains the right to decide in which cases it should be deemed necessary.

In addition, a preliminary ruling will be sought by a court only if the court is unable to pass judgment on its own without giving an answer to the question.

However, if the Supreme Administrative Court decides not to refer a question to the CJEU, it has an obligation to provide reasons for such a decision. If a court files a request for a preliminary ruling, the domestic procedure will be suspended for the duration of the proceedings before the CJEU.

If the Swedish government has failed to properly implement an EU directive and this has resulted in damages to a taxpayer, Sweden is obligated under the Frankovich Doctrine to compensate the taxpayer for such damages.

3. Miscellaneous matters

(a) Payment of tax

Generally, even if a taxpayer demands a re-appraisal or submits an appeal, it is obligated to pay the tax resulting from the decision to reassess its taxable income, but may apply for a suspension of the payment demands. This application should be sent to the tax authorities and may be granted if the taxpayer has sought re-appraisal or filed an appeal and it is doubtful whether the decision of the tax authorities will stand, or if the payment of...
taxes would cause significant damage to the taxpayer or if it would otherwise be regarded as unreasonable to demand payment.

The tax authorities may also grant a suspension if there are particular grounds. However, in most cases, it is uncertain whether the tax authorities will grant the taxpayer a suspension and even if the taxpayer is granted a suspension, the unpaid tax will continue to accumulate interest. As a rule, a suspension will always be granted on the payment of disputed tax surcharges.

(b) Penalties and interest

(1) Tax surcharges

If the tax authorities make an arbitrary assessment due to a lack of submitted information or reassess due to the submission of erroneous information on the taxpayer’s part, a tax surcharge will be levied in addition to other taxes payable. The tax surcharge varies from 2% to 40% of the amount in addition to the taxable amount as determined only on the basis of the submitted tax returns or filings. Late payment fees and other fees are levied if a tax-liable person or legal entity does not make payments or submit required tax returns on time.

The tax authorities may refrain from levying tax surcharges and fees if the submission of erroneous or insufficient information is deemed excusable on the taxpayer’s part or if it would be unreasonable to levy such surcharges or fees. Further, tax surcharges will not be levied if submitted erroneous or insufficient information is caused by an obvious typographical error; if the amount at hand is insignificant; if the taxpayer has voluntarily corrected the erroneous information; or if the tax authorities have made an assessment that is different from information submitted in a tax return but the reassessment itself does not cover factual data.
(2) Late payment interest

Late payment interest is levied on both preliminary tax and final tax in the case of late payment or with regard to income tax, employer’s contributions, excise duty, payroll tax and VAT. The interest currently ranges from 1.25% to 16.25% of the amount depending on, among other things, the size of the outstanding amount and the basis on which the tax authorities have levied the interest.
Section One: Country Analysis
Handling Tax Disputes in Sweden

III. Competent authority

1. Arbitration convention

Sweden has ratified the EU Arbitration Convention (90/436/EEC of 23 July 1990) and the protocol to extend the application of the convention as of 2000. The convention establishes a mandatory dispute resolution procedure in cases where the Member States involved are unable to reach a mutual agreement on the elimination of double taxation as regards companies in a community of interest within two years from the date the case was first submitted to one of the competent authorities of the states involved. Since its application is mandatory, the convention has an important advantage over the procedure described above. The Ministry of Finance handles the application of the Arbitration Convention.

2. Competent authority

Swedish double taxation treaties, in general, contain provisions on a competent authority procedure in accordance with Article 25 of the OECD Model Tax Treaty as a way to avoid international double taxation. The competent authority in Sweden is the Swedish Tax Agency for routine matters and the Ministry of Finance, as well as the Minister of Finance for more complicated matters. In practice, there are few cases where the competent authority procedure is used. It is possible, however, to initiate a competent authority procedure and simultaneously proceed with litigation regarding the same decision by the tax authorities to reassess.

A competent authority procedure could be initiated, for instance, if a taxpayer feels that it has been taxed in breach of the applicable double taxation treaty. The procedure also provides an opportunity for the states involved to either negotiate to facilitate the interpretation and application of the treaty or to remove double taxation that is not governed by the treaty.
Handling Tax Disputes in Switzerland

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I. Introduction

1. General

Tax audits are regularly performed in Switzerland, both at federal and cantonal levels.

This chapter summarizes the audit practice followed by the Swiss federal and cantonal tax authorities. Although the tax and the procedural principles are, in many respects, similar for tax audits of individuals and legal entities, this chapter focuses on the rules and principles applicable to tax audits of legal entities and includes aspects of tax audits of individuals in selected cases only.

Tax audits may be initiated either by the cantonal tax authorities, and cover cantonal and federal income taxes, or by the Swiss Federal Tax Administration (SFTA) and cover withholding taxes (WHT) for legal entities, stamp taxes or value added taxes (VAT).

Cantonal and federal income taxes are assessed by the cantonal tax authorities, based on the tax returns submitted annually by all taxpayers. During the tax assessment procedure, the cantonal tax authorities review the tax return and its exhibits and may request additional information before issuing a formal tax assessment. The assessment contains the decisive tax factors and generally the owed tax amount for the respective year. If no objection is filed against the assessment within a deadline of, generally, 30 days, the assessment becomes final and the performing of an actual tax audit will then be subject to certain conditions.

With regard to WHT, stamp taxes and VAT, taxpayers have an obligation to file returns and to immediately pay the respective taxes due. Unlike direct taxes, withholding taxes and stamp taxes are collected through a pure self-assessment procedure, meaning that the taxpayer declares the amount of taxes due and pays the said amount to the SFTA. For this
reason, the SFTA may, at their discretion, initiate federal tax audits to review whether everything has been correctly and duly reported.

The following chapter addresses the rules and principles applicable to federal tax audits. The rules and principles applicable to cantonal tax audits are not covered by this chapter, as this would go beyond its scope. However, rules and principles laid down in the Federal Act on the Harmonization of Cantonal and Municipal Direct Taxes[^264] ("Harmonization Tax Act" or "HTA"), which sets out the principles for the various cantonal tax laws in terms of tax liability, tax period, procedural law, tax object and tax offenses, are also addressed. Since the cantons had to adjust their legislation in line with the provisions of the HTA, the provisions of the HTA on tax audits give a fairly accurate view of the cantonal practices.

Social security contributions and customs duties are not covered in this chapter.

2. General description of the Swiss tax system

Switzerland is a confederation consisting of 26 cantons and 2,200 municipalities. In Switzerland, taxes are levied at the federal, cantonal and municipal level. Each canton is sovereign to the extent that their sovereignty is not limited by the Federal Constitution. This means that each canton is authorized to levy taxes and determine the applicable tax rates, except where the Federal Constitution prohibits the levying of certain taxes or reserves the right for the confederation. The municipalities may levy taxes if empowered to do so by their canton’s constitution. The cantons and municipalities generally levy income taxes and capital (wealth)

taxes (on individuals as well as corporate taxpayers), gift and inheritance taxes, as well as real estate transfer taxes.

A particularity of the Swiss tax system is that the cantonal tax authorities also assess and collect the direct federal tax on behalf of the federal government, under the latter’s supervision. Consequently, the cantonal tax authorities are entrusted to conduct tax audits for federal direct tax under the supervision of the SFTA. However, the SFTA is the sole competent authority that may perform tax audits with respect to withholding taxes, stamp taxes and VAT.

According to the Federal Constitution, the federal government collects the revenue of the federal direct tax on individual and corporate taxpayers (the cantons, however, receive a portion of federal direct taxes paid by individuals and legal entities), withholding taxes (on dividends, certain types of interest and income from other capital assets), stamp taxes (on contributions to the equity of companies and on the transfer for consideration of securities when a party or an intermediary to the transaction is a securities dealer, as well as on insurance premiums), VAT (on the supply of goods and services) and customs duties.

Finally, the SFTA also verifies that companies do not abusively claim the benefits of tax treaties under the Federal Anti-Abuse Decree, under special anti-abuse rules of tax treaties, or under the general anti-abuse doctrine as developed by the Swiss Federal Supreme Court.

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265 The HTA, similar to a directive, contains provisions that have to be included in cantonal tax legislations. Only references to the HTA and not to specific cantonal legislation will be made in this contribution.
266 Article 104 Federal Direct Tax Act (FDTA) of 14 December 1990.
267 Federal Withholding Taxes Act (WTA) of 13 October 1965.
270 Decree of the Federal Council concerning measures against the improper use of tax conventions concluded by the Swiss Confederation of 14 December 1962.
3. Organization of the Swiss Federal Tax Administration

The SFTA is a chapter of the Federal Department of Finance, one of the seven departments of the Swiss Federal Administration. The SFTA is made up of four main divisions. In addition to the two main divisions (i.e., the Principal Division of Federal Direct Tax, Withholding Tax and Stamp Taxes, and the Principal Division of Value Added Tax), which are expressly discussed further in this chapter, there are two other main divisions (i.e., the Principal Division for Tax Policy, which provides strategic support for the drafting of internal legislation, and the Principal Division Resources, which provides support on financial matters, IT and services).

(a) Principal Division of Federal Direct Tax, Withholding Tax and Stamp Taxes

As explained above, the SFTA does not directly perform federal direct tax audits, as such audits are usually performed by the cantons. However, its Division of Supervision of Cantons (which is a subdivision of the Principal Division of Federal Direct Tax, Withholding Tax and Stamp Taxes), is responsible for ensuring a consistent application of the FDTA by the cantonal tax administrations.271 As the supervisory authority, this division may, among other things, inspect and review all federal tax files with the cantonal tax authorities, and order the cantonal tax authorities to rescind federal income tax rulings granted by them, if the SFTA deems them to have been granted in violation of the federal law. It may also order investigation measures or, if necessary, implement such measures, participate in audits (which is not common) with the cantonal tax authorities, and demand, in individual cases, that tax assessments or decisions on appeals also be communicated to it.

Another subdivision of the Principal Division of Federal Direct Tax, Withholding Tax and Stamp Taxes is the Division of External Audits, which is in charge of conducting withholding taxes and stamp tax audits in Switzerland. This subdivision consists of three teams covering 12

271 Articles 2, 102 and 103 FDTA.
geographic zones, two teams responsible for banks and finance companies, one team for transfer pricing and rulings and one team for internal services. The audit procedure is initiated pursuant to the provisions of the Withholding Tax Act and the Stamp Taxes Act.\textsuperscript{272}

This audit division is the most active in Switzerland and focuses on legal entities.

Another subdivision, the Division for Exchange of Information in Tax Matters, handles information requests by foreign tax authorities and advises courts and authorities on mutual legal assistance in tax matters.

Finally, another subdivision related to tax audits is the Division of Criminal Matters and Investigations, which may, at the request of the director of the Federal Finance Department, start investigations where there is suspicion that serious tax offenses were committed, aided or instigated.\textsuperscript{273} The investigations of this subdivision are, however, purely internal investigations that may eventually lead to the opening of a formal tax evasion procedure with the competent cantonal tax authorities and/or a tax fraud procedure with the competent cantonal criminal authorities.

(b) Principal Division of VAT

A subdivision of the Principal Division of Value Added Tax is the Division of External Audits, which is made up of 20 teams covering various geographical areas, and is responsible for performing VAT audits in Switzerland.

4. State Secretariat for International Financial Matters (SIF)

The SIF also belongs to the Federal Department of Finance. It is an independent division that is not part of the SFTA. One of its sections is responsible for international tax policies (bilateral, multilateral and

\textsuperscript{272} Articles 37 STA and 40 WTA.
\textsuperscript{273} Article 190 FDTA.
exchange of information) and takes part in the negotiations of bilateral and multilateral tax treaties.

There is also a Transfer Pricing division, which does not perform tax audits, but is in charge of mutual agreement procedures and of bilateral advanced pricing agreements under tax treaties.

5. Organization of the Swiss cantonal tax administrations

It would go beyond the scope of this chapter to describe the organization of various Swiss cantonal tax administrations in detail. As a general rule, the cantons also have an audit division.

As described above, the direct federal taxes are assessed and collected by the cantonal tax administrations.\textsuperscript{274} Accordingly, the SFTA does neither collect federal income taxes nor independently audit individual taxpayers with respect to direct federal tax.

\textsuperscript{274} Articles 2 and 105 (3) FDTA.
II. Managing the tax audit process

1. General

Compared to other countries, Switzerland does not have a large number of auditors at the federal or cantonal level.

2. Tax audits

The question of whether or not a Swiss taxpayer will be audited depends on various factors. First of all, the tax authorities focus on taxpayers that have not been audited for a certain period of time (for federal, withholding, stamp taxes and VAT, the SFTA is by far not able to perform an audit every five years, which corresponds to the periods usually covered by one audit). There is no clear recurrence, and some taxpayers are audited more frequently than others.

Given their limited resources, the Swiss tax authorities tend to focus their audit efforts on larger businesses meeting certain criteria defined by the tax administration, whereas smaller or medium-sized businesses are audited randomly if, for example, the tax office notes inconsistencies or irregularities upon reviewing tax returns or is informed by other services of the administration of inconsistencies or other issues.

Companies with records of high tax adjustments following prior audits may also be audited more frequently.

3. Advance preparation for tax audits

The taxpayer must be notified in writing in advance of cantonal and federal direct tax audits, which is not an obligation for withholding or stamp tax audits. Nevertheless, the competent tax authority generally determines the scope of the tax audit and notifies the taxpayer in advance about the initiation of the tax audit, the taxes and periods to be covered, the documents to be prepared for review and the contemplated date of the first visit. The taxpayer should cooperate.
In Switzerland, companies are not required by law to have written documentation explaining their transfer pricing policy. Experience shows, however, that written transfer pricing studies can be of considerable help in convincing tax auditors with regard to the correct application of the arm’s-length principle.

The time granted to send documents and information, or the period between the audit notification and the tax auditor’s first visit, should be used to properly prepare for the tax audit and to anticipate any tax issues that may be raised by the tax auditor. Proper preparation should include:

- Putting together accounts, balance sheets and all agreements that were effective during the years under audit (the taxpayer should be aware that the tax auditor’s suspicion is likely to be raised if information requests cannot be honored promptly and/or completely).

- Reviewing transactions with related parties.

- Reviewing existing agreements and their compatibility with tax principles.

- Reviewing existing tax rulings.

- Discussing with the taxpayer’s counsel potential “hot topics” such as: overly aggressive tax planning made in the past; mistakes in returns filed for years under audit that have not yet been corrected; or issues that could be qualified as negligent tax underpayment or even tax fraud (as from 1 January 2016, a qualified tax fraud, i.e., a fraud exceeding CHF 300,000, is a predicate offense to money laundering).

- Discussing with the taxpayer’s counsel strategic considerations during the audit.

- Designating contact persons. Contact with the tax auditor should be limited, if possible, to one or two local company managers with knowledge of the business and its operations. These contact persons
should also be informed that if complex or delicate questions are raised during the audit, they could request time to prepare their answers.

- Setting up copying and documentation procedures if the audit is conducted in the company’s premises. The copying of any documents should be done by a designated employee of the taxpayer, so as to keep an exact list of all documents retained by the tax auditor.

4. Procedures during a tax audit

(a) Cantonal and federal direct taxes

Audit procedures have to be distinguished from the investigations that might be undertaken by the tax authorities during the ordinary tax assessment procedure to verify the accuracy of tax returns.

Audit procedures may be started at a subsequent stage, after taxation has become final.

(b) Investigation during the ordinary tax assessment procedure

During the ordinary tax assessment procedure (which is not an audit procedure), the cantonal authorities have broad investigative powers to clarify all legal and factual elements that are relevant for the complete and accurate assessment of the taxpayer. In doing so, they apply the procedural rules contained in the FTA and the HTA, as well as cantonal procedural rules. The tax authorities may request any further accounting books and records, contracts or any business-related documents or conduct an inspection at the taxpayer’s premises and view the files on-site. The taxpayer has a comprehensive duty to cooperate, to provide

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275 The provisions of the FDTA and of the Tax Act on the Harmonization of Cantonal and Municipal Taxes Act are, in many respects, similar, but it is recommended to consult the respective cantonal tax legislation on this specific subject.

276 Articles 123 and 130 FDTA, Article 46 HTA.

277 Article 123(2) FDTA.
the necessary information and documentation to the tax authorities and must keep the relevant documents for 10 years.\textsuperscript{278} Certain third parties identified by law, such as employers, debtors, creditors, asset managers and any other persons managing the taxpayer’s wealth, insurers and any persons who engaged in business transactions with the taxpayer, must issue written certifications to the taxpayer (and not to the tax administration directly) stating their commercial or financial relationship with the taxpayer.\textsuperscript{279} If the taxpayer does not submit these documents to the tax administration, the latter may demand these directly from the third party.\textsuperscript{280} Furthermore, other designated third parties, such as shareholders, partners and co-owners, must, upon request, provide information directly to the tax administration on the legal relationship with respect to the taxpayer’s shares, claims or other rights.\textsuperscript{281}

The federal, cantonal and municipal tax authorities can exchange information with each other and obtain all information from other federal, cantonal and municipal administrations.\textsuperscript{282}

Professional secrecy protected by law, such as bank secrecy (except during criminal investigations) or the attorney-client privilege, applies in the assessment procedure, meaning that neither the tax administration nor a court can request documents or information from banks or attorneys.\textsuperscript{283} The tax administration may, however, request the taxpayer to provide bank account documentation, but in case of refusal, it cannot obtain these documents from the respective bank.

A breach of procedural obligations (failure to file the tax return or to cooperate with the tax authorities) is subject to a fine of up to CHF

\textsuperscript{278} Article 126 FDTA, Article 42 HTA.
\textsuperscript{279} Article 127 (1) FDTA, Article 43 (1) HTA.
\textsuperscript{280} Article 127(2) FDTA, Article 43 (2) HTA.
\textsuperscript{281} Article 128 FDTA, Article 44 HTA.
\textsuperscript{282} Articles 111 and 112 FDTA, Article 39 HTA.
\textsuperscript{283} Article 127 (2) FTA, Article 43 (2) HTA.
10,000\textsuperscript{284} and entitles the tax administration to carry out a discretionary tax assessment.\textsuperscript{285}

Taxpayers have the constitutional right to be heard, which includes the right to produce documents to support their position, and the right to access information maintained by the administration about them (the internal working documents of the tax administration are, however, not available for consultation by the taxpayers), except where the safeguarding of public or private interests requires otherwise, or where the facts of a case have not yet been established. Documents containing information on other taxpayers may not be consulted, but the tax administration has the obligation to provide documents with the names of other taxpayers redacted or to furnish the relevant information at least orally. The tax authorities, based on the constitutional principle of proportionality, have to limit their requests for information and documents to those that are pertinent for the tax assessment. The tax administration cannot rely on documents that it refused to disclose to the taxpayer (even orally) for taxation purposes.

The tax assessment procedure ends with a formal assessment decision, which determines the tax base, the tax rate and the effective tax amount, taking into account the submitted tax return, and informing the taxpayer of any discrepancies with the positions declared in the tax return. In the absence of an objection within 30 days after notification, the assessment becomes final.

(c) Audit procedure (or supplementary taxation procedure) in direct tax matters

Final assessments can only be changed by a supplementary taxation procedure if certain requirements, as defined by law, are met. According to the FDTA and the cantonal tax acts, the tax authorities are entitled to

\textsuperscript{284} Article 174 FDTA, Article 54 HTA.
\textsuperscript{285} Article 130 (2) FDTA; Article 46 (3) HTA.
initiate an audit and to claim supplementary taxes if at least one of the following two requirements is met:\textsuperscript{286}

- New significant facts or decisive evidence were not known to the tax administration, as a result of which a tax assessment was omitted or a final tax assessment is incomplete.

- An omitted or finalized tax assessment is incomplete due to a crime or criminal offense.

Due to the above-mentioned requirements limiting the cantonal tax authorities' rights to contest final tax assessments, the authorities cannot, at their own discretion, reopen a final assessment and claim supplementary taxes. They must show that new significant facts or decisive evidence not known at the time of the tax assessment, have been discovered or prove that a criminal offense has been committed. However, proof that the taxpayer evaded tax or was at fault is not required as a condition to start a tax audit. Findings of withholding tax or VAT audits communicated by the SFTA to the cantonal tax authorities may constitute facts or evidence entitling the direct tax authorities to initiate an audit procedure.

If the taxpayer has completely and accurately filed its tax return, and the tax authorities had all the documentation and information available to issue a tax assessment, no supplementary taxes may be claimed once the assessment has become final, even if the respective tax authority made a mistake in preparing the tax assessment (except for evident computation errors or spelling mistakes). In principle, the tax administration can assume that the tax returns filed by taxpayers are complete and accurate, and if this is not the case, the fact that the tax authority did not request certain information or documentation from the taxpayer during the tax assessment procedure cannot be raised as a defense by the taxpayer to oppose a supplementary taxation procedure at a later stage.\textsuperscript{287} If the tax

\textsuperscript{286} Article 151 FDTA, Article 53 HTA.

\textsuperscript{287} Federal Supreme Court decision in ASA 51 (1982/83) p. 427.
return is, however, deemed to be incomplete or unclear, the tax authorities are expected to clarify the facts already at the level of the assessment procedure.\textsuperscript{288}

During the audit, the tax authorities have the same investigative powers as during the tax assessment procedure (see sub-paragraph (b) above), and the taxpayers have the same rights.

Since the initiation of an audit procedure in the field of direct taxes is subject to the above-mentioned requirements, in practice, most tax audits affecting companies are performed by the SFTA with respect to WHT or VAT. The findings of such tax audits (e.g., cases of constructive dividends) are communicated to the respective cantonal authorities in charge of levying cantonal and federal direct taxes and may lead to a supplementary tax assessment (see sub-paragraph (c) above).

Tax audits that end with supplementary taxes being levied are often accompanied by fines.

\textbf{(d) Withholding taxes and stamp taxes}

Under the Withholding Tax Act and the Stamp Taxes Act, taxpayers have the obligation to report any event that may be subject to either withholding or stamp taxes (often within 30 days), and pay the taxes due. Unlike direct taxes, withholding taxes and stamp taxes are collected through a self-assessment procedure and paid without a formal assessment procedure or a formal decision of the SFTA. This explains why the SFTA may start an audit procedure, at its discretion, verifying that everything has been reported correctly and completely.\textsuperscript{289} Usually, audits are communicated in advance in writing, however, this is not legally required.

\textsuperscript{288} Federal Supreme Court decision in RDAF 1999 II p. 3.
\textsuperscript{289} Article 37 STA and Article 40 WTA.
Audits can be limited in scope or be more extensive. In the first case, the taxpayer is requested to file certain documents with the tax authority, while in the latter case, the tax authorities perform an audit at the taxpayers’ premises.

The Division of External Audits within the Principal Division of Federal Direct Tax, Withholding Tax and Stamp Taxes is in charge of conducting audit procedures for withholding tax and stamp tax purposes. Banks and finance companies are audited by special teams.

During an audit procedure, the tax authorities have broad investigative powers and may request any accounting books and records, contracts or any business-related documents or conduct an inspection at the taxpayer’s premises and view the files on-site. The tax authorities cannot demand documents and information directly from third parties, but can request them from the taxpayer, provided that the requested information is pertinent to the tax assessment and the request does not violate the constitutional principle of proportionality. A refusal by the taxpayer to provide information may, in effect, result in a reversal of the burden of proof. For instance, in cases where payments have been made to foreign entities and where the taxpayer refused to disclose the names of the shareholders of such foreign entities or the beneficial owners of the payments, the tax authorities will consider, unless the taxpayer could prove to the contrary, these foreign entities as related parties and qualify the payments as taxable constructive dividends. Furthermore, the tax authorities may obtain any information from other divisions of the SFTA as well as from any cantonal or municipal administrations.

The tax authorities can also consult independent experts; however, this is extremely rare.

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The right of the tax authorities to levy withholding taxes or stamp taxes expires after five to seven years after the end of the calendar year in which the taxable event occurred (as will be explained below, this limitation period can be interrupted).\textsuperscript{291}

Once the audit procedure is completed, the tax authorities inform the taxpayer of their position in writing. This communication does not qualify as a formal decision subject to protest or appeal, but shall inform the taxpayer of the position of the tax authorities. The taxpayer then has the right to provide comments and ask for the amendment of the findings or enter into discussions with the authorities, especially where the facts or the legal interpretation are not entirely clear. If the parties cannot reach an agreement, the respective tax authority must then render a formal written decision, which will open the special objection and appeal procedures (see Judicial Tax Litigation below).

5. Limitation period for assessments

The running or expiring of the limitation period may be decisive in selecting the businesses to be audited.

With respect to the limitation period, Swiss law knows relative and absolute limitation periods. "Relative" means that the limitation period can be interrupted by qualifying acts of the tax administration or the taxpayer, whereas the "absolute" period cannot be interrupted and therefore represents the maximum limitation period. The law further contains different limitation period provisions for: (i) the assessment of taxes, (ii) the performance of an audit procedure; and (iii) the collection of taxes.

For \textit{cantonal and federal income tax purposes}, the relative limitation period to issue a tax assessment is five years after the tax period, however, this limitation period is suspended during appeal proceedings or if the taxpayer resides outside Switzerland. In addition, a new limitation period

\textsuperscript{291} Article 17 WTA, Article 30 STA.
starts each time the respective tax authority takes measures to determine (e.g., by requesting information) or enforce the tax claim. In any event, the absolute limitation period to assess cantonal and federal taxes is 15 years.

The right to initiate a tax audit for cantonal or federal taxes expires 10 years after the closing of the tax period in which no or an incomplete tax assessment has been issued. The right to assess supplementary taxes expires, in any event, 15 years after the closing of the tax period in which taxation has been omitted or is incomplete.

The limitation period for the collection of taxes is five years (relative limitation period) after the assessment has become final and 10 years (absolute limitation period) after the amount of taxes has been finally assessed.

The initiation of a criminal procedure is also considered to be a formal notification with regard to the opening of a supplementary taxation procedure.

On the other hand, the relative limitation period to assess withholding taxes and stamp taxes is five years after the end of the calendar year in which the taxable event occurred; it does not run if the taxes are guaranteed or owed by a taxpayer who is not resident in Switzerland and is interrupted (with a new period starting to run) by any action of the tax administration to determine (e.g., by requesting information) or enforce its tax claim. With respect to WHT and stamp taxes, no absolute limitation period exists. Also, recent case law implies that the initial limitation period

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292 Article 120 FDTA, Article 47 HTA.
293 Article 120 FDTA, Article 47 HTA.
294 Article 152 (1) FDTA, Article 53 (2) HTA.
295 Article 152 (3) FDTA, Article 53 (3) HTA.
296 Article 17 WTA, Article 30 STA, Article 42 VATA.
is not five but seven years, in most cases, by referring to a regulation outside of the specific tax act.

6. Voluntary disclosure

A voluntary disclosure is open to individuals and legal entities, if the following requirements are cumulatively met:

- No tax authority has knowledge of the offense.
- The taxpayer fully cooperates with the tax authority.
- The taxpayer makes serious efforts to pay the taxes owed.

The taxpayer still has to pay the supplementary taxes as well as interest, however, no fines will be imposed and no criminal proceedings will be initiated against the taxpayer (e.g., for tax fraud). The voluntary disclosure procedure described above is applicable to direct taxes, but there are similar rules applicable to VAT and withholding tax.

7. Areas of tax auditors' special attention

The general approach taken by tax auditors is to review the accuracy of the taxpayer’s returns on the basis of the taxpayer’s accounting books and records. The auditors have the right to review and, therefore, the right to be given access to, the documents they may consider relevant. The auditors may also request that additional information they deem necessary be provided. The taxpayer is expected to honor information requests promptly and completely.

(a) Direct federal and cantonal taxes

With regard to corporate income taxes, the cantonal tax authorities mainly rely on the findings of tax audits performed by the SFTA on legal entities for withholding tax or VAT. If the SFTA qualifies a payment as a constructive dividend payment (see sub-paragraph (f) below), such dividend is not only subject to withholding tax, but also will trigger a
direct tax adjustment. For this reason, the cantonal tax authorities tend to focus on individual taxpayers, especially taxpayers exercising an independent business activity (as sole practitioner or as partners in partnerships).

For *individual taxpayers*, the auditor will focus on the following:

(1) **Review of expenses**

For taxpayers exercising a business activity in particular, the auditor will review whether books are kept in accordance with legal principles, that only commercially justified expenses have been recorded and that no expenses of a private nature have been deducted as business expenses, or that no exaggerated business expenses (e.g., as a result of a too aggressive depreciation or provision policy) or even non-incurred expenses have been deducted.

For private individuals, the auditor will verify that the taxpayer does not deduct non-deductible expenses or that the deduction limits prescribed by law are not exceeded (e.g., property maintenance expenses).

(2) **Review of taxable income and wealth**

Individual taxpayers have to report all taxable income and their wealth in their tax return. The tax authorities may verify that the taxpayer did not omit, willfully or negligently, to report taxable income and wealth. In particular, a sudden increase of wealth that is not matched by equivalent income may raise suspicion that not all elements of income have been reported.

(3) **Private versus professional management of assets**

Under Swiss tax principles, individual taxpayers are not subject to cantonal and federal direct taxes on private capital gains.\(^{297}\) However, when the gain

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\(^{297}\) Article 16 (3) FDTA and Article 7 (4) (b) HTA.
qualifies as a gain from a professional or independent activity, it becomes fully taxable.\textsuperscript{298}

The distinction between private and professional gain is not easy to draw, especially in the field of portfolio management. A private individual managing their own wealth will be treated as a professional if their activities go beyond what should be considered as an ordinary management activity. The criteria especially considered by the tax authorities in their analysis are: (i) the frequency and volume of transactions (including the length of the holding period from acquisition to sale); (ii) their financing (recourse to loan or not); and (iii) the sophistication of the transactions (e.g., use of hedging techniques or transaction in derivative financial products). In contrast, it is generally not sufficient that the activity in question be carried out in a systematic manner or that the person has a particular knowledge due to their ordinary professional activity.\textsuperscript{299}

(4) Indirect partial liquidation theory

In a different context, when an individual taxpayer sells their company in a share deal, the so-called indirect partial liquidation is another way to convert what normally qualifies as a tax-free capital gain on the sale of shares of a company into taxable income. This theory, developed by the tax authorities and upheld by Swiss tax courts, is based on an economic interpretation of the notion of liquidation and of income from equity investments.

Effective as of 1 January 2007, a specific legal provision has been introduced to deal with this issue.\textsuperscript{300} According to this new provision and

\textsuperscript{298} Article 18 (1) FDTA, Article 8 (1) HTA.
\textsuperscript{300} Article 20a (1) (a) FDTA and Article 7a (1) (b) HTA.
the regulations of the SFTA, the sale of shares represents taxable income from investments, as opposed to a tax-free capital gain, whenever: (i) a seller, being an individual, owns shares as private assets, sells a minimum stake of 20% in a company to a person who is either a legal entity or an individual required to keep books and records; (ii) the substance of the acquired company, which is not necessary for its business activities and distributable within the meaning of commercial law at the time of the sale, is distributed within five years from the date of sale; and (iii) the seller participates in the distribution. In other words, partial liquidation generally applies to situations where an acquired company has excess liquidities that are distributed, directly or indirectly, to the purchaser within a period of five years from acquisition.

One of the main changes introduced by the legal provision in question, compared with past practice, is that the distribution of profits realized after the sale will no longer be subject to the application of the indirect partial liquidation.

Typical cases of indirect partial liquidation involve the following:

- The payment of a substantial dividend by the acquired company to its new parent (the purchaser) shortly after the acquisition.
- The granting of a loan at non-arm's-length conditions by the acquired company to its new parent, where the ability of the parent company to repay the loan may be questionable.
- The granting of securities by the acquired company to guarantee a debt of the parent company, where it is probable that the guarantee may be called.

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301 Circular Letter No. 14 of the SFTA, dated 6 November 2007, on the sale of participations from private fortune to professional fortune of a third party (“indirect partial liquidation”).

• The assumption by the purchaser of a debt of the seller vis-à-vis the acquired company.

All these cases have in common the fact that the resources of the acquired company, accumulated prior to the acquisition date, contribute, directly or indirectly, to the financing of its own acquisition. The tax authorities therefore hold that the acquired company does not need such resources for its own business. It is deemed to have disposed of them in the course of an indirect partial liquidation; the tax authorities thus impute such liquidation proceeds to the seller as taxable income (instead of a tax-free capital gain).

The seller is thus frequently subject to supplementary taxation on the deemed liquidation proceeds.

(5) Transposition theory

The transposition theory is applied in a transaction where an individual sells or contributes their stake in a company belonging to their private wealth to a company in which they hold a stake of at least 50% after the transfer. If the sale or the contribution is made at a value higher than the nominal value of the shares and the additional paid-in capital, the gain will be requalified as taxable income from investments. The taxable income corresponds to the difference between nominal value and the additional paid-in capital and the higher contribution, or transfer value of the shares.

The transposition theory was — as the indirect liquidation theory — first developed by the tax authorities and was upheld by courts.

Effective as of 1 January 2007, a specific legal provision was introduced to regulate this type of transaction.304

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303 Until the end of 2019, such stake needed to amount to at least 5% of the company’s shares.
304 Article 20a (1) (b) FDTA and Article 7a (1) (a) HTA.
(6) Restructurings

Individuals carrying out a business activity may restructure their activities (e.g., through a merger or transfer of businesses to partnerships and legal entities), with no immediate tax consequences, if certain conditions (such as the transfer of assets and liabilities at book values) are fulfilled. Furthermore, individuals converting their sole proprietorship or partnership in legal entities may do so tax-neutrally, but are prevented from selling their shares during a period of five years following the conversion.\(^{305}\)

The tax authorities will review such transactions to verify that all conditions of a tax-neutral restructuring are met.

(7) Tax avoidance schemes (including "substance over form" questions)

The general tax avoidance theory has been developed by the Federal Supreme Court. It allows the tax authorities to tax a structure, not based on its legal appearance, but on its economic substance, if the following three conditions are cumulatively met:\(^{306}\)

- The structuring of the transaction is unusual, inappropriate or inadequate for its economic circumstances.

- The taxpayer has chosen the transaction structure merely or essentially for the purpose of saving taxes.

- The transaction effectively leads to substantial tax savings had the tax authorities accepted it.

If these conditions are fulfilled, the tax authorities can tax the transaction based on its economic substance from a business point of view.

For corporate taxpayers, the auditor will focus on whether the books are correctly kept, whether provisions and depreciations are commercially

\(^{305}\) Article 19 FDTA and Article 8 para. 3 HTA; Circular letter No 5 of 1 June 2004 on Restructurings.

justified, as well as on the same points as described in the paragraph below for withholding tax purposes, since these are also relevant for direct tax purposes.

(8) Permanent establishments/Residency

The Swiss federal and cantonal direct tax laws distinguish between "unlimited" and "limited" income tax liability. Corporate taxpayers are subject to "unlimited" income tax liability, i.e., subject to federal and cantonal income tax in respect of their worldwide income if they have their registered seat or their place of effective management in Switzerland. Foreign entities may only be subject to "limited" income tax liability in respect of certain categories of Swiss-sourced income, the most important being the income from business activities derived through a permanent establishment.

The Swiss tax authorities review regularly if the place of effective management of a non-Swiss corporate entity is in Switzerland, and have been successful in subjecting foreign entities to full taxation in Switzerland.307

Concerning permanent establishments, since many principal companies conducting business with foreign contract manufacturers and commissionaires are based in Switzerland, such structures with foreign principal companies have not been actively audited from a permanent establishment perspective. On the other hand, the SFTA did not recognize the existence of a foreign permanent establishment in an offshore jurisdiction on the grounds of insufficient substance, i.e., insufficient qualifying business activity. Consequently, the profit of the permanent establishment was added to the Swiss head office.


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Section One: Country Analysis
Handling Tax Disputes in Switzerland

(b) Withholding tax

As mentioned above, the findings of withholding tax audits often have income tax implications, meaning that the transactions listed below are also relevant for income tax purposes. The SFTA will check that no constructive dividends were paid by Swiss legal entities. They essentially review transactions between related parties to make sure that these comply with the arm's-length principle. Related parties' transactions include the: (i) sale and use of tangible property; (ii) transfer and use of intangible property; provision of services; (iv) loans (including cash pooling transactions); and (v) any advantage granted to a related party that could be seen as not commercially justified.

The notion of the related party has been broadly defined by precedents of the Federal Supreme Court. It does not only include shareholders and persons related to the shareholders by direct or indirect share ownership links, but also parties that, because of their personal or economic relationships with shareholders, may be viewed as the cause that a deal does not comply with arm's-length standards.308

A hidden or constructive dividend distribution occurs when a company suffers an economic loss due to any transfer in value exceeding what would be granted to an independent third party in similar circumstances.

Constructive dividends may take different forms, such as excessive business expenses or non-justified business expenses charged to the profit and loss account, insufficient income received, unjustified charges to asset accounts, transfer of corporate assets, and waiver of claims.

According to the precedents of the Federal Supreme Court, three conditions must be fulfilled to re-characterize a transaction as a constructive dividend:

- The company has granted a benefit without receiving adequate consideration in return, as a result of which the company suffers a decrease in the value of its assets.

- The beneficiary is a shareholder or a person related to the shareholder, and the benefit would not have been granted to an unrelated third party dealing at arm's-length.

- The disproportion between the value of the goods or services and the compensation received in exchange was recognizable by the corporate bodies.\(^{309}\)

Constructive dividends trigger two levels of taxation. First, the net taxable profit of the company is increased by the amount of additional income that the company should have gained under normal business conditions, and additional direct taxes are levied. This is the reason why constructive dividends are systematically reported to the cantonal tax authorities that assess direct taxes. Second, because the full net taxable income was not properly booked, the deficiency of revenues is deemed to have been distributed as hidden dividend and is therefore subject to withholding tax. For withholding tax purposes, the deemed beneficiary of a constructive dividend is, in general, the entity that received a direct benefit ("direct beneficiary theory"). This can be company other than the direct parent company (for instance, a sister company). In contrast, for income tax purposes, the deemed beneficiary is the company’s direct parent. As a consequence of the application of the direct beneficiary concept for withholding tax purposes, the "direct beneficiary" is frequently unable to claim maximum treaty relief of Swiss withholding taxes, as it may not be

\(^{309}\) See Federal Supreme Court decision in ATF 82 (1956) I p. 288; also RDAF 1992 p. 85.
able to meet the direct ownership criterion set forth by the treaty for full withholding tax relief.

