

# Tax Administration Report on the 8th Annual IBA Finance & Capital Markets Tax Conference, 28-29 January 2019

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## *Session Chair*

Sam Kaywood *Alston & Bird, Atlanta*

## *Speakers*

Walter Boss *Bratschi AG, Zurich*

Jason Collins *Pinsent Masons, London*

Pia Dorfmueller *P+P Pollath + Partners, Frankfurt*

Diogo Duarte de Oliveira *Stibbe, Luxembourg*

Heather Gething *Herbert Smith Freehills, London*

Guglielmo Maisto *Maisto e Associati, Milan*

## **Introduction**

After the introduction of the panellists by Sam Kaywood, the panel addressed the challenges in communication between taxpayers, advisors, the respective competent tax authorities and third parties. In particular, the panel discussed:

the United Kingdom's taxpayers' rights;

the power of Her Majesty's Revenue and Customs (HMRC);

how to manage uncertain tax positions in the United Kingdom;

tax declaration process;

tax audits;

the mandatory disclosure for tax intermediaries' provisions, according to the Council Directive (EU) 2018/822 of 25 May 2018;

the opportunity to conduct joint (tax) audits in participating countries to reduce the risk of double taxation, in particular, from a German perspective;

the mechanisms of Dispute Resolution of the MLI (Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting) and the EU (Council Directive [EU] 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union); and

the procedures of tax audits in Switzerland.

### **Taxpayers' rights and HMRC's powers**

Focusing on the process of gathering information by the UK tax authority, the HMRC, Heather Gething stated that taxpayers should not blindly disclose information in response to enquiries by the HMRC, but should clearly consider its powers. In the context of investigation, the HMRC is generally entitled to start an inquiry within 12 months and may ask for the notices and documents of a taxpayer, after a self-assessment. In this regard, the HMRC is also entitled to use information gathered from third parties (eg, banks, transaction counterparties, etc), for which a competent and authorised officer may ask directly by notice in writing ('third party notice'). However, either the agreement of the taxpayer or, in the case of unknown taxpayers, the approval of the First-tier Tribunal is required. In particular, the Tribunal may not give an approval unless it is satisfied that, in the circumstances, the officer giving the notice is justified in doing so. However, it should be considered that the taxpayer is not entitled to be present at a hearing.

Under these circumstances, Gething advises a third party to consider relevant confidentiality agreements between the taxpayer and the third party; and therefore, precisely check whether the third-party notice is valid (ie, making sure that the taxpayers' or Tribunals' approval to the disclosure of certain information is given). To avoid breaching confidentiality clauses, a third party may wish to withhold the requested information by referring to its statutory rights of appeal to the First-tier Tribunal against such notices, or any requirement in the notice. This could be done on the grounds that it would be unduly onerous to comply with the notice or requirement. It is not about taking an aggressive approach with the HMRC; but it is about making clear which information is reasonably required. However, in the case of third-party notices issued by the Tribunal, no statutory right of appeal is available.

If a taxpayer is convinced that the issued notice is against the law, they could go to the Tribunal. However, the judicial review works as a last option, as it is quite expensive and time consuming. As such, no witnesses are allowed to be brought to court and no cross-examination takes place. Furthermore, if one is entitled to appeal against the notice and fails in front of the tribunal, severe penalties (up to 50 per cent of the tax advantage taken by the taxpayer) could be issued for not complying with the documents' production notice. In this case, advice is recommended.

As to the powers of the HMRC, Jason Collins referred to a publication from the House of Lords (Economic Affairs Committee), published on 4 December 2018, asking for a review of the powers of the HMRC. It states that the consultation on the HMRC's civil information powers proposed that the HMRC should be able to seek information from third parties without first seeking the agreement of the taxpayer or the tax tribunal (as is required at present), with no right of appeal. The House of Lords, however, took a stand and stated unequivocally that oversight by the tax tribunal of the HMRC's attempts to obtain information from third parties is an important taxpayer safeguard, which should not be removed without good reason.

In this regard, Guglielmo Maisto stated that, in Italy, tax auditors gather information about other taxpayers during the tax audits of the counterparts of such taxpayers, for example: in a transaction, or by evaluation of corporate records, such as, emails and notices. Furthermore, the taxpayers need to cooperate, as a failure to provide available documents, ultimately results in situations in which these documents will be banned from documentation to substantiate the taxpayers' own position.

### **Managing uncertain tax positions: a new world?**

Due to (intentionally or unintentionally) unclear provisions in domestic and international law; complex facts; new circumstances; and the behaviour of the fiscal authorities, taxpayers feel uncertain about their duty to disclose information and to be compliant with the respective laws. Furthermore, the tax authorities are becoming more intrusive and focused on anti-avoidance. Although the UK might be less aggressive in information gathering than other countries, this behaviour has still caused the taxpayers to mistrust the tax authorities.

