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RESOLVING TAX DISPUTES WITH REGULATORS

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EXPERT FORUM

RESOLVING TAX DISPUTES WITH REGULATORS

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CD: Could you provide a brief overview of recent tax enforcement in your jurisdiction? Have you observed an escalation in the number of tax disputes between companies and regulators over the past 12 months?

Gniadecka: In Luxembourg in 2016 and 2017, similar to other Organisation for Economic Co-operation and Development (OECD) countries, we have observed the step-by-step implementation of the key rules set out in the Base Erosion and Profit Shifting (BEPS) framework. Luxembourg provided updated guidelines for financial transactions and, as from 1 January 2017, introduced a further article, 56bis, into the Luxembourg Income Tax Law (LITL). The new article incorporates the principles of chapters 1 to 3 of the OECD guidelines, focusing on substance and equity requirements for intra-group financing activities. As the new requirements are still 'fresh', both for companies and authorities, it is difficult to judge if they have already brought the increased number of tax audits or disputes. Currently, taxpayers focus on reviewing their tax policies and transfer pricing studies, as well as legal documentation and manual procedures in respect to new functionality and equity requirements.

Oortwijn: The Netherlands' tax enforcement environment consists of general and targeted tax audits as well as a horizontal monitoring programme using a taxpayers' implemented tax control framework. Horizontal monitoring is a form of working in the present based on mutual trust, understanding and transparency between the company and the tax authorities. It has been deemed fit for the Dutch tax culture of collaboration and negotiation, unlike in other jurisdictions, such as Sweden, where it failed. There has been a significant and higher than expected increase in horizontal monitoring arrangements in 2016. The Dutch Court of Audit recently confirmed the proper working of these preventive enforcement measures but questioned the effectiveness of it. The number of tax disputes between companies and tax authorities on mainly cross-border transactions increased exponentially during the last 12 months.

Chien: In the US, on the federal front, the Internal Revenue Service (IRS) typically releases an annual list of 'compliance campaigns' that describe issue areas that the IRS will be focusing on for large corporate taxpayers. On the state and local front, many states in the US are focusing on transfer pricing, asserting local sales and income taxation rights on out-of-state sellers, and scrutinising specific transactions that would impact local asset-based taxes. While there has not necessarily been an escalation of tax investigations in the US, the scrutiny of local taxing authorities on subsidiaries of US-based multinationals has intensified in the

past few years due to media reports and the public perception of tax planning to minimise local taxes, that while legal, is discordant with the 'spirits' of the local law. Such tax investigations will typically focus on the issues of transfer pricing, permanent establishment, withholding tax and deductibility of interest expenses.

Gregor: In the US, the IRS has struggled to keep apace of its enforcement mandate in a time of declining budgets and funding. While much of its focus is on identifying the right populations of taxpayers to audit, the IRS has had to become innovative in its approach to auditing taxpayers in order to ensure it maintains a broad enforcement net. The biggest change by the IRS is the recent restructuring of its Large Business & International Division (LB&I) to respond to decreasing budgets and staff. This move is expected to result in an increase of the overall examinations while focusing those examinations on issues that the IRS has determined are the highest priority. The IRS will focus its enforcement efforts on centralised campaigns. Each campaign will include various elements, including regular education for examination teams, feedback from ongoing examinations and tax practitioners, and coordination of examinations of the particular issues.

Costigliolo: The number of tax disputes between Italian taxpayers and tax authorities in the last 10 years has been consistent; however, there has been a reduction over the last 12 months due to dispute resolution measures empowerment. There was an important growth in tax audit activities after 2010, also due to relevant international law changes, mainly related to cross-border operations and an exchange of information among different states. As the approach followed by the European Union (EU) and the OECD bodies in relationship to the so called 'anti-avoidance rules' became stronger and stronger, such as BEPS and Country by Country Reporting (CbCR), the Italian Tax Authority has focused its audit activities on cross-border challenges such as tax residence issues and the existence of hidden branches.

CD: Given that any company may become a target for regulatory audit, no matter what precautions it takes, what, in your opinion, is the best course of action if regulators launch a tax investigation?

Oortwijn: When companies are subject to a tax investigation, the best course of action is to manage and guide the audit process as much as possible by collaborating with the investigators and agree on scope, timing and structure of the audit process and communication protocols. With the vast tax information available in the media and public domain, tax investigators may well know the right questions to ask. For companies to be trusted by the

tax authorities, it is important that all of its legal, tax and financial information tells the same story – and where there is an outlier, companies should be able to support it using business logic.