The rate of Swiss withholding tax is 35%, and the Swiss entity that paid a constructive dividend has the obligation to claim the withholding tax from the direct beneficiary. If the beneficiary fails to pay back the withholding tax, a gross-up mechanism applies (the constructive dividend is deemed to represent 65% of the total), which increases the withholding tax rate to 53.85%.

(1) Sale of goods

There is neither a federal or cantonal statutory provision nor any specific regulation setting forth a method to determine the arm’s-length price in an intra-group transaction. The Swiss tax authorities have adopted a pragmatic approach, taking into account all circumstances of each specific case and following either court decisions (there are few decisions at an international level, but more inter-cantonal precedents) or more generally the transfer pricing guidelines of the OECD\textsuperscript{310} with a preference for the comparable uncontrolled price method (CUP). When no such comparable transaction is available, a variation of the CUP, introduced early in Switzerland by case law,\textsuperscript{311} is applied, under which the tax administration compares the intercompany price with the price an unrelated party would pay (or sell for) if it was in the related party’s financial situation. Recent developments show that in practice, transactional profit methods tend to be more frequently applied.

The Swiss tax authorities have not developed a "best method" rule, as other jurisdictions, to determine which method must apply. The taxpayer


\textsuperscript{311} Federal Supreme Court decision in ASA 135.
has to prove that the transfer price is an arm's-length price, no matter which method it uses.\textsuperscript{312}

(2) \textbf{Service activities}

The performance of services to related parties must be remunerated by a cost-plus method. Because the (former) Swiss practice of systematically accepting a cost-plus 5\% for any type of services has been criticized by the OECD, the Swiss tax authorities have announced that the applicable mark-up should take into account the nature of services rendered to comply with arm's-length principles.\textsuperscript{313}

(3) \textbf{Interest rates on loans}

The SFTA regularly issues instructions defining, as a safe harbor rule, the maximum and minimum applicable interest rates on related parties' mid-term and long-term loans (there are no prescribed rates for short-term advances). When advances are granted without specific payment terms, they are qualified as mid-term or long-term loans when they remain on the balance sheet for consecutive years without an instalment being repaid at least once a year. This instruction, which is periodically updated, prescribes a minimum interest rate when the Swiss entity acts as lender and a maximum interest rate when the Swiss entity acts as borrower. Interest rates also vary, depending, for example, on whether loans are guaranteed by a mortgage or not.

When a Swiss corporation borrows to on-lend to its shareholders, its profit margin (interest spread) must be at least 0.5\% (on the first CHF 10 million and 0.25\% on the amount exceeding CHF 10 million) and 0.5\% with respect to loans denominated in foreign currencies.

\footnote{312 See para. II 6 below on burden of proof.}
\footnote{313 Circular Letter of the SFTA No. 4, dated 19 March 2004, on the taxation of service companies.}
(4) Thin capitalization rules

The auditors also verify that loans between related parties do not exceed the applicable thin capitalization rules. The interest paid for an excessive loan is not deductible and any portion of a loan exceeding the maximum borrowing limits is requalified and treated as a constructive dividend subject to withholding tax.

On 6 June 1997, the SFTA issued a Circular Letter (regulation) setting out safe harbor rules that prescribe a maximum debt-to-equity ratio for each asset class.314 According to this regulation, a maximum debt-ratio is set for each asset class (as a general rule, a Swiss entity may borrow from related parties up to 100% of its cash position, 85% of current assets and 50% to 70% of fixed assets); the excessive portion of the loan is also added to the taxable equity of the company (at the cantonal level).

(5) Simulated loans

Another risk associated with intra-group loans is related to the concept of simulated loans. If a loan is not evidenced by a written agreement, is granted to an entity whose capacity to repay the loan is questionable, is not granted at arm’s-length conditions, or remains outstanding for a long period of time without interest actually being paid (but merely being accrued), the tax authorities could take the position that the parties entered into a simulated loan agreement and never had the intention of repaying the loan. As a result, the full amount of such loan may be treated as constructive dividend.315 The Federal Supreme Court has, to a certain extent, limited the right of the tax authorities to consider such loans as constructive dividends. The Federal Supreme Court held that the mere fact that the conditions of a loan (e.g., interest rate) were not at arm’s-length was not sufficient to regard the entire loan as being simulated. Thus, it must be distinguished between the granting and the conditions of a loan,

and the tax authorities can adjust the taxable income based on not arm’s-length interest payments, but not treat the loan as simulated.\(^\text{316}\)

(6) **Royalties**

As for the sale of goods, the Swiss tax authorities try to rely on the CUP method to determine the arm’s-length nature of royalties.\(^\text{317}\)

The Federal Supreme Court has ruled that the percentage rate of the royalty is not always decisive in determining whether the transaction is a constructive dividend distribution. The royalty rate should also be considered in connection with other circumstances, in particular with the financial result of the company paying the royalties. Depending on the circumstances, the licensee will know from experience whether the agreed-on rate is acceptable from an economic point of view.

(7) **Business restructurings and liquidation**

Another area of scrutiny by the tax authorities is business restructurings, where the business model of a Swiss entity is changed (e.g., by conversion of a full-fledged distributor to a limited risk distributor, a commissionaire or an agent), as such reorganization may lead to a deemed taxable transfer of intangibles or profit potential. When a company is being liquidated, the tax authorities may also decide to audit such company (as this would be the last opportunity to do so) and look for possible taxable transfer of goodwill or business to a related party.\(^\text{318}\)

(c) **Issuance stamp tax**

The 1% federal issuance stamp tax applies on the issuance and increase of equity in cash or in kind of legal entities (the first CHF 1 million is normally exempt). The issuance stamp tax is levied regardless of whether the contributions are duly recorded on the balance sheet or treated instead as

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\(^{317}\) ASA 31/141, RDAF 1963/135.

\(^{318}\) Federal Supreme Court decision of 9 July 2012, 2C_499/2011.

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hidden equity (e.g., because hidden reserves are created). Stamp duty is, however, usually only levied on contributions by a direct shareholder.\(^{319}\)

The SFTA will therefore focus on the following points:

1. **Valuation of assets contributed in kind**

Because the issuance stamp tax is due on the full value of assets contributed in kind, the tax authorities will review the valuation by the taxpayers and assess whether the valuation is acceptable.

2. **Hidden contributions to equity**

Contributions to equity may be recorded at full value or be treated as hidden contributions, in which case the contributed assets do not appear (or only for a symbolic amount). The issuance stamp tax is also due on such hidden contributions, which will be reviewed by the tax authorities.

3. **Corporate reorganizations**

Issuance stamp tax is generally not due on corporate reorganizations. The tax authorities regularly check that all conditions imposed by the Swiss regulations,\(^{320}\) to characterize a transaction as a reorganization qualifying for the exemption of the issuance stamp tax, are met.

4. **Transfer stamp tax**

Securities dealers are subject to a transfer stamp tax whenever they act as a party or as an intermediary to a transfer of taxable securities for consideration. The transfer stamp tax is 0.15% on the transfer of Swiss securities and 0.3% on the transfer of foreign securities.

The following persons qualify as securities dealer within the meaning of the Stamp Taxes Act: (i) banks and financial institutions; (ii) individuals and legal entities, as well as Swiss branches of foreign enterprises whose main

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\(^{320}\) Circular Letter No. 5 of the SFTA dated 1 June 2004 on Restructurings.
activity is to trade in securities for the account of third parties or to act as intermediaries in the trade of securities; and (iii) Swiss companies and pension funds whose assets, based on the last annual balance sheet, consist in taxable securities with a book value in excess of CHF 10 million.\(^{321}\)

In addition, a securities dealer must report all their transactions regarding securities in a special register (ad hoc register) that may be reviewed by the SFTA. The auditors will essentially check the following:

(1) **Notion of securities dealer**

The auditor will verify whether all persons qualifying as securities dealers are registered and comply with their obligations.

(2) **Verification of taxable transactions**

Because of the complexity of the definition of taxable securities and special transactions, where, as an exception, the transfer stamp tax is either not due or reduced, the tax auditor will review whether the securities dealers correctly reported the transactions in the ad hoc register.

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\(^{321}\) Article 13 STA.
III. Special tax audits

1. VAT audits

(a) Introduction

The SFTA examines whether the taxpayers have spontaneously registered, completed and filed the tax returns and paid the VAT.

Since the taxpayer is responsible for reviewing its tax liability and declaring the correct taxes amount, audits are particularly important in the VAT area. The number of VAT on-site audits performed has been between some 8,500 and 9,000 per year from 2013 to 2018. In addition, the SFTA reviewed the documents filed by the taxpayer, resulting in additional collected taxes (figures for 2018) of total CHF 208 million. Against the background that only some 380,000 taxpayers were registered for VAT in 2018, this is a considerable amount and emphasizes again the relevance of VAT audits.

The SFTA uses the following tools to identify potential taxpayers:

• Study the Swiss Official Gazette of Commerce (FOSC) regarding the registration of new companies that probably have to register with the SFTA for VAT.

• Review the books of other taxpayers. The SFTA can perform crosschecks. For example, if a taxpayer has paid non-taxable costs or assets for significant amounts, the SFTA may examine the suppliers’ books in order to ensure that they do not realize taxable turnover.

• Searches on the internet or via other media.

• Review of tax questionnaires completed by companies considered not liable for tax on a compulsory basis.

322 Activity report of the SFTA 2018, p. 4.
• Send a tax questionnaire or information request to entrepreneurs suspected to be taxpayers.

• On-site audit in case of doubt.

After having identified the taxpayers, the SFTA can review whether the tax returns have been filed and the tax amount has been paid in due time.

If the tax returns are not filed in due time, the SFTA will first send a reminder. In the absence of any answer, the authorities may directly assess the taxes due by means of an internal procedure (without performing an on-site audit) or may undertake an external examination (with an on-site audit).

(b) Initiation of the VAT audit

Except in extraordinary circumstances, an audit is always announced in advance in writing, but is not subject to any conditions. The date and the estimated duration of the examination are mutually agreed on with the taxpayer. If the latter wishes, the audit can possibly be scheduled in the offices of its accountant. A taxpayer may also request to be audited in order to make sure that its reporting complies with the law.

The taxpayers have to grant full access to their books and records. Certain third parties, as defined by the law, also have to collaborate and provide information or grant access to their books upon request. This applies in particular to persons who could be potential taxpayers or be held jointly liable for the payment of VAT, as well as to persons holding, within a VAT group, a qualifying participation in the taxpayer.

323 Article 78 (3) VATA.
324 Article 78 (4) VATA.
325 Article 78 VATA.
326 Article 73 VATA.
Depending on the scope of the activities, the duration of the physical on-
site audit by the SFTA in the premises of the company may be anything
from one day to several months.

(c) **Documents to be provided**

In addition to the latest balance sheet and profit and loss account, the
SFTA may request a copy of the following documents:

- The balance sheet and the profit and loss account for the five years
  preceding the end of the respective fiscal year

- The audit reports for the same period

- The accounting records relating to the five previous years, as well as
  those relating to the current year (with respect to real estate,
  documentation for up to 26 years may be required)

- The accounting ledgers for each exercise (cash book(s), postal and
  bank accounts, etc.)

- The accounting vouchers relating to cash accounts

- Any other accounting documents

- A statement regarding work in progress

- A list of debtors and creditors

- The inventories for the six previous financial years

- Copies of the VAT returns
(d) Limitation period

A VAT audit can be performed within five years after the end of the calendar year during which the taxable event occurred.\textsuperscript{327} This limitation period is interrupted and a new period starts afresh by any action of the tax authorities, such as determining or adjusting a tax claim or issuing a decision.

\textsuperscript{327} Article 42 VATA.
IV. Information-gathering powers

1. Exchange of information

(a) Exchange of information on request

During both the ordinary tax assessment procedures and the tax audit procedures, tax authorities usually do not solicit information from foreign tax authorities, unless there is a suspicion of tax fraud.

In its tax treaties, Switzerland has historically adopted a very restrictive position with respect to the exchange of information. According to the former Swiss practice, only information that is strictly necessary to apply the treaty correctly (i.e., to avoid double taxation), may be exchanged (see, however, special provisions of the Swiss Federal Anti-Abuse Decree below). In particular, no exchange of information was granted for the purpose of assisting another state in combating tax evasion (i.e., a mere omission to report taxable income). Only cases of tax fraud (defined under Swiss tax principles as the use of forged or false documents or other astute means to deceive the tax administration) or the like could lead to an exchange of information with certain countries.

The consequence of this historically restrictive attitude in providing information to foreign authorities, is that the Swiss tax authorities traditionally refrain from actively soliciting information from foreign tax authorities. However, they will use information that they receive voluntarily (or based on the newly installed automatic exchange of information) from foreign tax authorities.

Due to international pressure, Switzerland announced in March 2009 that it will withdraw its reservation to Article 26 of the OECD Model Tax Convention. Since then, dozens of treaties have been renegotiated with an extended exchange of information clause in Article 26 of the OECD Model Tax Convention. Further, on 1 February 2013, Switzerland enacted its new domestic law on administrative assistance, which allows for international
group requests if the respective treaty provides for it (i.e., essentially if the respective treaty follows the principles of Article 26 of the OECD Model Tax Convention). Since then, the Swiss Federal Supreme Court confirmed several decisions of the SFTA allowing for group and/or bulk requests (the latter meaning requests where several taxpayers are not identified via name and address, but unlike in group requests, the identification is not made via a fact pattern but via other means). In 2019, the Swiss Federal Supreme Court confirmed the transfer of taxpayer data to France based on a bulk information request that concerned some 40,000 taxpayers. In addition, Switzerland has concluded specific bilateral tax information exchange agreements with non-treaty countries.\(^{328}\) In general, one may say that Swiss information exchange practice has become very broad in recent years.

(b) Automatic exchange of information

On 19 November 2014, Switzerland signed the Multilateral Competent Authority Agreement, which allowed it to go forward with plans to activate automatic exchange of financial account information in tax matters (AEOI) with other countries beginning in 2017. The Multilateral Competent Authority Agreement was ratified on 18 December 2015. On 27 May 2015, Switzerland and the EU signed an agreement regarding the introduction of the global standard for the automatic exchange of information in tax matters. Switzerland and the EU Member States collect bank account information as from 2017 and exchange it as of 2018 for the first time. According to the Federal Act on Automatic Exchange of Information, the SFTA will automatically transmit information received from foreign states to the competent cantonal tax authorities.

\(^{328}\) Federal Supreme Court Decision of 26 July 2019, 2C_653/2018.
To date, Switzerland has agreed to automatically exchange information with 80 partner states.\(^{329}\) Domestic bank client confidentiality in Switzerland will not be affected by the implementation of the new global standard.

The implementation of the automatic exchange of information led to a considerable increase in voluntary disclosures in Switzerland (see above in II. No. 6).\(^{330}\)

(c) **Country-by-country reporting**

In the context of BEPS Action 13, Switzerland signed the Multilateral Convention on Administrative Assistance on 27 January 2016 (ratified on 26 September 2016) requiring multinational companies to report annually, and for each jurisdiction in which they do business, certain information on their turnover, activities, number of employees, taxes paid and more. The related domestic legislation entered into force on 1 December 2017. The mandatory filing of a country-by-country report started as from 2018, with information exchanges starting in 2020 with those partner states that have signed the Multilateral Competent Authority Agreement. However, voluntary filing was available for the years 2016 and 2017 and the SFTA received in 2017 voluntarily filed country reports from 100 Swiss-domiciled multinational companies concerning the year 2016.\(^{331}\)

(d) **Spontaneous exchange of tax rulings**

In the context of BEPS Action 5, and based on the OECD/Council of Europe multilateral convention on mutual administrative assistance in tax matters signed by Switzerland on 15 October 2013 (ratified by Switzerland on 18 December 2015),\(^{332}\) and on the revised Federal Act on Mutual Assistance in

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\(^{330}\) See Activity Report of the SFTA 2018, p. 3.

\(^{331}\) See Activity Report of the SFTA 2017, p. 12.

\(^{332}\) Article 7.
Tax Matters, Switzerland will spontaneously exchange certain types of rulings issued after 1 January 2010 and still in force on 1 January 2018.

2. Burden of proof

In general, the tax administration has the burden of proof and must therefore demonstrate the facts that lead to the existence or increase of the tax burden, while the taxpayer bears the burden of proof for any elements reducing or eliminating the tax burden.333

However, the required standard of proof imposed on the tax authorities is limited to what must be considered as reasonable. It is therefore sufficient for the tax administration to rely on strong indications, and it is then the taxpayer’s obligation to provide evidence contesting such facts.

Non-compliance with the cooperation duty by the taxpayer may result in a reversal of the burden of proof. For instance, in cases where payments have been made to foreign entities and where the taxpayer refused to disclose the names of the shareholders of such entities, the tax authorities considered, unless the taxpayer could prove to the contrary, these foreign entities as related parties.334

In a decision of the European Court of Human Rights of 3 May 2001 against Switzerland, the court held in a tax fraud case that taxpayers are under no obligation to incriminate themselves, i.e., are not obliged to submit any information to the tax authorities.335 This, however, generally only relates to criminal procedures and not to a tax assessment/audit procedure.

333 StE 1990, B 13.1 No. 8.
3. Swiss federal Anti-Abuse Decree

On 14 December 1962, the Swiss Federal Council enacted a decree concerning measures against the improper use of tax treaties of the Swiss Confederation for the avoidance of double taxation ("Anti-Abuse Decree"). Unlike most anti-abuse measures adopted by foreign countries, the Anti-Abuse Decree is not meant to restrict the benefits of foreign companies investing in Switzerland, but rather to limit the use of Swiss intermediary companies investing abroad. This self-imposed measure felt indispensable to answer the concern of important treaty partners, notably the US, about the repeated use of intermediary Swiss companies by multinational companies with favorable tax regimes investing abroad. In enacting the Anti-Abuse Decree, the Swiss government wanted to prevent the possible termination of certain tax treaties.

Under the Anti-Abuse Decree, the SFTA spontaneously reviewed whether Swiss companies claiming treaty benefits (e.g., by obtaining a relief of foreign withholding tax on dividends, interest or royalties) meet the conditions imposed by the tax treaty in question (domicile or registered seat, taxation, beneficial ownership, etc.). If a Swiss company obtained treaty relief without fulfilling the conditions of the double tax treaty, then the SFTA was empowered to recover the foreign withholding tax from the Swiss company on behalf of the foreign tax authority and to repay it to the foreign tax administration. If no other remedy was available, the SFTA could also inform the foreign tax administration that treaty relief was obtained improperly. The Anti-Abuse Decree only applied where the applicable tax treaty does not already contain anti-abuse provisions.

\[336\text{ Article 4 Anti-Abuse Decree.}\]
As of 1 July 2017, the Anti-Abuse Decree was partially repealed. Due to this amendment, the above-mentioned examinations are no longer to be conducted by the SFTA. Such reviews should exclusively be performed by the tax authorities of the other contracting country. However, the Anti-Abuse Decree still provides certain measures to prevent Swiss intermediary companies investing abroad from being abused by persons that are not treaty-entitled.
V. Resolution procedures

1. Administrative level

During a tax audit, a number of meetings between the auditor and the taxpayer may take place in order to discuss or, if possible, resolve issues of importance that have arisen prior to the final meeting. Once the audit procedure is completed, the tax authorities inform the taxpayer of their position in writing. The taxpayer then has the right to provide comments and ask for an amendment of the findings or to enter into discussions with the authorities, especially where the facts or the legal interpretation are not entirely clear. If the parties cannot reach an agreement, the respective tax authority must then render a formal written decision, which may be contested through an objection and appeal procedure within 30 days from the date of notification of the decision.

2. Judicial tax litigation

(a) Cantonal and federal direct taxes

First level of appeal: Once the competent tax authority has issued a formal tax assessment in the course of the ordinary tax assessment procedure, the taxpayer may file a formal objection with the same tax authority that issued the assessment within 30 days as from notification.

This procedure applies to federal and cantonal taxes and is mostly free of charge.

The taxpayer has a constitutional right to be heard (see above in II. 4.). After the examination of the objection, the tax authority either confirms the assessment or modifies the tax assessment in whole or in part. This may also be to the disfavor of the taxpayer.

Second level of appeal: The taxpayer may file an appeal against the decision on the formal objection before a first instance court, which is either a cantonal tax appeal commission or a cantonal administrative court.
(usually within 30 days). The second level of appeal is not free of charge. The commission or the cantonal administrative court have full jurisdiction over cases referred to them. The organization of the appeal commission or the administrative courts may differ from canton to canton.

**Third level of appeal:** The taxpayer (or the tax authority), to the extent permitted by cantonal law, can file an appeal before the second instance cantonal court. The second instance cantonal court usually has a more limited jurisdiction (mainly regarding the establishment of facts) than the first instance court. Depending on the organization of the appeal procedure, certain cantons have only the second level of appeal as mentioned above.

**Fourth level of appeal:** The taxpayer (or the tax authority) may file an appeal with the Federal Supreme Court (usually within 30 days).

This court has only limited subject-matter jurisdiction over pure cantonal tax law (only arbitrary decisions or decisions violating constitutional rights may be reversed) unless the cantonal tax aspects that are challenged are part of the federal harmonized law (namely HTA).

As regards federal direct tax matters, the Federal Supreme Court has full subject-matter jurisdiction, but does not re-examine the facts of the case. The already established facts may only be corrected if they have been evidently incorrectly established or based on a violation of law.

The same appeal procedure applies in the case of an audit procedure resulting in an assessment of supplementary income taxes.

**(b) Federal withholding tax and stamp taxes**

**First level of appeal:** The first level of appeal against a formal decision is an objection with the same tax authority that issued the assessment, i.e., the SFTA (usually within 30 days).
Second level of appeal: The taxpayer may file an appeal against the decision of the SFTA before the Federal Administrative Court (usually within 30 days), which has full jurisdiction in the areas of withholding tax, stamp taxes and VAT.

Third level of appeal: The decision of the Federal Administrative Court may then be appealed before the Federal Supreme Court (usually within 30 days). The same restrictions as mentioned with respect to direct taxes apply.

(c) VAT

The appeals procedure is essentially the same as that for withholding tax and stamp taxes.

3. Managing the audit process

(a) Advance rulings

In Switzerland, it is common to request advance rulings from competent cantonal or federal tax authorities. These advance rulings can address a variety of issues, such as transfer pricing or complex legal interpretation issues. There is no regulation limiting a taxpayer’s ability to file a tax ruling, however, a ruling does not provide for preferential taxation, but is an efficient way to clarify any issues with regard to taxation. There is no legal entitlement to obtain a tax ruling, although tax authorities usually deal with ruling requests. The tax rulings are protected by the constitutional principle of good faith and usually reduce the likelihood of future audits.

Tax rulings may be obtained with respect to a specific transaction, or in general to confirm future taxation. Tax rulings are not public, but might be subject to the spontaneous exchange of information.\textsuperscript{337} Tax rulings may be negotiated with the cantonal tax authorities (for both cantonal and federal

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\textsuperscript{337} See Chapter III/1/d above.
income tax matters) and with the SFTA (for withholding tax, stamp taxes and VAT).

On a bilateral basis, Switzerland agrees to enter into advance pricing agreements (APAs) with foreign tax authorities. Such agreements are dealt with by the SIF; the Swiss tax authorities have not issued any regulation regarding bilateral APAs and follow the OECD guidelines that are similar to those applicable to mutual agreement procedures.
VI. Competent authority/Arbitration Convention

1. Arbitration Convention

Because Switzerland is not a member of the EU, Swiss taxpayers may not rely on the EU Arbitration Convention (90/436/ECC Convention of 23 July 1990).

However, a number of bilateral tax treaties contain an arbitration clause.338

2. Competent authority

The Tax Division of the SIF is the "competent authority" in competent authority proceedings, as described in Article 25 of the OECD Model. There is no federal or cantonal regulation dealing with the competent authority process, and the Swiss tax authorities have adopted a pragmatic approach. The SIF usually consults with cantonal administrations, but it remains the sole negotiator in international negotiations.

Swiss domestic law does not contain a provision allowing for automatic corresponding adjustments for Swiss group companies whose related parties had an initial (primary) adjustment in a foreign jurisdiction. In principle, an adjustment is possible if the Swiss assessment is not yet final. If the assessment is already final, an adjustment is possible by way of a revision (see below). However, revision proceedings are only possible after a competent authority procedure has been completed, which is prescribed by all Switzerland's tax treaties.

338 Many tax treaties concluded by Switzerland, which contain an arbitration clause, are quite restrictive since: (i) the taxpayers have no right to request an arbitration procedure; (ii) both contracting states must consent to an arbitration procedure; and (iii) the arbitration procedure comes into consideration only if the states have been unable to reach a consensus in a competent authority procedure. Many new treaties negotiated in the last few years include a mandatory arbitration clause (as an example, see Article 25 of the tax treaty between Switzerland and the Netherlands).
The Federal Tax Act sets forth three alternative conditions for a taxpayer to ask for a revision of a final tax assessment to its benefit: 339 (i) significant new facts or evidence have been discovered that could not have been known during the assessment procedure; or (ii) the tax authority did not consider, on purpose or not, important facts or evidence, or has violated fundamental procedural rules (e.g., the constitutional right to be heard); or (iii) a crime or a criminal offense influenced the assessment or the decision. 340

The Swiss tax authorities do not necessarily consider a claim for corresponding tax adjustment meeting one of the above-mentioned conditions and entitling a taxpayer to a revision, unless such corresponding tax adjustment is accepted in competent authority proceedings.

A Swiss taxpayer thus often cannot avoid a double tax burden resulting from a foreign primary adjustment purely based on domestic law, but rather should invoke a tax treaty between Switzerland and the related party’s residence state if any is in force.

The competent authority procedure set forth in most of the Swiss tax treaties is similar to the Article 25 OECD Model Convention. One major difference is that Swiss agreements do not grant a taxpayer the right to a competent authority agreement after the time period during which a final tax assessment may be reconsidered under Swiss law, i.e., after 10 years from the date of the final tax assessment. It is therefore imperative that a competent authority request be filed within this 10-year period to interrupt the running of the limitation period, as the SFTA will otherwise not entertain it. Under Swiss tax law, a final tax assessment may be reviewed only under certain conditions (e.g., significant new facts become known; see above). However, the SFTA treats a decision negotiated in

339 The review in favor of the taxpayer is the counterpart of the tax administration’s right to perform tax audits and to claim supplementary taxes after a tax assessment has become final.
340 Article 147 FDTA, Article 51 HTA.
competent authority proceedings as a valid ground for reopening and correcting a taxpayer’s final tax assessment.
Handling Tax Disputes in Turkey

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I. Managing the tax audit process

1. General

(a) Turkish tax authorities

Revenue management in Turkey is structured under two different ministries. The Ministry of Treasury and Finance is responsible for the administration of tax revenue, whereas the Ministry of Trade is responsible for customs revenues. The Ministry of Treasury and Finance oversees the Revenue Administration (Gelir İdaresi Baskanlığı), which is the state institution responsible for tax administration.

Since the early 1950s, the structure of Turkey’s tax administration has been unstable and constantly subject to amendment due to political circumstances. The enactment of the Law on the Revenue Administration’s Structure and Responsibilities on 5 May 2005, however, was the most important step in restructuring the Turkish Revenue Administration (Gelir İdaresi Baskanlığı).

According to the Decree No. 646 published on July 2011, the tax audit departments organized under different authorities were united under the Turkish Tax Inspection Board (TTIB). Before the TTIB’s establishment, tax audits were performed by finance inspectors, tax inspectors, revenue controllers and tax auditors working within the Ministry of Treasury and Finance. Under Statutory Decree No. 646, Ministry of Treasury and Finance employees were appointed to the positions of senior tax inspectors, tax inspectors and assistant tax inspectors.

Since then, all Finance Ministry tax inspection professionals have been gathered under a single roof and organized as a consolidated administration that can manage their tax inspection duties more efficiently.
Overview of tax auditing in Turkey

According to statistics published by the TTIB, the Turkish tax authorities conducted more than 135,000 tax audits and issued more than 127,000 audit reports in 2018. The tax authorities carried out tax assessments amounting to TRY 8,722,800,218 (approximately EUR 1.4 billion using the EUR/TL FX rate of 6.3) in 2018. As in previous years, the largest additional tax take was in VAT (TRY 4,917,247,676 or approximately EUR 780 million). These significant figures, however, may be misleading. Averaging at approximately 1.63% in 2018, tax audits remain at quite a low level in Turkey. This is partly caused by the insufficient proportion of auditors employed, which is inadequate in comparison to the number of taxpayers, although inadequacies of the Turkish tax audit mechanism have also been flagged.

2. Tax audits

(a) Expected periodicity

According to Article 138 No. 213 of the Tax Procedure Law (TPL), tax audits may be done at any time before the end of the period of assessment, which is five years. Tax audits cannot include taxes not assessed or declared within five years from the beginning of the year that follows the year in which the tax receivable has arisen. Tax authorities may perform spontaneous tax audits and need not give prior notice to taxpayers. Furthermore, the Tax Administration has discretionary power when determining what taxpayer will be audited and the audit's timing schedule. Consequentially, there is no recourse against the tax authorities' decision to carry out an audit. Therefore, there is no clear periodicity and it is perfectly possible that some companies are audited more frequently and intensively than others. It is also possible that a taxpayer may be subject to multiple tax audits within the same tax period in the event of the discovery of new information or documents implying a taxpayer failed to declare their real income. In practice, however, due to the low level of tax audits, it is difficult to reach the conclusion that every company is subject
to audit at least once every five years, after which the statute of limitations expires.

(b) Selection of tax audit targets

Although taxpayers are audited on a discretionary basis, principles and criteria determined in the annual working plans and programs are referred to in the selection of taxpayers to be subject to a tax audit. Furthermore, the Revenue Administration developed a special computer program called the Model of Central Risk Analysis and Layering ("Model") in 2009. The Model randomly chooses taxpayers to be audited based on a multifactor risk analysis. Since tax audit levels remain low in Turkey, the development of the Model system aims to bring about the maximum level of efficiency from the limited number of audits accomplished by the undermanned revenue authorities.

The Model aims to find taxpayers with a high risk of violating their taxation duties and evaluates taxpayer data in the database using statistical and mathematical methods. It first splits taxpayers into groups according to their sectors and/or regions. Taxpayers divided into groups are then stratified into different layers according to their size, which is determined based on their balance sheets, income tables, declarations and electronic data registered in the Electronic Tax Office Automation System. By way of layering, the Revenue Administration aims to evaluate each taxpayer alongside other taxpayers of a similar size. Using the Model, taxpayers in a certain sector or region will be analyzed according to their layers (largest/large/medium/small/smallest) and a coefficient indicative of risk will be calculated for each taxpayer. The Model analyzes each variable potentially affecting the tax basis as a risk item. Accordingly, taxpayers that seem to be at a high risk of violating their taxation duties will be determined this way.

341 Tr. Merkezi Risk Analizi ve Katmanlastirma Modeli.
This information is then used when selecting taxpayers that will be subject to a tax audit.

Tax authorities may also mandate cooperation, requiring taxpayers to surrender their books and documents in connection with the audit of another taxpayer. This situation is called a "cross audit." In practice, this is not considered a full audit but rather, a cursory examination. In the event of the discovery of any tax regulation violation in the documents subject to a cross audit, a new, distinct and full tax audit may be initiated in respect of the cooperating taxpayer.

3. **Advance preparation for tax audits**

(a) **Commencement**

According to Article 138 of the TPL, tax authorities may perform spontaneous tax audits and do not have to notify the taxpayer. In practice, however, taxpayers are generally notified about tax audits prior to the execution of the procedure. Therefore, there are certain issues that a taxpayer should always consider in order to be on the safe side in the event of a spontaneous tax audit.

Furthermore, the Turkish tax audit system is conducted under the freedom of evidence principle. The TPL clearly states that taxable events and proceedings may be proven by any kind of evidence, except oath, and not only by material evidence. In other words, the TPL does not prescribe any fundamental restrictions on the documentation the auditors may demand. For this reason, auditors may ask to see any document that they appraise as relevant to the ongoing tax audit.

To begin, when the tax auditors arrive at the taxpayer’s premises for an audit, the taxpayer may ask the auditors to present a document or identification proving their authority. As a general rule, tax audits are conducted in the taxpayer’s workplace. The taxpayer may, however,
request the tax audit to be conducted in the relevant tax office, particularly if the workplace is not available or if imperative reasons, such as death or vacation, are present in the workplace. A tax audit is normally commenced upon the signing of the audited taxpayer of the Protocol on the Commencement of a Tax Audit ("Protocol") issued by the auditor responsible. Auditors are obligated to deliver one copy of the Protocol to the audited taxpayer, one copy to the unit to which they are attached, and one copy to the tax office.³⁴³ The Protocol must contain the following items:

- Identification, title, address and field of activity of the audited taxpayer

- Audit type (full or limited: A full audit includes all components of the tax basis relating to one or multiple periods of taxation and may be conducted in relation to one or multiple types of tax. A limited audit includes only a specific tax basis item and is limited to a certain matter.)

- Reason of the audit

- Subject of the audit

- Audit period

- Approval of the audited taxpayer if the audit will be performed in the tax office

- Place and time, as well as signature of the auditor and the taxpayer or its representative

- Information about the rights and obligations of the taxpayer in relation to the audit

³⁴³ Article 140 of the TPL.
(b) Influence of regret and reformation

The commencement of a tax audit upon the signing of the Report has a significant influence on the possibility of relying on the provisions on regret. Accordingly, it is not possible to benefit from the provisions on regret and reformation once the tax audit has commenced. The Turkish Council of State (Danistay) has developed a significant case law on this issue. In particular, the Turkish Supreme Administrative Court indicated in its case law that asking another department a mere question about the taxpayer or the determination of certain issues in an examination report does not mean that an audit has been initiated. Therefore, the taxpayer can still apply to benefit from the regret and reformation provisions in such events.

(c) Preparation steps

Proper preparation should include, among others, the following:

- Putting together all documentation (books and records, accounts, balance sheets, filed tax returns and all agreements in connection with the period under audit) that may be legally required by the tax authorities (Any delay by the taxpayer in providing the tax authority with the requested information may be viewed as lack of willingness to cooperate with the tax authority.).

- Reviewing books and records that must be kept as such documentation has to be presented, if requested by the tax auditor, within a certain period of time to be determined by the tax auditor (which cannot be fewer than 15 days). Fines would apply if the documentation is not presented or presented late.


345 Article 256 and 355-bis of the TPL.
• Discussion with the taxpayer’s counsel on potential "hot topics" such as overly aggressive tax planning made in the past, mistakes in returns filed for years under audit that have not yet been corrected, or issues that could qualify as negligent tax underpayment or even as tax fraud (Turkey operates rules on regret and reformation, under which it is possible to rectify past transactions that may qualify as tax fraud by filing a "voluntary disclosure." Under certain conditions, this kind of voluntary disclosure will remove any criminal exposure of the individuals involved if the tax assessed thereafter is paid in full, but such disclosure must be filed before the initiation of a tax audit.

• Designation of contact persons (It is better to limit the number of persons the auditor may contact for gathering oral information, as the information flow may be controlled better by proceeding this way, as well as to designate a suitable workplace for the tax auditor. Under Turkish law, a tax auditor conducts the audit in the taxpayer’s workplace as a general rule. Therefore, there is a risk that the tax auditor may attempt to mingle and converse with personnel other than the designated managers. The taxpayer should make certain that employees refrain from facilitating this type of "informal information gathering.").

4. Limitations period for assessments

In Turkey, the period of reference for tax auditing purposes is called the "assessment year." Tax audits may be initiated at any time before the end of the assessment period. According to Article 114 of the TPL, the assessment period is five years, starting from the beginning of the year that follows the year in which the tax receivable has arisen.

In addition to the rules governing the statute of limitations for tax assessment, the TPL contains provisions allowing for corrections in the

346 Article 371 of the TPL.
event of errors in calculation or taxation. Calculation errors are as follows: 347

- Errors in tax assessment
- Errors in tax proportions and tariffs
- Repetitive taxation

Taxation errors are as follows: 348

- Error in the identity of a taxpayer
- Error in tax liability
- Error in the subject
- Error by taxation during an exemption period

The statute of limitations for corrections cannot be less than one year starting from the following:

- The date on which an error was committed, for taxes assessed and declared within the last year of the statute of limitations
- The date on which the taxpayer was notified about the payment order, for taxes notified by announcement and accrued without being subject to a lawsuit
- The date on which an attachment is levied according to the Law on Collection Procedure of Public Receivables, for taxes notified by the notification and announcement of the payment order 349

347 Article 117 of the TPL.
348 Article 118 of the TPL.
349 Article 126 of the TPL.
Finally, the statutes of limitations for tax penalties are as follows:\textsuperscript{350}

- Five years starting from the first day of the year following the year in which the irregularity was committed, for irregularity penalties caused by nonfulfillment of formal and procedural rules on invoices\textsuperscript{351} and by not paying or partially paying stamp duty\textsuperscript{352}

- Five years starting from the first day of the year following the year in which the tax receivable relating to the tax evasion has arisen, for tax evasion penalties

- Two years starting from the first day of the year following the year in which other irregularities were committed

5. **Areas of tax auditors’ special attention**

The general approach taken by the tax auditor is to review the accuracy of the taxpayer’s returns based on the taxpayer’s relevant books and records, including correspondence and files. The auditor has the right to review, and, therefore, the right to be given access to, the documents they may consider relevant. The auditor may also request that additional information they deem helpful or necessary to be supplied. The taxpayer is expected to honor information requests promptly and completely.

Normally, the tax auditor commences the audit by ascertaining details of the taxpayer’s business transactions. Subsequently, the auditor generally will identify certain critical areas on the basis of “sample testing.”

In respect of procedures and form, the auditor will particularly focus on the issues mentioned below.

\textsuperscript{350} Article 374 of the TPL.  
\textsuperscript{351} Article 353 of the TPL.  
\textsuperscript{352} Article 355 of the TPL.
(a) Procedure and form

(1) Financials and accounting

The methodology for conducting the audit usually assumed by tax authorities boils down, firstly, to a review of the correctness of tax returns filed by the taxpayer and a comparison of the same with the taxpayer’s tax records. This is the norm for the start of the audit. Based on these findings, the auditors can and will go into greater depth in the commercial documentation.