Following this, Jason Collins then raised questions about the difference between (illegal) tax evasion and unsuccessful (but legal) tax avoidance. From the HMRC's perspective, there seems to be no difference as both result in unpaid taxes. However, it is a critical distinction when it comes to uncertain positions; for instance, filing a tax return is becoming ever more problematic because one is unsure whether facts and circumstances result in a taxation (and therefore a filing obligation) or not. Collins reported that the HMRC is currently focusing on areas such as transfer pricing or diverted profits tax ('Google tax'- targeted at large multinationals, but probably also applicable to medium-sized groups).

Collins also addressed the issue of changing economic environments in transfer pricing cases. For example, a transfer pricing position may be correct at the time of implementation, but then it might be unclear or even wrong at a later stage (eg, 'correct' margins in using the cost-plus method). Due to an oversight, the transfer pricing agreements were not amended. From the HMRC's perspective, this is an untenable situation, which is why the Profits Diversion Compliance Facility was introduced in January 2019.

According to the HMRC's guidance on this facility (published 10 January 2019), it has found that some Multinational Enterprises (MNEs) have adopted cross-border pricing arrangements, which are based on an incorrect fact pattern and/or are not consistent with the Organisation for Economic Co-operation and Development's (OECD) Transfer Pricing Guidelines. The new facility is designed to 'encourage MNEs with arrangements that might fall within its scope to review both the design and implementation of their TP policies, change them if appropriate, and use the facility to put forward a report with proposals to pay any additional tax, interest and, where applicable, penalties due.'<sup>11</sup> In fact, this creates the opportunity to come back to the HMRC and avoid criminal investigations that could be triggered within a tax audit. Based on this development, in the case of uncertainty about the underlying facts and the tax consequences, it seems reasonable to disclose such information to avoid criminal investigations. Besides this, UK taxpayers have the duty to correct tax returns whenever mistakes become apparent to them, so the taxpayers make a self-adjustment up to a maximum disclosure as early as possible to cooperate with the authorities in order to avoid penalties.

Kaywood added, that in the United States, there is no obligation to amend filed tax returns, even if the files are completely wrong. If US taxpayers are audited, they are granted a ten-day period to disclose information and correct the files without punishment. However, nowadays, tax authorities want the taxpayers to self-police and self-enforce more than before.

### ***Mandatory Disclosure for Tax Intermediaries***

Diogo Duarte de Oliveira stated that, according to the Council Directive (European Union) 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 ('the Directive'), intermediaries are required to disclose (aggressive) cross-border arrangements.

After a brief overview of the new provisions that must be adopted and published in the EU Member States by 31 December 2019, Duarte de Oliveira highlighted a significant part of the directive: the timeline of applicability. Instead of covering cross-border arrangements implemented after 31 December 2019, the Directive has a retroactive effect; it includes arrangements implemented as of 25 June 2018 as the formal date of the Directive's entry into force.

Duarte de Oliveira also discussed some of the concerns arising from the broad wording and the lack of detailed definitions used in the Directive. This creates legal uncertainty for professionals and taxpayers, and a risk of incorrect reporting or over-reporting. The term 'intermediary' is broadly defined in the Directive as 'any person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border arrangement'.

In addition to this, Duarte de Oliveira also briefly described the UK disclosure rules, enacted in 2014. He focussed particularly on the DOTAS regime (Disclosure of Tax Avoidance Schemes), which could offer guidance on what to expect following the transposition of the new EU rules into the EU Member States' domestic law. Under this regime, certain people must provide information to HMRC about avoidance schemes within five days of the schemes being made available or implemented. Usually the promoter of the scheme is also the providing person. Additionally, the users of such schemes might be subject to DOTAS, being required to notify the HMRC under certain circumstances.

Gething added that before implementing DOTAS, HMRC received a huge amount of data from the taxpayers as – in uncertain areas – the UK taxpayers would rather disclose information to avoid either penalties or further queries. Since the implementation, however, the UK taxpayers stick to the DOTAS rules, taking a more accurate view on which information is or is not subject to disclosure. Consequently, the HMRC suffered a reduced market view based on the reduced information quantity. Although the Directive also works with hallmarks and a main benefit test, the regime is not similar to the DOTAS regime. Other countries, such as: the US, Canada, Ireland and Portugal, have also implemented rules on the disclosure of tax avoidance schemes that differ from the Directive.