Chien: The best course of action is to cooperate. Do not stonewall. Any hint of non-cooperation will only result in escalating scrutiny by the authorities and a deterioration of trust. Cooperate by providing the specific information that is legally requested and helping the authorities interpret and understand that information. Often, it is highly beneficial to taxpayers to help the authorities better understand the company's business and value chain, especially for companies whose revenues are largely attributable to offshore technology and IP assets. Concurrently, the taxpayer should understand the context for the tax investigation. Is it because the entire industry is being scrutinised? Is it routine? Is it due to a specific transaction? Or is the taxing authority in a particular jurisdiction results-oriented? Frequently, tax authorities may overreach by requesting extra-jurisdictional information in investigations involving cross-border transactions. In these cases, the taxpayer should carefully assess the pros and cons of voluntarily cooperating, and consider how else the taxing authority could obtain the requested extra-jurisdictional data, for example, through the network of increasing exchange of information treaties.

Gregor: The first step that any company should take if it is subject to any audit by the IRS, or any other state or non-US regulatory agency, is to immediately identify what issues the IRS, or any other agency, might be targeting at that moment, and independently look at what particular other areas of exposure the company might have. Changes toward issue-based enforcement by the IRS should not lull taxpayers into complacency about other material tax positions it may have taken. IRS examination teams will still have broad authority to identify issues outside the official LB&I campaigns. Additionally, we are expecting that new campaigns will get announced on a regular basis meaning that

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a new issue could pop up mid-way through an audit, and the examination team may turn to it at any point.

Costigliolo: Broadly speaking, a 'do not panic' approach is always best. Nervous behaviour on the taxpayer's side is often very dangerous, as this could significantly affect the tax auditors' attitude. It is also important to find the best possible balance and try to be collaborative and fair. Also, choosing tax professionals with a wide experience of tax audit assistance is very important as they will be able to verify that tax auditors are behaving properly.

Gniadecka: In the current demanding environment, the priority is to have a strategy which I call 'the first line of defence'. For transfer pricing matters, it means, first and foremost, to be well prepared on the documentational side. Transfer pricing documentation, be it masterfiles or local entity files, needs to be prepared on a regular basis, without waiting for the audit. Furthermore, the content of the documentation should be reviewed and understood by those who will be the primary contacts for tax authorities during an audit. Although this may seem obvious, it is often the case that multinationals that use external advisers for transfer pricing compliance work, lack expertise or know-how as to how intercompany transactions are documented, what methods are used for testing purposes and whether there are any inconsistencies in methodologies applied. If done properly at the very beginning of a tax audit, it allows for a proper assessment of the risks and advantages of implementing transfer pricing policies by the entity. Once the correct basic steps are ensured, multinational enterprises (MNEs) have the potential to steer the audit process in a structured manner.

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CD: To what extent are tax audits now more likely to take on a cross-border component? What additional challenges might this pose for multinational companies?

Chien: Tax audits will reflect a taxpayer's commercial transactions and relationships and the area of tax being scrutinised. On the income tax front, taxing authorities will generally be looking at tax avoidance; either underreported revenue or overreported deductions in the local jurisdiction. If the audit is of either a subsidiary of a multinational enterprise, or the parent, the audit should have a substantial cross-border component due to the actual transactions between corporate entities in a global group. Permanent establishments and transfer pricing are two popular 'grey' areas of direct income tax that taxing authorities typically focus on in the cross-border context. On the indirect tax front, taxing authorities may focus on domestic transactions and whether there is valid documentation to support VAT/GST input credits, or to exempt certain transactions from VAT/GST. With the EU, Japan, Korea and South Africa now requiring offshore sellers of 'digital' goods and services to register and comply with local VAT/GST regulations, there will be an increasing cross-border component to indirect tax investigations. The challenges for multinational enterprises will be in obtaining the requested information, determining what is extra-jurisdictional and whether to volunteer the data, and coordinating a consistent, factual presentation of the facts to taxing authorities across jurisdictions.

Gregor: Allegations of tax evasion on a global basis are on the rise. As countries begin to receive information from the implementation of CbCR as part of the BEPS initiative, countries are increasingly asserting that companies either lack the requisite substance in another jurisdiction to rely on a tax treaty for reduced rates of tax, or that a company's level of activity in a particular jurisdiction was sufficient to create a permanent establishment, generally subjecting it to increased rates of tax. Countries are coupling increased enforcement efforts with more regular use of anti-abuse provisions, whether a substance over form or abuse of law-type provision, and allegations of criminal tax violations. The confluence of increased information and more powerful enforcement tools has created a perfect storm and multinational companies are apt to feel like a lone ship caught in the middle.