Under the Turkish Commercial Code, each merchant is under an obligation to keep commercial books and records and to produce financial statements. Commercial books and financial records must be kept in Turkish and figures must be in Turkish lira.

Furthermore, in 2006, the Turkish Accounting Standards, which are in line with International Financial Reporting Standards, were published by the Turkish Accounting Standards Board and have been in effect since 1 January 2006. The legal requirement to apply Turkish Accounting Standards to financial statements was included in the new Turkish Commercial Code, effective as of 1 July 2013.

(2) Formal requirements

Under the Turkish Commercial Code, the following documents must be retained for 10 years:

- Commercial books, inventories, opening balance sheets, interim balance sheets, financial statements, annual activity reports, group financial statements, working orders and other organizational documents facilitating the comprehension of these documents.

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353 Article 64 et seq. of the Turkish Commercial Code.
354 Article 82/5 of the Turkish Commercial Code.

Baker McKenzie
• Commercial letters received
• Copies of commercial letters sent
• Documents upon which commercial books rely

According to Article 253 of the TPL, however, the period for storage of records is five years. Since there are contradictory provisions within Turkish law itself, retention of the required records for 10 years is recommended to prevent any difficulties.

Turkish Commercial Code permits the electronic storage of financial records.\textsuperscript{355} There are specific requirements for the electronic storage of the documents and the usage of electronic facilities for keeping accounting records. Aside from opening and interim balance sheets, financial statements and group financial statements, the documents listed above can be stored electronically, as long as they are accessible at any time and can be converted into readable form within a reasonable time.

Moreover, according to General Communiqué of E-Books No. 1, approval from the Revenue Administration or the General Directorate of the Ministry of Customs and Trade Domestic Trade must be obtained in order to keep commercial books electronically. Once this is accomplished, these books cannot be kept in paper anymore. In the event documents only stored electronically are requested during a tax audit, the taxpayer must be able to provide the auxiliary tools necessary to read the documents.

With regard to the storage location, there is no definite place legally determined for hard copies (such as the headquarters of the company). In terms of electronic storage, according to Communiqué No. 1 regarding E-Book application, e-books should be stored within the boundaries of the Republic of Turkey and in places where the laws of the Republic of Turkey prevail. However, this does not prevent a second archiving abroad.

\textsuperscript{355} Article 65/4 of the Turkish Commercial Code.
Nonetheless, where a court or a governmental authority requests, such records must be submitted within a period to be determined by the requesting authority, which shall not be fewer than 15 days.\(^\text{356}\)

(3) **Documentation of intra-group transactions**

Turkey's transfer pricing rules came into effect on 1 January 2007. As an OECD member, its transfer pricing rules generally follow OECD Transfer Pricing Guidelines. The Revenue Administration issued domestic transfer pricing guidelines in 2010 as well. Turkish transfer pricing regulations accomplish the following: (i) define disguised profit distribution through transfer pricing and transactions within the scope of the transfer pricing provisions; (ii) define related parties; (iii) define the arm's-length principle; (iv) specify general documentation requirements; (v) specify transfer pricing methods; (vi) provide information on advance pricing agreements; (vii) set penalties and adjustments; (viii) specify treasury loss rules; and (ix) specify the authority of the president to set procedures related to transfer pricing rules.

Turkish corporate taxpayers are obligated to self-assess the arm's-length nature of their related party transactions. According to General Communiqué No. 1, a special form must be submitted with the annual tax return listing all related parties' transactions during the fiscal period by type and size. This form is a two-page listing of the various types of possible related party transactions where the taxpayer indicates by checking boxes that the company has undertaken any such transactions.

This form provides a starting point for the tax office to consider whether to investigate transfer pricing matters.

Taxpayers registered with the tax office for major taxpayers are required to prepare an "annual transfer pricing report," containing details of transactions with related parties both in Turkey and abroad. Other

\(^\text{356}\) Article 14 of the TPL.
companies, on the other hand, are required to prepare the report only for transactions relating to parties abroad. The annual transfer pricing report must include all of the specifically required listed information and if deemed necessary, the Revenue Administration is authorized to request additional information or documentation from the taxpayer.

In an effort to harmonize Turkish transfer pricing documentation requirements for multinational enterprises with the OECD’s recommendations under Action 13 of the BEPS, the Revenue Administration released Draft General Communiqué No. 3 on Disguised Profit Distribution through Transfer Pricing on 16 March 2016. The Draft General Communiqué No. 3 envisaged implementing in Turkey the OECD’s "standardized three-tier" approach to transfer pricing documentation under Action 13 of the BEPS Action Plan consisting of Country-by-Country (CBC) reporting, master file and local file. The General Communiqué No. 3 was published in the Official Gazette on 7 December 2017 without regulations regarding transfer pricing documentation under Action 13 of the BEPS Action Plan. Hence, CBC reporting is not yet in force in Turkey.

(4) Increased obligation to cooperate

The TPL does not provide a unique obligation of cooperation. Instead, it imposes several duties on the taxpayer and other third parties involved in a tax audit, which may be considered altogether an increased obligation to cooperate. First, the audited taxpayer has to present the books and documents required by the tax auditor, within a specific period to be determined (which cannot be fewer than 15 days). Violation of this duty will have several consequences:

- The violation will constitute a reason for a de facto assessment of tax by the administration.

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357 Article 14 of the TPL.
358 Article 30 of the TPL.
• A tax fraud may be present due to the concealment of books and documents required.\textsuperscript{359}

• A special irregularity fine will have to be paid.\textsuperscript{360}

As mentioned above, a tax auditor may also prefer to gather information through third parties involved in a tax audit. In this case, public administrations, taxpayers or other real persons or legal entities transacting with the taxpayers must provide the information required by tax auditors. Otherwise, a special irregularity fine will have to be paid.

Finally, the taxpayer is under obligation to provide to the tax auditor all explanations relevant to the tax audit.\textsuperscript{361} This duty is also valid for the employees of the taxpayer, and a special irregularity fine will have to be paid in the event of violation. The taxpayer may also be invited to the auditor’s office in order to discuss certain issues in relation to the audit. Participation in these meetings and cooperation with the tax auditor are important and accelerates the tax audit procedure. The taxpayer’s independent accountant or certified public accountant may also join these meetings, regardless of where these will be held. A representative authorized to act on behalf of the taxpayer may also participate in these meetings. These persons must be duly appointed in order to be able to represent the taxpayer, and they must present their certificate of authority to the tax auditor before the meeting.

(b) Substantive issues

(1) Permanent establishment/residency

There have been numerous permanent establishment assessments for the determination of a permanent establishment over the last few years. While double tax treaties generally include the standard definition of permanent

\textsuperscript{359} Article 359 of the TPL.
\textsuperscript{360} Article 355-bis of the TPL.
\textsuperscript{361} Article 257 of the TPL.
establishment, Turkey's approach to determining whether a permanent establishment has been created differs substantially from that taken in most countries, relying on Turkey's reservation in the Model Double Tax Treaty.

The Turkish tax authority also initiated tax audits on non-resident electronic service providers based on "digital permanent establishment" assertions in 2018.

(2) **Transfer pricing**

According to Article 13 of the Corporate Income Tax (CIT) Law, the following methods may be used to determine an arm's-length price:

(i) Comparable uncontrolled price (CUP) method

(ii) Cost-plus method

(iii) Resale price method

(iv) Transactional profit method

Taxpayers are allowed to use any one of these methods as the most appropriate, and set the price or value in accordance with the chosen method. If none of these methods result in the determination of an arm's-length price or value, any other method that the taxpayer deems appropriate given the nature of the transaction may be used, provided that the method selected abides by the arm's-length principle.

The Turkish tax administration is not legally bound by the official commentary to the OECD Model Tax Convention or the OECD Transfer Pricing Guidelines. OECD guidance, however, is an important source of interpretation to help determine an arm's-length price.

The CIT Law does not impose an explicit hierarchy among the traditional transfer pricing methodologies. Rather, it directs that the taxpayer choose the method most appropriate, given the nature of the transaction. General
Communiqué No. 1 implies, however, that in the first instance, the CUP method should be tested and only if that method is inappropriate should other methods be tried. In this sense, therefore, the CUP method has the highest priority. In light of the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the strict hierarchy of the traditional method and transactional profit method (namely, the profit split and transactional net margin methods) has been removed by the Law No. 6728, published in the Official Gazette on 9 August 2016, and Article 13 of CIT has been amended accordingly.

Transfer pricing audits are usually part of a regular audit for CIT purposes. Neither Turkish law nor administrative guidelines indicate a tax audit threshold. The Turkish tax authorities have not indicated what constitutes a high level of risk and have not issued any guidance as to what types of transactions would likely raise a transfer pricing concern. The general provisions regarding tax audits also apply for transfer pricing purposes.

(3) Beneficial Ownership

Most of the double tax treaties to which Turkey is a party require the non-resident entity receiving dividends, royalties and interests from a Turkish entity to be the beneficial owner of this income, in order to benefit from the reduced withholding tax rates provided by the double tax treaties. Hence, in order to avoid any tax assessment and penalty risks at the Local Entity level for dividend distributions, Local Entity’s new shareholder should be the real beneficial owner of the dividend income. The current withholding tax rate on dividend payments is 15% in Turkey.

The Turkish tax authority started to conduct tax audits on Turkish subsidiaries of certain multinational entities based on the beneficial owner claims. The Turkish tax authority claimed that the non-resident shareholders of the Turkish subsidiaries are not the real beneficial owners of the dividends received from the relevant Turkish subsidiary; the real beneficial owners are their ultimate parent company.
(4) Restructuring/Business reengineering

Corporate reorganizations (such as a merger, a split-up or a contribution of an entire business) may trigger the taxation of the latent gains if the reorganization does not meet the "legitimate needs of an economic or a financial nature" (which is the equivalent of the business purpose test that exists in a number of countries). Moreover, the tax losses carried forward may be reduced or lost as a result of such corporate reorganization.

Turkish law imposes a stamp tax on all agreements and documents that reference a monetary value. However, share transfer agreements that are signed after 9 August 2016, regarding the share transfers of joint stock companies, limited companies and partnership limited by shares, are exempt from stamp tax according to the Stamp Tax Law, which was amended accordingly by Law No. 6728.

(5) Thin capitalization

According to Article 12 of the CIT Law, under the thin capitalization regime, interest and similar payments and foreign currency losses deemed paid or calculated on the basis of thin capital are non-deductible. Thin capital refers to loans that:

(i) are taken directly or indirectly from shareholders or persons related to the shareholder

(ii) are used in the business

(iii) exceed (at any time in a taxable period) three times the borrowing company’s equity

Equity at the beginning of the fiscal year is the basis for calculating the ratio.
The following loans are not included in the thin capitalization calculation:

(i) Loans received from third parties under a non-cash guarantee of a shareholder or related parties

(ii) Loans obtained by shareholders or related parties from third-party banks, financial institutions or capital markets and that are granted to related parties under the same conditions

Interest and other items paid (except exchange rate differences realized) on loans taken from shareholders and persons related to shareholders in excess of the 3:1 debt-to-equity ratio are treated as hidden dividend distributions for tax purposes. For non-residents (including branches), such hidden profit distributions are deemed profits remitted to the head office.

6. Special tax audits

(a) VAT/Customs

Under the VAT Law, deliveries of goods and services made in Turkey within the context of commercial, industrial and agricultural activities, as well as independent professional activities, are subject to VAT. Note that there is no VAT-only registration in Turkey except for special VAT registration of non-residents who perform services to Turkish individuals (who are not VAT taxpayers) electronically. Once a company is tax registered in Turkey, it is registered for all kind of taxes, including corporate income tax, VAT, withholding tax, stamp tax, etc., and it should fulfil all tax filing obligations. Accordingly, resident taxpayers would need to register with the Turkish tax authorities and issue a separate Turkish invoice for each sale, which must be issued on forms printed by a specially licensed printing house (unless the Turkish resident is registered to an electronic invoicing system) and include specifically listed information under the TPL, including the VAT amount. As VAT revenues are one of the major sources of tax revenues, Turkish tax authorities frequently perform special VAT audits.
However, this special type of audit does not mean that the audited period will not be audited again in the future.

VAT arising from services provided electronically by those without a residence, workplace, headquarters or business center in Turkey to individuals who are not VAT taxpayers must be declared and paid by the service providers.

According to the *communiqué* published by the Ministry of Treasury and Finance regarding the principles and procedures related to this VAT practice, these electronic service providers will declare the VAT arising from their electronic services by way of a "Special VAT Registration for Electronic Service Providers."

(b) Wage tax

Wage tax audits concentrate on taxpayers with employees and focus on the taxpayers’ withholding and tax-paying obligations. These audits also examine whether all employees are registered with the competent authorities.

Unrecorded employment has been a long-known problem of the Turkish economy. Stoppage (tax deduction at source) is the primary method used for employee benefits. Accordingly, employers are responsible for calculating and withholding tax at the rates specified in the Income Tax Law from an employee’s gross wage and therefore, they make the required payment to the tax authorities. According to statistics published by the Turkish Statistical Institute, unrecorded employment as of 2018 was 33.42%.

(c) Others

Since 2001, the Revenue Administration has been implementing a blacklist system, classifying taxpayers under different codes and subjecting them to a different VAT return regime.
Unfortunately, the blacklist of the Revenue Administration is not disclosed and as such it is not possible to know what companies are in the blacklist. Taxpayers may be included in codes in the following cases:

- If it is determined during a tax audit that the taxpayer issued or used fake or misleading documents
- If the taxpayer could not be found in their address, has not submitted VAT declarations for several taxation periods, or if it is found that their capital, capacity or number of employees are not suitable for their volume of business
- If the taxpayer directly procures goods or services from a third party that performed the above-mentioned acts
- If the taxpayer notifies that their printed documents are lost or stolen
- If the documents of the taxpayer are reproduced by a third party

Taxpayers listed in these codes are not entitled to the ordinary VAT return regime and they must fulfil the following conditions in order to benefit from VAT returns:

- Provide a guarantee amounting to fourfold of the requested VAT return
- Be granted a positive tax audit report, if unable to provide such guarantee
- Obtain a final court decision annulling the determinations that caused them to be listed in the blacklist

7. **Burden of proof**

As previously mentioned, the Turkish tax audit system is conducted under the freedom of evidence principle. The TPL clearly states that taxable events and proceedings may be proven by any kind of evidence, except
oath, and not only by material evidence. In other words, the TPL does not prescribe any fundamental restrictions on the documentation the auditors may demand.

Auditors may ask to see any document that they believe relevant to the ongoing tax audit.

The main rule for burden of proof is regulated under Article 190 of the Turkish Civil Procedural Code, which cites that unless the law has a special provision, the burden of proof lies with the party claiming a fact to its benefit. Similarly, the TPL also provides that the burden of proof lies with the party claiming a fact not in conformity with economical, commercial and technical requirements, or claiming a fact that is abnormal and unusual. The tax authorities therefore have the burden of proof with regard to facts leading to an increase in the taxable income, while the taxpayer has the burden of proof with regard to facts resulting in a decrease in income.

In this respect, it should be noted that books and records diligently kept in accordance with the law benefit from a presumption of correctness and that the tax authorities claiming that they are incorrect need to prove it. It is thus very important to maintain proper books and records in order to shift the burden of proof to the tax authorities.

8. Potential consequences

(a) Additional or de facto assessment

If the tax authorities find irregularities or evidence of tax loss, the tax audit normally concludes with the issuance of a tax report that specifies the amount of tax arrears and the amount of default interest to be paid. Turkish tax authorities may follow two different routes in reassessing a taxpayer’s taxable basis before issuing such a tax report.

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362 Article 3 of the TPL.
Additional assessment consists of the reassessment of tax using the tax basis or the tax basis difference and relying on books, records and documents evaluated during the audit. In practice, additional assessment generally occurs because of unintentional accounting errors such as mathematical, recording and evaluation errors, as well as omissions or repetitions.

De facto assessment occurs when it is not possible to determine the tax basis, as a whole or in parts, by relying on the books, records or documents. In such cases, tax auditors, unable to reassess the tax base due to the lack of necessary information on the value of the relevant good or service, may apply to evaluation commissions established under the relevant tax office.

Following the evaluation by these commissions, the exact amount of the additional assessment will become clear.

According to TPL, de facto assessment will be accomplished under the following circumstances:

- If a tax declaration is not submitted within the prescribed term
- If the tax basis is not shown in the tax declaration submitted within the prescribed term
- If books mandatory under the TPL are neither kept nor certified, or they are not presented to the auditors during the tax audit
- If books and relevant documents are not complete, in due form and clear enough to ensure the determination of the tax base correctly
- If new evidence proves that books kept or declarations submitted were misleading

Furthermore, tax auditors also have the authority to conduct a de facto assessment without needing the additional evaluation of tax evaluation...
commissions. In this case, tax auditors will specify the tax basis determined de facto in their report, and tax offices will assess the tax necessary on that amount.

Contrary to accounting errors, accounting frauds are subject to de facto assessment. Major accounting frauds encountered during tax audits are as follows:

- Intentional accounting errors
- Undocumented transactions
- Recording before or after the real transaction
- Opening of fake accounts
- Issuance of fake documents
- Issuance of misleading balance sheets

(b) **Late payment interest**

According to TPL, late payment interest will apply following an additional or de facto assessment.

The period for which a late payment interest will be paid depends on the date on which the tax becomes definite. Accordingly, if the tax becomes definite without being subject to a lawsuit, late payment interest will be paid for the period starting from the due date on which the tax should normally have been paid, until the accrual date of the last assessed tax. For the unpaid part of taxes subject to a lawsuit, however, late payment interest will be paid for the period starting from the due date on which the tax should normally have been paid, until the notification of the decision of the relevant court.

Late payment interest rate is currently 1.6% as of December 30, 2019 and it applies on a monthly basis.
(c) Substance over form

As in many other European countries, Turkish tax law also adheres to the "substance over form" doctrine. According to the "substance over form" rule, as provided in Article 3 of the TPL, the real substance of the taxable event and the commercial purpose of the transactions on which the taxable event relates to, are generally decisive for the qualification of the transaction for tax law purposes.

Therefore, tax laws cannot be circumvented by virtue of the misuse of law concepts. In the event of any such misuse, the tax arises as it would have arisen had the form been in line with the substance.

(d) Tax offenses and administrative fines

The TPL provides two main categories of tax offenses: irregularities and tax loss. In the event that an irregularity or a tax loss is found as a result of a tax audit, administrative fines will apply. While failure to follow substantive obligations causes the occurrence of offenses, which leads to tax loss, formal obligations cause the occurrence of irregularity offenses.

Irregularity is defined as the failure to follow the legal provisions on form and procedure of the TPL. Even if there is no tax evasion caused, the simple fact that formal or procedural obligations were violated is sufficient for an irregularity offense to be noted. The TPL classifies irregularities in the first and second degrees, and fines to be applied in the event of these irregularities are determined separately, according to this classification. The administrative fine varies between TRY 8.5 and TRY 220 for first-degree irregularities (for 2020), according to the relevant taxpayer group. For second-degree irregularities, the administrative fine varies between TRY 4.7 and TRY 67 (for 2020). The fine amounts are applied twofold if the irregularity act caused a de facto assessment of the tax base.

On the other hand, tax evasion is defined as the failure to assess tax in due time, or an under-assessment of tax due to the taxpayer’s failure to fulfil...
their fiscal obligations in time, or due to his/her deficient fulfilment of fiscal obligations. Tax evasion is directly related to the accrual phase of the taxation process. Therefore, the assessment of tax in a timely and accurate way is vital. If tax evasion is committed because of these actions, the taxpayer is required to pay the amount "evaded," in addition to the original tax accrued and relevant interests. If, however, the taxpayer committed tax evasion by committing tax fraud, they are punished with imprisonment, as mentioned above, in addition to a fine amounting to threefold of the evaded tax amount.

9. Strategies for dealing with tax audits

(a) Cooperation or confrontation

A tax audit must be handled in an informed and responsible manner. Although the taxpayer is normally burdened with numerous requests for information, which may impair the running of its day-to-day business, a tax audit should be dealt with cooperatively by the taxpayer and settled on an amicable basis wherever possible. A persistent failure to cooperate will raise a tax auditor's suspicions.

(b) Settlement or litigation

Potential tax disputes may be settled during an audit, thus preventing litigation. Although the taxpayer should, at all times, emphasize to the tax auditor their willingness to litigate, settling tax disputes at the administrative level if possible is preferred, as the litigation procedure is often very long in Turkey. This constitutes the main reason taxpayers prefer to request conciliation, even if they believe that the report issued upon the tax audit is wrong. The fact that the tax evasion penalty will have to be paid, if the lawsuit is lost, is another factor considered by taxpayers.
10. Conversion of a regular tax audit into a criminal investigation

(a) General

Under Turkish law, a regular tax audit may trigger a criminal investigation if auditors conducting a tax audit are of the opinion that there is sufficient evidence to suspect the existence of a criminal act, which typically involves the committing of tax fraud. In this case, tax auditors may submit a request to conduct a tax audit through investigation to the competent criminal court of peace, if they deem it necessary. Tax auditors have a discretionary power in this regard and they are the competent authority that will decide whether to request a tax audit through an investigation. A tax audit through an investigation may be conducted in the workplace, residence or any other property of the taxpayer and it aims to seize all kinds of documents and information that point toward tax fraud. This type of audit can be conducted only if the competent criminal court of peace accepts the auditor’s request, with a decision specifying the place and exact objects that will be investigated, as well as the reasoning behind such an investigation. Books, documents and records found during an investigation must be reviewed within three months and items not indicating tax fraud must be returned to the taxpayer. After that stage, the procedure followed during a tax audit through investigation does not differ from a regular tax audit.

A tax audit through investigation may be also initiated upon a denunciation received, provided that tax auditors deem it necessary upon a preliminary examination. A denunciation must be in writing and must include the identity and address of the denunciator. If the denunciation is found groundless, as a result of a tax audit through investigation, the investigated taxpayer may request the denunciator's identity, which the tax office cannot refuse.
(b) Ongoing obligations during a tax audit through inspection

Even if the books, documents and records of the taxpayer are seized during a tax audit through inspection, this should not affect a taxpayer's ongoing obligation to submit its tax declarations in a timely manner. The taxpayer may submit a written request in order to take copies of books and documents necessary to be able to submit relevant tax declarations. If, however, the period between the date on which books and documents were seized and the due date for tax declaration is less than one month, the due date for tax declaration is automatically extended for an additional month.

Moreover, the taxpayer is under an obligation to record their transactions in new books to be duly certified, until their original books and documents that were seized during inspection are returned. Once the original books and documents are returned, the taxpayer may transfer all records in the new books to the original ones.

(c) Tax fraud

Tax fraud is defined under Article 359 of the TPL as the performance of the following actions with an intention to commit tax fraud, constituting sufficient reason to initiate a criminal proceeding, even if they did not cause any tax evasion at the end:

- Fraudulent acts on accounts
- Creation of fake accounts
- Keeping of double books
- Forgery or concealment of books, records and documents
- Issuance or use of fake or misleading documents
- Destruction of books, records and documents
• Destruction of pages of books
• Forgery of original or exemplary documents
• Printing of documents as an authorized print house, without authorization

If the public prosecutor arrives at the conclusion that tax fraud has been committed based on the facts determined by the tax auditors and additional elements discovered during their own investigation, they may decide to file a lawsuit.

(d) Penalties

Penalties will apply in the event the taxpayer is found guilty as a result of the lawsuit and these will depend on the action that caused the tax fraud.

Accordingly, fraudulent acts on accounts, creation of fake accounts, keeping of double books, forgery, or concealment of books, records and documents, and issuance or use of fake or misleading documents are subject to imprisonment varying from 18 months to three years. The imprisonment may however, be postponed if the following conditions are satisfied:

• If the imprisonment decided by the court is fewer than two years
• If the person subject to criminal liability was not previously subject to an imprisonment of more than three months
• If the court reaches the conclusion that the relevant person will not commit another offense in the future

The following group of acts constitutes tax fraud, namely: the destruction of books, records and documents; the destruction of pages of books; forging of original or exemplary documents; or printing documents as an authorized print house without authorization. This group of acts is subject to an imprisonment of three to five years. As the imprisonment provided
for these acts exceeds the threshold for postponement, there is no possibility for such a postponement.

It should be noted that criminal investigation is independent of administrative measures and the same act may incur criminal and administrative liability simultaneously. For example, fraudulent acts on accounts may cause criminal liability as a result of tax fraud, and monetary fines as a result of tax evasion caused, if any.

If a criminal investigation seems imminent, the presence of an attorney is advisable as the regulations on criminal proceedings are complicated and if not followed properly, may result in an even worse position for the relevant individual. It is also advisable to avoid panicked reactions, such as taking trips abroad or emptying bank accounts, as these may increase the suspicions of public prosecutors and may even constitute grounds for arrest.

11. Tax reduction reward for compliant taxpayers

In an attempt to encourage taxpayer compliance, Law No. 6824 on the Restructuring of Certain Receivables and Amending Certain Laws and Law Decrees provides that eligible income taxpayers that conduct commercial, agricultural and self-employment activities, as well as corporate income taxpayers – excluding those operating in the finance and banking sectors, insurance, reinsurance and retirement companies and retirement investment funds – can benefit from a 5% income/corporate income tax reduction on their annual income/corporate income tax returns. The maximum deduction amount is TRY 1.2 million. If the calculated deduction amount is higher than the tax to be paid, the remaining amount can be offset from the taxpayers’ accrued declared taxes within one year following the submission date of the annual income/corporate income tax return. To qualify, taxpayers must meet the following conditions:

- The tax returns (annual income tax returns and corporate income tax returns; advance tax returns; withholding tax returns; withholding tax
and premium returns; VAT returns; and special consumption tax returns) for the years in which the tax reduction will be calculated, as well as the two preceding years, should be declared within the statutory period. In addition, the related due taxes must be paid by the submission date of the income tax and corporate income tax returns. The declaration of tax returns for correction or voluntary disclosure purposes after the statutory period still satisfies this condition.

- The taxpayer should not be subject to any tax assessment for the year in which the tax reduction will be calculated and for the two preceding years. If the tax assessment is completely canceled through a definite court decision, or within the scope of reconciliation or correction provisions of the Tax Procedure Code, it still meets this condition.

- The taxpayer should not have any overdue tax debts, including tax penalties, exceeding TRY 1,000 as of the submission date of the annual income/corporate income tax return from which the tax reduction will be calculated.

- The taxpayer should not commit any fraudulent acts under Article 359 of the TPL during the year in which the tax reduction will be calculated and for the four preceding years.
II. Resolution procedures

1. Administrative level

If the tax audit concludes against the taxpayer, auditors will issue a tax audit report constituting the basis of a future tax assessment. The tax audit report does not have an executive character in itself and only constitutes a preparatory stage before the final tax assessment, which will be made by the tax office. Once issued, the tax audit report will be analyzed by the Report Evaluation Commissions, before being submitted to tax offices. The Report Evaluation Commissions is composed of three tax auditors, each of whom must have at least 10 years of experience. Their duty is to ensure the conformity of the report with tax laws, decrees, regulations, communiqués, circulars and rulings. Following the opinion of the Report Evaluation Commissions, auditors will finalize the report and submit this to the relevant tax office for notification to the taxpayer.

Turkish law provides two different administrative mechanisms that a taxpayer may apply, which are conciliation and reduction of penalties. It is possible to request conciliation both before and after the audit. Reduction of penalties, however, is possible only after the finalization of the tax audit process.

(a) During audit: conciliation before tax assessment

(1) General

Under Turkish law, the fundamental objective of the audit is to check whether the audited parties have duly performed their duties arising from the provisions of fiscal laws. Although a number of meetings take place between the auditors and audited parties, these are for clarification and discussion of eventual problems encountered during the tax audit. As such, the auditors act as investigators rather than negotiators.

The only mechanism that a taxpayer may adopt as last recourse during the audit is conciliation. Conciliation is an administrative resolution method
included in Turkish law in 1963 to promote the resolution of disputes between the taxpayer and the auditor without going to the fiscal courts, by submitting these to a conciliation commission. The conciliation procedure has been subject to several amendments and the possibility of applying for conciliation before audit was accepted in 1985. In 2018, there were 39,375 conciliation files overall, 33,827 of which were successful, according to the statistics published by the Turkish Revenue Administration.

Although the ultimate aim of conciliation was to prevent future judiciary action between the taxpayer and the Revenue Administration, after 40 years of experience, a more effective solution is still needed. In practice, it has become customary for conciliation commissions to give the taxpayer a discount of 80% for penalties in general and to leave taxes assessed and late payment interests untouched.

The Law No. 7194 on Digital Service Tax and Amendment of Certain Laws and Law Decree No. 375 ("Law"), published on the Official Gazette dated December 7, 2019 and No. 30971 added a new provision to TPL, stating that in the case where the taxpayer duly pays the settled original tax amount and 75% of the settled tax penalty within the legal deadline, a 25% discount will be applied to the tax penalty amount determined in the settlement.

(2) Competent authority

As mentioned earlier, the conciliation procedure is conducted by conciliation commissions acting on behalf of the tax administration. Conciliation commissions are established within tax offices and they are composed of one president and two members, although their exact composition depends on the place where conciliation is requested. Furthermore, if the tax amount submitted for conciliation is higher than TRY 3 million, the conciliation procedure will be conducted by the Central Conciliation Commission, headed by the president of the Revenue Administration. Neither the taxpayer, their representative nor the auditor

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who conducted the tax audit should be a member of the conciliation commission.

(3) **Scope and procedure**

The taxpayer may request conciliation for any tax assessment and tax loss penalties, except for tax evasion caused by tax fraud, irregularity and special irregularity penalties. It is upon the conciliation request that the auditor may start acting more as a negotiator than an investigator. Audited taxpayers may request conciliation anytime during the audit, until the issuance of the last protocol. The term of litigation will cease once a conciliation request is submitted. If the conciliation period ends without success, it will however continue to operate.

A conciliation request may be submitted to the following:

- The auditor
- The administration to which the auditor is attached
- The team or group directorate to which the auditor is attached

If a conciliation request is present in an audit protocol, it may substitute for a written application submitted to the relevant authority.

Following the taxpayer's request, the auditor will contact the president of the relevant conciliation commission and will determine a conciliation meeting date. The taxpayer must be notified of the meeting date at least 15 days in advance or this must be written down and sent to the audit protocol. The meeting date may be moved to an earlier date, if requested by the taxpayer.

The auditor must give the conciliation commission and the taxpayer a report on the tax assessment and the penalty envisaged, at least 15 days before the meeting date. If the meeting date is sooner, as requested by the taxpayer, the auditor must inform the relevant parties at a time before that date.
Conciliation cannot be realized without the said report being sent to the concerned people and institutions.

During the conciliation procedure, the administration will make an offer to the taxpayer. The taxpayer should then answer, in writing, whether the offer is acceptable or not. If the parties come to an agreement and the conciliation protocol is signed, it is not possible to reapply for conciliation after the tax assessment, nor apply for judicial remedies. If the conciliation procedure fails, it is however possible to apply for judicial remedies until the expiration of the term of litigation. It is not possible to re-apply for conciliation after the release of tax assessment notices.

(4) Failure of the conciliation procedure

The conciliation procedure is considered a failure in the following cases:

- If the taxpayer does not come to the meeting at the place and time that they have been previously notified of
- If the taxpayer does not sign the conciliation protocol
- If the taxpayer requests that they sign the conciliation protocol with reservation

If, as a result of the failure of the conciliation procedure, the term of litigation has expired before the notification of the protocol on failure or has fewer than 15 days remaining, an additional 15 days is granted to the taxpayer, starting from the date on which the protocol on the failure of the conciliation process is notified.

Even if the conciliation procedure fails, the amounts of the tax basis difference offered by the conciliation commission will be included in the protocols. As a last chance, the taxpayer who rejected the conciliation commission’s offer may apply to the relevant tax office until the last day of the term of litigation to declare that they accept the amount offered by the conciliation commission. In this case, the parties will be deemed to
have reached an agreement on the date of declaration. In the event of the conciliation procedure’s failure, the relevant tax office will assess the necessary taxes on the tax basis proposed in the audit report and will notify the taxpayer of such. The taxpayer may resort to judicial remedies within 30 days following this notification. The Council of State accepts that the taxpayer may resort to judicial remedies within 30 days upon the notification of the protocol on the failure of the conciliation procedure, without waiting for a notification of the tax assessed, as the latter will not make any changes to the taxpayer’s legal situation.\(^{363}\)

(5) **Execution of conciliation protocol**

If the parties reach an agreement as a result of the conciliation procedure, a conciliation protocol will be signed and submitted to the relevant tax office. This conciliation is final and cannot be subject to court review. Moreover, any reduction of penalties cannot be requested upon conciliation.

The conciliation protocol replaces the tax accrual slip. If the protocol is notified to the taxpayer before the due date of the taxes or penalties, the amounts specified therein must be paid by the due date, including the default interest incurred from the date on which the relevant tax should have been paid, until the date on which the conciliation protocol was signed. If the protocol is notified after the due date, however, these amounts and the default interest must be paid within one month following the notification.

(b) **After the release of the tax assessment notices**

Once the tax assessment notice is issued, taxpayers may request either conciliation or reduction of penalties within 30 days as of the date of their receipt or bring an action against taxes assessed and penalties imposed.

Otherwise, the said taxes and penalties contained in the tax assessment notice will become definite.

(1) Conciliation after release of the tax assessment notices

According to the TPL, conciliation may be requested after the release of tax assessment notices in the following situations:

- If there are tax, calculation or taxation errors or any other error of fact
- If the taxpayer or the addressee claims that there is an erroneous written explanation of tax authorities or that the jurisprudence on implementation of a provision has been amended
- If the taxpayer or the addressee claims that the tax evasion was caused by not being able to duly fit into the frame of legal provisions
- If the reasons constituting the basis for assessment and tax penalties are evaluated differently by tax courts, regional administrative courts, the Council of State or the Ministry of Treasury and Finance

The conciliation request must be submitted within 30 days following the notification of the tax assessment or penalty. Following the submission of the conciliation request, the date and place of the conciliation meeting will be notified to the taxpayer at least 15 days prior. The meeting date may be sooner, if requested by the taxpayer.

The stages of the conciliation procedure and its consequences are the same, regardless of whether the conciliation has succeeded or not. As mentioned earlier, tax evasions caused by tax fraud cannot be subject to conciliation, either during audit or after the release of the tax assessment notice. In addition, irregularity and special irregularity penalties cannot be subject to conciliation after the release of the tax assessment notice.
(2) Reduction of penalties

Reduction of penalties is applied to the taxes assessed and to the penalties related, if the taxpayer does either of these:

- Submits an application to the relevant tax authority within 30 days from the notification
- Does not initiate judicial proceedings

and declares one of the following:

- The payment will be made on the due date.
- The payment will be made within three months as of the due date, provided that security is granted.

Once an application is submitted, the taxpayer automatically becomes entitled to the reduction, provided that the above-mentioned conditions are satisfied. The main tax assessed, however, is not affected by the reduction of penalties. If the reduced penalty is not paid within the above-mentioned terms, reduction becomes invalid and the whole amount will be collected.

Reduction of penalties may be demanded for any kind of tax, except those collected by the customs administration, as they are not within the scope of the TPL. As to the penalty type, reduction may be demanded only for monetary penalties caused by tax evasion and irregularity.

Penalties resulting from conciliation, however, cannot benefit from reduction. The amount reduced differs according to the type of penalty:

- For penalties caused by tax evasion, half of the penalty will be reduced for the request and one-third of the penalty will be reduced for subsequent requests.
• For penalties caused by irregularity, one-third of the penalty will be reduced each time.

According to the Law No. 7194 on Digital Service Tax and Amendment of Certain Laws and Law Decree No. 37, published on the Official Gazette dated December 7, 2019 and No. 30971 amending the TPL, if the above conditions are met, the reduction will be applied as 50% for all types of penalties.

2. Judicial tax litigation

(a) Tax courts

Tax courts are the competent body for the filing of the appeal against a final tax assessment resulting from a tax audit. A taxpayer that is dissatisfied with the decision of the tax authority may file an action in tax courts within 30 days from the notification of the tax audit report.

As mentioned above, if, as a result of the failure of the conciliation procedure, the term of litigation has expired before the notification of the protocol on failure or fewer than 15 days remains, 15 days more will be granted to the taxpayer, starting from the date on which the protocol on the failure of the conciliation process is notified.

The tax court located in the place where the tax office responsible for the audit is based will be the court competent to hear disputes arising from the audit. Generally, disputes before tax courts are subject to written proceedings, unless one of the parties requests an oral hearing. Once requested by one party, an oral hearing must be scheduled by tax courts. Tax courts will not find the facts de novo and may not change the result reached by the tax office. Actions initiated against tax assessments resulting from a tax audit are normally "actions of nullity" (iptal davasi). It will only examine whether the administrative act on tax assessment is in conformity with the law and may either approve or annul it.
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(b) Regional administrative courts

Law No. 6545, published in the Official Gazette on 28 June 2014, introduced a new appeal system. The new appeal system went into effect when the regional administrative courts began operating on 20 July 2016.

Law No. 6545 abolished the judicial system of two instances, where first instance court decisions were subject to objection before the regional administrative courts or appeal before the Council of State.

The regulation introduced a system of three instances comprising: (i) judgement by the tax courts of first instance; (ii) first appeal (istinaf) before the regional administrative courts; and (ii) second appeal (temyiz) before the Council of State.

Accordingly, in order to challenge the first instance tax courts' decisions, an appeal must be filed before the regional administrative courts within 30 days of its notification, provided that the dispute value is higher than TRY 6,000.

If the dispute value is lower than TRY 7,000, the first instance court's decision is final and cannot be appealed.

If the dispute value is between TRY 7,000 and TRY 176,000, the regional administrative courts' decision is final.

(c) Council of State

An appeal may be filed with the Council of State against the regional administrative court decisions within 30 days of their notification if the dispute value is higher than TRY 176,000.