Based on a hybrid loan example (introduced by Kaywood) including the US and Luxembourg rules, Duarte de Oliveira described the required steps to find out whether a structure might be subject to disclosure. Due to the unclear definitions of hallmarks and main benefits, however, the steps might lead to different results, even in comparable cases. Therefore, clarification guidelines need to be issued by the Member States.

Finally, the legal professional privilege was bespoken. To avoid breaching this privileges available in some Member States, Member States shall take the necessary measures to require intermediaries to notify any other intermediary or the relevant taxpayer of their reporting obligations.

Pia Dorfmüller added that, in practice, this results in the requirement of corresponding disclaimers, but also in the alternative for the taxpayer to waive the obligation and engage the intermediary to report accordingly.

## ***Joint tax audits***

For many years, the cross-border transactions of enterprises have been growing. This has impacted on the area of tax audits and on how fiscal authorities could increase their effectiveness in appreciating the information. Over 40 years ago, the first simultaneous tax audits were implemented between the US and Canada, but the opportunity of conducting joint audits is quite recent. The OECD Joint Audit Report 2010, attracted a lot of attention because it deals with the legal framework; contains practical considerations and recommendations; and shows advantages and disadvantages. Currently, article 26 of the OECD MTC, as well as the Council Directive 2011/16/EU on administrative cooperation in the field of taxation (EU Mutual Assistance Act) of 15 February 2011 (amended by the Council Directive 2014/107/EU as regards mandatory automatic exchange of information in the field of taxation) combined with domestic implementation acts provide the legal framework, Dorfmueller said.

The possibility to exchange information between countries is, therefore, key for joint audits. Joint audits are coordinated bilateral and multilateral tax audits. They are conducted in the context of mutual administrative assistance; alongside both the exchange of information on request and the spontaneous and automatic exchange of information. In the first instance, joint audits focus on a joint clarification of the facts and circumstances (actively involving taxpayers). This could be very helpful, for example, in cases of permanent establishments or in the area of transfer pricing. Ideally, the participating tax authorities reach an agreement on the tax consequences resulting from the facts jointly found; thereby, avoiding the risk of double taxation.

Dorfmueller showed that this procedure could also reduce uncertainties in tax matters. According to the OECD report on Tax Certainty 2017 (updated in 2018), reducing uncertainties is key to avoid adverse effects on investment and trade. Consequently, it is a high priority for taxpayers and tax administrations. Furthermore, joint audits are usually less time-consuming than subsequent dispute resolution mechanisms.

According to the OECD, currently 10 countries: Belgium, Canada, Finland, France, Germany, Italy, the Netherlands, Norway, the UK and the US; are engaged in the OECD Joint Audit Project, 2018. Germany is also part of the Joint Audit Expert Group and is interested in such procedures, as it has been noticing that Mutual Agreement Procedures ('MAPs') and arbitration might reduce the German tax base. In Germany, a taxpayer can ask the competent tax authority for joint audit procedures and will likely find them to be receptive. Therefore, due to the federalism in Germany and their competence in tax audits, some federal states implemented competence centres. Bavaria has been particularly active in this (International Tax Centre, Munich, since 2013). The Bavarian International Tax Centre alone (ITC) generated €180m in surplus earnings in the first three years, with 50 Bavarian tax auditors from 13 local tax offices. Together with the Federal Central Tax Office (Bundeszentralamt für Steuern) and its seven coordinators, the federal states are currently handling up to 45 joint audit cases in 15 countries worldwide, with an average duration of 1-1.5 years. For further information, an English language guidance note on coordinated external tax audits with the tax administrations of other states and jurisdictions (circular of the German Federal Ministry of Finance, 9 January 2017, IV B 6 - S 1315/16/10016:002) was issued on 6 January, 2017.

However, there are also obstacles to be considered. One main obstacle is the different audit approaches and cycles. In addition to this, a lack of knowledge amongst the participating parties has also been identified. Furthermore, the lack of supporting technical means and uncertainties about the legal framework causes reluctance amongst the tax authorities and taxpayers. Dorfmueller has experienced these difficulties herself, particularly when working with the Italian tax authorities, due to the different audit cycles. Nevertheless, these obstacles do not seem to be insurmountable and will, hopefully, be eliminated in the next years.

## ***Dispute resolution***

Where a joint audit is not available, or results in a tax dispute between the taxpayer and one or more of the fiscal authorities due to cross-border activities, the current and future dispute resolution mechanisms could lead to the avoidance of double taxation.