Gniadecka: Tax auditors are becoming more active in seeking information in other jurisdictions where an MNE is present, especially between neighbouring countries where, even in pre-BEPS times, tax authorities were used to cooperating. If this scenario is to develop into full-blown cross-border audits, it is probably only a question of time and matter of tax departments' resources and common language. Nevertheless, this evolution requires MNEs to be prepared for more intensive tax audits and an escalation of disputes across several jurisdictions at the same time. The best preparation is establishing a solid first line of defence and having an ability to explain in a consistent manner the

business and tax arrangements at a cross-border level. This includes a consistency in reporting figures quoted in different types of reports, such as masterfile and CbCR, which for complex companies is definitely a challenge. Moreover, it also triggers for each MNE's tax function, practical questions on organising the resources to accommodate the disputes, as well as recognising the increasing sensitivity of reputational issues.

Costigliolo: The European and worldwide tax 'state-of-the-art' has been substantially renewed over the last few years. For example, the BEPS programme has significantly changed the rules of cross-border challenges. In recent years, issues such as permanent establishment, transfer pricing or business relocation are ordinary challenges questioned by the Italian Tax Authority towards international groups. Another example of the influence in Italy of the EU and international legislator is the 2015 reform of the 'anti-avoidance' rules provided by the tax code, which follow the example of the BEPS principles. Under the new rules, an abuse-of-law exists when a transaction "lacks of any economic substance and, while formally consistent with tax law, is aimed at obtaining undue tax advantages". The new definition is built on a 'substance-over form' approach, which can be regarded as one of the main principles of the new path followed by the EU – especially by the EU Court of Justice – in the last few years in order to

contrast tax avoidance. In this context, multinational companies must be more aware of the need to demonstrate the economic soundness and juridical correctness of the operations they put in place.

Oortwijn: With the increasing transparency measures inspired by BEPS and implemented by various individual countries, as well as the exchange of information between tax authorities, tax investigators will have access to additional sources of information and be able to see a broader picture of the overall value chain. Different interpretations of the BEPS guidelines to the same cross-border transactions may well cause disputes to cross-border transfer pricing. As a result, multinational companies will be faced with more uncertainty and cross-border tax disputes.

CD: With litigation a costly and time-consuming way of resolving a dispute, are you seeing more alternative dispute resolution (ADR) methods used in tax disputes?

Gregor: In addition to the restructuring of LB&I, the IRS is providing taxpayers with increased access its fast-track settlement programme. Under a new policy, all taxpayers are entitled to go to fast track appeals. Previously, these options were only permitted with examination team agreement. Fast track settlement is an alternative dispute resolution (ADR) mechanism within the IRS Office of Appeals that allows taxpayers to accelerate access to the administrative appeals function in order to settle a particular issue. Examination teams have become increasingly flexible in their use of fast track settlement, including by tentatively agreeing to a settlement that is sent to the appeals office for approval through the fast track programme. This extra step is necessary in cases where an issue is unclear and the IRS and taxpayers are agreeing to a settlement taking into account hazards of litigation.

Costigliolo: First of all, it is important to notice that, in Italy, a tax litigation procedure can last for 10 years or more. ADR methods, in certain circumstances, are strongly recommended. In Italy, following a tax audit, the lawmaker mainly provides two different ADR methods in order to resolve the dispute: an administrative settlement before the litigation procedure activation and a judicial settlement. With the first procedure, a taxpayer may ask for a 'pre-court' settlement and sign a deed with the tax authority, in which the taxes due would be re-determined. Following the subscription of the deed, tax penalties will be reduced to one third of the minimum amount provided by law. Otherwise, if the taxpayer filed an appeal against the tax assessment, until the public hearing is held, a further settlement – the judicial settlement – might still be possible, with the consequences including the possible reduction of the tax amount claimed in the tax assessment and

a correspondent cut of the penalties – to 40 percent for judicial settlement before the provincial tax court and 50 percent for judicial settlement before the regional tax court respectively. The pursuit and subscription of a settlement with the tax authority has to be evaluated with close attention, in order to better verify the economic pros and cons related to the procedure.

Oortwijn: In the UK, the ADR approach to resolving tax disputes proved successful in domestic tax disputes. Denmark began applying ADR in cross-border tax disputes stemming from transfer pricing in 2016. In the initial 2013 BEPS Action 14, 'Make dispute resolution more effective', ADR mechanisms were identified as the means for addressing cross-border tax disputes in a Mutual Agreement Procedure (MAP). In the final 2015 BEPS plan, the ADR approach was replaced with the mandatory binding 'baseball' method. This is a missed opportunity caused by OECD internal political pressure to deliver a set of BEPS guidelines within the G7 allowed political window of change by the end of 2016.