The Council of State cannot find the facts de novo and decide upon the substance of the dispute. However, it will control the conformity of the decision to the law. Appealed decisions may be approved or rejected, in full or in part. Rejected decisions are sent back to the relevant regional administrative court for reconsideration. In the event the relevant regional
administrative court insists on its first decision, the Assembly of Tax Chambers of the Council of State will review the decision and may either approve or reject it. The decision of the Assembly of Tax Chambers is final. If, however, the relevant tax court abides by the rejection, it has to re-evaluate the dispute and take a new decision in light of the rejection. This new decision may be subject to appeal again.

Disputes before the Council of State are also generally subject to written proceedings. Contrary to first instance tax courts, however, a hearing will be scheduled only if deemed necessary by the Council of State.

(d) Tax rulings and circulars

Article 413 of the TPL grants taxpayers the opportunity to request from the Revenue Administration, or other bodies authorized by the Revenue Administration, a written opinion on ambiguous or uncertain tax issues. Such authorized bodies are the Directorates of the Tax Administration, in provinces where they are present, and Revenue Offices in provinces where the Directorates are not present.

At a taxpayer’s written request, the above-mentioned authorities must respond by a ruling (mukteza/özelge) or circular (sirküler). The advantage of a tax ruling is that a taxpayer who acts in reliance on the ruling will not be subject to a tax penalty and late payment interest. This benefit, however, is only available when the taxpayer requests the ruling before payment of the tax due. A tax ruling is personal in the sense that it is only binding for the requesting taxpayer. Other taxpayers with the same issue cannot rely on the ruling. Nevertheless, the circulars apply to all taxpayers. A new regulation on tax rulings, the Regulation on Responding to Taxpayer Explanation Requests, was published in the Official Gazette dated 28 August 2010 and numbered 27686 ("Tax Ruling Regulation"). It introduced changes and explanations relating to the issuance of tax rulings (mukteza/özelge) to accelerate the tax ruling process, to create transparency and to allow public access to the rulings.
In order to accelerate the process, the Tax Ruling Regulation requires that taxpayers apply directly to the presidency of the tax offices in their provinces or to the local revenue offices where there are no tax offices, instead of applying directly to the Ministry of Treasury and Finance (i.e., Revenue Administration). Tax ruling applications will be made using the "Tax Ruling Application Form," which is published on the official website of the Revenue Administration. According to Article 9 of the Tax Ruling Regulation, taxpayers that are responsible for taxes and legal representatives holding an authorization certificate are entitled to request a ruling (mukteza/özelge). The Tax Ruling Regulation has explicitly disseminated a negative list of the issues for which an advance ruling application cannot be made, such as issues that are subject to a court case, are under inspection, or are not dependent on real cases, but limited to theoretical discussion.

Moreover, the Tax Ruling Regulation introduces a new commission that will issue tax rulings and circulars in order to clarify tax applications. According to the Ministry of Treasury and Finance, the Tax Ruling Regulation also aims to prevent diverging views by different tax offices on the same topic or even on the same cases. In this respect, all tax rulings will be published on the internet.

Article 140 of the TPL states that tax authorities cannot issue tax audit reports contrary to circulars. It is further stated that tax audit reports' conformity to circulars and tax rulings will be evaluated by the Report Evaluation Commissions. Therefore, circulars and rulings can also be considered as binding sources for tax audits. According to the Tax Ruling Regulation, explanation requests of taxpayers on behalf of which a tax audit has already started are not evaluated within the scope of rulings.

(e) Waiver from legal remedy

The Law No. 7194 on Digital Service Tax and Amendment of Certain Laws and Law Decree No. 375, published on the Official Gazette dated December 7, 2019 and No. 30971, amended the TPL and introduced a new withdrawal
mechanism in litigation. Accordingly, taxpayers will be able to withdraw from their lawsuit by paying only a certain portion of the original tax/penalty depending on certain circumstances. This waiver mechanism covers the decisions rendered by the first degree tax court that are open to appeal before the regional administrative court and decisions rendered by regional administrative court that are open to appeal before the Council of State.

To benefit from the waiver mechanism, the taxpayer should pay 60% of the tax canceled by the court, the entire tax approved by the court and 75% of the tax loss penalty approved by the court. If the taxpayer was subject to a tax penalty independent from an original tax or due to tax fraud under Article 359 of the Tax Procedural Code, the taxpayer should pay 25% of the penalty amount canceled by the court and 75% of the penalty amount approved by the court.

3. Miscellaneous matters: payment of tax

Once the tax authorities have issued the final tax assessment, taxes are normally due and payable within 30 days of the receipt of the notice by the taxpayer or on the date determined by the tax office. However, payment demands may be suspended if certain conditions are fulfilled, once the taxpayer initiates judicial procedure.

Before first instance tax courts, all payment demands are suspended once a judicial action is filed. This suspension does not require the taxpayer to submit an application for suspension or the tax court to make a decision with this regard. The suspension is automatic.

Before the regional administrative courts or the Council of State, however, the suspension is not automatic. The judge may make the decision of the suspension of payment demands if requested by the taxpayer in writing and if security is granted, in the event it is deemed necessary by the relevant court. Requests of suspension of payment demands are considered primarily due to their urgent nature. The rejection of the first
instance decision by the regional administrative court upon the objection or the Council of State upon appeal, however, automatically suspends all payment demands.

Parties may object to the decision on acceptance or rejection of the suspension within seven days from its notification. The objection may be filed with the following:

- The Assembly of Tax Chambers, if the main dispute is before the Council of State
- The nearest regional administrative court, if the main dispute is before a regional administrative court
- The regional administrative court to which a tax court is attached, if the main dispute is before a tax court
- The nearest court on duty or the court on duty constituted without the judge who has taken the decision on suspension, if the main dispute is taken by a tax court during the work break

The objection against the decision on the suspension of payment demands must be resolved within seven days from its submission. These decisions on objection are final and cannot be reviewed.
III. Competent authority

In the event a person or a company faces or is likely to face double taxation that arose from cross-border taxation conflicts, the person or the company may apply for the elimination of double taxation by way of the competent authority procedure under a bilateral tax treaty. In order to prevent double taxation resulting from changes in income allocation, effected either by Turkish or by non-Turkish tax authorities, the Turkish double taxation treaties (DTTs) in place provide competent authority proceedings that the taxpayer is entitled to apply for.

Although significantly inspired and influenced by the OECD model conventions, Turkey’s reservations during the negotiations of the initial OECD model resulted in the development of a Turkish model of tax treaties in 1969. The Turkish model is developed through the incorporation of Turkey’s reservations on the 1963 OECD model into the current OECD models.
Handling Tax Disputes in Ukraine

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I. Managing the tax audit process

This overview summarizes current tax audit practices in Ukraine. Although the tax procedure principles applicable to individual and corporate taxpayers are similar in many aspects, the discussion set forth covers only the general principles applicable to corporate taxpayers.

1. General

(a) Applicable law

The general principles of the Ukrainian tax system, as well as the taxes and duties (mandatory payments) that may be levied in Ukraine are defined in the Tax Code of Ukraine ("Tax Code"). The Tax Code stipulates that tax rates, tax exemptions, and the procedures and mechanisms for tax assessments and payments may be changed only by introducing the relevant changes to the Tax Code. It precludes changing taxes, their rates, as well as tax privileges throughout a fiscal year. Any tax changes or amendments determining tax rates, tax exemptions, the procedures and mechanisms for their assessment and payment must be introduced into the Tax Code, at the latest, six months prior to a new fiscal year in order to become effective at the beginning of the new fiscal year.

The Tax Code provides for the categories of taxes that may be levied in Ukraine. There are two categories of taxes in Ukraine: statewide and local. Statewide taxes and duties, and the mechanisms and procedures for their assessment and payment, are established by the Tax Code and are levied throughout the entire territory of Ukraine. Local taxes and duties, as well as applicable rates, are established by local village or city councils in accordance with and within the maximum rates established by the Tax Code.

The Tax Code provides uniform rules for, among other things: the filing of tax returns and the settlement of tax liabilities; the statutory period of limitations; the rates and procedure for calculating penalty interest for late
tax payments and penalties for the violation of tax rules; and the administrative procedure for appealing the assessment of tax deficiencies.

(b) Types of tax audits

Under the applicable Ukrainian legislation, a tax audit may be carried out in the form of one of these audits: (1) a chamber non-documentary audit; (2) a documentary audit (scheduled or unscheduled, chamber or on-site); and (3) an instant (factual) tax audit.

(1) Chamber non-documentary tax audits

A chamber non-documentary tax audit is generally carried out by the Ukrainian tax authorities with respect to all of the taxpayer’s filings and data from the system of electronic VAT administration. This audit is conducted by the tax auditors in the tax office, using the tax returns and other mandatory filings of the taxpayer that are related to the computation of the taxpayer’s tax liability. Generally, during this audit, the taxpayer’s tax returns and other mandatory filings are reviewed for, among other things, timeliness, completeness and correctness, as well as for possible arithmetic or methodological errors that may have been committed by the taxpayer when it determined its tax liability.

Chamber tax audits may be conducted only within 30 calendar days of the filing deadline. Findings established by the tax office during the chamber tax audit may serve as grounds for conducting other types of audits.

(2) Documentary “scheduled” on-site tax audits

A “scheduled” on-site tax audit of a taxpayer is carried out only if such an audit is planned in the statewide “time schedule.” The schedule of the on-site tax audits is to be made public on the official site of the State Fiscal Service by 25 December of the year preceding the year in which the audit is to be conducted. A scheduled on-site tax audit is carried out at the location of the taxpayer pursuant to a formal written decision of the head of the relevant tax office. Depending on the risk category assigned to a
taxpayer, the scheduled tax audit may be conducted no more than: (i) once a calendar year if a taxpayer is in a "high risk" basket; (ii) once in two calendar years, if a taxpayer is in a "medium risk" basket; and (iii) once in three calendar years, if a taxpayer is in a "low risk" basket. During the audit, a taxpayer is audited with respect to its general compliance with Ukrainian tax, currency control cash settlement laws, etc. The applicable law expressly prohibits scheduled tax audits with respect to specific (particular) taxes, save for: (i) compliance with customs duties, taxes, uniform social contribution, personal income tax levying requirements; and (ii) the performance under the state treasury of financed loans, and guaranteed loans.

The taxpayer must be properly notified in advance regarding the forthcoming scheduled on-site tax audit by being served at least a 10-day prior written notice indicating the start date of the audit.

The duration of a scheduled on-site tax audit may not exceed: (1) 30 business days for "large-scale" taxpayers; (2) 10 business days for "small-scale" taxpayers; and (3) 20 business days for other-sized taxpayers.

Under certain conditions, the duration of a scheduled on-site audit may be extended for an additional 15, five or 10 business days, as applicable to the respective groups of taxpayers.

A scheduled tax audit may be interrupted for 30 business days; upon the expiry of such a 30-day period, an audit may not continue beyond its unused statutory period. Under certain circumstances (e.g., inquiry of information from foreign public authorities regarding the activities of a taxpayer, consideration by a court of a case related to the subject matter of a tax audit, etc.), the tax audit may be postponed until the relevant procedures are completed.
(3) Documentary "unscheduled" on-site tax audits

An "unscheduled" on-site tax audit, in contrast to a "scheduled" one, is not pre-planned and is conducted upon the occurrence of one of the following events:

- As a result of the receipt of "tax information," the tax office establishes facts that point to a violation by the taxpayer of the tax, currency control and other legislation within the authority of the tax office. Under these circumstances, the unscheduled tax audit will be conducted if the taxpayer fails to produce the requested information and supporting documents within 15 business days after the receipt of a written request for information from the relevant tax office.

- The taxpayer fails to file a tax return, calculations, transfer pricing report or transfer pricing documentation in time.

- The taxpayer files an adjusted tax return correcting previously reported tax results for the audited period.

- The tax office establishes the inaccuracy of the data reported in a filed tax return. A tax audit will be conducted if the taxpayer fails to produce the requested information and supporting documents within 15 business days after the receipt of a written request for information from the tax office.

- The taxpayer submits: (a) objections to a tax audit report and/or additional documents supporting data in filed tax returns; or (b) a complaint regarding the issued tax assessment notification, in which the taxpayer requests their partial or full reversal on the grounds of the failure of the tax officer(s) to inquire, during the tax audit, into circumstances and materials for tax audit purposes.

- The taxpayer undergoes liquidation, de-registration, reorganization or bankruptcy.
• The taxpayer files: (a) for VAT refund; and/or (b) a VAT return with a negative balance of VAT liability in excess of UAH 100,000 (approximately EUR 3,000).

• The taxpayer’s customer files a complaint with the tax office regarding either of the following:
  o (a) The failure to issue; or (b) an improper issuance by the taxpayer of a VAT invoice; (c) missing the deadline for registering the VAT invoice; (d) adjustment calculation in case the taxpayer fails to produce the requested explanations and supporting documents within 15 business days following receipt of a written request from the tax office.
  o (a) The failure to issue; or (b) an improper issuance by the taxpayer of an excise invoice; and/or (c) procedure for registering the excise invoice, if the taxpayer fails to produce the requested explanations and supporting documents within 15 business days following receipt of a written request from the tax office.

• The tax office is given, through a court decision in a criminal case, permission to conduct a tax audit.

• A higher-level tax office establishes, in the course of exercising controlling functions over a lower-level tax office, that the facts of the taxpayer’s under-reporting of tax liabilities were not identified by such lower-level tax office.

• The tax office obtains information regarding: (a) the failure of the tax agent to comply with the personal income tax levying requirements; or (b) a person who is engaging in a business activity without the mandatory state registration.

• The tax office receives documentary information that proves the deviation of terms in a transfer pricing-controlled transaction from the arm’s-length principle or the tax office has determined, upon the
results of monitoring and analysis of a transfer pricing report, documentation or other information sources, the deviations of terms in a controlled transaction from the arm's-length principle.

• The taxpayer fails to file or improperly files the transfer pricing report/transfer pricing documentation, or the tax office determines violations during the review of these documents.

• The tax office has received a transfer pricing report (the audit is conducted in respect of compliance with transfer pricing legislation).

• The taxpayer has not filed the adjustment report on the results of the conducted e-audit (in respect of the determined violations) in a timely manner.

• The tax office has established discrepancies in registered excise invoices/adjustment calculations and excise tax returns.

• The taxpayer fails to provide requested information for the purposes of a cross-check, within 10 business days following the receipt of a written request from the tax office.

The unscheduled on-site tax audit may also be conducted at the request of the taxpayer and as part of a criminal case investigation. It is forbidden to hold unscheduled on-site tax audits in certain cases (e.g., a taxpayer files a VAT return with a negative balance of VAT liability in excess of UAH 100,000 (approximately EUR 3,000)) with respect to issues that have already been covered during previous tax audits.

An unscheduled on-site tax audit is carried out at the location of a taxpayer pursuant to a formal written decision from the head of the tax office with audit jurisdiction over the taxpayer. The taxpayer must be properly notified of the unscheduled audit prior to the tax office commencing such audit.
The duration of unscheduled on-site tax audits may not exceed: (1) 15 business days for "large-scale" taxpayers; (2) five business days for "small-scale" taxpayers; and (3) 10 business days for other-sized taxpayers. The duration of an audit may be prolonged by an additional 10, two or five business days, as applicable to the respective groups of taxpayers.

Under certain conditions, the duration of an unscheduled on-site tax audit of entrepreneurs may not exceed three business days.

Like scheduled on-site tax audits, an unscheduled on-site tax audit may be interrupted for 30 business days and, under certain circumstances, postponed for the time when conducting certain fact-finding procedures that are necessary for the completion of the tax audit.

(4) Chamber documentary tax audits

The chamber documentary tax audit, including that in the form of an unscheduled chamber documentary tax audit, is conducted by the tax office on the same grounds as scheduled and unscheduled on-site tax audits, as previously discussed.

The chamber documentary tax audit is conducted by the tax auditors at the location of the tax office, with a view to the taxpayer's compliance with Ukrainian tax, currency control, tax and other legislation within the authority of the tax office, including an employer's compliance with certain Ukrainian labor law requirements, on the basis of: (i) tax returns; (ii) financial, statistical and other mandatory filings; (iii) tax and accounting registers; (iv) supporting (primary) documentation of the taxpayer related to the computation of their tax liability; and (v) documents and "tax information" legitimately procured by the tax office from other sources, including in the course of tax audits of other taxpayers.

(5) Instant (factual) tax audits

The instant (factual) tax audit is carried out at the location of the taxpayer with a view to the taxpayer’s compliance with Ukrainian law requirements
on: (i) cash settlement transactions; (ii) patents and licensing; (iii) mandatory (state) registration; (iv) production and turnover of excisable goods; and (v) proper documentation by employers of labor relationships with employees.

An instant (factual) tax audit is conducted without the prior notification of the taxpayer, upon the occurrence of one of the following events:

- As a result of a tax audit of a third party, the tax office establishes facts suggesting possible violations by the taxpayer of applicable legislation governing: (a) the production and turnover of excisable goods; (b) cash settlement transactions; (c) patents and licensing; (d) mandatory (state) registration; and (e) other permits, controlling functions that are with the tax office.

- Upon the receipt — in due order — from state or local governing authorities of information regarding the taxpayer’s possible violation of applicable laws, the controlling function over which is with the tax office.

- Upon the receipt of a proper, written notification by a customer of a violation by the taxpayer of: (a) cash settlements; and (b) patents and licensing procedures.

- Upon a taxpayer’s failure to lodge — or lodging of zero data — mandatory filings with regard to (cash) settlement operations.

- Upon the receipt — in due order — of information regarding a taxpayer’s violation of laws applicable to producing, recordkeeping, warehousing and transporting of spirits, alcoholic beverages and tobacco, as well as special purpose use of spirits by the taxpayer.

- After the instant (factual) tax audit during which the tax office established the violation of applicable law (within a 12-month period thereafter).
Upon the receipt — in due order — of information regarding: (a) improper documentation of labor relationship; (b) salary payments by employers without levying applicable taxes; and (c) the engagement of a private individual in business activity without mandatory state registration.

The duration of an instant (factual) tax audit may not exceed 10 calendar days and may, under limited circumstances, be extended by five more days.

(c) Expected periodicity

The expected periodicity (i.e., frequency of tax audits) depends on the type of tax audit in question. As noted above, the periodicity of a "scheduled" on-site tax audit depends on the risk category assigned to a taxpayer. An "unscheduled" on-site tax audit, as previously discussed, may be conducted only upon the occurrence of one or more of the statutory circumstances that were also indicated previously. A chamber non-documentary tax audit is conducted with respect to any and all tax filings lodged by the taxpayer, whereas a chamber documentary tax audit may be carried out on the same terms as scheduled and unscheduled on-site audits. Finally, an instant (factual) audit is conducted upon the occurrence of any of the statutory circumstances provided for that type of tax audit.

In any eventuality, each taxpayer is likely to be audited at least once every three years, which corresponds to the applicable statute of limitations.

(d) Tax audit selection criteria

The criteria for selecting taxpayers that will be subject to a tax audit would include the following, among other things:

- The taxpayer files two consecutive corporate profits tax quarterly returns (or one annual return, as applicable) with a negative balance of corporate profits tax liability.
- The taxpayer’s level of payment of corporate profits tax/VAT is at least 50% less the tax payment level in the relevant sphere.

- The automatic comparison system shows discrepancy in input VAT and tax liabilities reported by counterparts (i.e., input VAT is overstated by more than UAH 1 million (approximately EUR 30,000) or more than 5% of the overall input VAT, but not less than UAH 100,000 (approximately EUR 3,000)).

- The taxpayer remits income (interest, royalties, etc.) to foreign residents registered in "offshore zone" countries.

- The taxpayer’s other expenses exceed the total operational expenses by 30%.

- The tax office has received information from a third party about the taxpayer’s tax evasion.

- The taxpayer is viewed to be engaging in tax avoidance, or in artificial business operations.

- The taxpayer is selling goods (works, services) below cost.

- The taxpayer declared export/import transactions without actually carrying out such.

- The taxpayer’s payables doubled during the two previous years, while the inventory increased, etc.

(e) Statute of limitations

The general rule is that the Ukrainian tax authorities can exercise their authority to issue an assessment of a taxpayer’s liability with respect to a tax return only within a period of 1,095 days (2,555 days in the case of transfer pricing tax audits) following: (a) the final statutory date of filing the tax return; (b) the final statutory date of discharging "payment obligations" (i.e., assessed taxes and applicable penalties); or (c) the date
the tax return was actually filed, whichever is later. After the expiration of this period of limitations, the taxpayer may not be levied additional taxes, tax penalties or late payment interest with respect to such past due tax liability.

The exceptions to this general rule are as follows:

- The failure of a taxpayer to file a tax return for the reported period, during which the tax liability in question has arisen.

- An executive officer of a corporate taxpayer or an individual taxpayer is convicted of criminal tax evasion with respect to the tax liability in question.

The 1,095-day limitation period also applies to a taxpayer’s obligation to eliminate its tax liability. If the taxpayer’s liability, which has been ascertained and reported by the taxpayer, or, alternatively, assessed by the tax office, remains unpaid during such 1,095-day period, then the taxpayer will be released from such liability.

Finally, the 1,095-day limitation period also applies to a taxpayer’s obligation to pay “financial penalties” in the form of tax penalties and late payment interest.

2. Anticipation of and preparation for a tax audit

(a) Legal requirements

In order to conduct a scheduled on-site tax audit, the tax office must notify the taxpayer, in advance and in writing, regarding such scheduled audit by serving at least 10 days before the audit: (i) a copy of the Order on Conducting Documentary On-Site Audit, issued by the head of the tax office with jurisdiction over the taxpayer; and (ii) a written notice indicating the audit start date. Both the order and the notice must be issued in the format prescribed by law.
As opposed to the scheduled on-site audit, no advance written notice is served to the taxpayer when the intent is to conduct an unscheduled on-site audit. Instead, a copy of the Order on Conducting Unscheduled Documentary On-Site Audit is hand-delivered to the taxpayer immediately before the audit is commenced.

Likewise, no advance prior written notice is served to the taxpayer with the intent to conduct an instant (factual) tax audit, which starts immediately after serving to the taxpayer an order issued by the head of the tax office with the audit jurisdiction over the taxpayer.

The chamber documentary audit, in turn, is conducted pursuant to an order of the head of the tax office, a copy of which must be delivered by registered mail to the taxpayer with the indication of a start date and a location at which the audit would be conducted.

Finally, the chamber non-documentary audit is conducted without the issuance by the tax office or serving to the taxpayer of any order or notification concerning the conduct of the audit.

The taxpayer has the right to deny the tax auditors access to its premises and documentation and, as such, the commencement of the tax audit if, for the purposes of the documentary on-site and instant (factual) audits, the tax auditors: (i) fail to present an assignment letter, an order based on which the audit is carried out, or a service ID to the taxpayer; or (ii) present a defective assignment letter for conducting such an audit, a defective order based on which audit is carried out, or a defective service ID.

An assignment letter must contain the following information: (i) date of its issuance; (ii) the details of the issuing tax office; (iii) the details of an order based on which the audit is carried out; (iv) name of the taxpayer that will be audited; (v) the purpose and grounds of the audit; (vi) the type of audit (i.e., scheduled or unscheduled); (vii) the date of commencement and duration of the tax audit; and (viii) the details of the tax officers authorized to conduct the audit. The assignment letter must be signed by
the head, or their deputy, and carry the stamp of the tax office that has audit jurisdiction over the taxpayer.

An order based on which the audit is carried out must contain the following information: (i) date of its issuance; (ii) the details of the issuing tax office; (iii) the details of an order based on which the audit is carried out; (iv) the name of a taxpayer that will be audited; (v) the purpose and grounds of the audit; (vi) the type of audit (i.e., scheduled or unscheduled); (vii) the date of commencement and duration of the tax audit; (viii) the period to be audited; and (ix) the details of the tax officers authorized to conduct the audit. The order, based on which the audit is carried out, must be signed by the head, or their deputy, and carry the stamp of the tax office that has audit jurisdiction over the taxpayer.

If the taxpayer groundlessly: (a) does not grant access to its files; (b) creates "inadequate" conditions for the auditors; or (c) ignores the lawful requests of the tax auditors in connection with the conduct of a tax audit, the administrative penalty in the amount varying from UAH 85 (approximately EUR 2.5) to UAH 170 (approximately EUR 5) may be imposed on the senior officers of the taxpayer, pursuant to the final ruling of a court. Separately, the tax office may attach tax liens to the assets of the taxpayer that denies the tax office its right to conduct a documentary tax audit or instant (factual) tax audit.

(b) Practical recommendations

It is essential that the taxpayer prepare in advance for a tax audit. Such preparation should consist of, among other things, the regular preparation and review of the documentation that the taxpayer must submit to the tax auditors from the standpoint of its conformity with applicable legal standards. Upon receipt of an audit notice, the taxpayer should organize an internal review of its sensitive files and topics, in order to develop an audit strategy with respect to those identified weaknesses.
It is also advisable that only designated individuals communicate with the tax auditors. All documents and information requested by the tax auditors should be reviewed before these are given to the tax auditors.

In connection with the preparation for a tax audit, it is advisable that the taxpayer does the following:

• Recognize in advance its weaknesses, so that its tax audit strategy is identified.

• Collect the financial documentation as well as the commercial contracts in place for the period being audited. It is important to note that a request of the tax auditors for information, that cannot be accommodated reasonably and promptly, may create suspicion and cause undesired attention on the part of the tax auditors to such unfurnished information.

• Review its financial and accounting documentation from the standpoint of conformity to applicable legal standards (this documentation must be prepared in advance and must be readily available for the purposes of a tax audit).

• Review its existing contracts and their compatibility with the relevant tax principles.

• Designate a contact person with sufficient knowledge of the business and operations of the taxpayer, as well as tax audit expertise. It is strongly advised that the numbers of the taxpayer’s employees, who will communicate with the tax auditors during the tax audit, be limited, in order to prevent or minimize the "leak" of any information sensitive to the taxpayer.

• Designate a workplace (e.g., a separate room) for the tax auditors as yet another tool for limiting access of the tax auditors to sensitive information not directly related to the tax audit.
3. Areas of tax auditors' special attention

(a) Procedure and form

As a general rule, a tax audit starts with a review of the correctness of the tax returns filed by the taxpayer and how they reconcile with the taxpayer's accounting ledgers. Based on their findings, the tax auditors usually proceed with an in-depth study of the taxpayer's commercial documentation. As a rule, the tax auditors apply a specific threshold level of materiality for testing the taxpayer's operations. Bearing in mind the constraints with respect to the duration of an on-site tax audit, the tax audit is usually carried out by means of sampling and targeting the most "problematic" areas of the taxpayer's business.

(b) Formal requirements

As a matter of law, a taxpayer may be denied otherwise deductible expenditures if these have not been properly documented. This requirement applies to all transactions undertaken by the taxpayer. For this reason, it is extremely important that the taxpayer has properly executed contracts and other supporting documentation.

(c) Substantive issues

During a tax audit, the taxpayer's compliance with the applicable financial and tax rules will catch the tax auditors' special attention. For this reason, as recommended above, the taxpayer must regularly review its financial and accounting documentation from the standpoint of these documents' conformity to applicable legal standards. Even if the failure to comply with these rules does not result in an underpayment of tax, a taxpayer's "responsible" officers may nevertheless be subject to an administrative penalty ranging from UAH 85 (approximately EUR 2.5) to UAH 170 (approximately EUR 5).
(1) Transactions involving a tax haven jurisdiction

The Ukrainian tax authorities pay special attention to the operations of the Ukrainian taxpayer, which involve payments made: (a) for the benefit of; (b) through the mediation of; or (c) to or through the bank accounts of, a foreign person who is deemed to have a "low-tax jurisdiction status." Such a status is attributed to foreign persons who are established in one of the countries classified under applicable Ukrainian legislation. The list of "low-tax jurisdictions" is determined by the Cabinet of Ministers and currently comprises 79 jurisdictions. It includes territories that: (i) apply a corporate income tax rate at five or more percentage points below the Ukrainian corporate income tax rate; or (ii) have not concluded with Ukraine a double tax agreement with the provisions on the exchange on information; or are not cooperative in information exchange on request.

The list of "low-tax jurisdiction status" includes, among other things, jurisdictions known as being an "offshore zone," which equates essentially to traditional "tax havens." It should be noted that the Ukrainian tax authorities still pay much more attention to transactions involving traditional "offshore zones."

In addition to inquiring into the substance of such operations, the tax auditors also check the compliance of the taxpayer with the so-called "low-tax jurisdiction deductibility" limitation. Under this limitation, the taxpayer is allowed to make deductions for only a certain portion of its expenditures, if the payment of such expenditures is considered to be made to a foreign person with such "low-tax jurisdiction status."

(2) Permanent establishment

The activities of a representative office of a foreign company in Ukraine are often subject to close scrutiny by the Ukrainian tax authorities during a tax audit. If the activities of the representative office are determined by the authorities to exceed the scope of mere preparatory and auxiliary activities and, thereby, rise to the level of a permanent establishment, tax
penalties will be imposed on the foreign company (through its representative office in Ukraine). Additionally, criminal charges may be brought against the relevant officers of the representative office.

(3) Transfer pricing

Transfer pricing rules are stipulated by the Tax Code and, generally, apply from 1 January 2013. On 1 September 2013, the Law on Amendments to the Tax Code on Transfer Pricing ("Transfer Pricing Law" or "TPL") came into effect. The TPL is predominantly in line with the OECD Transfer Pricing Guidelines.

In general terms, the transaction should be considered controlled and subject to transfer pricing rules if it is conducted:

- With a non-resident related party
- With a non-resident party from a low-tax jurisdiction
- Through a non-resident commissionaire
- A non-resident party that is a fiscally transparent entity
- Between a non-resident party and its permanent establishment in Ukraine
- With a non-resident party that is exempt from corporate income tax

Transactions between related parties, which are conducted through a formally independent intermediary, may be also recognized as controlled, unless it has been proven that such an intermediary performs significant functions or bears significant risks.

The transactions above are considered to be controlled only if the annual income of the taxpayer or its related parties within the reporting period exceeds UAH 150 million (approximately EUR 4.7 million), with minor
transactions below UAH 10 million (approximately EUR 320,000) being out of the scope of the transfer pricing rules.

The Tax Code provides for filing of a special transfer pricing report by 1 October of the year following the reporting year, covering only controlled transactions exceeding UAH 10 million (approximately EUR 320,000).

All taxpayers are obligated to prepare, maintain and file, upon the request of the tax office, a complete set of the transfer pricing documentation.

Transfer pricing tax audits may be scheduled on the following grounds:

(i) Sending of a special notification by tax authorities to State Fiscal Service of Ukraine on the identified unreported controlled transactions.

(ii) Identification by the tax office that conditions of a controlled transaction do not satisfy the arm’s-length principle.

(iii) Failure to file, or filing with violations, a transfer pricing report or transfer pricing documentation.

Tax audits are performed under the procedure as established by the Ministry of Finance of Ukraine and may not last longer than 18 months. In certain cases, such as the submission of the request to foreign tax authorities, price expertise, etc., the period of tax audit may be extended for another 12 months.

It is prohibited to conduct two transfer pricing audits of one controlled transaction from one taxpayer within the same calendar year (save for certain cases). A taxpayer can object to such a transfer pricing audit within 30 days, and the relevant tax decision can be subject to administrative or court appeal under the current general procedure in effect.

The TPL establishes special penalties for non-compliance with transfer pricing rules.
(4) Withholding tax

The correctness of the taxpayer’s assessment, as well as the withholding and remitting of Ukrainian withholding tax, is yet another area of special attention in tax audits. The taxpayer is charged with the duty of acting as a "tax agent" (when paying the so-called "Ukraine-sourced income," (e.g., interest payments, dividend distributions, royalty payments)), for its foreign counterparties. As a tax agent, it must withhold and remit to the treasury the 15% Ukrainian withholding tax, unless an applicable tax treaty provides otherwise. The application of tax treaty relief is permissible, but only if on or prior to the payment date, the taxpayer will have in its possession the so-called "residence certificate" of the payee. It is a formal instrument issued by the appropriate state authorities of the foreign payee’s jurisdiction confirming the entitlement of such payee to the benefits of the applicable tax treaty. If the taxpayer is found to be in violation of the aforementioned requirements, it will be subject to tax penalties as a "tax agent."

4. Special tax audit: VAT

VAT continues to be another area that the Ukrainian tax authorities pay special attention to. VAT is one of the major sources of tax revenue for the state.

During a tax audit, VAT is usually very closely watched, with particular focus on the "actuality" of the taxpayer’s operations. Once the "sham transaction" is established, the taxpayer will most likely be denied the VAT credit in the amount of the VAT paid during such "sham transaction."

5. Electronic data processing (EDP) access during audit

For purposes of inquiring into a tax return, the auditing tax officer may require the taxpayer to produce documents or information in its possession, or those within its power to secure, and that may be reasonably required to establish whether the tax return is incorrect or incomplete.
According to the Tax Code, large and medium-scale taxpayers are requested to file electronically both tax returns and supporting (primary) documentation. VAT reporting must be filed electronically. Further, an "electronic office" has been launched and taxpayers may opt to get registered in it for electronic tax filing, administering, control and communication with the tax office. Through the "electronic office," the Ukrainian tax authorities have access to any information and document submitted electronically by the taxpayer.

6. E-audits

An e-audit is a special kind of chamber documentary tax audit that is initiated upon the request of the taxpayer in a "low-risk" basket and may be conducted only if the taxpayer maintains records in electronic form.

In order to initiate an e-audit, the taxpayer should submit an application 10 days before the expected commencement of the e-audit, but not earlier than the date the State Fiscal Service of Ukraine officially announces the introduction of the e-audit procedure for respective groups of taxpayers (i.e., taxpayers under the simplified tax regime, micro, small and medium-sized business representatives under the general taxation system, and other taxpayers).

The taxpayer is allowed to determine the tax periods for which it wants to undergo the e-audit, but only if during these periods the documentary unscheduled or scheduled audits were not carried out on those issues that the taxpayer wishes to oversee.

After conducting the e-audit, the tax office issues a certificate that confirms the taxpayer’s compliance with the applicable taxation rules or, alternatively, states violations that were discovered. The taxpayer has the right to present its objections to the results of the e-audit.

If the tax office states that there were violations, the taxpayer has to submit the adjusted tax return within 20 business days; otherwise, the
supervisory tax office will have the right to conduct an unscheduled on-site tax audit.

7. Information-gathering powers

(a) Information obtained from unrelated parties

As noted above, the Ukrainian tax authorities may conduct an unscheduled on-site or instant (factual) tax audit of a taxpayer on the basis of information obtained from a third party that has had a contractual relationship with the taxpayer, and which has provided information that, in the tax office’s opinion, requires further clarification.

With the adoption of the Tax Code, the powers of the tax office have been materially broadened, requiring a third party — other than in the course of an on-site or instant (factual) audit of such third party — to produce documents that are in its possession or within its power to secure, which are relevant to the suspicion of tax liabilities on the part of the taxpayer.

An unscheduled tax audit will be conducted if the taxpayer fails to produce the requested information and supporting documents within 15 business days from its receipt of a written request for information by the tax office.

Advocates (i.e., attorneys admitted to practicing the law in Ukraine) cannot be requested to provide documents and information that are subject to the client-attorney privilege without the consent of the client concerned, unless a court authorizes such a request. Likewise, third-party auditors cannot be requested to disclose information that they obtained, or to produce documents they created, while they carry out statutory and non-statutory audits.

Separately, the Tax Code has vested the tax authorities with the right to carry out cross-checks of the audited taxpayer’s counterparties. Cross-check: (i) constitutes a separate procedural action; and (ii) is performed in furtherance of the tax audit of the taxpayer with a view to verifying the existence of the contractual relationship of the audited taxpayer with a
cross-checked counterparty. Generally, cross-checks should not result in tax assessments or tax penalties for such a counterparty, but may not unreasonably serve as grounds for an unscheduled audit of such a counterparty.

(b) Information provided by foreign tax authorities

The authority of the Ukrainian tax authorities to obtain tax audit-related documents or information is not enforceable outside Ukraine. For this reason, Ukrainian tax authorities cannot force foreign third parties to produce such documents or information. However, the Ukrainian tax authorities may request assistance from foreign tax authorities in obtaining documents and information from third parties located in their own foreign jurisdiction.

Such documents and information may be requested from foreign tax authorities pursuant to an applicable double tax treaty. Most of the double tax treaties of Ukraine provide for an exchange of information along the lines established by the OECD Model Treaty. While, on the surface, these provisions may be viewed as concerning only such documents and information necessary for the application of the relevant tax treaty, it can be argued that, by virtue of the operation of these provisions, the relevant Ukrainian authorities may request information about a “resident” of a state that has a tax treaty with Ukraine.

Recently, Ukrainian tax authorities started to more actively use this opportunity with the view to obtaining information about taxpayers from foreign tax authorities.

Separately, and in addition to the said mechanism of exchange of information, Ukraine has acceded to the 1988 Convention on Mutual Administrative Assistance in Tax Matters (“1988 Convention”) with some reservations. The convention became applicable in Ukraine on 1 July 2009.
The 1988 Convention sets forth the procedure for cross-border administrative assistance in tax matters, namely: (i) the exchange of information, including simultaneous tax examinations and participation in tax examinations abroad; (ii) assistance with the recovery of tax claims; and (iii) assistance with the service of documents, including those related to judicial decisions.

The 1988 Convention applies in Ukraine with respect to the following taxes and mandatory payments: (i) corporate profits tax; (ii) personal income tax; (iii) pension fund duty; (iv) land tax; (v) VAT; (vi) excise duty; (vii) vehicle tax; (viii) unified tax; (ix) state duties; (x) rent payments; (xi) environmental tax; and (xii) real estate tax.

Ukraine has reserved the following rights: (i) to fulfill the requests of other parties to the 1988 Convention only with regard to taxes analogous to those listed above; and (ii) to not provide administrative assistance with regard to tax claims outstanding on the date on which the 1988 Convention came into force for Ukraine.

Currently, 126 jurisdictions participate in the 1988 Convention, including 17 jurisdictions covered by territorial extension, and Azerbaijan, Belgium, Denmark, Finland, France, Georgia, Iceland, Italy, Korea, Moldova, the Netherlands, Norway, Poland, Slovenia, Spain, Sweden, the UK and the US, among others.

Being rather a new instrument in the hands of the Ukrainian tax authorities, it remains to be seen how actively the mechanisms of the 1988 Convention will be used to procure information from foreign tax authorities.