The Multilateral Convention to implement tax treaty-related measures and prevent base erosion and profit shifting (the so-called 'Multilateral Instrument' or 'MLI') entered into force on 1 July 2018 and currently covers 87 jurisdictions. The MLI contains provisions to improve the current dispute resolutions in bilateral or multilateral double-taxation agreements. These provisions set a minimum standard and ensure that treaty-related disputes are resolved in a timely, effective and efficient manner. However, the minimum standard does not comprise the arbitration clauses (Part VI of the MLI). Guglielmo Maisto clarified that only 28 jurisdictions (15 EU Member States) have chosen to apply the MLI arbitration regime (in March 2019: 29 countries) in their Double Taxation Agreement. However, these jurisdictions also made various reservations, which might significantly reduce the arbitration clause. Furthermore, the arbitration clauses will only apply in cases of corresponding notifications of the jurisdictions.

The EU also implemented the Council Directive (EU) 2017/1852 of 10 October 2017, on tax dispute resolution mechanisms in the within the EU. This applies to any complaint submitted from 1 July 2019 onwards, relating to questions of income dispute or capital earned in a tax year commencing on, or after 1 January 2018.

Therefore, Maisto discussed whether taxpayers resident in the EU may choose between the MLI or the EU arbitration clauses. Several EU Member States choose not to apply MLI arbitration clauses (ie, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia). Other EU Member States (ie, Finland, France, Germany and Spain) also reserve the right not to apply these clauses. However, this is conditional on whether the scope of the EU convention on eliminating double taxation connected with the adjustment of the profits of associated enterprises (90/463/EEC) is fulfilled. Also, according to the EU Directive, the MLI arbitration clauses may not apply if the arbitration procedure has already been started (by analogy of article 26, paragraph 2 MLI). This is because the submission of a complaint under the EU Directive would then result in the termination of a commenced MLI arbitration procedure. As a result, Maisto does not foresee many arbitration proceedings happening in the future (despite their availability in the EU) as the proceedings are too time consuming, and so will not create tax revenue within short periods of time. Furthermore, domestic proceedings might be less costly in terms of tax revenues. However, the mere possibility that taxpayers could choose the arbitration route might trigger settlements between different countries.

### ***Tax audits in Switzerland***

Before giving insights into the Swiss tax audit regime, Walter Boss pointed out that in Switzerland the aforementioned joint audit procedures are currently unavailable. For example, a non-Swiss tax auditor would not be permitted to address questions directly to the taxpayer. However, based on the current exchange of information provisions, questions could be asked via the Swiss tax auditor. In case of a tax dispute, a mutual agreement procedure may be chosen.

In Switzerland (as in many other countries), a self-assessment regime is active and, therefore, the tax returns of the taxpayers must be complete and correct. However, no legal obligation exists to go beyond that (for example, providing information in the case of an offensive tax position). As a special item in the tax audit process, Boss described the 'cooperation maxime', which characterizes the interaction between the taxpayer and the tax authority in matters relating to the clarification of tax positions. Under this cooperation maxime, the taxpayer is obliged to cooperate with the tax authority in establishing the facts and circumstances resulting in the filed tax position. However, this maxime also ensures the taxpayers' right to participate in the tax audit process. This could allow them to directly affect the formation of opinion process on the level of the tax authority. If the taxpayer does not cooperate, thus impeding the tax auditor's duties in examining the proof of information, he or she is permitted to assess a high (estimated, but proportional) tax burden. This, in turn, is supposed to encourage the taxpayer to cooperate. In general, the tax auditor is forbidden to threaten the taxpayers by accusing them of tax fraud. Furthermore, the taxpayer has the right to learn about the contents of their tax files. They also have the right to be informed about third party information given to the tax authority about their position, so they can offer proof to the contrary.

### ***Conclusion***

In conclusion, the panel has given great insights into both the status quo and the developments regarding communication with the tax authorities. Insights were also given regarding the current and potential compliance requirements. At the end of the session, the panellists briefly discussed Kaywood's question about the request of fiscal authorities for documents. The documents discussed included: tax due diligence reports; and auditors working papers on tax accruals, possibly containing valuable information about potential tax risks. Collins, Gething and Dorfmueller, made it clear that such information does not need to be disclosed in Germany and the UK. Kaywood informed the panel that in the US potentially exaggerated information might be used by tax auditors. Because of this, it is recommended that the parties in mergers and acquisitions transactions at least destroy the 3<sup>rd</sup> party information for potentially unsuccessful transactions. Maisto hinted that the detailed activity reports of advisors' invoices can give rise to requests from the tax authorities and suggested that the degree of details should be chosen carefully.

[1] <https://www.gov.uk/government/publications/hmrc-profit-diversion-compliance-facility/profit-diversion-compliance-facility> (<https://www.gov.uk/government/publications/hmrc-profit-diversion-compliance-facility/profit-diversion-compliance-facility>); see chapter 1.3.

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