Gniadecka: ADR is taken into consideration more now than it was in the past, but whether it will lead to more successfully settled tax disputes is doubtful. For example, a MAP is a long, drawn out process which requires a lot of work to be done by tax authorities and taxpayers. Moreover, experience tells us that some countries are used to arbitration procedures, whereas others lack the drive to enter into such discussions, or are simply unwilling to arrive at mutually agreed conclusions. Limitation on resources side, as well as the uncertain outcome of the procedure itself, taxpayers need to plan strategically to determine which disputes will be subject to MAP. Only time will tell how ADRs evolve and to what extent it will be possible to efficiently use both tools.

Chien: In most jurisdictions, tax disputes are frequently settled through the administrative framework prior to court-adjudicated litigation. Often, the taxpayer will have contemporaneously posted a reserve for uncertain tax positions that could cover any subsequent related assessments resulting from an investigation. For disputes involving cross-border transactions, where the transaction is with a treaty partner, then the taxpayer may be qualified to have the dispute resolved via the mutual agreement procedures under the relevant tax treaty.

CD: In today's mass communication environment, where tax disputes can quickly acquire intense media attention, what steps can companies take to mitigate the reputational impact?

Oortwijn: The first step is to ensure that tax is well represented at the company's board level

– BEPS guidelines have shifted the international tax rules of engagement to focus on the economic aspects of transactions. In order to manage the reputational risk, it is key that a company's value chain analysis (VCA) and the actual tax positions across the company's operations are in synch. With the different interpretations of similar transactions in different jurisdictions stemming from BEPS, this is and will remain a challenging task.

Gniadecka: Since the BEPS project, managing the reputational aspect has become an increased part of the tax and transfer pricing function. Effective results can only be triggered by joint efforts in at least two areas: transfer pricing compliance and lobbying actions – both at local and international level. The other area of internal interest is communication with non-tax stakeholders of the company, which are often the first to talk to the authorities and, therefore, the first to trigger the potential for reputational impact. Maintaining regular conversations with these teams and explaining the tax and related risks linked with their behaviour would also help to mitigate the impact.

Chien: Many jurisdictions, such as most OECD-member countries, have strict confidentiality rules that prohibit tax officers from disclosing taxpayer information, and subject infractions to both civil and criminal penalties. For countries that do not have such confidentiality protections, taxpayers should expect that high-profile taxpayers, especially foreign multinationals, may have information about the tax investigation leaked to the media.

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Not coincidentally, these countries are generally countries that are more results-oriented in tax investigations. However, taxpayers should be keenly aware that public scrutiny does not stem only from tax investigations. Rather, in many jurisdictions, taxpayer accounts are publicly available, usually for a small fee. Increasingly, there is discussion among lawmakers in various jurisdictions for tax filings, such as the comprehensive CbCR, to also become publicly available. For multinational companies with a minimal presence in a country, such publicised local

accounts that reflect little local revenue, and taxes paid, can appear discordant against a company's own promotional announcements of substantial revenue growth in a country.

Costigliolo: A prompt reaction with proper messages is always very important when dealing with the media. In addition, it is useful to isolate the tax challenges and focus media attention on the results achieved by the company during the years under inspection. However, these considerations are not a shield against certain charges, especially from the local press. However, time often heals every kind of wound.

Gregor: A day does not go by without discussions in the mainstream media of the need for tax reform and increased enforcement to combat perceived abuses by multinational corporations. Public opinion has shifted in recent years, such that corporate tax planning that historically was viewed as the fiduciary obligation of a company to minimise its tax expenses is now universally condemned as tax evasion or avoidance. Many jurisdictions have bought into this narrative, and enforcement efforts have followed suit. This has created a feedback loop wherein public perception and enforcement activities reaffirm condemnation of tax planning structures and strategies.

CD: What final piece of advice would you give to companies in terms of managing their interaction with regulators and reaching a favourable resolution to a tax dispute?

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Kathleen Gregor, Ropes & Gray, LLP

Costigliolo: With regard to what multinational companies are interested in, we can say that taking a chance to reach a satisfactory dispute resolution is always very important. It is fundamental to dedicate attention during the tax audit phase so as to enhance the taxpayer's position, the relationship with tax authorities and build the basis for a prospective settlement which can be reached at different stages of the tax litigation proceeding or even before it commences.

Chien: Cooperate and treat the audit team like a welcome guest in your home, even if they first entered by barging in, guns blazing. Be specific and truthful with the authorities, in both written and verbal interactions. Transparency and exchange of information among countries is here to stay. Understand the value-drivers of your business, and what activities actually happen in the local audit jurisdiction, vis-a-vis headquarters. On the policy front, do not underestimate the winds of political change on tax, especially perceived tax avoidance by multinationals and the will of politicians and political appointees to be seen taking action on tax avoidance. The political environment, and revenue shortfall, will frequently drive tax investigations, especially of profitable multinationals.