The tax authorities are required to maintain confidentiality with regard to all of the information in their possession concerning a taxpayer, except for information in the public domain. Taxpayer information may be disclosed to a third party only on the basis of a judicial decision.
Separately, although Ukraine has not yet made an official commitment to the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information ("CRS MCAA"), the bill on implementing the Common Reporting Standard (CRS) is, at present, in the pipeline.

Tax information exchange agreements with Belize, Andorra, and the Cayman Islands have been initialed and similar agreements are being negotiated with Panama, Seychelles, the Isle of Man, Bahrain and Argentina.

8. **Multijurisdictional tax audits**

Ukraine does not ordinarily engage in the conduct of multijurisdictional tax audits in cooperation with the tax authorities of other foreign jurisdictions, save for the requests submitted to foreign tax authorities as part of transfer pricing tax audits.

Acceding to the 1988 Convention, however, multijurisdictional tax audits may be reasonably expected to become a regular practice as part of "simultaneous tax examinations and participation in tax examinations..." in or by the states that are parties to the 1988 Convention.

9. **Burden of proof**

As a general rule, a taxpayer may not be held liable for a tax violation and thereby become subject to tax penalties unless the tax authorities prove that the taxpayer is at fault. The tax authorities carry the burden of proof regarding those facts and circumstances that establish or substantiate the tax claim brought against the taxpayer. In practice, the tax authorities do not usually experience significant difficulties in producing formal evidence that, in their view, proves the claims they have made against the taxpayer, thereby forcing the latter to take an active legal defense stance.
10. Potential consequences

(a) Adjustment of income and assessment of additional tax

A tax audit is concluded with a formal "tax assessment notice" which constitutes the instrument through which the tax authorities notify the taxpayer regarding the latter’s alleged tax violation and the corresponding tax penalties. The consequences of an alleged violation may take the form of, among other things: (a) a readjustment of the taxable base for the purposes of the corporate profits tax (either by means of disallowing certain costs or allowances or, in the instance of a transfer pricing violation, adjusting the taxpayer’s taxable income); or (b) an adjustment of output or input VAT.

(b) Substance over form

The "substance over form" doctrine is not well established in Ukraine. The Ukrainian tax authorities do not have the formal right to reclassify a transaction or contract (which may be interpreted as circumventing tax laws by misusing the concepts of the law) and to assess taxes based on the alleged substance of such transaction or contract.

Nonetheless, the tax authorities may challenge a particular transaction or contract in court on the basis that it has been concluded by the taxpayer without a real business purpose, or it has been concluded with the view to disguise or defer the realization of income or to avoid the payment of taxes. In this eventuality, a court may reclassify the challenged transaction or contract.

(c) Tax penalties

Penalties for the failure of a taxpayer: (a) to file, or to file in a timely manner, a tax return; (b) to pay, or pay in a timely manner, taxes; and (c) to comply with other tax obligations, can be generally divided into two broad categories: tax (administrative) penalties and criminal penalties.
Tax penalties are imposed by the Ukrainian tax authorities and may be appealed by a taxpayer either: (a) to a higher level tax office in accordance with the administrative appeal procedure; or (b) to an administrative court in the form of tax (administrative) litigation. Criminal penalties are imposed by the criminal courts in cases of tax evasion involving "significant" amounts, as discussed in more detail further.

The applicable Ukrainian law provides for the following tax penalties:

- If the taxpayer fails to file, or to file in a timely manner, a tax return, it will be required to pay either of these two penalties:
  - UAH 170 (approximately EUR 6) for every instance of such failure
  - UAH 1,020 (approximately EUR 37) for every repeated instance of such failure, if the taxpayer was repeatedly penalized for such failure to file, or to file in a timely manner, a tax return within the consecutive year

- If the tax authorities assess an additional tax liability in connection with the understatement by the taxpayer of its tax liability in a filed tax return, it will need to pay the following penalties:
  - 25% of the understated tax liability for the first violation
  - 50% of the understated tax liability for the second violation

- If the taxpayer fails to pay its reported tax liability, it will be required to pay the following penalties:
  - 10% of the reported tax liability if such liability is extinguished within 30 calendar days after the statutory deadline
  - 20% if such liability is extinguished later than 30 calendar days after the statutory deadline
If the taxpayer alienates its assets, which are subject to a tax pledge, without the prior approval of the tax authorities, it will be required to pay the penalty amounting to the price of such assets.

- If the taxpayer fails to withhold, or to charge and collect, tax as applicable, it will be required to pay the following penalties:
  
  o 25% of the tax liability for the first violation
  
  o 50% of the tax liability for the second violation
  
  o 75% of the tax liability for the third and any subsequent violation

- If the taxpayer independently identifies an underpayment of its tax liability and voluntarily discloses and extinguishes such liability, it will be required to pay either of these two penalties:
  
  o 3% of such understated liability, if it is identified via the adjusted tax return and paid prior to filing such adjusted tax return
  
  o 5% of such understated liability, if it is identified via the consecutive tax return

- If the taxpayer fails to file a transfer pricing report or transfer pricing documentation, or if the taxpayer has not reflected all controlled transactions in the transfer pricing report, it will be required to pay these penalties:
  
  o Three hundred times the subsistence rate (currently UAH 630,600 or approximately EUR 23,600) for failure to submit a transfer pricing report (including failure to submit the transfer pricing report in a timely manner)
  
  o 1% of the sum of the controlled transactions, which were not reflected in the transfer pricing report, but not more than 300 times the subsistence rate (currently UAH 630,600 or approximately EUR 23,600)
o 3% of the sum of the controlled transactions in respect of which transfer pricing documentation was not filed; but not more than 200 times the subsistence rate for all of the unreported controlled transactions (currently UAH 420,400 or approximately EUR 15,750)

In addition, an administrative penalty may be imposed on the senior officers of the taxpayer. Such a penalty may vary from UAH 85 (EUR 3) to UAH 170 (EUR 6).

If the amount of underpaid tax liabilities exceeds 3,000 times the social tax allowance (currently UAH 3,153,000 or approximately EUR 116,700) and intent to evade taxes is proven, the senior officers of the taxpayer may be subject to criminal liability.

In this context, tax evasion in excess of 7,000 times the social tax allowance (currently UAH 7,357,000 or approximately EUR 272,480) constitutes tax evasion on an especially large scale and is penalized with a fine in an amount ranging from UAH 255,000 to UAH 425,000 (approximately EUR 9,500 to EUR 15,500), as well as a renunciation of its right to hold certain positions and confiscation of property.

(d) Late payment interest

Where adjustments result in the assessment of an additional tax liability, late payment interest will be assessed on the sum total of such additional tax liability and tax penalties, as applicable, after the taxpayer fails to discharge such additional tax liability and penalties in a timely manner. Late payment interest is established to be: (i) 120% of the rate of refinancing of the National Bank of Ukraine — in case tax liabilities are assessed by the tax authorities; or (ii) 100% of the rate of refinancing of the National Bank of Ukraine — if the tax liabilities are assessed by a taxpayer or by a tax agent after 90 calendar days following the due payment date. With the current rate of refinancing of 15.5% per annum, late payment interests, therefore, are: (i) 18.6% per annum; and (ii) 15.5% per annum, respectively.
11. Strategic considerations

(a) Settlement or litigation

A tax dispute may be settled: (a) during the course of a tax audit; (b) during the course of an administrative appeal procedure; or (c) in court. The taxpayer should usually appear before the Ukrainian tax authorities as being willing to litigate the tax dispute. However, the taxpayer should also be mindful of all available settlement opportunities.

(b) Interpretation of ambiguities in the tax legislation

Under the applicable Ukrainian law, any ambiguities in tax law must be interpreted in favor of the taxpayer.

(c) Mitigating, exempting and aggravating circumstances

The taxpayer may not be held liable by the tax authorities for a violation of the tax laws as a result of the taxpayer’s reliance on an individual tax ruling issued by tax authorities in response to the taxpayer’s request for a tax law clarification. Such individual tax ruling must be registered in the single base of individual tax rulings, which is publicly available on the official website of the tax office. The taxpayer may act upon such a tax ruling until it is canceled or amended by the tax authorities.

The individual tax ruling may be challenged by a taxpayer in court. The conclusions of the court have to be considered by the tax authorities when issuing the new tax ruling.

12. Conversion of a regular tax audit into a criminal investigation

If, during the course of a tax audit, information has been discovered suggesting that a taxpayer has committed criminal tax evasion, that tax audit may be converted to a criminal investigation. Once such information has been established, the tax auditors must notify the Ukrainian criminal investigation authorities accordingly; upon their assessment of the
received information, the latter will decide whether or not to initiate a
criminal investigation.

As a matter of Ukrainian law, criminal liability for tax evasion does not
apply to a corporate taxpayer. Instead, only an individual, in its capacity as:
(a) a taxpayer; or (b) an "officer" of a corporate taxpayer may be criminally
liable for "deliberate" tax evasion.

(a) Premises that may be searched

Tax auditors are not expressly permitted by law to search the premises of
a taxpayer during an on-site tax audit. In contrast, during a criminal
investigation, the taxpayer’s business and administrative premises may be
searched upon the respective court ruling, and the taxpayer has little
power to prevent such a search.

(b) Seizure of documents

During a regular on-site tax audit, the tax auditors may not seize original
documents potentially pertaining to a tax assessment (except in certain
limited cases, pursuant to a court order), but they may obtain a copy of
such documents. Once a criminal investigation is launched, the criminal
investigators may, subject to a court ruling, seize originals, provided that
they leave the taxpayer with copies of such seized originals and an exact
list of such seized originals.
II. Resolution procedures

1. Administrative level

(a) During an audit

During a tax audit, the taxpayer should nominate a representative or several representatives who will be responsible for liaising with the tax auditors with respect to the matters arising during a tax audit, including the provision of the requested documentation, information and explanations.

During the tax audit, the tax auditors may hold a series of meetings with such representatives to clarify any uncertainties or elicit explanations pertaining to the assessment of the taxpayer’s liabilities, if such a need arises.

Once the tax auditors have concluded the audit, they will provide the taxpayer with a so-called "tax audit act" (i.e., a statement of their conclusions regarding any errors or omissions of the taxpayer, as well as the amount of any additionally assessed tax liabilities). This act precedes a formal tax assessment notice, that is, the so-called "tax notification decision," which is issued on the basis of the already issued tax audit act, and by virtue of which the taxpayer is assessed for additional taxes, tax penalties and late payment interest.

The period for the issuance of the act depends on the type of tax audit and must be issued within the following time frames:

- Five business days after the conclusion of scheduled and unscheduled on-site tax audits
- Three business days after the conclusion of chamber non-documentary tax audits
• Five business days after the conclusion of chamber documentary tax audits

• One business day after the conclusion of factual tax audits

The period for the issuance of the act is not part of the maximum statutory period for conducting tax audits (as discussed in more detail above). Within 10 business days after receiving the act, the taxpayer may challenge the results of the act by filing written objections with the tax office conducting the tax audit. The tax office, in turn, has seven business days to consider the written objections of the taxpayer.

In the event the tax audit was conducted in respect of compliance with transfer pricing rules, the taxpayer may challenge the results of the act by filing written objections within 30 days after receiving the act. The tax office, in this case, has 30 business days to respond to the written objections of the taxpayer.

Formal tax assessment notice is issued within 15 business days after the delivery of the act to a taxpayer or, in the case of the taxpayer’s written objections against the act, within three business days after the response of the tax office to the objections of the taxpayer.

If the tax assessment notice assesses the taxpayer for additional taxes, tax penalties or penalty interest, the taxpayer may challenge the notice either in accordance with the administrative appeal procedure or, alternatively, the tax litigation procedure, as discussed in more detail below. The taxpayer may not simultaneously pursue both of these routes.

(b) Administrative appeal

Once the tax assessment notice has been received by the taxpayer, the taxpayer may elect to challenge the assessment by pursuing an administrative appeal procedure. During the administrative appeal procedure, the tax assessment notice is automatically suspended. In order to launch the administrative appeal procedure, the taxpayer must lodge
with the higher-level tax office a so-called "complaint" with a claim to reconsider the assessment. This type of claim must be lodged within 10 calendar days after the receipt by the taxpayer of the tax assessment notice. Applicable Ukrainian legislation does not prescribe the form or other requisites of such a complaint.

The higher-level tax office has the right: (i) to dismiss the complaint; (ii) to cancel the challenged notice; or (iii) to amend the challenged notice. The regional level tax office must justify in writing if the taxpayer's complaint is dismissed in full or in part. The regional level tax office normally has 20 calendar days to respond; however, this period can be extended up to a maximum of 60 calendar days.

If the tax office fails: (a) to respond in a timely manner to the taxpayer's complaint or appeal; or (b) to inform in a timely manner the taxpayer regarding the extension of the aforementioned 20-day period, then the taxpayer's complaint or appeal, as applicable, is automatically considered satisfied in full.

The administrative appeal procedure is exhausted by the national-level tax office's issuance of its tax decision. If the taxpayer disagrees with this decision, it may be challenged in court.

2. Judicial tax litigation

(a) Applicable procedural law and relevant courts

Since the Code of Administrative Procedure of Ukraine ("Code") came into force on 1 September 2005, all tax disputes have been referred to the jurisdiction of the system of administrative courts of Ukraine.

The system of administrative courts includes: (1) district administrative courts as courts of first instance; (2) appellate administrative courts as courts of second instance; and (3) the Cassation Administrative Court of the Supreme Court (effective from 15 December 2017), as court of third
instance. In exceptional circumstances, a case can be referred to the Grand Chamber of the Supreme Court.

(b) Official court fees

Under applicable Ukrainian legislation, the fee for filing a lawsuit challenging the tax office’s tax assessment is established to be 1.5% of the claim, but not less than one statutory subsistence rate (not less than UAH 2,102 in 2020 (approximately EUR 79)) and not more than 350 statutory subsistence rates (not more than UAH 735,700 in 2020 (approximately EUR 27,550)).

(c) The procedure

According to applicable legislation, the validity of the tax assessment notice is suspended once a lawsuit has been filed by the taxpayer with the court of first instance. As a general rule, the lawsuit may be filed within three years upon the receipt of such notice by the taxpayer (this term is rather disputable; the risk of application of shortened terms shall be specifically considered (i.e., one month from the date of completion of the administrative challenging procedure or 10 days from the date upon receipt of the notice by the taxpayer)). This notice is normally suspended until the decision of the first instance court comes into legal force (i.e., either upon expiration of the term for challenging thereof with the court of second instance, if no such challenge is made, or after consideration of the case by the court of second instance and rendering of the decision in the case upholding the decision of the court of first instance). Should the court of second instance cancel the decision of the first instance court and render an enforceable decision, such decision shall be considered effective immediately upon rendering.

If the procedure for filing the claim has not been properly observed, the court may issue a ruling on returning the claim without consideration. Under the general rule, the administrative court of first instance must review the case with respect to substantive matters and issue a decision
within a reasonable period of time, which, however, shall not exceed one month starting from the date of the opening of the case. Both the substantive decision and certain procedural rulings (separately from the substantive decision) may be appealed to the appellate administrative court. The appeal shall comply with the established requirements to its form, must be grounded and be accompanied by required attachments. The legislation provides different terms for challenging substantive decisions and procedural rulings (as a general rule, 30 days or 15 days upon rendering thereof; however, specific terms may be applied).

The appellate administrative court may: (1) uphold the decision of the first instance court; (2) cancel the decision in full or in part, issue a new one, or change the decision of the court of first instance; (3) cancel the decision in full or in part and terminate the proceedings in relevant part, or dismiss the appeal without the hearing on the merits in full or in part; (4) hold the decision of the first instance court invalid in full or in part and terminate the proceedings in case in the relevant part; (5) cancel the decision and expedite the cause for new trial to another first instance court as per the established court jurisdiction. The decisions of the appellate administrative court may be further appealed by filing a cassation complaint. As a general rule, cassation complaints may be filed with the Cassation Administrative Court of the Supreme Court of Ukraine within 30 days from the date the decision was rendered or ruling was given by the appellate administrative court (although specific terms may be applied).

(d) Legal grounds for judicial review

Effective from 15 December 2017, grounds for appealing the decisions of the courts of the first and second instances are rather limited and do not cover cases categorized as non-significant. Thus, a case can be referred for cassation when, among other things: (i) it is fundamental for building court practice; (ii) it is of a significant public interest; (iii) a court has incorrectly categorized the case as non-significant, which is beyond the scope of the Cassation Administrative Court of the Supreme Court; or (iv) there is
incorrect application by the court of rules of substantive law or violation of procedural law.

The procedure of "admission" of the motion, which is granted by the cassation court, precedes the consideration of the motion by the Cassation Administrative Court of the Supreme Court itself. Thus, for the motion to be considered, it shall be recognized admissible (i.e., grounded) by the cassation court.

Another exceptional stage in the administrative procedure is the review of the case under newly established circumstances. The legal grounds for filing a motion for such review are as follows:

- The discovery of significant circumstances, which were not known to the party that invokes them at the moment the case was pending.
- The decision of the court establishing a misrepresentation or a false statement made by a witness or an expert or by a translation, or declaring documents or evidence as forged, if the party invoking such misrepresentation, false statement or forgery can prove that these facts have influenced the decision in the case.
- The sentence of the court proving that the judge in the case had rendered an unlawful decision or made an unlawful ruling.
- The cancellation of the decision of the court, which was the basis for rendering the decision or giving the ruling in the case.
- The decision of the Constitutional Court of Ukraine that rendered as unconstitutional the law or other mandatory acts, or an official interpretation of the provisions of the Constitution of Ukraine, which is different from how they were applied by the court for rendering the decision, provided the decision has not been yet executed.
- In the event that an international judicial institution, the jurisdiction of which is officially recognized by Ukrainian authorities, establishes that
a violation of Ukraine’s international obligations took place during the course of consideration of the case in courts.

A motion for the review of the case under newly established circumstances must be filed with the court that was the first to be influenced by the newly established circumstances, or with the Grand Chamber of the Supreme Court (depending on the grounds for review), within 30 days (following the day on which the affected party has become aware of such circumstances, sentence took effect, decision of constitutional court was officially made public), but not later than three years or 10 years depending on the grounds.

(e) European Court of Human Rights

If all possibilities for legal recourse in the Ukrainian courts have been exhausted, a taxpayer may file a claim with the European Court of Human Rights (ECHR). The ECHR renders decisions only with respect to the payment of compensation by the relevant state to the taxpayer, but it does not award specific performance. The procedure of consideration of the case by the ECHR is rather complicated and long-lasting.

(f) Court of Justice of the European Union

Ukraine is not a member of the EU. For this reason, the Court of Justice of the European Union has no jurisdiction over Ukrainian tax disputes.

Accordingly, the practice of the Court of Justice of the European Union in the tax area is not applicable to Ukraine.
III. Competent authority/Arbitration convention

Since Ukraine has not yet become an EU Member State, the EU Arbitration Convention does not apply in Ukraine.

However, the taxpayer may theoretically resort to the competent authority procedure of an applicable tax treaty whenever there is a risk of potential double taxation resulting from a reallocation of income by foreign or Ukrainian tax authorities.

Ukraine has a network of about 70 tax treaties, most of which are based on the OECD Model Convention. Almost all of these tax treaties provide for a competent authority procedure. At the same time, no implementing regulations have been adopted in Ukraine to date.

As a matter of established practice, this procedure has not been recognized yet, either by the taxpayers or the Ukrainian tax authorities as an effective instrument of double taxation prevention.
Handling Tax Disputes in the United Kingdom

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I. Tax enquiries (“Audits”)

1. Selection of tax audit targets

While some tax returns are randomly selected for audit, HM Revenue & Customs (HMRC) typically uses a risk-based approach to select cases for audit where it considers that tax is at risk based on the available information.

Risk identification for large businesses is driven by the company's customer compliance manager (CCM), who carries out an annual "Business Risk Review" (BRR, now known as "BRR+" following a review) to obtain information from which to assess risk and identify issues for audit.

Through the BRR, the CCM will consider the inherent risks posed by the taxpayer (size, complexity, international reach, group structure, financing arrangements, and degree and pace of change), and how the taxpayer effectively mitigates this risk through its behavior (governance structure, management accountability, transparency with HMRC, internal processes and systems, and involvement in non-commercial tax planning). Businesses are given a low, moderate, moderate-high or high rating. Taxpayers are subject to regular risk assessment depending on their risk rating in respect of specific tax returns to identify issues for audit.

In addition to the information provided by the taxpayer in its tax return and financial statements and information obtained through the BRR+, HMRC uses information from various other sources to supplement its risk assessment.

This includes: information available on the taxpayer's website, press releases, stock exchange announcements and other information published in the media, information available on domestic databases such as

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364 The technical term for an HMRC investigation into a business' tax affairs in the UK is a tax enquiry. However, for the sake of consistency with the other jurisdictions noted in this handbook, we will refer to enquiries as "audits" throughout this chapter.
Companies House and the Land Registry, and information gathered through exchanges of information with overseas tax authorities. Such information exchange has increased significantly in recent years, with HMRC having power to exchange information under bilateral agreements or under multilateral agreements such as the OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters (see more details below).

HMRC also profiles risks for particular sectors, industries and types of taxpayer, for example the High Risk Corporates Program, which focuses on large businesses with complex tax affairs that HMRC find controversial. HMRC’s Risk and Intelligence Service is responsible for collecting, analyzing, interpreting and disseminating the information available to HMRC from various sources using sophisticated software (and is authorized to use criminal investigation powers).

The Disclosure of Tax Avoidance Schemes rules (DOTAS) (which impose an obligation on promoters and certain users of marketed tax avoidance schemes to disclose details of the schemes to HMRC) are a further source of information from which HMRC identifies targets for audit. As a result of information disclosed under these rules, HMRC has investigated, litigated, and in some cases enacted retrospective legislation to close down loopholes in respect of numerous tax avoidance schemes.

HMRC is taking an increasingly aggressive approach to audits, particularly of larger multinationals as a result of political pressure and media attention on multinationals’ tax bills in light of the international focus on Base Erosion and Profit Shifting (BEPS). Issues of particular focus in this context include transfer pricing, permanent establishment (PE), interest deductibility and fixed establishment for VAT. For example, the requirement for businesses seeking an advance pricing agreement for transfer pricing purposes to include in their application an estimate of the potential of diverted profits tax (DPT) to apply to the arrangement has led
to HMRC increasing their audit activities in respect of multinational tax structures and arrangements.

2. **Publishing tax strategy**

The Finance Act 2016 introduced a requirement for large businesses to publish an annual tax strategy online. The measure is aimed specifically at improving compliance by large businesses. The affected entity must set out its risk management and governance arrangements in relation to UK taxation. The publication rules have effect for financial years beginning on or after 15 September 2016. Guidance is provided at [Publish your large business tax strategy](https://www.gov.uk/guidance/large-businesses-publish-your-tax-strategy).

Baker McKenzie London has been involved in assisting a number of clients in preparing their tax strategies, and in our experience the level of detail included in these strategies differs considerably from company to company. We have seen some companies opting for very detailed strategy documents and others taking the opportunity to create global policies, while some choose very short statements.

3. **Conduct of a tax audit**

An audit is initiated by a written notice from HMRC to the taxpayer, which is usually accompanied by an informal request for the taxpayer to provide HMRC with specified categories of information and documents. The audit may be a general "check" of the tax return, with a view to identifying potential issues, or directed at a specific issue which HMRC has previously identified through the risk review. The requests for information and documents will reflect the intended breadth of the audit. Even where the audit is commenced as a general "check" of a return, HMRC will typically have identified particular risks that it wishes to focus on.

For VAT and other indirect taxes, HMRC does not formally "open" any audit, and will simply write to the taxpayer to request information. HMRC
can assess based on its "best judgment" (i.e., HMRC estimates the tax at issue where it does not have actual figures), but normally HMRC will cooperate with the taxpayer to ascertain the relevant facts and amounts involved prior to making the decision to issue an assessment.

HMRC’s approach to settling disputes is set out in its published Litigation and Settlement Strategy (LSS) and further elaborated in the Commentary to the LSS.

HMRC states that it seeks to handle the resolution of issues identified through an audit efficiently and cost effectively, and through a non-confrontational and collaborative approach. In particular, HMRC states that it will: seek to establish, understand, clarify and confirm the relevant facts with the taxpayer as quickly and efficiently as possible; articulate the basis of its enquiries in terms of perceived tax risks early on; and take early specialist advice in complex cases once sufficient facts have been established.

"HMRC will seek to work with the customer to understand fully the relevant facts and law, sharing and testing the strengths and weaknesses of HMRC’s own arguments, and fully understanding and testing the strengths and weaknesses of the customer’s arguments, before reaching a considered view on the strength of its case."

The key to resolving tax audits swiftly and efficiently is often to keep control of the fact-gathering stage. Understanding the focus of HMRC’s enquiries, and providing facts relevant to those enquiries, will not only speed up the fact-gathering stage but also help to narrow the scope of the audit. Early engagement between the tax team and the business will generally put the taxpayer on the front foot, for example by ensuring that all documents and information requested can be easily and quickly located. HMRC will sometimes request to meet with the taxpayer during the fact-gathering stage of an audit, although this is more common with transfer pricing and DPT audits, as noted below.
Particular issues with transfer pricing and DPT Audits

As previously noted, HMRC will often request to meet with the taxpayer during the fact-gathering stage of a transfer pricing or DPT audit as this is perceived to be a cost-effective way to focus the enquiry and gather relevant information. This practice has become increasingly prevalent over recent years.

HMRC is more likely to request meetings with taxpayers where the audit is being conducted by the Large Business directorate of HMRC. Large Business transfer pricing audits frequently involve significant requests to interview considerable (10 to 30) numbers of employees, and also often request large volumes of employee emails. In some cases, HMRC may also request meetings with particular individuals from the businesses’ operational units (e.g., head of sales, head of marketing, etc.).

HMRC will generally ask that the meeting take place at the taxpayer’s offices. HMRC can also interview third party customers in relation to ongoing disputes in order to gain a wider perspective and further information regarding the dispute.

In the more unusual scenario where the transfer pricing or DPT audit is on a smaller scale, and is run by HMRC’s Small/Medium-Sized Business Directorate, requests for meetings with the taxpayer or for volume provision of data are more uncommon, and are likely to be on a smaller scale.

Practical preparation for meeting with HMRC

HMRC does not have the power to compel a taxpayer to attend a meeting. The decision whether to accept, decline or delay a meeting with HMRC, and who to send to the meeting, will depend on the potential benefits and disadvantages of each option which will in turn depend on the specific facts and circumstances of each case. If the decision is taken to decline a meeting, the taxpayer may wish to propose an alternative option, for
example to interview relevant individuals from the business internally and to provide a written note of those interviews to HMRC. In some circumstances, the taxpayer may want to offer a meeting, for example where the facts are particularly complex and HMRC has misunderstood information provided during correspondence.

In order to prepare properly for the meeting, the taxpayer should seek to agree on an agenda for the meeting with HMRC at the earliest opportunity and to confirm who will be attending from HMRC. The taxpayer should take notes at the meeting in order that they can review and comment on any note subsequently produced by HMRC.

Historically, HMRC audits were conducted by the taxpayer’s CCM, who would seek assistance from specialists within HMRC on particular areas. For larger businesses with complex tax affairs, the procedural aspects of the audit (opening the audit, issuing correspondence, setting up meetings, arranging calls and closing the audit) are now conducted by a “caseworker.” However, the substantive issues arising in the audit will be dealt with by appropriate specialists from the relevant areas (e.g., for a large corporate, this may be a corporation tax specialist, and for companies belonging to large multinational groups, transfer pricing specialists). Increasingly, HMRC is also utilizing "accelerated issues coordinators" in transfer pricing or DPT audits, where there is a significant amount of material that has to be progressed in a short period of time.

4. Domestic information gathering powers

HMRC has wide-ranging statutory powers to obtain information and documents for the purposes of checking the tax position (which includes the foreign tax position) of the taxpayer. These powers fall into two categories: (i) the power to issue information notices requesting information and documents; and (ii) the power to inspect the taxpayer’s business premises. HMRC may make a request for information and documents and conduct an inspection of business premises whether or not there is an open audit.
(i) HMRC has the power to issue information notices to the taxpayer and to third parties. The taxpayer may only appeal an information notice that has not been approved before issue by the First-tier (Tax) Tribunal ("Tribunal"). A third party information notice may not be issued without advance approval from the Tribunal (although HMRC has proposed in a consultation document on reform of information powers that it should no longer have to obtain the Tribunal’s permission for such a notice).

The notices will specify the information and documents requested, the means and form by which the documents should be provided and the time period for providing them. There are financial penalties for failing to comply with a formal information notice. HMRC has the right to access computers (at any reasonable time) used in connection with relevant documents, and it is anticipated that HMRC will increasingly demand that documents be provided in electronic form.

(ii) HMRC has power to inspect the taxpayer’s premises, business assets on the premises and business documents on the premises. HMRC will often issue information notices requesting copies of documents in conjunction with an inspection. The power to inspect is just that: a power to examine. HMRC does not have the right to force entry into premises and cannot conduct a search for documents. HMRC’s guidance describes this as a right to look with the eyes, but not to search with the hands. Inspections can be announced (such inspections will normally be arranged at a time that is convenient for the taxpayer) or unannounced (i.e., conducted out of the blue and normally first thing in the morning as a "dawn raid"). Unannounced inspections are rarer in the UK than on the continent, but have become more common over the last few years, increasing by 34% in the period between 2011 and 2017.

It can be a criminal offense, in certain limited circumstances where the request for documents is a formal one that has been approved by the
Tribunal, to destroy documents that have been requested by HMRC in the course of a criminal investigation, and care should be taken to halt any document destruction policies on receipt of an information notice. In the case of a non-criminal tax audit, a failure to provide HMRC with information requested utilizing HMRC’s statutory information gathering powers can lead to daily penalties being levied against an individual or a business.

There are a number of restrictions on HMRC’s power to obtain information and documents. The key restrictions are: (i) relevance; (ii) privilege; and (iii) "power or possession."

(i) An officer of HMRC may only require a taxpayer or third party to produce information and documents that are, in the opinion of the officer, reasonably required for the purpose of checking the tax position of the taxpayer. Challenging widely drawn information requests on the basis of relevance can be a useful tool in narrowing the enquiry and focusing efforts on understanding and resolving the issues, and can lead to the swifter resolution of the audit.

(ii) A taxpayer and a third party are not required to provide copies (or permit HMRC to inspect) documents that are protected from disclosure by legal professional privilege. HMRC will ask the taxpayer to identify documents that it is not disclosing on the grounds of privilege. Where HMRC disputes the taxpayer’s claim to privilege, the Tribunal is empowered to determine whether the documents are privileged. This process involves strict time limits and advice should be sought as early as possible if HMRC disputes a claim to privilege.

(iii) An information notice may only require a taxpayer or a third party to produce information and documents that are in its "power and possession." Possession means physical control over the document and power means the ability to obtain the document, or a copy of it, from whomever holds it. The courts have held "power" to have a wide
meaning in this context and to include de facto power to obtain a
document by influence or otherwise and without great expense. It is
possible that a parent company may be considered to have de facto
power over documents held by subsidiaries, but less likely that a
subsidiary can be said to have de facto power over documents held by
its parent company.

Where a taxpayer or a third party resists providing information requested
by HMRC on the grounds that the documents are not in their power or
possession because they are held by overseas affiliates, we are seeing
HMRC increasingly threatening to use its international information powers
to obtain the documentation (see 5. The international perspective). In
deciding whether to request the information or documents from the
overseas affiliate, the UK taxpayer or third party will need to weigh the
benefits of retaining control of the information flow with losing its ability
to argue the "power and possession" defense, and potentially opening the
floodgates for HMRC to request significant additional documentation held
by those overseas affiliates.

5. The international perspective

The UK is party to over 100 bilateral double tax treaties which provide for
the exchange of information between HMRC and overseas tax authorities
where such exchange of information is foreseeably relevant for carrying
out the provisions of the relevant treaty or the administration of
enforcement of domestic tax laws. The UK has also signed a small but
growing number of bilateral Tax Information Exchange Agreements (TIEAs)
with tax haven jurisdictions which provide similar information exchange
powers.

In addition to these bilateral agreements, the EU Council Directive
2011/16/EU provides for administrative cooperation in the field of taxation
and sets out minimum standards for information exchange between EU
Member States. These include mandatory automatic exchanges of
information (concerning employment income, director’s fees, life insurance products, pensions, and ownership of and income from immovable property) as well as spontaneous information exchange, (for example, where HMRC or the tax authority in the other EU Member State has grounds for supposing there may be a loss of tax in the other state). Under the Directive, “country by country reports” under BEPS Action 13 must also be exchanged, as well as reports of cross-border arrangements under "DAC6."

The UK is also a member of the Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC), which now has 40 members. The forum was established to supplement the ongoing work of national tax administrations and its members exchange information as part of JITSIC’s aim to identify and curb abusive tax schemes at an international level. As a result of the recent expansion of JITSIC, there has been increased use of international information exchanges in recent years, with a far shorter lead time for the process to be completed. The time for an information exchange was previously averaged as over 18 months, but now on occasion has been substantially reduced.

HMRC’s powers to exchange information are subject to a number of restrictions and protections. For example, the OECD Commentary on the information exchange article in the Model Convention (on which most bilateral treaties are based) states that Contracting States are not at liberty to engage in "fishing expeditions” or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Under UK domestic law, HMRC is not permitted to provide information to an overseas tax authority unless it is satisfied that the overseas tax authority is subject to rules of confidentiality as strict as those applying to HMRC in the UK.

However, HMRC is not required to notify a taxpayer before requesting or sharing information about them with an overseas tax authority. It is therefore very difficult for taxpayers to establish and defend against any breach of the restrictions on information sharing in these international
agreements or the domestic law. There are potential public law challenges which can be made, for example, seeking interim injunctions to prevent the exchange or to prevent HMRC from relying on certain information. Early advice should be sought in this regard.

In our experience, HMRC is showing increasing willingness to participate in wide-ranging multilateral information exchanges, seemingly as a result of the international focus on tax, the BEPS process and political pressure to scrutinize the tax affairs of large multinationals. Taxpayers should also be aware of the Fiscalis 2020 program which has been implemented among EU Member States in 2014 to provide funding for multilateral tax information-sharing exercises and IT harmonization between EU Member State tax authorities. The UK’s continued participation in this initiative will depend on whether it remains a member of the EU or not.

6. Strategies for resolving tax audits

In order to develop a successful strategy for resolving issues arising in a tax audit, it is necessary to understand and reflect on HMRC’s approach to resolving disputes. HMRC’s published LSS and associated commentary sets out the framework within which HMRC will settle tax disputes, and applies to all such disputes resolved through civil procedures.

HMRC will only resolve a tax dispute in accordance with the law, both with respect to the substance of the decision and the procedure by which the resolution is put into effect. Where a number of issues arise in an audit, HMRC will not resolve these in a "package deal," and will not compromise its view of the law on one issue in order to resolve others.

If HMRC believes that it would be unlikely to succeed in litigation on an "all-or-nothing" issue (meaning that either 100% of the tax is due or none at all), it will concede the point, and will not attempt to "split the difference" 50:50 with the taxpayer.
The key to resolving an all-or-nothing dispute without ending up in litigation lies in persuading HMRC that the taxpayer has the stronger technical argument through careful technical debate in the correspondence. Even in these circumstances, HMRC may have already formed an entrenched internal policy view from which it cannot be dissuaded, and litigation may be inevitable.

Where the issue is not "all or nothing" but there is a range of alternative approaches which are each reasonably likely alternative outcomes to litigation, HMRC may choose to settle the issue out of court on the basis of one of the alternative outcomes. However, HMRC will not settle for a result which it does not believe to be within the range of appropriate alternative possible outcomes in line with the LSS, and so it will be important for the taxpayer to demonstrate a clear technical basis for any proposed settlement.

HMRC does not have the resource to take forward every potential tax risk, and in deciding whether to pursue a case, will consider the potential tax at stake with respect to the taxpayer, the potential tax at stake with respect to other customers with similar issues, the strength of HMRC's view, as well as the impact/effort or cost/benefit analysis of taking the dispute forward.

However, cases may be taken forward even where the amounts involved are relatively low if, for example, this is deemed appropriate because there is a point of principle or policy at stake, failing to take the case may have an adverse effect on taxpayer behavior, or the decision will have precedent value going forward.

In cases where HMRC's position seems entrenched, often the best way to focus HMRC on potential options for settlement can be for the taxpayer to demonstrate confidence in its case and a willingness to push the matter to litigation, which in many cases will prompt HMRC to think seriously about options for a negotiated settlement. Another option where HMRC has
become entrenched in its view and litigation seems inevitable, is to consider Alternative Dispute Resolution (ADR) procedures such as facilitated discussions. These discussions involve a trained facilitator (who can be another officer from HMRC who has not previously been involved in the matter, or an external third party) who facilitates between the parties and helps them to discuss their options, understand the strengths and weaknesses of their case, and think about alternatives that enlarge the number of potential settlement options.

The decision-making process within HMRC in relation to tax disputes has been overhauled in recent years as a result of comments made by the Parliamentary Committee responsible for overseeing HMRC's accounts and negative stories in the press in relation to alleged "sweetheart" deals between HMRC and large UK corporates. Since 2011, there has been a tax assurance commissioner responsible for the internal governance process within HMRC and for the decision-making process in relation to cases to be litigated, as well as proposed settlement agreements ("HMRC Code of Governance").

Where the same issue arises with respect to more than one taxpayer, HMRC’s approach to resolving that point, and, in particular on whether to pursue litigation, are now determined by the Contentious Issues Panel and the Anti-Avoidance Board, recommendations of which will be considered by three HMRC commissioners, including the tax assurance commissioner. This is also the case with the Transfer Pricing and Diverted Profits Boards who will make recommendations to HMRC’s commissioners on cases that involve these specialist areas.

For standard but complex tax cases, or those that have been referred by caseworkers, where the amount in dispute does not reach certain thresholds or the issue being considered is not sensitive or likely to create an undesired precedent, the review of a case will be undertaken by the Customer Compliance Group Dispute Resolution Board (CCGDRB). Where the same issue arises in more than one case, and the CCGDRB becomes
involved in the decision on whether or not to litigate, considerable delays may arise. Where HMRC is seeking a helpful precedent for use in resolving other cases, it will also want to take the case with the "worst" facts. If the taxpayer's case has "better" facts, (e.g., there is a clear commercial rationale behind the transaction in the taxpayer's case, and no suggestion of avoidance, whereas in other similar cases the transaction was clearly undertaken solely for tax planning purposes), the taxpayer should be alert to the possibility of HMRC delaying the progress of their enquiry so that the weaker case proceeds in the Tribunal first. One useful tool in this scenario is the ability of the taxpayer to apply to the Tribunal for a direction requiring HMRC to issue a closure notice which the taxpayer can then appeal. An application for closure of the audit can only be made if HMRC has had a reasonable period of time and access to sufficient information to form a view and conclude the audit. This is another reason why it is important, in conducting the enquiry, to ensure that the fact-gathering process at the start of the enquiry is as focused and efficient as possible.

If issues arising in the audit are "sensitive," in that a settlement in this case might have a significant and far-reaching impact on HMRC policy, strategy or operations, or prompt significant national publicity or the tax at stake is at least GBP 100 million, any proposed settlement will need to be considered by the Tax Disputes Resolution Board (TDRB), a board made up of directors from business areas across HMRC who are required to consider the terms of the proposed settlement and make recommendations to the Commissioners of HMRC. The TDRB may reject proposed settlements, or apply additional conditions for acceptance. HMRC cannot enter into settlements of this size and nature without the approval of three HMRC Commissioners, who will take into account the recommendations of the TDRB.

Settlement decisions in larger cases below the GBP 100 million threshold may be subject to scrutiny by CCGDRB and the Transfer Pricing and Diverted Profits Board depending on the issue involved. A sample of cases
considered by these boards is also reviewed by the TDRB. These boards will also provide comments and recommendations on the larger cases ultimately reviewed by the TDRB.

As a result of these recent changes to internal governance procedures within HMRC, we are seeing increasing delays in obtaining approval of settlements.

For direct tax, the general position is that HMRC may open an audit into a tax return within 12 months from the date when the tax return is filed or amended. Once an audit is open, HMRC will request information and make enquiries in order to determine if the tax return is correct. When HMRC's enquiries are complete, the audit will be closed by the issue of a closure notice, stating HMRC's conclusions. The closure notice must either state that no amendment of the tax return is required or that amendments required to give effect to HMRC's conclusions must be made.

If HMRC is out of time to open an audit, or the audit has been closed, HMRC may still raise an assessment determining further tax to pay ("discovery assessment") if HMRC discovers that there has been a loss of tax, and either the loss of tax was brought about carelessly or deliberately by the taxpayer; or at the date when the audit was closed or the time limit for opening the audit had expired, HMRC could not have been reasonably expected, on the basis of the information made available to it before that time, to have been aware of that loss of tax, unless the return was prepared in accordance with the generally accepted prevailing practice at the time. There is substantial and complex case law on HMRC's procedural right to raise a discovery assessment.

Generally, an assessment may not be made more than four years after the end of the accounting period. However, this time limit is extended to six years where the loss of tax was brought about carelessly, and 20 years where the loss of tax was brought about deliberately. The limit is extended to 12 years where the loss of tax relates to "offshore matters."
For VAT owed by the taxpayer: HMRC normally has two years from the end of the relevant accounting period to assess for underpaid or over-recovered VAT. If new evidence of facts comes to HMRC’s attention which allows them to justify the raising of an assessment, HMRC will have an additional 12 months from the date it received this information to raise an assessment, so long as the assessment is in any case raised within four years from the end of the relevant accounting period. In addition, HMRC has up to 20 years to assess for VAT where there has been deliberate conduct by the taxpayer to bring about a loss of tax, or where the taxpayer has failed to register for VAT in the UK where it had an obligation to do so.

For VAT owed to the taxpayer: The taxpayer has to make a claim for VAT before the expiry of four years from the end of the relevant accounting period in which the overpayment took place.

7. Consequences of assessments
   
   (a) Interest

   Simple interest is payable on any underpaid tax assessed. The rate of interest for late payment and/or underpayment of tax is 3.25% (the official Bank of England base rate + 2.5%). A lower rate is charged on late payments of interim instalments. Interest is also payable on penalties not paid by the due date. Interest payable on late paid corporation tax is deductible for tax purposes, but interest on other overdue tax is generally not deductible. The amount of interest is not negotiable, even where there is a reasonable excuse or the late payment is a result of an innocent error.

   (b) Penalties

   There is a consolidated regime for culpable errors in returns (and supporting documents) which applies to most taxes. The level of penalty is tax-geared and is determined by whether inaccuracy was careless (up to 30% of the tax lost), deliberate but not concealed (up to 70% of the tax lost), and deliberate and concealed (up to 100% of the tax lost). If the
inaccuracy was a result of an innocent error, but is later discovered by the taxpayer and the taxpayer fails to take reasonable steps to inform HMRC, this will be treated as a careless inaccuracy.

However, if a taxpayer reasonably relies on professional advice in preparing and filing its tax return, it will not be subject to penalties. In order to rely on this defense, the taxpayer must have consulted an adviser it reasonably believed to be competent, the taxpayer must have provided the adviser with the relevant information and documents, the taxpayer must have checked the advisor’s work to the extent that it was able to do so, and the taxpayer must have implemented the advice.

In addition, HMRC has a discretion to reduce the level of penalty depending on the nature and quality of disclosure made by the taxpayer, and whether the penalty is a result of a prompted disclosure, or an unprompted disclosure (i.e., notified to HMRC at a time when the taxpayer had no reason to believe HMRC had discovered the inaccuracy). HMRC has additional powers to reduce penalties in special circumstances and may suspend penalties, provided the taxpayer complies with conditions imposed.

HMRC has power to impose a number of other penalties as well (e.g., where the taxpayer fails to comply with an information request, or fails to observe record-keeping requirements).

(c) Postponement of payment

For direct tax, if the taxpayer appeals the assessment, they may request postponement of payment of the tax due pending the resolution of the appeal in the Tribunal. If HMRC denies the request, the taxpayer may apply to the Tribunal. For indirect tax, the tax assessed will need to be paid before the assessment can be appealed, unless the taxpayer can demonstrate to HMRC or the Tribunal that doing so would cause hardship.
(d) **Follower notices and accelerated payment notices**

These notices are designed to promote early settlement of disputed tax avoidance cases and to change the economics of using tax avoidance schemes by requiring payment of the disputed tax upfront in cases where the same or similar arrangement has been judicially defeated in another party’s litigation, the scheme has been assigned a DOTAS reference number, or is being challenged under the UK’s recently introduced General Anti-Abuse Rule (GAAR). The rules came into effect on 17 July 2014.

HMRC may issue a Follower Notice in the following circumstances:

- HMRC is still enquiring into the return (enquiry cases) or the taxpayer has made an appeal against a closure notice or discovery assessment and the appeal is still ongoing (appeal cases).

- The taxpayer made the return on the basis that a particular tax advantage arose from tax arrangements implemented.

- HMRC is of the opinion that there is a final judicial ruling that is relevant to the taxpayer’s tax arrangements.

A judicial ruling is final if all appeal rights have been exhausted, and so may even be a decision of the Tribunal where no appeal to the Upper Tribunal (Tax and Chancery Chamber) has been pursued or granted. Follower Notices must be issued within 12 months of the judicial ruling, the date the return or the date the appeal was made, whichever is the latest, (although the time limit is extended to two years where the judicial ruling was made before the rules came into force on 17 July 2014).

Upon receipt of a Follower Notice, the taxpayer is required to amend its return or withdraw its appeal. If the taxpayer continues to dispute the case, HMRC has the power to issue a penalty in the amount of 50% of the denied tax advantage. HMRC has stated that it will only issue such penalties where the taxpayer is ultimately unsuccessful and the tax advantage is denied on the same basis as the previously decided case. The
taxpayer may appeal to the Tribunal against the penalty on the basis that it was reasonable in the circumstances for the taxpayer to have continued to dispute the case.

HMRC may issue an accelerated payment notice in enquiry cases and appeal cases where the taxpayer has made its return on the basis that a particular tax advantage arose from tax arrangements implemented, and either HMRC has issued a Follower Notice, the scheme was notifiable under the DOTAS regime, or HMRC has issued a counteraction notice under the GAAR. There have been a number of attempts to judicially review accelerated payment notices on the grounds that they are procedurally unfair, in part as they are not subject to appeal at the Tribunal. However, these have been unsuccessful.

The notice will specify the amount of the accelerated payment, which will be HMRC’s estimate of the additional tax that will be due if the tax arrangements do not succeed. Where an accelerated payment notice has been issued, the taxpayer cannot request postponement of payment of the tax assessed. The taxpayer will be required to make the accelerated payment as a payment on account. Once the accelerated payment is made, interest on the tax in dispute stops accruing and is only payable up to the date of the accelerated payment if the tax arrangements do not succeed. If the taxpayer is ultimately successful in defending the tax arrangements, the payment will be repaid by HMRC with interest.

(e) Publication of deliberate defaulters

HMRC also has power to publish details of "deliberate defaulters" where it charges the taxpayer a penalty for a "deliberate" error, the tax at stake is more than GBP 25,000, the issue was not brought to HMRC’s attention through a voluntary disclosure, and maximum reduction of the penalty was not given for the quality of the taxpayer’s disclosure. Currently these lists are available on the www.gov.uk website, are updated by HMRC approximately every three to four months, and cover both individuals and large and small businesses.

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8. **Conversion to criminal investigation**

HMRC reserves the right to pursue a criminal investigation with a view to prosecute where they consider it necessary and appropriate (see the LSS).

Where criminal proceedings have not been started, HMRC may decide to investigate under the civil fraud procedure. Under the serious tax civil fraud procedure, (Code of Practice 9) the company (or senior employee of the company) is offered immunity from prosecution of tax fraud if the company admits to "deliberate conduct" and makes a complete and accurate disclosure of all their deliberate and non-deliberate conduct that has led to irregularities in their tax affairs ("**Contractual Disclosure Facility**"). If the relevant HMRC officer is satisfied that they have received full disclosure, they will assess for the relevant tax, interest and issue penalties in relation to the deliberate conduct, but also grant immunity from prosecution by HMRC. If HMRC subsequently discovers that the disclosure was inadequate, it is likely to start criminal proceedings against the taxpayer.

If the company denies any deliberate conduct, then it will not receive immunity from prosecution. In those circumstances, HMRC may continue with civil investigation or start criminal proceedings. If HMRC prosecutes, it may use the denial of deliberate conduct as evidence to support a charge of dishonest behavior that led to, or was intended to lead to, the loss of tax.

9. **New offenses aimed at tackling tax evasion**

In the past five years there has been an increasing focus, on international and domestic levels, on tax transparency and efforts to tackle tax evasion. The UK government has been heavily involved in these efforts and has now expanded its focus to enforcement and corporate criminal liability. In the HMRC Single Departmental Development Plan issued in 2015, which covers the period 2015 to 2020, HMRC stated its intention of increasing criminal prosecutions to 100 a year. As a result, it has passed a number of
new tax offenses, including one aimed at enforcing liability in relation to
corporate criminal tax evasion.

The Corporate Criminal Offense of the Failure to Prevent the Facilitation of
Tax Evasion (CCO) came into force on 30 September 2017. The CCO seeks to
punish criminal tax evasion by a UK taxpayer (this includes multinationals
with establishments in the UK and other non-UK entities that carry on any
part of their business in the UK) where the evasion would be criminal
under existing UK law, even if the evasion occurs overseas and leads to a
non-UK tax loss.

The evasion must be criminally facilitated by a natural or legal person who
is associated with a corporation, and the corporation must have failed to
take reasonable steps to prevent such facilitation.

Conduct that contravenes the law of another country may give rise to a
foreign tax evasion offense where under UK law the actions of the
taxpayer and the associated person would be an offense and the overseas
jurisdiction has equivalent offenses at both the taxpayer and the
associated person levels.

The penalties for the offense range between 100% and 300% of the actual
intended gross tax gain, and both aggravating and mitigating factors will
be taken into account. A corporation can defend against the offense by
demonstrating that it has in place reasonable prevention procedures.

10. Diverted profits tax

The DPT is a UK tax targeting profits considered to have been artificially
diverted from the UK corporation tax base, applicable from 1 April 2015.

The tax is designed to counter the use of “aggressive tax planning
techniques used by multinational enterprises to divert profits from the
UK.” It seeks to deter and counteract the diversion of UK profits by groups
that seek to avoid creating a PE in the UK, or use arrangements or entities
that lack economic substance through the creation of deductible expenses or the diversion of income within a group where it is reasonable to assume that this would not have occurred if tax planning had not been a consideration.

DPT has significant implications for the global supply chains of multinational groups which transact with, from or through the UK, whether they are headquartered in the UK or overseas. It can result in foreign corporations being subject to DPT on the profits attributable to a deemed PE in the UK, irrespective of the double tax treaty position, or in the re-characterization of supply chain arrangements involving UK companies to reflect the alternative arrangements that would have been implemented absent tax planning. Further, where there is a deemed avoided PE, any royalties that would have been subject to withholding had the avoided PE been an actual PE, are attributed to the notional profits of the avoided PE and subject to DPT.

The DPT is charged at the rate of 25% on diverted profits, 6% higher than the UK corporation tax rate. Corporations must pay the tax before they can make substantive representations to HMRC or appeal against an assessment on the merits to the Tax Tribunal.

DPT has been designed to create a strong incentive for groups to provide full disclosure of their high-risk transfer pricing arrangements and to encourage early engagement with HMRC on the resolution of transfer pricing audits. At the beginning of 2019, HMRC introduced a new regime in which they invite businesses who in HMRC’s view are potentially within the scope of DPT to register for the "Profit Diversion Compliance Facility" (PDCF). Businesses who receive such an "invitation" must consider whether to commit themselves to making a report, within a six-month period, on their recent approach to transfer pricing, with all relevant details.
II. Resolution procedures

1. Appealing an assessment

For direct tax, the taxpayer will have 30 days from the date of the closure notice, assessment or discovery assessment to appeal to HMRC. This simply requires a straightforward letter to HMRC stating that the taxpayer appeals the assessment and the grounds for that appeal, along with a request for postponement of payment of the tax due. It is permissible to notify the appeal to the Tribunal on the same date as the appeal is made to HMRC. However, if there is no reason to do so, the taxpayer need only make the appeal to HMRC.

Following receipt of an appeal, HMRC will respond, to confirm whether the request for postponement of payment of the tax has been accepted (if HMRC denies the request, the taxpayer may apply to the Tribunal). HMRC will then usually offer to conduct an "internal review" of the decision to issue the closure notice and amend the return or issue the discovery assessment. The internal review is usually carried out by an independent officer of HMRC with no previous connection to the dispute. HMRC is not required to offer this review, and if the review is not offered, there is no time limit by which the taxpayer must notify the appeal to the Tribunal. However, HMRC’s published guidance states that officers should normally always offer a review.

If HMRC offers a review, the taxpayer may either accept the offer of the review or notify the appeal to the Tribunal within 30 days of the date of the offer of a review. If the taxpayer accepts the offer of a review, HMRC will have 45 days (or such longer period as the parties may agree) to conclude the review. If the review upholds or varies the closure notice and amended assessment or discovery assessment, the taxpayer will need to notify the appeal to the Tribunal within 30 days of the date of the letter concluding the review.
For VAT, after HMRC issues a decision to assess (or deny a claim for a VAT repayment), the taxpayer (or relevant interested party) has 30 days to either request a review (an internal review by HMRC) or to appeal directly to the First-tier (Tax) Tribunal. Where the taxpayer requests a review, it is unable to appeal until the end of the review (or when the review is deemed to have ended — 45 days after the request). Any review decision can, within 30 days, be appealed by the taxpayer (or relevant interested party) to the First-tier (Tax) Tribunal.

For Customs & Excise duties, if the taxpayer wants to challenge a decision of HMRC, it must first seek a review within 30 days of the original decision. On receipt of the review decision, the taxpayer can, within 30 days, appeal the review decision to the First-tier (Tax) Tribunal.

The internal review process is predominantly intended to confirm that the correct procedure was followed in issuing the relevant decision, and in our experience, decisions are rarely reversed on substantive grounds through an internal review unless a key technical argument has been missed. A closure notice, or assessment issued in a complex case with the involvement of HMRC policy teams and other specialists, will not be overturned by an internal review. However, the procedure can sometimes provide a valuable extension of time, before the case is notified to the tribunal, in which to continue settlement discussions with HMRC.

Prior to making an appeal in respect of indirect taxes, the taxpayer must pay the tax in dispute to HMRC (unless it can demonstrate to the satisfaction of HMRC, or the First-tier (Tax) Tribunal, that paying the tax in dispute would cause hardship). If the taxpayer is successful at the First-tier (Tax) Tribunal, HMRC is obligated to repay the tax even if it is appealing the judgment of the Tribunal.

Appeals are notified to the First-tier (Tax) Tribunal in Birmingham by email via a seven-page form entitled the "Notice of Appeal" and the taxpayer may wish to submit separate accompanying grounds of appeal.
(taxappeals@justice.gov.uk), or the taxpayer can submit their appeal directly to the Tax Tribunal portal at https://www.gov.uk/tax-tribunal/appeal-to-tribunal.

2. Negotiation, settlement and ADR

It remains possible to seek a negotiated settlement of the appeal with HMRC even after the appeal has been notified to the Tribunal (paragraph 19 of the LSS). The taxpayer may wish to apply for a stay of the appeal in the Tribunal while negotiations are ongoing with HMRC. Once an appeal has been lodged, an application for a stay can be made in writing to the Tribunals Service. If the taxpayer and HMRC are engaged in constructive dialogue, it is often possible to obtain HMRC's consent to the stay prior to making the application to the Tribunal.

Where a closure notice has been issued, a negotiated agreement will be effected through a contract settlement. Any proposed contract settlement should be carefully drafted and reviewed to ensure that it provides full and final settlement of all past issues the taxpayer is seeking to conclude. HMRC cannot enter into forward agreements in respect of future tax liabilities.

Contract settlements at this stage are still subject to HMRC's internal governance procedures (see Strategies for dealing with a tax audit), and may require certain levels of sign-off within HMRC. A contract settlement, whether in respect of a direct tax appeal, or a VAT appeal takes effect as though it were a decision of the Tribunal.

The First-tier (Tax) Tribunal is obligated to seek, where appropriate, to bring to the attention of HMRC and the taxpayer the availability of any appropriate alternative procedure for the resolution of the dispute, and if the parties so wish and provided that it is compatible with the Tribunal's overriding objective to deal with cases fairly and justly, to facilitate the use of such procedure.
The concept of using ADR to resolve tax disputes has been embedded into the LSS, and HMRC has published detailed guidance for officers on utilizing ADR. Mediation is defined by the Centre for Effective Dispute Resolution (CEDR) as "a flexible process conducted confidentially in which a neutral person actively assists parties in working towards a negotiated agreement of a dispute or difference, with the parties in ultimate control of the decision to settle and the terms of the settlement." HMRC increasingly encourages the use of ADR in all commercial and personal tax cases and especially in relation to small to medium cases. A high percentage of cases that are accepted for ADR are resolved through that process.

HMRC has a significant number of officers who have been through training provided by CEDR to become accredited mediators. In large and complex cases, HMRC may also agree to the use of an external third party mediator, and to share the costs of the mediator with the taxpayer.

One of the cornerstones of mediation is that it is a flexible, confidential, voluntary and cost effective process. Mediation is consensus building and can help revive negotiations that have reached an impasse. The introduction of an independent mediator can change the dynamic of the dispute, bringing a fresh perspective and new ideas. The process is intended to assist both the taxpayer and HMRC to gain insight into their case and to foster a positive working relationship going forward. If the mediation is ultimately unsuccessful, nothing is lost as the process is confidential, nothing is shared by the mediator with HMRC without the taxpayer’s consent, and the preparation undertaken for the process will be useful for the subsequent litigation.

As ADR is a more informal process, it typically takes significantly less time than litigation to conclude. HMRC works towards a timetable of three months for facilitated discussions and six months for mediation.
Cases which HMRC accepts as generally suitable for ADR include those: where there is a lack of clarity around each party’s position; where there are entrenched views on both sides and strained relationships between the HMRC case team and the taxpayer’s tax team; particularly fact-heavy cases (such as transfer pricing); cases involving non-tax issues; and those where litigation will not result in a decision of precedential value. Cases that are unlikely to be suitable for mediation include those cases: where the facts are agreed and the only point is legal; where HMRC is seeking judicial precedent; where resolution requires departure from an established HMRC view on a technical issue; where HMRC doubts the strength of the evidence and wants to test it through cross-examination in court; cases with an "all or nothing" outcome; and those where ADR would require a hearing listed in the Tribunal to be postponed.

Taxpayers can request ADR by notifying their CCM, or a caseworker who will make the request to HMRC’s Dispute Resolution Unit (DRU). If the case is considered appropriate for ADR, HMRC will appoint a trained HMRC facilitator to assist the caseworker with the process. Decisions to refuse a request for ADR are reviewed by the ADR Panel. HMRC has indicated that it does not consider ADR to be suitable for disputes about payments, fixed penalties on the grounds of reasonable excuse, tax credits, PAYE or cases that are being dealt with by HMRC’s criminal investigators.

3. Tax litigation

(a) First-tier (Tax) Tribunal

The First-tier (Tax) Tribunal is the UK court of first instance for all tax appeals on direct and indirect tax matters. Once an appeal is notified to the First-tier (Tax) Tribunal, preparation begins for a hearing. HMRC is required to provide the taxpayer with a statement setting out its case; the taxpayer is not required but may seek to respond to technical points raised by HMRC. The parties may seek to agree on a statement of facts, and will exchange lists of documents to be used in the hearing, witness statements from witnesses of facts, experts reports, and summary arguments prior to
the hearing itself. In contrast to many civil law jurisdictions, evidence and argument are presented both orally and in writing in the UK.

Judges in the First-tier (Tax) Tribunal are normally specialists with tax backgrounds and may be assisted by another member of the Tribunal who is a non-lawyer with specialist expertise in the relevant area of tax.

The general rule in the First-tier (Tax) Tribunal is that the parties bear their own costs, irrespective of who wins the case. However, where the case is categorized as complex (on the basis that it will require lengthy or complex evidence or a lengthy hearing, involves a complex or important principle or issue, or involves a large financial sum), a cost-shifting regime applies, such that the losing party is required to pay an amount towards the winning party’s costs (usually in the region of 50 to 70%). The taxpayer may opt out of this cost-shifting regime (usually within 28 days of being notified that the case has been categorized as complex), but will not be able to opt back in at a later date.

There are currently no fees payable in the First-tier (Tax) Tribunal.

(b) Appeals to higher courts

A decision of the First-tier (Tax) Tribunal can be appealed to the Upper Tribunal (Tax and Chancery Chamber) on an arguable point of law with the permission of either the First-tier (Tax) Tribunal or the Upper Tribunal.

Appeals cannot be made on questions of fact, unless the decision was so unreasonable no reasonable decision maker would have made it.

A decision of the Upper Tribunal may be appealed to the court of appeal with the permission of the Upper Tribunal or the court of appeal. Permission will only be granted where the proposed appeal would raise some important point of principle or practice or there is some other compelling reason for the court of appeal to hear the appeal.
A decision of the court of appeal may be appealed to the Supreme Court, either with the permission of the court of appeal, or the permission of the Supreme Court. Permission will only be granted if the appeal raises an arguable point of law of general public importance which ought to be considered by the Supreme Court.

A cost-shifting regime applies in all of the higher courts in the UK, such that the losing party will generally be ordered to contribute to the winning party’s costs.

(c) Questions of European law

Where the outcome of a particular matter turns on an interpretation of a provision of EU law, the UK domestic courts can make an order for reference to the Court of Justice of the European Union (CJEU), on the courts' initiative or at the request of one of the parties. The litigation in the domestic courts will be stayed, pending the decision of the CJEU. Cases involving questions of European law therefore often take significantly longer than purely domestic tax cases.

In contrast to some other Member States, where referrals are generally made by higher appeal courts, in the UK it is not unusual for the First-tier (Tax) Tribunal to make referrals on both direct and indirect tax matters within the European sphere.

If the UK leaves the EU with an agreement, cases pending before the CJEU (where applications have already been lodged) are likely to proceed to a decision.

(d) Judicial review

Not every decision HMRC makes can be appealed to the First-tier (Tax) Tribunal. Where HMRC exercises discretion in reaching a decision, and the taxpayer does not have a statutory right of appeal to the Tribunal, it may be possible for the taxpayer to challenge the decision through judicial review.
An application for judicial review may be brought, for example, on the grounds of illegality (e.g., where HMRC acted outside its statutory powers in making the decision), irrationality (i.e., where the decision was so irrational no rational decision maker would have made it), procedural unfairness (e.g., where HMRC failed to give reasons for reaching a particular decision), or breach of legitimate expectation created by the words or actions of HMRC.

Judicial review is subject to different (and generally more formal and complex) procedural rules than statutory appeals in the Tribunal, and is generally a more expensive process. In most cases, the application for judicial review will be made to the Administrative Court, and in some cases, permission can be sought to transfer the application to the Upper Tribunal.

The courts will only entertain judicial review where the taxpayer has exhausted all other remedies open to it. However, the time limit for making the claim is "promptly," and in any event, within three months of the date of the decision complained of. If a claim is to be made, swift action must be taken, and where other remedies remain open to the taxpayer, a stay may be sought of the judicial review claim pending the outcome of those other avenues of resolution.
III. Competent authority mutual agreement procedure

Where double taxation arises as a result of the actions of one state that is a party to a double tax treaty with the UK (whether that is the result of the actions of HMRC or the overseas tax authority), under the terms of the double tax treaty, the taxpayer may request that HMRC, as the UK competent authority, enter into a mutual agreement procedure (MAP) with the competent authority of the other State, to seek to resolve the double taxation.

Depending on the terms of the double tax treaty, the deadline for requesting MAP is either six years from the end of the accounting period to which the double taxation relates, or (under more recently concluded treaties) three years from first notification of the action giving rise to double taxation.

HMRC will accept protective requests for MAP where the action giving rise to double taxation in the other state is subject to appeals that have not been finalized.

There is no requirement for the MAP to resolve the double taxation. For transfer pricing matters resulting in double taxation, a MAP can also be initiated under the European arbitration convention. The procedures can be requested in parallel. The UK is now beginning to include arbitration clauses, consistent with Article 25(2) of the OECD Model Tax Convention in some of its tax treaties.

Where an agreement is reached by the two competent authorities, HMRC has the authority to give effect to the agreement, irrespective of domestic deadlines for amending returns. HMRC will normally request the taxpayer to submit an amended return based on the negotiated outcome.

While the taxpayer has no formal rights in connection with how MAP negotiations are conducted, HMRC’s competent authority team generally welcomes input from the taxpayer that will assist them in the
negotiations, and will keep the taxpayer informed as the negotiations proceed.

The length of time to reach resolution through MAP will often depend on the other state involved, and may take from as little as six months to more than two years in some cases.

A request for MAP should be made in writing, and provide in detail the tax years concerned, the nature of the action giving rise or expected to give rise to double taxation, the full names and addresses of the entities involved, and the UK taxpayer’s tax office and corporation tax reference number.

HMRC published updated guidance on the UK’s practice in relation to methods for reducing or preventing double taxation in February 2018, in a new Statement of Practice (1 of 2018) on the MAP.

The UK has published draft legislation to allow the implementation of the EU Directive on Tax Dispute Resolution Mechanisms which aims to introduce an effective and efficient framework for resolving double tax disputes.
Section Two

Litigation before the Court of Justice of the European Union
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I. Introduction

EU law’s claim for supremacy, the direct effect of EU law and the cooperation between national courts and the Court of Justice (CJ) within the framework of the preliminary rulings procedure are three issues that are crucial to the importance of the CJ in handling tax controversies.

Under the doctrines of direct effect and supremacy, many EU laws are immediately applicable in the legal systems of the Member States and prevail over provisions of the national law, which are inconsistent with EU law.

National courts must recognize and enforce these rules, as well as any rights and obligations that they create, by setting aside inconsistent domestic laws. Both doctrines concern national legislation and national constitutional law.

To prevent a different construction of provisions in EU law and to ensure the uniform interpretation and application of EU law, the Treaty on the Functioning of the European Union (TFEU, formerly the EC Treaty) has conferred on the CJ the ultimate authority to decide these questions of EU law, particularly through Article 267 of the TFEU. Under Article 267 of the TFEU, where a national court considers a case before it raises a question of EU law and the settlement of this question is necessary to enable it to decide the case, it is permitted, and under certain circumstances obligated, to seek from the CJ a preliminary ruling on the question of EU law.

Therefore, any tax controversy should be thoroughly reviewed for potential inconsistencies with the rules applied by EU law. In particular, rules differentiating between resident taxpayers and non-resident taxpayers (referred to as vertical discrimination) should be subjected to particular scrutiny, since they are bound to be an obstacle to the implementation of the internal market and are, therefore, inconsistent with EU law. If a rule is considered inconsistent with EU law, the parties
concerned should, in the absence of comparable decisions by the CJ, seek the interpretation of the CJ.
II. General points

The Court of Justice of the European Union (CJEU) consists of two courts. These are the CJ, which was known as the ECJ and is the supreme body, and the General Court, which was formerly known as Court of First Instance of the European Communities.

The competences of the two courts differ. The General Court is responsible for certain classes of cases, in particular, direct actions including competition law, state aid, trade, agriculture and trademark cases. In contrast, preliminary rulings from national courts, actions for failure to fulfill obligations under EU law, as well as actions for annulment, are, among others, part of the CJ’s competence. Moreover, the CJ is also competent for appeals against decisions of the General Court.

The advocates general assist the CJ in its tasks. It is their responsibility to present a legal opinion on the cases assigned to them. They give their opinion on a legal solution to the case before the judges deliberate and deliver their judgment with complete impartiality and independence. Their duties should not be confused with those of a prosecutor or a similar official. The EU Commission, as a guardian of the EU’s interests, takes this role. In the past, the CJ often followed the opinion of the advocates general.

1. Indirect taxes

Article 113 of the TFEU specifically provides for the harmonization of indirect taxes (in particular, excise duties and turnover taxes). Since 1967, there have been numerous harmonization measures on such taxes and duties, which have culminated — with respect to VAT — in the Directive on the common system of VAT in 2006 (Directive 2006/112/EC of 28 November 2006, OJ 2006 L 347/; “VAT Directive”). As the system of VAT imposed by the TFEU operates through the national legal systems, Member States are obligated to ensure that their laws and practices are aligned with that system and, hence, with the TFEU rules imposing that
system. If a Member State fails to implement the system properly, taxpayers may have grounds for complaint or action, or they may refuse to pay VAT charges imposed by the Member States in contravention of the VAT Directive. The correct interpretation of the VAT Directive, as well as its correct implementation into national law, is at the center of the majority of all preliminary rulings decided by the CJEU with respect to VAT issues. In addition to the VAT Directive, national laws must also comply with the basic freedoms laid out in the TFEU and the general principles of EU law. However, the current system was intended to be preliminary. Now, the EU plans a far-reaching reform to implement a single EU VAT area. The new rules include regulations to implement further information exchange and cooperation.

2. Direct taxes

(a) Impact of directives

No specific provision is made for the approximation of national laws governing direct taxation, but the framers have deemed them to fall within the competence of the Member States. The basis for action by the EU in this field mainly lies in Article 115 of the TFEU, a general provision applicable to all areas and allowing for the adoption of measures for the approximation of laws, which will have a direct impact on the establishment or functioning of the internal market.

Since all decisions have to be unanimous, it was difficult for the Member States to agree on certain common standards with regard to direct taxes. Therefore, only a few directives, such as the well-known Merger Directive or the Parent-Subsidiary Directive, were implemented.

However, based on the final conclusions of the initiative against base erosion and profit shifting (BEPS) by the Organisation for Economic Co-operation and Development (OECD), the focus of the Member States shifted. They realized that a consistent approach is necessary to avoid further erosion of the tax base. Therefore, they agreed on the Anti-Tax
Avoidance Directives, which include, among others, rules with regard to controlled foreign companies (CFC), interest limitation, hybrid mismatches, exit taxation and general anti-abuse rules.

Furthermore, the former information exchange directive was amended as regards mandatory automatic exchange of information in the field of taxation and in relation to reportable cross-border arrangements as another measure to protect the national tax base. The Member States have to adopt and publish the implementation by 31 December 2019. The national rule has to be applied from 1 July 2020.

(b) Impact of the jurisprudence of the CJEU

Even though there is no right to harmonize the area of direct taxes at the EU level, the direct taxation right of the Member States, however, is restricted by EU law. As repeatedly stated by the court, direct taxation falls within the competence of the Member States, but they must exercise that competence consistently with community law.365

Since then, in numerous decisions in which the CJ applied a rule already in force in fields other than direct taxation by using the TFEU, which sets out the fundamental freedoms of the internal market, the court has defined the obligation to exercise fiscal competence consistently with EU law in accordance with the prohibitions in the fields of the free movement of persons, services and capital, as well as the freedom of establishment of any discrimination or restriction, except if they are justified.

The taxpayer benefits, in particular, from decisions of the CJ on German anti-directive/treaty shopping rules (Deister Holding and Juhler Holding366 followed by the decision in the case GS367). These German rules have been

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found to violate EU law (Parent-Subsidiary Directive and the freedom of establishment). As the rules do not only cover wholly artificial arrangements, the conditions of the rules imply, neither taken individually nor as a whole, the existence of abuse or fraud and the taxpayer is unable to provide alternate proof. Based on this decision, further national regulations can be claimed to be in violation of EU law.

In addition, the CJEU’s judgement (Bevola and Jens W. Trock\textsuperscript{368}) on the deductibility of final losses was in favor of the taxpayer. This was rather surprising because the previous decision, Timac Agro\textsuperscript{369} seemed to end the discussion on the possibility of the deduction of final losses in favor of the Member States, but the CJEU decided in Bevola that if the national rule allows the deductibility of PE losses for a resident PE then it violates EU law if the deduction of losses of foreign PEs is not allowed. In its decisions Memira Holding AB\textsuperscript{370} and Holmen AB,\textsuperscript{371} the CJEU determined what circumstances are required to achieve a deductibility of final losses. Since case law is indecisive, it is recommended to seek a CJEU decision.

Apart from the question of whether tax rules are in accordance with the fundamental freedoms or implemented directives, there is another point to consider regarding EU law. If a national tax rule was only in favor of the resident taxpayer, it could be qualified as a violation of the EU state aid regulation. To harmonize the direct tax regulations, the EU Commission examined whether there were national tax regulations that were not consistent with EU law under state aid aspects and raised actions against the respective regulation or tax rulings. Consequently, the respective Member State was obligated to recover the amount. If, however, the Member State refuses to claim back the tax benefit and files an appeal against the decision, the filing of the appeal does not suspend the

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\textsuperscript{369} Judgment of 17 December 2015, Timac Agro Deutschland, C-388/14, EU:C:2015:829.
\textsuperscript{370} Judgment of 19 June 2019; Memira Holding AB, C-607/17, EU:C:2019:510.
\textsuperscript{371} Judgment of 19 June 2019, Holmen AB, C-608/17, EU:C:2019:511.
\end{flushright}
obligation to recover the payment, which can lead to the Member State being referred to the CJ due to a failure to recover the state aid.

In addition, German courts request a preliminary ruling if they suspect a national regulation is in violation of EU state aid rules. The legislation procedure can be affected as well. As an example, the rule to prevent the forfeiture of losses in case of a necessary restructuring had to be approved by the EU to become effective which significantly delayed legislative proceedings and the application of the rule.
Section Two: Litigation before the Court of Justice of the European Union

III. Procedure

Procedure before the CJ is similar to that followed before national courts. Natural persons or legal entities whose interests are adversely affected by a Member State’s breach of its obligations under the Treaty can call upon the EU Commission to act. They cannot, however, institute proceedings themselves in the CJ.

Whatever the type of case, there is always a written stage and usually — depending on the request of a party — an oral stage, which takes place in open court. Proceedings before the CJ are governed by rules contained in the treaties, the Protocol on the Statute of the Court and its Rules of Procedure.

The oral phase includes the presentation of oral arguments at the hearing and, in important cases regarding a new question of law, ends with the advocate general’s opinion, which is also published on the website of the CJ. The representation of parties in the proceedings by a lawyer is a requirement. Counsel to a party may be a lawyer entitled to practice before a court of a Member State. In preliminary ruling proceedings, if national law does not require parties to be represented by a lawyer in the proceedings before the national court, such parties are entitled to submit their own written and oral observations. The active participation of counsel for the parties to the proceedings concludes with the hearing at which oral arguments are presented. The language of the case is always that of the national court making the reference.

There is no charge or fee payable to the CJ for the proceedings. In a preliminary ruling proceeding, such proceedings before the CJ are a mere interlude in the action before the national court for the parties to the main proceedings. The decision on costs is, thus, a matter for the national court and is to be decided under national rules. Costs incurred by national governments or the EU Commission are not recoverable. Therefore, it has

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372 https://curia.europa.eu/
to be noted that if a tax issue arises in more than one jurisdiction, it may be advantageous to compare the costs in each jurisdiction. Court fees may vary heavily in different countries, thus influencing the decision of where to file a claim to obtain the CJ judgment on a cost-conscious basis.

In the case of references for preliminary rulings, the procedure is outlined as follows.

1. **Written procedure**

In preliminary rulings, proceedings before the court are initiated by the national court's decision to submit questions to the CJ on EU law. During the time of the proceedings before the CJ, the national proceedings are usually stayed. The preliminary rulings procedure under Article 267 of the TFEU is available to any national court or tribunal (with certain exceptions). The discretion (or obligation) to request a reference from the CJ arises where a question of EU law is raised before the national court and this court considers that a decision on that question is necessary to enable it to give judgment. Such decision is at the discretion of the national court and does not require a motion from the parties. An obligation to refer exists for courts "against whose decisions there is no judicial remedy under national law." The parties to the national proceedings are not entitled to make a reference to the CJ on their own initiative.