Gniadecka: Each regulator has its specific approach based on several aspects embedded in law and practice, depending on the judiciary system involved. Nevertheless, one should be thoroughly prepared, taking advantage of the fact that no authority will know your business better than your own in-house experts. From my experience, I have noticed that there is a good knowledge of the audited topic which is well-prepared in terms of a variety of arguments, both tax and practical.

Gregor: Understanding the opposition is the single biggest asset that a company can have going into any tax enforcement proceeding. In the US, that might mean understanding the IRS's new methods and campaigns. Internationally, that may mean understanding the political climate of a particular country. Strategies must be developed taking into account the unique characteristics and motives of a particular country. In potentially high-profile or particularly material tax issues, companies should be developing these strategies with input from various sources – internal tax teams, public relations teams, general counsel office, accounting firms, local law firms and international counsel. Putting together a team that can balance the unique concerns of a particular country against the local climate could mean the difference between navigating a dispute efficiently to a quick settlement and protracted, public litigation involving allegations of criminal misconduct.

Oortwijn: I would advise companies to try and agree on significant material tax positions by way of an Advance Pricing Agreement (APA). A MAP could also be changed into an APA procedure. Furthermore, horizontal monitoring or compliance agreements with the tax authorities could be worthwhile to consider – to the extent available.

CD: What predications can you make for the relationship between companies and regulators on tax issues over the coming year? Should companies be doing more

to address their tax plans in the current environment?

Chien: In the coming year, many jurisdictions are integrating the OECD's BEPS proposals into domestic law, and will be receiving the first of its transfer pricing-related CbCR and master files to review. While I expect tax investigations on high-profile multinationals to continue in the coming year, many taxing authorities will be taking some time to digest the firehose of information that will become available. Many companies are taking a wait and see approach, but it may be prudent to proactively reassess one's structure, and canvass internal business and functional leads about changes to the business to identify transactions, business areas and jurisdictions ripe for a tax investigation.

Gniadecka: The deeper transparency on tax structures and planning is unavoidable in the current environment, and there is a lot of work to do on it on both sides. Lack of security and lack of understanding on disclosure consequences, specifically for larger and complex MNEs, could block the goodwill and taxpayers' effort on further disclosure in the short-term. The CbCR, together with the BEPS masterfile, will be the basic tools for addressing the MNE's structure, profile as well as plans, and these will be a focus in the next 12 months.

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Gregor: There is likely to be continued upheaval in the international tax world as the BEPS initiatives are further implemented and countries adjust their local laws. This also means that many jurisdictions will keep up aggressive attacks on perceived historical tax abuse. We are likely to see more challenges to structures using anti-abuse regimes, even where structures or transactions were considered market standard at the time of implementation. Particularly where a targeted company is perceived as an outsider to a particular jurisdiction, enforcement agencies are likely to continue to feel there is a political mandate supporting aggressive enforcement.

Oortwijn: Regulators will likely interact much more with companies over time as a result of increased transparency and disclosures. On the other hand, lacking efficient data technology, it is questionable as to whether more transparency and disclosures will lead to enhancement of tax authorities' ability to understand a company's business. Another factor is the comparability mismatch stemming from the many different interpretations of the same transactions as reported and disclosed for different purpose and in different places. Companies should take their VCA as the reference point for their tax plans and make sure that all filings and disclosures toward regulators are synchronised. I would also advise companies to implement an integrated global tax compliance process to manage data consistency, identify tax risks and identify tax opportunities.

Costigliolo: Recently, both Apple and Google signed pre-court settlements with the Italian Tax Authority, recognising they had not paid the proper amount in tax. The most important aspect of these settlements is that the two companies introduced a renewed path of their business plans in Italy, starting from their tax position in the country. In order to obtain this result, both signed an APA with the tax authority. This is an example of the new relationship between companies, especially international companies, and the Italian Tax Authority, which is grounded on a cooperative compliance or enhanced basis, instead of an aggressive position on the taxpayer's or the tax authority's side. It is important to consider that in order to assist the companies to obtain a better certainty of their tax position in Italy, the lawmaker introduced in 2015 a new cooperative compliance programme for taxpayers, with proper processes and internal controls procedures relating to their tax risks. Participation in the cooperative compliance programme will mainly allow taxpayers to achieve a common evaluation of potential tax risks with the tax authority before filing tax returns. CD