To obtain a decision from the CJ on the interpretation or validity of EU law, a lawsuit, therefore, must be initialized before a national court. Due to the very nature of the CJ's decisions (which effects the situation in the case at issue, as well as the legal situation in general), one of the first questions to be answered before initiating such a lawsuit is: Where are the chances best for a referral by the national court to the CJ? Most preliminary proceedings in 2017 have been referred to the CJ by Germany, Italy, the Netherlands and Austria, but other European jurisdictions have proven reluctant in this respect in the past. At least in part, this situation can be explained by the mindset of the judges in the various jurisdictions whose inclination to have
national rules made subject to examination by the CJ varies widely. If the same tax issues should arise in more than one country (most obviously, for instance, in cases involving the VAT Directive), it is recommended to check where the national judges have developed a pro-taxpayer attitude and where courts pursue a pro-government approach. Another important issue to be factored in when deciding in which EU Member State a lawsuit should be filed is the likely duration of the proceedings before a national court.

After receiving a copy from the Registry of the CJ of the request for a preliminary ruling, the parties to the proceedings before the national court, and any Member State government that wishes to, may submit a document referred to as "written observations" within two months. The purpose of the written observations is to suggest the answers that the court should give to the questions referred to it on the basis of a thorough analysis of the factual and legal situation. Such written observations should not be considered the means by which to reply to written observations submitted by other interested parties; the parties may only reply to the other parties' documents in the hearing. The written observations are notified to all parties once the written procedure is completed. The CJ may set the maximum length of written pleadings or observations lodged before it.

When drafting documents to be submitted to the CJ, all interested parties need to bear in mind the implications of the translation regularly required for the internal purposes of the court. The language of the case may be different from the working language of the court, the latter of which is currently French. In addition, the judges and advocates general are not required to use the language of the case. Using clear language in the original document is strongly recommended.

2. Oral procedure

The decision to open the oral procedure is taken by the court upon the suggestion of the judge-rapporteur and after hearing the advocate general.
once the written procedure is completed and the necessary translations
have been made.

The hearing starts with oral arguments from counsel for the parties.
Afterward, counsel will answer questions from members of the court. The
hearing will conclude with brief responses from those counsels who wish
to make them. The time for addressing the court is limited by court rules
and rarely exceeds 30 minutes. While the most important part of the
proceedings with respect to the arguments brought forward by each party
is the written procedure, the oral procedure is an opportunity to reply
briefly to the main arguments set out in written observations of other
parties.

According to the statistics of the CJ, the average duration of a preliminary
ruling procedure is 14.7 months from the date of the referral to the
decision by the CJ.
IV. Effect of preliminary ruling

A preliminary ruling on the interpretation of a provision of EU law is binding on the referring court and is binding, de facto, on all national courts, insofar as it answers an abstract question of law that could arise again. Such ruling clarifies and defines, where necessary, the meaning and scope of that provision as it must be or ought to have been understood and applied from the time it came into force. It follows that the rule, as thus interpreted, must be applied by the courts to legal relationships arising from and established before the judgment ruling on the request for interpretation. The CJ has limited the retroactive effect only in a small number of cases in the interest of legal certainty and on the basis of good faith.

If national tax laws are held to be in breach of EU law, any taxes levied on the basis of such laws have to be restituted in principle. When national tax provisions are challenged on the basis of EU law, national time limits and statutes of limitations should apply, but if these rules make it impossible to exercise rights under EU law, EU law prevails.373

Past experience shows that the CJ does not refrain from making decisions that, due to the nature of the process, have a "destructive" effect on a national tax system by implying heavy financial consequences on the national budget. National courts have different tendencies when dealing with EU law, resulting in a notable reluctance to call upon the CJ by some jurisdictions. Member States, however, are obligated to make good on damage caused to individuals by violations of EU law for which they are responsible, if an alleged violation stems from a decision of a national court adjudicating at last instance. However, it is required that the rule of violated EU law is intended to confer rights on individuals, that the breach

is sufficiently serious and there is a direct causal link between that breach and the loss or damage sustained by the injured parties. 374

A taxpayer who considers a national tax rule to be incompatible with EU law should diligently analyze the best way to have their case brought before the CJ. As 28 jurisdictions are involved in proceedings before the CJ, tax litigation in the EU requires careful planning and management of procedures, as well as taking into account the different approaches to EU law in the various Member States. Positive outcomes from the majority of tax-related preliminary ruling procedures at the CJ prove that EU law is a tool that, if handled correctly, may provide invaluable support to a taxpayer in disputes with national tax authorities.

374 Köbler, 30 September 2003, C-224/01, ECR I-10239, para. 59.
Section Three

The Competent Authority Process
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I. Introduction

Competent authority provisions vary little from treaty to treaty. However, despite a general consensus regarding the scope of competent authority jurisdiction, countries may differ on certain points regarding jurisdiction or other aspects of the competent authority procedure.

The OECD has reported a total of 6,605 Mutual Agreement Procedure (MAP) cases pending in OECD member countries as of the end of 2018 (the most recent period for which data is available), which is a 3% decrease in year-end inventory from 2017.\textsuperscript{375} The MAP statistics cover 89 jurisdictions and nearly all MAP cases worldwide. The MAP statistics are reported in total cases and by case type — either transfer pricing cases (i.e., attribution of profits to a permanent establishment or determination of profits between associated enterprises under Articles 7 and 9 of the OECD Model Tax Convention on Income and on Capital ("OECD Model"), respectively) or other cases (i.e., all cases that do not involve transfer pricing). Although more MAP cases were closed in 2018 than in 2017, the number of new MAP cases increased. Transfer pricing cases increased by nearly 20% while other cases increased by more than 10%.

The typical competent authority agreement either sets forth a general interpretation or prescribes a specified result for a particular case. It is often quite brief and conclusory in nature.

II. Overview of the competent authority process

1. Applicable provisions

The competent authority process is a process established by the tax treaty to resolve disagreements or questions regarding the interpretation or application of the treaty. The provisions of most European bilateral tax treaties generally follow those of Article 25 (Mutual Agreement Procedure) of the OECD Model. The 2017 OECD Commentary on Article 25 and the 2007 OECD Manual on Effective Mutual Agreement Procedures (MEMAP) provide the most complete general guidance regarding the intended operation of the competent authority process. In addition, the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project included Action Item 14, Making Dispute Mechanisms More Effective. The final BEPS Action Item 14 report, issued by the OECD in October of 2015, provides a minimum standard, which all OECD member countries, non-OECD G20 and Inclusive Framework member countries have committed to follow, and recommends best practices regarding the competent authority process. Compliance with the minimum standard is being monitored through a peer review process executed by the Forum on Tax Administration’s MAP Forum. Particular bilateral treaties may depart from the OECD Model in certain respects, so the applicable treaty provisions should always be reviewed carefully. In addition, it should be noted that some countries supplement the general guidance provided by the OECD Commentary on the OECD Model with national guidance or other practices regarding the operation of the process, which may impose additional procedural or substantive limitations.

377 Id.
The key aspects of the typical treaty competent authority provisions, and practical and strategic issues relating to those provisions, are outlined below.

2. **Purpose of the competent authority process**

The purpose of the competent authority process is to provide a mechanism for Contracting States to resolve disputes and interpretive questions under the treaty by mutual agreement. The typical treaty provides that officials designated by the Contracting States as their respective "competent authorities" will "endeavor" to resolve "any difficulties or doubts arising as to the interpretation or application of the Convention." Most but not all treaties also permit the competent authorities to "consult together for the elimination of double taxation in cases not provided for by the Convention."

3. **Alternative procedures**

The competent authority process has historically been the only means of promoting the proper application and interpretation of treaties in particular cases on a cross-border basis, although residents of the EU Member States may now also seek resolution of some issues under the EU Arbitration Convention or in the Court of Justice of the European Union. Residents of countries that have added arbitration provisions to their bilateral treaties may also be able to invoke arbitration under such treaties. The BEPS Action 14 Final Report has identified 20 countries, including many, but not all, European countries, that have committed to adopt and implement mandatory binding arbitration procedures as part of

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379 OECD Model, Article 25(3) (2017).
380 Id.
the mutual agreement procedure. As part of the OECD’s Multilateral Instrument (MLI), 29 jurisdictions have opted into mandatory arbitration. Under the MLI, the mandatory binding arbitration rules will apply only if both parties to a treaty have opted in and agree on the procedures to be implemented.

National procedures, such as administrative appeals and litigation, are normally also available to the taxpayer, but these may prove less effective in some cases in avoiding double taxation because of their potential inability to ensure full relief without the agreement of the other Contracting States. While there is no guarantee that the competent authorities will reach an agreement that prevents taxation not in accordance with the treaty or eliminates double taxation in a given case, they have historically done so in the great majority of cases presented to them.

The taxpayer should, however, evaluate all available procedural options at the outset to avoid surprises, as the use of one process may preclude the subsequent use of others. For example, although the standard treaty language states that the taxpayer may seek competent authority consideration “irrespective of the remedies provided by the domestic law of the [Contracting] States,” some countries take the position that

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382 See BEPS Action 14 Final Report Part II (Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Slovenia, Spain, Sweden, Switzerland and the UK are the European countries noted in the report, along with Australia, Canada, Japan, New Zealand and the US).

383 The jurisdictions opting into mandatory arbitration under the MLI are Andorra, Australia, Austria, Barbados, Belgium, Canada, Curacao, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, the Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK.

384 For instance, the Agreement Between Ireland and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Signed on 30 March 2011, Article 25(1); Convention Between the Kingdom of the Netherlands and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income Signed on 26 February 2010, Article 25(1); see also Commentary to Article 25 of the OECD Model, para. 18 (2017).
competent authority consideration may be precluded or delayed if the tax authorities wish to litigate the case in national courts first. Further, where a case has been litigated under domestic law, some countries take the position that the litigation prevents the competent authority from agreeing to an inconsistent result with the competent authority of the other country. It is also important to note that some countries require the taxpayer to seek competent authority consideration in certain circumstances to protect any otherwise available foreign tax credits. 385

385 See Rev. Proc. 2015-40, § 6.04(3)(a) (taxpayers that fail to request competent authority relief may be denied foreign tax credits for the foreign taxes resulting from such adjustments). Specifically, under Treas. Reg. § 1.901-2(e)(5)(i), foreign tax payments are not treated as noncompulsory (which is a requirement for a foreign tax to be creditable in the US) unless a taxpayer has exhausted all remedies to reduce a taxpayer’s liability for foreign tax, which include requesting competent authority procedures under the applicable tax treaties.
III. Scope of jurisdiction

1. Persons permitted to request competent authority consideration

Treaties typically provide that a "person" may present their case for competent authority consideration where they "consider that the actions of one or both of the Contracting States result or will result for him/her in taxation not in accordance with the provisions of [the] Convention."\(^{386}\) Although this standard language is drafted from the perspective of an individual, competent authority consideration is also available to legal entities and is used predominantly by companies rather than by individuals.\(^ {387}\)

Access to competent authority consideration is generally limited to persons who are residents in one of the Contracting States.\(^ {388}\) As noted above, most treaties also permit competent authorities to consider cases of double taxation "not provided for by the Convention."\(^ {389}\) Some competent authorities accept such cases as a general practice while others have generally declined to do so, citing jurisdictional concerns notwithstanding the provisions of the treaty.

Similarly, some but not all competent authorities follow the OECD interpretation of this provision as permitting consideration of cases involving a permanent establishment of a third-country resident and do so where necessary to avoid double taxation, even where neither the permanent establishment nor the company of which it is a part is a resident of one of the Contracting States.

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386 See, e.g., OECD Model, Article 25(2) (2017).
387 See OECD Model, Article 3(1)(a) (2017) (defining "person" to include "an individual, a company and any other body of persons").
389 OECD Model, Article 25(3) (2017).
2. **Broadly applicable agreements**

Normally, treaties also provide that the competent authorities shall consider "any difficulties or doubts arising as to the interpretation or application of the Convention." Most competent authorities take the view that this provision authorizes them to conclude broadly applicable agreements on issues of treaty interpretation, and a number of such agreements have been concluded.

Other provisions of the treaty may support this interpretation of the competent authority’s role as extending beyond the resolution of particular cases. For example, Article 3 (General Definitions) often authorizes the competent authorities to agree on a common meaning of a term not defined by the treaty, although the OECD Model lacks this explicit confirmation.

3. **Future years**

Most competent authorities take the view that they are authorized to resolve issues for future as well as past years. It is on this basis that many competent authorities now routinely conclude advance pricing arrangements or agreements (APAs) to resolve transfer pricing issues for future years (and past years as well, in many cases). BEPS Action 14 identifies the establishment of an APA program as a key best practice and

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390 See, e.g., OECD Model, Article 25(3) (2017).
392 See, e.g., Rev. Proc. 2015-40 § 4.01. The taxpayer may pursue an accelerated competent authority procedure (ACAP) to extend a competent authority resolution to subsequent filed years if the facts and circumstances are the same. Likewise, BEPS Action Item 14 includes as a best practice the resolution of recurring issues in subsequent filed years if the facts and circumstances are the same.
393 See OECD MEMAP, § 6.2 (February 2007).
recommends that countries establish such a program "as soon as they have the capacity to do so" to increase both tax certainty and efficiency.394

4. Limitations of authority

It is important to recognize that the authority of the competent authorities may vary from country to country. There may be legal differences as well as institutional or political differences. There may also be substantial differences stemming from the relationship of the competent authority to other functions of the national tax administration, such as examination, administrative appeals, the judiciary and the legislature.395 Unfortunately, there may also be substantial unilateral restrictions imposed at the national level, such as the exclusion of specified issues from competent authority consideration.396 However, BEPS Action Item 14 provides a number of minimum standards to ensure access to MAP.397

395 BEPS Action Item 14, Part I.A.2.3 (2015) includes as a minimum standard for MAP that Competent Authority staff have the authority to resolve MAP cases under the respective tax treaty without requiring the approval of the audit team.
396 OECD MEMAP § 3.2.4; see also Commentary to Article 25 of the OECD Model, para. 27 (2017).
397 BEPS Action 14 Final Report.
IV. Initiation of proceeding

1. When permitted

The standard Mutual Agreement Procedure Article makes it clear that the taxpayer need not wait for the tax in question to be imposed before requesting competent authority consideration. The OECD Commentary further confirms, for example, that the taxpayer need not wait for the issuance of a formal notice of assessment, if imposition of the tax appears "probable." However, if the case involves the taxation of a particular taxpayer for past taxable periods, many competent authorities prefer to wait until at least a tentative adjustment has been proposed in writing, and some will require the issuance of a formal notice before proceeding, notwithstanding the provisions of the OECD Commentary. Some may, however, agree to proceed at an earlier stage if persuaded that the case involves taxation clearly not permitted by the treaty, such as the improper assertion of a withholding tax obligation.

2. Deadlines and statutes of limitations

Many treaties follow the OECD Model practice of setting a deadline for the submission of competent authority requests. Where a deadline is set by treaty, it is normally — but not always — three years from the date of the "first notification" of the action resulting in taxation not in accordance with the provisions of the Convention.

The term "first notification" is generally interpreted as referring to the date on which the particular taxpayer first receives written notification of the particular action giving rise to the taxation, such as a notice of assessment or demand for payment. The OECD Commentary encourages competent authorities to construe this term liberally, so as not to exclude cases from consideration. However, competent authorities sometimes take

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399 See, e.g., OECD Model, Article 25(1) (2017).
400 Commentary to Article 25 of the OECD Model, para. 21 (2017).
conflicting positions regarding the interpretation of this term, so it is advisable to confirm the relevant interpretations in advance if possible. In addition, it is not entirely clear when the "first notification" should be deemed to occur in the case of a tax collected through withholding, as there is arguably no "action" by the tax authorities involved. The OECD Commentary suggests that the relevant date should be considered to be the date on which the income from which the tax was withheld was paid, or, if the taxpayer can establish that it was not aware of the withholding, the date on which the taxpayer first discovers that it has occurred.401

Although it is inconsistent with BEPS Action Item 14 and OECD MEMAP best practices,402 a few countries have argued that their domestic statutes of limitations may be applied to preclude competent authority consideration even prior to the deadline set by the treaty, although the legal basis for such an argument is unclear.403 More commonly, countries may take the position that their domestic statutes of limitations limit the application of a competent authority agreement if the treaty is silent on the matter of deadlines. Others maintain that this approach is barred by the standard treaty language providing that, "any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." The variety of interpretations applied makes it advisable to confirm the positions of the relevant competent authorities as early as possible.

3. Where initiated

Most treaties require that the competent authority process be initiated in the Contracting State where the person requesting consideration is a resident.404 An exception to this general rule may be provided for

401 Commentary to Article 25 of the OECD Model, para. 24 (2017).
403 See Commentary to Article 25 of the OECD Model, para. 98 (2017).
404 See, e.g., OECD Model, Article 25(1) (2014).
Section Three: The Competent Authority Process

competent authority cases involving the nondiscrimination provisions of the treaty, which cover nationals of the Contracting States even if they are not residents of either state; in nondiscrimination cases under such treaties, the process may, therefore, generally be commenced in the state of nationality.\(^{405}\)

Some treaties, on the other hand, either do not specify where the competent authority process must be initiated, leaving open the possibility that they may be initiated in either Contracting State, or explicitly provide the taxpayer a choice.\(^{406}\) As a practical matter, where the case involves a person in each Contracting State, such as a parent company and its subsidiary, a common practice is to file the competent authority request simultaneously in both states. Some countries require or strongly encourage this approach.

\(^{405}\) OECD Model, Article 24(1) (2017).

\(^{406}\) The BEPS Action Item 14 Final Report, Part I.A.3.1 (2015) includes as a minimum standard for MAP that countries amend Article 25(1) of their bilateral treaties to permit a request for MAP assistance to be made to the competent authority of either Contracting State or, if that is not possible, implement a bilateral notification or consultation process. The OECD Model was modified to allow for the competent authority process to be initiated in either Contracting State. Article 25(1) (2017).
V. Conduct of proceeding

1. Staff

The competent authority almost invariably has staff to assist with the analysis and discussion of cases. The size and training of the staff vary considerably from country to country. They may have a legal, an accounting or, less frequently, an economics background. However, they are normally drawn from the ranks of career tax administrators, often from the examination function. The staff is usually responsible for: developing the underlying facts and analysis of the case; preparing a position paper, if its tax administration initiated the adjustment; or replying to the position paper of the other competent authority. Inadequate staffing levels and resources to support the MAP function have been an issue for some countries. However, this will be addressed to meet the BEPS Action Item 14 Final Report minimum standard, which directs countries to allocate adequate personnel, funding, training and other program needs "to enable competent authorities to carry out their mandate to resolve cases of taxation not in accordance with the provisions of the Convention in a timely and effective manner."\textsuperscript{407}

2. Unilateral relief

Treaties typically provide that the competent authority receiving the request should first evaluate the possibility of providing unilateral relief.\textsuperscript{408} Although relief is provided unilaterally from time to time, it is unfortunately still rare in practice. The case normally proceeds, therefore, to bilateral consideration.

3. Case discussions

Competent authorities normally prefer to discuss and resolve cases in face-to-face meetings. Those with a large number of bilateral cases typically

\textsuperscript{408} See, e.g., Commentary to Article 25 of the OECD Model, para. 32 (2017).
meet frequently, sometimes as often as three or four times per year, while meetings between other competent authorities tend to be less frequent. Competent authorities with established relationships may be more willing to communicate by telephone or other remote means, and this practice appears to be increasing as case inventories grow.

It is important to realize that the taxpayer is not considered a party to the competent authority proceeding, as governments tend to view the proceeding primarily as a means of dividing taxing jurisdiction over the amounts in question. Consequently, the taxpayer is not permitted to participate directly in the competent authority case negotiations. However, most competent authorities are willing to meet on a unilateral basis with the taxpayer to discuss the case, and taxpayers are increasingly being permitted to present their factual view of the case simultaneously to both competent authorities.

4. **Collection of tax**

Competent authorities vary in their willingness or ability to suspend the collection of the amount in dispute during the consideration of the case. Their position is normally governed by local law or practice, although a few competent authorities have agreed to suspend the collection of tax on a bilateral basis. The taxpayer, therefore, may or may not be required to pay part or this entire amount in advance of competent authority consideration.

The OECD MEMAP and the BEPS Action Item 14 Final Report identify suspension of collections during MAP as best practice.\(^{410}\)

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\(^{409}\) OECD MEMAP, § 3.3.2 (February 2007).

5. Timing

The competent authorities are not required by treaty to reach a mutual agreement, and treaties do not set a deadline for the conclusion of such agreements. Competent authorities have come under growing pressure in some countries in recent years to reach agreement more quickly. However, staffing and other resource limitations, and the increased complexity of some cases, have made this an increasingly difficult goal for many to achieve. In many countries, the conclusion of a competent authority proceeding is likely to take at least a year or two, and often longer. The BEPS Action Item 14 Final Report specifies an average time frame of 24 months as a minimum standard for the resolution of MAP cases. Given the MAP Forum peer review process, competent authorities will likely strive to reach a resolution within this period. In addition, the growing acceptance of arbitration should improve resolution time.

6. Basis for agreement

Many competent authorities will attempt to resolve cases on the basis of principle, which the OECD MEMAP and BEPS Action Item 14 has identified as best practice. However, as cases often involve issues on which the countries disagree fundamentally and as there is no mechanism in most treaties to ensure a principled approach, this is not always possible in practice. In this event, the competent authorities are likely to attempt to reach a compromise, even if they are unable to articulate a fully principled basis for it. Such situations lend a certain degree of unpredictability to the competent authority process that may make it more suited for situations

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411 The most recent OECD statistics indicate that the average time for completion of a competent authority case in OECD member countries that reported data was approximately 33 months for transfer pricing cases (30 months in 2017) and 14 months for other cases (17 months in 2017).
412 BEPS Action Item 14 Final Report Part A.1.3 (2015). All countries are working to achieve the minimum standard.
in which the taxpayer’s primary goal is to avoid double taxation, rather than to achieve a particular tax treatment in each country.
VI. Implementation of agreement

Once an agreement has been reached, its implementation does not normally prove problematic in practice.

Required repatriations, currency exchange and other collateral issues are normally addressed in the competent authority agreement.

The taxpayer has the option of rejecting an agreement reached by the competent authorities if it so chooses. However, this is a rare occurrence, as the competent authority process is often the best available means of avoiding double or inappropriate taxation.
Section Four

Tax Dispute Resolution Mechanisms within the EU
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I. Historical and general background

1. Judicial and economic double taxation

From a treaty perspective, there are two types of double taxation:

- Juridical double taxation arises where the same profit or income is subject to tax in the hands of the same legal entity for the same time period by two different countries. Examples of juridical double taxation arise in the event of a conflict of residence, or from an adjustment regarding the attribution of profits to a permanent establishment (PE) dealing with its head office.

- Economic double taxation arises where two countries tax the same profit or income in the hands of two legally distinct entities. It can result from a transfer pricing adjustment between two associated enterprises situated in two jurisdictions.

Transfer pricing adjustments (Article 9 of the OECD Model Tax Convention) currently represent the bulk of international tax disputes in terms of the amounts involved and the complexity of the questions they raise, hence the importance of mechanisms that make it possible to eliminate economic double taxation.

2. Mutual agreement procedure and corresponding adjustments

Both juridical and economic double taxation can be eligible for the mutual agreement procedure (MAP) provided by the applicable bilateral tax treaty (Article 25 of the OECD Model Tax Convention). In the event of economic double taxation resulting from a transfer pricing adjustment, Article 9-2 of the OECD Model Tax Convention (where included in the applicable bilateral treaty) can provide the possibility for the contracting states to eliminate double taxation unilaterally, without the need to open a MAP.
3. Arbitration

Some bilateral treaties further include an arbitration clause in the event of unresolved taxation by the competent authorities under a MAP. For instance, this is the case with the treaties concluded between the United States and Belgium, the United States and France, the United States and Germany, the United States and Spain, and the United States and Switzerland, as well as between Canada and the United States, France and the UK, France and Germany, and the Netherlands and the UK. In these treaties, the arbitration clause may possibly apply to resolve either juridical or economic double taxation.

Moreover, 30 countries opted in for the introduction of a mandatory arbitration provision into their applicable tax treaties through the

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414 Article 24.7 of the USA/Belgium double taxation convention (DTC) signed on 27 November 2006.
415 Article 26.5 of the USA/France DTC signed on 31 August 1994, as amended by the 2009 protocol signed on 13 January 2009.
416 Article 25.5 of the USA/Germany DTC signed on 29 August 1989, as amended by the 2006 protocol signed on 17 August 2006.
417 Article 26 of the USA/Spain DTC signed on 22 February 1990, as amended by the 2013 protocol signed 14 January 2013, which will enter into force on 1 January 2020 for tax determined with reference to a taxable period and on 27 November 2019 for withholding tax and other tax.
418 Article 25.6 of the USA/Switzerland DTC signed on 2 October 1996, as amended by the 2009 protocol signed 23 September 2009, not yet in force.
419 Article 26.6 of the USA/Canada DTC signed on 26 September 1980, as amended by the 2007 protocol signed on 21 September 2007.
420 Article 26 of the UK/France DTC signed on 19 June 2008.
421 Article 25 of the Germany/France DTC signed on 21 July 1959, as amended by the 2015 Protocol signed on 31 March 2015.
422 Article 25 of the UK/Netherlands DTC signed on 26 September 2008, as amended by the 2013 protocol signed on 12 June 2013.
423 Andorra, Australia, Austria, Barbados, Belgium, Canada, Curaçao, Denmark, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, the Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK.
Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI").

The European convention of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (90/663/EEC), amended by the Protocol of 25 May 1999 ("Arbitration Convention") also provides both a MAP and an arbitration mechanism to eliminate double taxation resulting from transfer pricing adjustments and adjustments in the profits attributed to PEs, if both countries involved are EU Member States having implemented the Arbitration Convention (see Section 4 (a) below).

On 10 October 2017, the EU adopted a directive on tax dispute resolution mechanisms in the European Union (2017/1852) ("European Directive," see Section 4 (c) below). The European Directive aims at introducing an effective and efficient framework for the resolution of tax disputes concerning the interpretation and application of tax treaties and conventions.

4. Genesis of the EU Arbitration Convention and the European Directive on tax dispute resolution mechanisms in the EU

This timeline provides an overview of the history of the dispute resolution procedures.

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424 The MLI is the result of the work conducted under and further to the OECD/G20 Base Erosion and Profit Shifting Action 15. The MLI aims at implementing the results of OECD/G20 Base Erosion and Profit Shifting project by the modification of bilateral tax treaties in force. The MLI was signed by more than 90 countries as of 18 November 2019. Pursuant to the MLI, if two countries opted in for the mandatory arbitration clause, this clause will be introduced in the bilateral convention in force between these two countries. The text of the MLI is available here: https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

The European Commission proposed a Directive to eliminate double taxation in the case of transfers of profits between associated enterprises.

25 May 1999

1 January 1995
The Arbitration Convention was initially in force for a five-year period, from 1 January 1995 to 31 December 1999.

23 July 1999
The Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (96/436/EEC) was signed.

13/16
The European Commission proposed a Directive to eliminate double taxation in the case of transfers of profits between associated enterprises.

1 November 2004

28 July 2006
Code of Conduct adopted by Council decision 2006 C 112/01.

2003
Accession of Austria, Finland and Sweden following the ratification of the 1995 Arbitration Convention (95/C 26/01).

2008
Accession of Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia following the ratification of the 2005 Arbitration Convention (2005/C 166/01).

March 2013
JTF adopts report recommending amendments to the Revised Code of Conduct yet to be approved by EU Council (JTF/002/2015/EN).

10 October 2017
Adoption of the European Directive on tax dispute resolution mechanisms (2017/1652).

1 December 2014

9 December 2014

30 June 2019
Deadline for the transposition of the European Directive.

1 July 2019
Application of the European Directive to any complaint submitted from 1 July 2018 onwards relating to questions of double taxation relating to income of capital earned in a tax year commencing on or after 1 January 2018.

Competent authorities of Member States concerned may nevertheless agree to apply this Directive with respect to any complaint that was submitted prior to that day or to earlier tax years.
(a) The Arbitration Convention

It took almost 20 years from the European Commission’s proposal for a council directive "to eliminate double taxation in the event of a transfer of profits between associated enterprises" in the 1970s, to the actual signing of the Arbitration Convention in 1990. The Arbitration Convention only entered into force on 1 January 1995 for a five-year period.

Given the nature of the instrument as a multilateral convention that needed to be ratified by all the Member States to enter into force, its extension beyond 1 January 2000 was not automatic. A protocol amending the Arbitration Convention to the effect that it shall be extended for a further five-year period and shall automatically be extended every five years for a five-year period, unless a contracting state objects, took four and a half years to enter into effect.426 Meanwhile, the Arbitration Convention was ineffective.

Furthermore, the accession of each new Member State to the Arbitration Convention had to be ratified by all the existing EU Member States, which created further delays in the applicability of the Arbitration Convention to cases involving new EU Member States. Specific rules were applied to deal with cases submitted after a Member State’s accession to the Arbitration Convention, but are related to earlier years.

(b) EU Joint Transfer Pricing Forum

(1) Background of the EU Joint Transfer Pricing Forum

The European Union Joint Transfer Pricing Forum (JTPF) was informally set up by the commission in June 2002 and was formally established by a decision of the European Council on 22 December 2006.427 The JTPF works

426 To extend the Arbitration Convention for a period after 1 January 2000, a protocol was issued on 25 May 1999 (1999/C 202/01). The 1999 protocol was ratified by the last contracting state (Italy) on 4 August 2004. The Arbitration Convention therefore became effective on 1 November 2004, with retroactive effect as of 1 January 2000.

427 Decision 2007/75/EC
within the framework of the OECD Transfer Pricing Guidelines and operates on the basis of consensus to propose to the commission pragmatic, non-legislative solutions to practical problems posed by transfer pricing practices within the EU. Since its creation, the JTPF has accomplished significant work to improve the functioning of the Arbitration Convention.

(2) **Main achievements relating to the Arbitration Convention**

The work of the JTPF resulted in the Council’s adoption of a Code of Conduct for the effective implementation of the Arbitration Convention and a Revised Code of Conduct on 30 December 2009.

The Code of Conduct ensures a more effective and uniform application of the Arbitration Convention by all Member States by establishing common procedures concerning the following:

- The starting point of the three-year period, which is the deadline for the taxpayer to present their case to the competent authority.
- The starting point of the two-year period, during which competent authorities must attempt to reach an agreement that eliminates double taxation.
- The arrangements to be followed during the MAP phase provided by the Arbitration Convention.
- The practical arrangements for the arbitration phase provided by the Arbitration Convention in the event that no agreement has been reached by the competent authorities within the first two years of the MAP phase.

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428 2006/C 176/02 (Official Journal of the EU, 28.7.2006).
The Revised Code of Conduct provides common interpretations in the following areas:

- Definition of "serious penalties"
- Scope of the Arbitration Convention
- Interest charged/credited by tax administrations when a case is dealt with under the Arbitration Convention
- Functioning of the Arbitration Convention
- Date from which a case is admissible under the Arbitration Convention
- Interaction of the Arbitration Convention and domestic litigation

Several other reports and communications have been released by the JTPF, including a Final Report on Secondary Adjustments on 18 January 2013, a Communication on Potential Approaches to non-EU Triangular Cases on 25 January 2011, and a Report on Improving the Functioning of the Arbitration Convention in March 2015. The latter document includes recommendations to amend the Revised Code of Conduct.

(c) The European Directive on tax dispute resolution mechanisms in the EU

As part of the EU Action Plan for A Fair and Efficient Corporate Tax System in the European Union, the EU Council adopted the directive on tax dispute resolution mechanisms in the EU on 10 October 2017. It is aimed

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433 The text of the directive is available here: https://eur-lex.europa.eu/legal-content/FR/TXT/PDF/?uri=CELEX:32017L1852&from=EN.
at building on existing systems in the EU, including the Arbitration Convention. However, the scope of this directive is broader than the one of the Arbitration Convention since it encompasses disputes that arise "from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and, where applicable, capital" and also provides for "rights and obligations of the affected persons when such disputes arise." Thus, it covers disputes concerning the interpretation and application of bilateral tax treaties among Member States and is not restricted to transfer pricing disputes and adjustments in connection with the allocation of profits to a PE. Furthermore, the legal nature of the European Directive makes it a more powerful legal instrument than the Arbitration Convention.

The improvements to the current rules are intended to give taxpayers greater certainty when it comes to seeking resolution to their interpretation of tax treaties or double taxation problems. The European Directive sets clearer deadlines for Member States to agree on a binding solution, giving citizens and companies more timely decisions.

Furthermore, Member States have a legal duty to take conclusive and enforceable decisions under the improved dispute resolution mechanisms. If not, the national courts will do this for them. 436

Member States had until 30 June 2019 to bring into force the laws, regulations and administrative provisions necessary to comply with the European Directive. It applies to any complaint, submitted from 1 July 2019 onward, regarding questions of dispute relating to income or capital earned in a tax year commencing on or after 1 January 2018. Competent authorities of Member States concerned may however agree to apply the European Directive with regard to any complaint that was submitted prior to that day or to earlier tax years.


Baker McKenzie
5. Articulation of the application of the Arbitration Convention and the European Directive

By effect of the amendment by the protocol adopted in 1999, the Arbitration Convention has been automatically extended every five years since 31 December 2004, unless contracting states decide otherwise.

The European Directive requires that other mutual agreement procedures or dispute resolution procedures, if any, are terminated to benefit from the European Directive’s application. This would exclude parallel submissions under the Arbitration Convention and the European Directive, although there is no specific provision as of today as to the articulation between the Arbitration Convention and the European Directive.
II. The European Directive on tax dispute resolution: a three-step procedure

The European Directive is applicable to any complaint submitted from 1 July 2019 onwards relating to tax disputes concerning income or capital earned in a tax year commencing on or after 1 January 2018, unless the competent authorities decide to apply the European Directive with regard to complaints submitted prior to 1 July 2019 or to earlier tax years.

1. Step 1: Introducing a recourse under the European Directive

(a) Scope of the European Directive

The European Directive lays down rules on a mechanism to resolve disputes between Member States when those disputes arise from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and, where applicable, capital.

According to its preamble, the European Directive is intended to ensure the effective resolution of disputes concerning the interpretation and application of bilateral tax treaties and the Arbitration Convention, in particular disputes leading to double taxation.

However, its scope is broader, as the European Directive applies to disputes arising from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and capital.

The European Directive defines ‘double taxation’ as the imposition by two or more Member States of taxes covered by an agreement or convention in respect of the same taxable income or capital when it gives rise to either an additional tax charge, an increase in tax liabilities, or the cancellation or reduction of losses that could be used to offset taxable profits.
(b) Deadline for the taxpayer to submit the complaint

The complaint must be submitted by the taxpayer within three years from the receipt of the first notification of the action resulting in, or that will result in, the question in dispute, regardless of whether the affected person has recourse to the remedies available under the national law of any of the Member States concerned.

(c) To whom the request must be submitted

The taxpayer has to simultaneously submit the complaint with the same information to each competent authority, and has to indicate in the complaint which other Member States are concerned.

(d) Required information for a case to be regarded as submitted

A case will be regarded as submitted when the taxpayer provides the competent authorities of each of the Member States concerned with the following information:

- The name(s), address(es), tax identification number(s) and any other information necessary for identification of the affected person(s) who presented the complaint to the competent authorities and of any other person concerned.

- The tax periods concerned.

- Details of the relevant facts and circumstances of the case, including details of structure of the transaction and of the relationship between the affected person and the other parties to the relevant transactions, as well as any facts determined in good faith in a mutual binding agreement between the affected person and the tax administration, where applicable. More specifically, the nature and the date of the actions giving rise to the question in dispute (including, where applicable, details of same income received in the other Member State and of inclusion of such income in the taxable income in the other Member State, and details of the tax charged or that will be charged
in relation to such income in the other Member State), as well as the related amounts in the currencies of the Member States concerned, with a copy of any supporting documents.

- Reference to the applicable national rules and to the relevant agreement or convention. Where more than one agreement or convention is applicable, the affected person making the complaint shall specify which agreement or convention is being interpreted in relation to the relevant question in dispute. Such an agreement or convention shall be the applicable agreement or convention for the purposes of the European Directive.

- The following information provided by the affected person who presented the complaint to the competent authorities, together with copies of any supporting documents:
  
  - An explanation as to why the affected person considers that there is a question in dispute.
  
  - The details of any appeals and litigation initiated by the affected person regarding the relevant transactions and of any court decisions concerning the question in dispute.
  
  - A commitment by the affected person to respond as completely and quickly as possible to all appropriate requests made by a competent authority and to provide any documentation at the request of the competent authorities.
  
  - A copy of the final tax assessment decision in the form of a final tax assessment notice, tax audit report or other equivalent document leading to the question in dispute and a copy of any other documents issued by the tax authorities with regard to the question in dispute where relevant.
Section Four: Tax Dispute Resolution Mechanisms within the EU

- Information on any complaint submitted by the affected person under another MAP or under another dispute resolution procedure under an agreement or convention and an express commitment by the affected person that they will put an end to such other ongoing proceedings, if applicable.

- Any specific additional information requested by the competent authorities that is considered necessary to undertake the substantive consideration of the particular case. The competent authorities of each of the Member States concerned may request this information within three months from the receipt of the complaint. Further requests for information may be made during the MAP if the competent authorities consider this necessary. The taxpayer that receives a request shall reply within three months of receiving the request. A copy of this reply shall also be sent simultaneously to the competent authorities of the other Member States concerned.

(e) Acceptance/rejection of the complaint

Each competent authority shall acknowledge receipt of the complaint within two months from the receipt of the complaint. Each competent authority shall also inform the competent authorities of the other Member States concerned of the receipt of the complaint within two months of the receipt.

The competent authorities of each of the Member States concerned shall make a decision on the acceptance or rejection of the complaint within six months of the receipt thereof or within six months of the receipt of the additional information, whichever is later. The competent authorities shall inform the affected person and the competent authorities of the other Member States of their decision immediately. Within a period of six months from the receipt of a complaint, or within six months of the receipt of the additional information, whichever is later, a competent authority may decide to resolve the question in dispute on a unilateral basis, without involving the other competent authorities of the Member
States concerned. In such cases, the relevant competent authority shall notify the affected person and the other competent authorities of the Member States concerned without delay, following which the proceedings under this directive shall be terminated.

(f) **Introducing a parallel recourse under bilateral treaties**

The submission of a complaint as provided under Article 3 puts an end to any other ongoing proceedings under the MAP or dispute resolution procedure under an agreement or convention that is being interpreted or applied in relation to the relevant question in dispute. Other ongoing proceedings concerning the relevant question in dispute shall end with effect from the date of the first receipt of the complaint by any of the competent authorities of the Member States concerned.

(g) **Articulation with judicial proceedings**

The fact that the action of a Member State that gave rise to a question in dispute has become final under national law shall not prevent the affected persons from having recourse to the procedures provided for in the European Directive.

The submission of the question in dispute to procedures covered by the European Directive does not prevent a Member State from initiating or continuing judicial proceedings or proceedings for administrative and criminal penalties in relation to the same matters.

The taxpayers may have recourse to the remedies available to them under the national law of the Member States concerned. However, where the affected person has commenced proceedings to seek such a remedy, the terms of the six-month period (period under which the competent authorities have to make a decision on the acceptance or rejection of a complaint) and the two-year period (period under which the competent authorities have to endeavor to resolve the question in dispute) respectively shall commence from the date on which a judgment delivered
in those proceedings has become final or on which those proceedings have otherwise been definitively concluded or where the proceedings have been suspended.

Where a decision on a question in dispute has been rendered by the relevant court or other judicial body of a Member State, and the national law of that Member State does not allow it to derogate from the decision, that Member State may provide that:

- Before an agreement has been reached by the competent authorities of the Member States concerned under the MAP on that question in dispute, the competent authority of that Member State is to notify the competent authorities of the Member States concerned of the decision of the relevant court or other judicial body, and that that procedure is to be terminated as from the date of such notification.

- Before the affected person has made a request for an Advisory Commission to be set up as will be described below, the provisions relating to the resolution by an Advisory Commission do not apply if the question in dispute had remained unresolved during the whole of the MAP. In this case, the competent authority of that Member State is to inform the competent authorities of the Member States concerned of the effect of the decision of the relevant court or other judicial body.

- The dispute resolution process with the Advisory Commission is to be terminated if the decision of the relevant court or other judicial body was rendered at any time after an affected person made a request to set up an Advisory Commission but before the Advisory Commission or the Alternative Dispute Resolution Commission (described below) has delivered its opinion to the competent authorities of the Member States concerned. In this case, the competent authority of the relevant Member State concerned is to inform the other competent authorities of the Member States concerned and the Advisory Commission or the
Alternative Dispute Resolution Commission of the effect of the decision of the relevant court or other judicial body.

(h) Denial of access

A taxpayer may be denied access to the dispute resolution procedure provided by the European Directive where penalties were imposed in that Member State in relation to the adjusted income or capital for tax fraud, willful default and gross negligence.

Where the commencement of judicial or administrative proceedings could potentially lead to such penalties, and if these proceedings were being conducted simultaneously with any of the proceedings referred to in the European Directive, a competent authority may stay the proceedings under the European Directive, as of the complaint’s date of acceptance until the date of the final outcome of those proceedings.

Member States may deny access to the dispute resolution procedure on a case-by-case basis, where a question in dispute does not involve double taxation. In this case, the competent authority of said Member State has to inform the taxpayer and the competent authorities of the other Member States concerned without delay.

(i) Other aspects

Some of the issues expressly dealt with by the Revised Code of Conduct and/or by reports of the EUJTPF as described in Part III below (e.g., thin capitalization, secondary adjustments, triangular cases) are not specifically addressed by the European Directive as of today.

2. Step 2: The MAP under the European Directive

(a) Two-year period

Where the competent authorities of the Member States concerned accept a complaint, they must endeavor to resolve the question in dispute by
mutual agreement within two years, starting from the last notification of a decision of one of the Member States on the acceptance of the complaint.

The period of two years may be extended by up to one year at the request of a competent authority of a Member State concerned to all of the other competent authorities of the Member States concerned, if the requesting competent authority provides written justification.

Where the competent authorities of the Member States concerned have not reached an agreement on how to resolve the question in dispute within the two-year period, the competent authority of each of the Member States concerned have to inform the affected person and indicate the general reasons for the failure to reach agreement.

Where the case has been submitted to a court or tribunal, the two-year term is computed from the date on which a judgement delivered in those proceedings has become final, on which those proceedings have otherwise been definitively concluded or where the proceedings have been suspended.

(b) Outcome of the MAP phase under the European Directive

The competent authorities have to endeavor to resolve the question in dispute by mutual agreement within two years (possibility extended by one year) of the last notification of the decision of one of the Member States on the acceptance of the complaint.

Once the competent authorities have reached an agreement as to how to resolve the question in dispute within this period, the competent authority of each of the Member States concerned must immediately notify this agreement to the affected person, as a decision that is binding on the authority and enforceable by the affected person, subject to the affected person accepting the decision and renouncing the right to any other remedy, where applicable.
Where proceedings regarding other remedies have already commenced, the decision shall only become binding and enforceable once the affected person has provided evidence to the competent authorities of the Member States concerned that action has been taken to terminate those proceedings. Such evidence should be provided no later than 60 days from the date on which the decision was notified to the affected person. The decision shall then be implemented without delay, irrespective of any time limits prescribed by the national law of the Member States concerned.

Double taxation is regarded as eliminated if the profits are included in the computation of taxable profits in one state only, or if the tax chargeable to those profits in one state is reduced by an amount equal to the tax chargeable on them in the other.

3. **Step 3: The arbitration phase**

Where the competent authorities of the Member States concerned have not reached an agreement on how to resolve the question in dispute within the two-year period (possibly extended by one year), the competent authority of each of the Member States concerned has to inform the affected person and indicate the general reasons for the failure to reach agreement.

This phase, which follows the MAP phase, is referred to as the arbitration phase.

The arbitration phase is divided into three periods, during which the competent authorities must constitute an Advisory Commission or an Alternative Dispute Resolution Commission. The latter has to render its opinion and the competent authorities must reach a final decision.

(a) **The choice of the dispute resolution method**

The choice of the method for dispute resolution should be flexible, which could be either through ad hoc structures or through more permanent structures. Dispute resolution procedures could take the form of an
Advisory Commission consisting of both representatives of the tax authorities concerned and independent persons of standing, or could take the form of an Alternative Dispute Resolution Commission (the latter providing flexibility in the choice of dispute resolution methods).

(1) Constitution of an Advisory Commission

Upon a request made by the affected person to the competent authorities of the Member States concerned, an Advisory Commission should be set up by such competent authorities where:

- The complaint submitted by such affected person was rejected by at least one, but not all, of the competent authorities of Member States concerned, or
- The competent authorities of the Member States concerned failed to reach an agreement on how to resolve the question in dispute by mutual agreement within two years (possibly extended by one year).

The Advisory Commission is composed of the following:

- One chair
- One representative of each competent authority concerned (if the competent authorities agree, the number of such representatives may be increased to two for each competent authority)
- One independent person of standing, who should be appointed by each competent authority of the Member States concerned from a pre-existing list of persons of standing (if the competent authorities agree, the number of such persons appointed may be increased to two for each competent authority)
The list of independent persons of standing\footnote{The list of independent persons of standing is available on the website of the European Council (https://www.consilium.europa.eu/uedocs/accords/tables/1990093.pdf).} consists of all the independent persons of standing nominated by the Member States. For this purpose, each Member State has to nominate at least three individuals who are competent and independent, and who can act with impartiality and integrity.

Each Member State has to notify the Advisory Commission of the names of the independent persons of standing it has nominated. Each Member State must also provide the commission with complete and up-to-date information regarding those persons' professional and academic background, their competence, their expertise and any conflicts of interest that they may have. Member States may specify in the notification which of those persons may be appointed as a chair.

The Advisory Commission should be set up no later than 120 days from the receipt of the request. Once set up, its chair shall inform the affected person thereof without delay.

(2) Constitution of an Alternative Dispute Resolution Commission

The competent authorities of the Member States concerned may agree to set up an Alternative Dispute Resolution Commission instead of an Advisory Commission. The competent authorities of the Member States may also agree to set up an Alternative Dispute Resolution Commission in the form of a committee that is of a permanent nature ("Standing Committee").

An Alternative Dispute Resolution Commission may apply, where appropriate, any dispute resolution processes or technique to solve the question in dispute in a binding manner. As an alternative to the type of dispute resolution process applied by the Advisory Commission, i.e., the independent opinion process, any other type of dispute resolution process,
including the "final offer" arbitration process (otherwise known as "last best offer" arbitration), can be agreed by the competent authorities of the Member States concerned and applied by the Alternative Dispute Resolution Commission.

(b) The opinion of the Advisory Commission or the Alternative Dispute Resolution Commission

The Advisory Commission or the Alternative Dispute Resolution Commission has to deliver its opinion to the competent authorities of the Member States concerned no later than six months after the date on which it was set up. Where the Advisory Commission or Alternative Dispute Resolution Commission considers that the question in dispute would need more than six months to deliver an opinion, this period may be extended by three months. The Advisory Commission or Alternative Dispute Resolution Commission must inform the competent authorities of the Member States concerned and the affected persons of any such extension.

The Advisory Commission or Alternative Dispute Resolution Commission has to base its opinion on the provisions of the applicable agreement or convention that provide for the elimination of double taxation of income and, where applicable, capital, as well as on any applicable national rules.

The Advisory Commission or Alternative Dispute Resolution Commission has to adopt its opinion by a simple majority of its members. Where a majority cannot be reached, the vote of the chair should determine the final opinion. The chair has to communicate the opinion of the Advisory Commission or Alternative Dispute Resolution Commission to the competent authorities.
(c) Costs of proceedings

The expenses of the independent persons of standing\(^{438}\) and the fees of the independent persons\(^{439}\) have to be shared equally among the Member States unless the affected person has made:

- A notification of withdrawal of complaint
- A request following a rejection and the Advisory Commission has decided that the relevant competent authorities were correct in rejecting the complaint

Costs that are incurred by the taxpayer shall not be borne by Member States.

(d) The decision of the competent authorities

The competent authorities concerned have to agree on how to resolve the question in dispute within six months of the notification of the opinion of the Advisory Commission or Alternative Dispute Resolution Commission.

The competent authorities may make a decision that deviates from the opinion of the Advisory Commission or Alternative Dispute Resolution Commission. However, if they fail to reach an agreement as to how to resolve the question in dispute, they shall be bound by that opinion.

The final decision shall be binding on the Member States concerned and shall not constitute a precedent. The final decision has to be implemented subject to the affected person(s) accepting the final decision and renouncing the right to any domestic remedy within 60 days of the date when the final decision was notified.

\(^{438}\) For an amount equivalent to the average of the usual amount reimbursed to high-ranking civil servants of the Member States concerned.

\(^{439}\) Limited to EUR 1,000 per person per day for every day on which the Advisory Commission or Alternative Dispute Resolution Commission meets.
The competent authorities may agree to publish the decision, in full or in part, subject to the consent of the enterprises concerned.
III. The Arbitration Convention: a three-step procedure

The Arbitration Convention is applicable to claims commenced on or after 1 July 2019 which deal with disputes relating to taxable periods beginning before 1 January 2018, and to claims commenced before 1 July 2019 (unless the competent authorities decide to apply the European Directive in the case of claims lodged before 1 July 2019 or for taxable periods beginning before 1 January 2018). It also remains applicable to complaints submitted after 1 July 2019, concurrently with the applicability of the European Directive; the articulation between the two mechanisms has not been expressly clarified to date, except for the exclusion of parallel recourses under the directive and other conventions.

1. Step 1: Introducing a recourse under the Arbitration Convention

(a) Scope

(i) General scope

According to its title, the Arbitration Convention is intended to eliminate "double taxation in connection with the adjustment of profits of associated enterprises." However, its scope is broader, as Article 4 of the Arbitration Convention encompasses not only transfer pricing adjustments between associated enterprises (Article 9 of the OECD Model Tax Convention) but also certain adjustments in connection with the allocation of profits to a PE (Article 7 of the OECD Model Tax Convention).440

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440 Article 1 of the Arbitration Convention:

1. Where: (a) an enterprise of a contracting state participates directly or indirectly in the management, control or capital of an enterprise of another contracting state; or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one contracting state and an enterprise of another contracting state, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises, then any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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The report issued by the JTPF in March 2015 notes that:

The issue of whether a PE exists (Article 5 OECD MTC) is indeed not covered by the AC [Arbitration Convention]. Disputes on this issue may therefore only be solved by other means, e.g., MAP under an applicable Double Taxation Convention (DTC). However, once the existence of a PE is established, the AC should be applicable to solve an eventual dispute on the amount of profit attributable to this PE.

Therefore, in order to clarify the articulation between the conventional MAP and the European arbitration, the JTPF recommended adding the following paragraph to the Revised Code of Conduct in its March 2015 report:

If access to the Arbitration Convention or the treatment of cases under the Arbitration Convention depends directly on the result of a mutual agreement procedure under an applicable Double Taxation Convention, care should be taken to ensure that the deadline under Article 6(1) of the Arbitration Convention does not expire. The enterprise should file separate requests for a mutual agreement procedure under the Arbitration Convention and a mutual agreement procedure available under the applicable Double Taxation Convention. The requests may be combined in one letter. The two-year period referred to in Article 7 (1) AC will not start before the issue addressed under the Double Taxation Convention is solved.441

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2. Where an enterprise of a contracting state carries on business in another contracting state through a permanent establishment (PE) situated therein, there shall be attributed to that PE the profits that it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

441 JTPF/002/2015/EN - n°8.
(2) Losses

The Arbitration Convention also applies where any of the enterprises concerned have incurred losses rather than gained profits.

In its March 2015 report, the JTPF recommended that the Revised Code of Conduct should be amended to clarify that, "an action ... does not require that the transfer pricing adjustment ... leads to an actual payment of tax." 442

(3) Thin capitalization

The Revised Code of Conduct states: "profit adjustments arising from financial relations, including a loan and its terms, and based on the arm's-length principle are to be considered within the scope of the Arbitration Convention." A few countries have lodged reservations about this statement. 443

(4) Secondary adjustments

Secondary adjustments are defined by the OECD as adjustments that arise from imposing tax on a secondary transaction, i.e., a constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends, constructive equity contributions or constructive loans.

The Final Report on Secondary Adjustments, published by the JTPF on 18 January 2013, notes that the application of secondary adjustments may lead to double taxation. It recommends that Member States do not apply secondary adjustments where this is not compulsory. Where secondary adjustments are compulsory under the legislation of a Member State, it is

442 JTPF/002/2015/EN - n°5.
443 Bulgaria, Czech Republic, the Netherlands, Greece, Hungary, Italy, Latvia, Poland, Portugal, Slovakia.

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recommended that Member States provide ways and means to avoid double taxation by endeavoring to solve it where secondary adjustments are compulsory under the legislation of a Member State, through a MAP.

In their responses to a questionnaire on secondary adjustments,\textsuperscript{444} most Member States that apply secondary adjustments stated that they do not consider double taxation issues resulting from secondary adjustments as covered by the Arbitration Convention, since only a few consider these covered by the Arbitration Convention. Some other Member States indicated that the applicability of the Arbitration Convention to secondary adjustments remains an open question for them. However, most Member States applying secondary adjustments would be willing to address these in the course of a MAP. Therefore, in cases where it is not possible to avoid double taxation at the outset, in the event of potential double taxation resulting from a secondary adjustment, a taxpayer would have to file two requests: a request under the Arbitration Convention and a request for a MAP. The latter would require, in each case, the conclusion of a treaty between Member States that includes a MAP provision comparable to Article 25 of the OECD Model (preferably including an arbitration clause per Article 25 (5) OECD Model).

(5) Triangular cases

An EU triangular case is defined as a case where, in the first stage of the Arbitration Convention procedure, two competent EU authorities cannot fully resolve an instance of double taxation arising in a transfer pricing case because an associated enterprise situated in another Member State had a significant influence in contributing to a non-arm’s-length result. According to Article 1.1 of the Revised Code of Conduct, EU triangular cases are included in the scope of the Arbitration Convention.

The Revised Code of Conduct provides guidance on how to deal with such cases. In the event of an EU triangular case, the competent authorities

\textsuperscript{444} JTPF/018/REV1/2011.
should immediately invite the other EU competent authority to take part in the proceedings and discussions as an observer or as an active stakeholder, and they should decide together on what approach they favor. Different approaches may be adopted, though the Revised Code of Conduct encourages the competent authorities to apply a multilateral procedure to resolve such double taxation cases where possible. As soon as possible, the taxpayer should inform the tax administrations involved that one or more other Member State(s) could be involved in the case.

Non-EU triangular cases are triangular cases where the associated company, identified as being the source of non-arm's-length results in a chain of relevant transactions or financial relations, is situated outside the EU. Non-EU triangular cases are not addressed in the Revised Code of Conduct, but were the subject of work by the JTPF.

(b) Deadline for the taxpayer to submit the case

The taxpayer may present their case within three years of the first notification of the action that results or is likely to result in double taxation, which in turn falls within the scope of the Arbitration Convention.

The Revised Code of Conduct states that the date of the “first tax assessment notice or equivalent that results or is likely to result in double taxation within the meaning of Article 1 of the Arbitration Convention, e.g., due to a transfer pricing adjustment,” should be considered the starting point for the three-year period.

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445 Article 6 (2) (b) of the Revised Code of Conduct: The competent authorities can decide to adopt a multilateral approach, a bilateral procedure or several bilateral procedures.


447 A reservation was lodged by Italy.
(c) To whom the request must be submitted

The request for the opening of a MAP under the Arbitration Convention may be presented by the taxpayer to the competent authority of the state of which it is an enterprise or in which its PE is situated.

(d) Introducing a parallel recourse under bilateral treaties

In practice, taxpayers should generally file a request to open a MAP under both the applicable bilateral treaty and the Arbitration Convention (except when the deadline to present a case under one of those procedures has expired).

(e) Articulation with judicial proceedings

Taxpayers can initiate recourses under the Arbitration Convention and/or bilateral treaties irrespective of the remedies provided by the domestic law, i.e., in practice in parallel with domestic judicial recourses. Symmetrically, the submission of a case to the MAP or Advisory Commission under the Arbitration Convention does not prevent a Member State from initiating or continuing judicial proceedings or proceedings for administrative penalties in relation to the same matters.

However, where the domestic law of a Member State does not permit the competent authorities of that state to derogate the decisions of their judicial bodies, the taxpayer cannot request the opening of a MAP procedure under the Arbitration Convention, unless it has allowed the time provided for appeal to expire or has withdrawn any such appeal before a decision has been delivered.

The question of the articulation of the two types of recourses is relatively complex and depends on each country’s legal system. It is recommended that it be carefully analyzed before lodging recourse under one or the other as the order in which proceedings are initiated may matter.
(f) Denial of access

A taxpayer may be denied access to the Arbitration Convention where final legal or administrative proceedings have resulted in a final ruling that, by action giving rise to an adjustment within the scope of the Arbitration Convention, one of the enterprises concerned is liable to a serious penalty.

A decision is considered final when it can no longer be appealed; either it has not been disputed by the taxpayer and the period for appeal has expired, or it has been challenged by the taxpayer and confirmed by a decision than can no longer be appealed. In the event of a pending recourse against a serious penalty, the competent authorities may suspend the proceedings under the Arbitration Convention until the resolution of the pending recourse.

A list of what different countries regard as a "serious penalty" can be found under the Individual Declarations on Article 8 of the Arbitration Convention and reproduced in the annex of this chapter.

In its March 2015 report, the JTPF recommended adding the following to the actual Revised Code of Conduct: "Member States should consider providing domestic legal remedies for determining whether the denial of access to the Arbitration Convention by their administrative bodies is justified."448

2. Step 2: The MAP under the Arbitration Convention

(a) Two-year period

The competent authorities should reach an agreement that eliminates double taxation within two years of the date on which the case was first submitted to one of them, otherwise they should set up an Advisory Commission (see step 3 described hereafter). Both competent authorities

448 JTPF/002/2015/EN - n°9.

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may, with the consent of the taxpayer, waive this two-year period if they are about to reach an agreement.

The Revised Code of Conduct specifies that the two-year period starts on the latest of the following dates:

- The date of the tax assessment notice, i.e., a final decision of the tax administration on the additional income, or equivalent.
- The date on which the competent authority receives the request and all the information necessary to regard it as properly submitted.

Where the case has been submitted to a court or tribunal, the two-year term is computed from the date on which the judgment of the final court of appeal was given.

(b) **Required information for a case to be regarded as submitted**

A case will be regarded as having been submitted when the taxpayer provides the following:

(a) Identification (such as name, address, tax identification number) of the enterprise of the Member State that presents its request and of the other parties to relevant transactions

(b) Details of the relevant facts and circumstances of the case (including details of the relations between the enterprise and the other parties to the relevant transactions)

(c) Identification of the tax periods concerned

(d) Copies of the tax assessment notices, tax audit report or equivalent leading to the alleged double taxation

(e) Details of any appeals and litigation procedures initiated by the enterprise or the other parties to the relevant transactions and any court decisions concerning the case
(f) An explanation by the enterprise of why it thinks that the principles set out in Article 4 of the Arbitration Convention (arm’s-length principle) have not been observed

(g) An undertaking that the enterprise shall respond as completely and quickly as possible to all reasonable and appropriate requests made by a competent authority and have documentation at the disposal of the competent authorities

(h) Any specific additional information requested by the competent authority within two months of the receipt of the taxpayer’s request

The Revised Code of Conduct indicates that if the competent authority believes that the enterprise has not submitted the minimum information necessary for the initiation of a MAP, it should invite the enterprise, within two months of the receipt of the request, to provide the authority with the specific additional information it needs.

In its March 2015 report, the JTPF recommended that the above-mentioned point h. be amended as follows:

Requests for additional information and responses to those requests should be complete, well-targeted and submitted without unnecessary delay (responses should be sent to both CAs). Failure to cooperate during any part of the procedure of the Arbitration Convention may have direct consequences on the length of time needed to obtain relief and whether such relief can ultimately be provided.449

(c) Proceedings during the mutual agreement phase under the Arbitration Convention

The Revised Code of Conduct encourages Member States to take appropriate measures to speed up the proceedings. The competent


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authority should acknowledge receipt of a taxpayer’s request to initiate a MAP within one month of the receipt of the request, and at the same time, inform the competent authority(ies) of the other Member State(s) involved in the case. A common working language should be agreed upon. The taxpayer should be kept informed by the competent authority to which they made the request of all significant developments that affect them during the course of the procedure.

(d) Outcome of the MAP phase under the Arbitration Convention

Double taxation is regarded as eliminated if either the profits are included in the computation of taxable profits in one state only, or if the tax chargeable to those profits in one state is reduced by an amount equal to the tax chargeable on them in the other.

3. Step 3: The arbitration phase

If the competent authorities concerned fail to reach an agreement that eliminates double taxation within two years of the date on which the case was first submitted to one of them, they should set up an Advisory Commission charged with delivering its opinion on the elimination of the double taxation in question. This phase, which follows the MAP phase, is referred to as the arbitration phase of the Arbitration Convention.

The arbitration phase is divided into three periods of six months, during which the competent authorities must constitute an Advisory Commission. The latter must render its opinion and the competent authorities must reach an agreement.

(a) Constitution of an Advisory Commission

The Advisory Commission should, in principle, be established by the competent authorities no later than six months following the expiry of the
two-year period, in order for them to reach an agreement under the MAP phase.\textsuperscript{450}

The Advisory Commission is composed of the following:

- A chair

- Two representatives of each competent authority concerned (this number may be reduced to one by an agreement between the competent authorities)

- An even number of independent persons of standing to be appointed by mutual agreement from a pre-existing list of persons of standing or, in the absence of agreement, by the drawing of lots by the competent authorities concerned

The independent persons of standing who may be called for an Advisory Commission are nominated by the contracting states. Each contracting state should nominate five persons and inform the Secretary-General of the Council of the European Communities thereof. The independent persons of standing must be nationals of one of the EU Member States and a resident of the territory to which the Arbitration Convention applies, but not necessarily a national of one of the two contracting states involved in the case.\textsuperscript{451}

The appointed representatives and independent person(s) of standing nominated on an Advisory Commission elect a chair from among those persons of standing on the list. Each competent authority concerned may object, however, to the appointment of the person of standing chosen. The chair must possess the qualifications required for appointment to the

\textsuperscript{450} In practice, however, cases have been observed where the Advisory Commission has not been convened.

\textsuperscript{451} The list of independent persons of standing is available on the website of the European Council.

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highest judicial offices in their country or be a "jurisconsult" of recognized competence.

In theory, the contracting states should take all necessary steps to ensure that the Advisory Commission meets without delay once a case is referred to it.

(b) The Advisory Commission’s opinion

The Revised Code of Conduct proposes detailed rules for the functioning of the arbitration phase.

The associated enterprises concerned may provide any information, evidence or documents that seem to them likely to be of use to the Advisory Commission in reaching a decision. They and the competent authorities shall give effect to any request made by the Advisory Commission to provide information, evidence or documents, subject to the observance by the competent tax authorities of their respective domestic law or normal administrative practice and provisions relating to the maintenance of trade, business, industrial or professional secrets. Each of the associated enterprises may, at its request, appear or be represented before the Advisory Commission.

In its March 2015 report, the JTPF recommended to explicitly inform enterprises of the possibility to state their case before the Advisory Commission. It recommends amending the Revised Code of Conduct as follows:

At the outset of the arbitration procedure each of the enterprises involved should be informed by their respective competent authorities of their right to make a statement before the advisory commission.452

A case is considered to be referred to the Advisory Commission on the date the chair confirms that its members have received all relevant

452 JTPF/002/2015/EN - n° 38.
documentation and information. The Advisory Commission should deliver its opinion no more than six months from the date on which the matter was referred. The Advisory Commission’s opinion should be based on the arm’s-length principle (or on the principles for the allocation of profits to permanent establishments).

The members of the Advisory Commission shall keep confidential all matters that they learn as a result of the proceedings.

(c) The costs of the Advisory Commission procedure (administrative costs of the Advisory)

The costs of the Advisory Commission procedure (administrative costs of the Advisory) and fees and expenses of the independent person of standing\textsuperscript{453} are shared equally by the contracting states concerned. The costs incurred by the associated enterprises remain at their expense.

(d) The decision of the competent authorities

The competent authorities that are parties to the procedure shall, acting by common consent on the basis of the arm’s-length principle (or of the principles for the allocation of profits to permanent establishments), make a decision that will eliminate the double taxation within six months of the date on which the Advisory Commission delivers its opinion. They may deviate from the Advisory Commission’s opinion. However, if they fail to reach an agreement within six months, they are obligated to act in accordance with the Advisory Commission’s opinion, which becomes binding.

The competent authorities may agree to publish the decision, in full or in part, subject to the consent of the enterprises concerned.

\textsuperscript{453} Unless the competent authorities agree otherwise, the fees of the independent persons of standing amount to EUR 1,000 per person per meeting day of the Advisory Commission.
(e) Suspension of tax collection during cross-border dispute resolution procedures

The Revised Code of Conduct encourages Member States to adopt necessary measures suspending tax collection during the cross-border dispute resolution procedures under the Arbitration Convention, under the same conditions as those applicable to domestic appeal/litigation. Several countries have implemented such a measure in their domestic legislation.
IV. Conclusion

The Arbitration Convention was recognized as an excellent mechanism to resolve double taxation in transfer pricing disputes involving two or more EU Member States. However, the last statistics released by the JTPF are somewhat disappointing.

In effect, the figures included in the statistics on pending MAPs relate to the pending cases as of 1 January 2018, cases initiated and completed during 2018, and consequently the cases pending as of 31 December 2018 under the Arbitration Convention. According to the data, the total number of pending cases grew slightly, with a higher amount of cases initiated than completed (727 and 674 respectively) during 2018. The average cycle times of cases range from 16 to 50 months.454

Furthermore, the statistics on pending MAPs provide an overview of the number of cases that are pending two years after their initiation and the reasons hereof. From this overview, it can be derived that 932 of the total 1,988 cases were pending for more than two years. Two of the primary reasons are that: (i) cases were pending before a court; and (ii) the time limited was waived with the taxpayer’s agreement.455

Due to the increased focus on transfer pricing by many tax administrations, the importance of MAPs is expected to increase in the near future. Taxpayers may (re)consider their transfer pricing controversy strategy as a result of this, and analyze the opportunities available within the EU and by each Member State.

The OECD and the EU are at the origin of the two main recent policy developments with respect to the improvement of dispute resolution mechanisms.

454 Taxud/D2.
455 Taxud/D2.
Indeed, the outcome of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Action 14: Making Resolution Mechanisms More Effective constitutes a major breakthrough. Under this measure, 30 countries opted in for the introduction of a mandatory arbitration provision into their applicable tax treaties through the MLI, and whereby the members of the BEPS Inclusive Framework and the OECD Member States have committed to a minimum standard that should help make dispute resolution more effective.

The European Directive is meant to respond to the need for the improvement of the effectiveness and efficiency of the dispute resolution mechanisms within the EU. Such an improvement was considered necessary because of more regular and focused tax audit practices established by tax administrations, resulting in a potential increase in the number of cases of double or multiple taxation with high amounts at stake.

456 Andorra, Australia, Austria, Barbados, Belgium, Canada, Curaçao, Denmark, Fiji, Finland, France, Germany, Greece, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Malta, Mauritius, the Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK.

457 The minimum standard aims at: (i) ensuring that treaty obligations related to MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner; (ii) ensuring the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and (iii) that taxpayers can access the MAP when eligible.
ANNEX: List of serious penalties as reproduced under the Unilateral Declarations on Article 8 of the Arbitration Convention

Austria\textsuperscript{458}

An infringement punishable by a 'serious penalty' is constituted by any intentional or negligent evasion of tax or duty that is penalized under the law on tax offenses.

Belgium\textsuperscript{459}

The term "serious penalty" means a criminal or administrative penalty in cases:

Either of a common law offense committed with the aim of tax evasion, or

Infringements of the provisions of the Code of income tax or of decisions taken in implementation thereof, committed with fraudulent intention or with the intention of causing injury

Bulgaria\textsuperscript{460}

The term "serious penalties" means penalties of every kind, imposed for actions constituting administrative or tax infringements, including infringements of procedural law concerning tax assessment and tax collection, as well as for crimes against the tax system. "Serious penalties" imposed on the enterprise are also deemed to exist when penalties are imposed for offenses committed against the tax system on an individual from that enterprise whose actions have influenced the amount of tax liabilities of the enterprise or the collection therewith.

\textsuperscript{458} Official Journal C 026, 31/01/1996.
\textsuperscript{459} Official Journal L 225, 20/08/1990.
\textsuperscript{460} Official Journal L 174, 03/07/2008.
Croatia

The term "serious penalty" means a penalty for all taxation-related offenses laid down in the General Tax Act and special tax laws, and a penalty for economic crimes laid down in the Criminal Code.

Cyprus

The term "serious penalty" includes penalties for:

(a) Fraudulently or willfully making or submitting a false statement, return, document or declaration in respect of income or claims to any allowances or deductions

(b) Fraudulently or willfully submitting false accounts

(c) Refusing, failing or neglecting to submit a tax return

(d) Refusing, failing or neglecting to keep proper records or to make documents and records available for inspection

(e) Aiding, assisting, counseling, inciting or inducing a person to make, deliver or furnish any return, statement, claim, accounts or document, or to keep or prepare any accounts or documents, which is or are materially false

The legislative provisions governing the above-mentioned penalties are included in the Assessment and Collection of Taxes Laws.

Czech Republic

An infringement of the tax laws punishable by "serious penalty" is constituted by any infringement of the tax laws penalized by detention,
criminal or administrative fines. For these purposes, by "infringement of the tax law" is meant:

(a) Failing to pay the charged taxes, social insurance taxes, health insurance taxes and fees paid for state policy of employment.

(b) Tax or similar payment evasion.

(c) Failing in fulfilling notification duty.

**Denmark**\(^{464}\)

The concept of "serious penalty" means a penalty for the intentional infringement of the provisions of the Criminal Law or of special legislation in cases which cannot be regulated by administrative means.

Cases of infringement of the provisions of tax law may, as a general rule, be regulated by administrative means where it is considered that the infringement will not entail a punishment greater than a fine.

**Estonia**\(^{465}\)

The term "serious penalty" will be interpreted as signifying criminal penalties for tax fraud pursuant to Estonian domestic law (Penal Code).

**Finland**\(^{466}\)

The term 'serious penalties' includes criminal sanctions and such administrative sanctions which are imposed in respect of the breach of tax laws.

\(^{466}\) Official Journal C 026, 31/01/1996.
France\textsuperscript{467}

The term "serious penalties" includes criminal penalties and tax penalties, such as penalties for failure to make a tax return after receiving a summons, for lack of good faith, for fraudulent practices, for opposition to tax inspection, for secret payments or distribution, or for abuse of rights.

Germany\textsuperscript{468}

An infringement of the tax laws punishable by a "serious penalty" is constituted by any infringement of the tax laws penalized by detention, criminal or administrative fines.

Greece\textsuperscript{469}

The term "serious penalties" includes administrative penalties for serious tax infringements, as well as criminal penalties for offenses committed with respect to the tax laws in accordance with the relevant provisions of the Code of Books and Records, of the Income Tax Code, as well as all specific provisions which define the administrative and criminal penalties in tax law.

Hungary\textsuperscript{470}

The term "serious penalty" means criminal penalties established in relation to criminal tax offenses, or tax penalties in relation to tax defaults in excess of HUF 50 million.

\textsuperscript{467} Official Journal L 225, 20/08/1990.  
\textsuperscript{468} Official Journal L 225, 20/08/1990.  
\textsuperscript{469} Official Journal C 160, 30/06/2005.  
\textsuperscript{470} Official Journal C 160, 30/06/2005.
Ireland 471

Ireland will regard as 'serious penalties' those where criminal proceedings are being taken, or have been taken, in the particular case because serious tax evasion was suspected.

Italy 472

The term "serious penalties" means penalties laid down for illicit acts, within the meaning of the domestic law, constituting a tax offense.

Latvia 473

The concept of "serious penalty" means a penalty for any infringement of tax law. The term "serious penalties" means administrative penalties for serious tax infringements, as well as criminal penalties.

Lithuania 474

The term "serious penalties" includes criminal penalties and administrative penalties such as penalties for lack of good faith and for opposition to tax inspection.

Luxembourg 475

Luxembourg considers a "serious penalty" as what the other Contracting State considers to be so for the purposes of Article 8.

Malta\textsuperscript{476}

The term "serious penalty" means a penalty, whether administrative or criminal, imposed on a person who willfully with intent to evade tax or to assist any other person to evade tax:

(a) Omits from a return or any other document or statement made, prepared or submitted for the purposes of or under the Income Tax Acts, any income which should be included therein

(b) Makes any false statement or entry in any return or other document or statement prepared or submitted for the purposes of or under the Income Tax Acts, or

(c) Gives any false answer, whether verbally or in writing, to any question or request for information asked or made in accordance with the provisions of the Income Tax Acts

(d) Prepares or maintains or authorizes the preparation or maintenance of any false books of account or other records or falsifies or authorizes the falsification of any books of account or records

(e) Makes use of any fraud, art or contrivance whatever or authorizes the use of any such fraud, art or contrivance

Netherlands\textsuperscript{477}

The term "serious penalty" means a penalty imposed by a court due to intentionally committing an offense as listed in Article 68(2), or Article 69(1) or (2) of the General Tax Act.

\textsuperscript{476} Official Journal C 160, 30/06/2005.
\textsuperscript{477} Official Journal C 160, 30/06/2005.
Poland

The term "serious penalty" means penalty of fine, penalty of imprisonment or both of them imposed jointly, or penalty of deprivation of liberty for culpable infringement of tax law provisions by a taxpayer.

Portugal

The term "serious penalties" include criminal penalties as well as administrative penalties applicable to tax infringements defined by law as serious or committed with intent to defraud.

Romania

The term 'serious penalty' includes the commission of any criminal act provided by the tax evasion law or the accountancy law or the company law or the tax legislation. It also includes administrative penalties in regard to:

- Refusal to submit the tax statements (declarations) or the informative statements at the request of the tax bodies
- Refusal to supply documents and records requested by the tax inspection authorities
- Failing to submit the periodical financial documents and the accounting reports or, submitting such documents or reports which include incorrect data
- Actions included in the tax record, according to the legislation in force

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479 Official Journal C 160, 30/06/2005.

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Slovakia\textsuperscript{481}

The term 'serious penalty' means a penalty imposed according to the Criminal Code for criminal offenses committed with respect to the infringement of the pertinent tax laws, Tax Administration Act or Act on Accounting.

Slovenia\textsuperscript{482}

The concept of "serious penalty" means a penalty for any infringement of tax law.

Spain\textsuperscript{483}

'Serious penalties' shall include administrative penalties for serious and very serious tax infringements, as well as sentences for offenses affecting public finances.

Sweden\textsuperscript{484}

An infringement of the tax laws punishable by a 'serious penalty' is constituted by an infringement of the tax laws penalized by detention, criminal or administrative fines.

United Kingdom\textsuperscript{485}

The UK will interpret the term "serious penalty" as a penalty for deliberate inaccuracy. In considering whether to proceed under the Arbitration Convention, the UK will take into account the facts and circumstances which have led to the taxpayer becoming liable to such a penalty.

\textsuperscript{481} Official Journal L 174, 03/07/2008.
\textsuperscript{482} Official Journal C 160, 30/06/2005.
\textsuperscript{483} Official Journal L 174, 03/07/2008.
\textsuperscript{484} Official Journal C 026, 31/01/1996.
\textsuperscript{485} Official Journal L 225, 20/08/1990.
Dawn Raid App

**Raids by the authorities can happen at any time.**

Baker McKenzie has expanded our Global Dawn Raid App to provide step-by-step guidance not just on antitrust/competition-related raids, but also for tax and anti-bribery & corruption related investigations. This platform can provide you with practical assistance for your teams in handling unannounced inspections and provide instant access to Baker McKenzie’s experts across 44 countries.

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Is your tax department ready to handle a raid? Do you have the right procedures in place to protect the rights of your company, management and staff? The Dawn Raid App offers answers to a wide range of practical questions on a country-by-country basis under local laws to equip your teams on the ground in the event of a raid.

**Take action in the face of an unexpected visit from the tax authorities.**

Instant access to Baker McKenzie’s tax advisors is just a few clicks away through the Global Dawn Raid App. Through the app, you will be connected with a local contact to assist you when the tax authorities pay an unexpected visit. From initial guidance to dispute resolution, help is an app away.

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