The International Compliance Assurance Programme and Joint Audits: A New Epoch of Transfer Pricing Tax Audits?

This article discusses two new, internationally coordinated regulations that address the problem of double taxation: the joint tax audit and the International Compliance Assurance Programme. It gives an outlook on whether those two measures could start a new epoch of transfer pricing tax audits.

1. Status Quo of Tax Audits – A Practitioner Perspective

A figure will be used to introduce this article (see Figure 1). How many beams are shown in the picture? From the perspective of the person on the left, four beams would be the correct answer, whereas the person on the right sees only three beams. However, both are right from their perspectives. This figure sketches a typical situation within a transfer pricing tax audit. The tax inspector and the taxpayer interpret the situation differently, even though both may have good arguments in favour of their positions. It may even be the case that both are right.

Examples of different interpretations of the factual background could be: the classification of an entity as routine or entrepreneur; the relevance of intangibles; or the comparability between an intercompany transaction and a third-party transaction. Different interpretations of the factual background could result in different conclusions with regard to the arm’s length price. Therefore, the outcome of a tax audit is uncertain. Different interpretations of the factual background result in a first step in a conflict between a taxpayer and the tax administration and could result in a second instance in an adjustment of the taxable income, which may lead to double taxation. Double taxation could either be accepted by the taxpayer or a mutual agreement procedure (MAP) could be initiated in order to try to eliminate the double taxation. In practice, the taxpayer quite often does not apply for a MAP, since it is time consuming. The latest statistics of the OECD on open transfer pricing cases document roughly 4,000 open cases, as depicted in Table 1, at the end of 2016. For Germany, almost 600 transfer pricing cases had been open at the end of 2016. The average length of a transfer pricing case is 30 months.

The sheer number of open cases and the resulting length of the cases hinder taxpayers from applying for a MAP. In addition, in practice, taxpayers agree to a compromise in terms of taxable income in tax audits with tax authorities, promising in return that they will not apply for a MAP. Without this waiving of their right to apply for a MAP, the compromise would not be possible. As a result, either because they would not like to become involved in a drawn-out MAP or since they waive their right as part of the compromise, they accept double taxation.

2. Overview Joint Audit and ICAP

As national governments and the OECD are aware of the double taxation problem, programmes have been initiated to avoid conflicts and to reduce double taxation. The joint tax audit and the International Compliance Assurance Programme (ICAP) are two examples of such coordinated regulations.

A joint audit is a form of reinforced administrative cooperation between two or more tax administrations to examine the financial statements of one or more related taxable persons (both legal entities and individuals) with regard to cross-border business activities. The joint audit team therefore consists of representatives of competent authorities from each country. During a joint audit, the auditors focus on critical areas of direct taxation, such as transfer pricing, and the main goal is to enhance the administrative cooperation due to simultaneous action by tax administrations. An example would be a multinational with entities in Germany and Italy. A version of a joint audit would take place when a German and an Italian taxpayer, which are related to each other, are audited at the same time.

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1. This would only be possible under a phenomenological world view. Simply put, phenomenology states that perception depends on the individual and his background, i.e. it has a subjective dimension.
same time, but without the German tax inspector being present in Italy and vice versa ("simultaneous joint audit"). Another type of a joint audit would occur when both taxpayers are audited together, i.e. when the tax inspectors from Italy participate in the meeting in Germany and vice versa. The result should be a common understanding of the factual background and the avoidance of double taxation.\(^5\) Joint audits have already been implemented into local legislation. For instance, in Germany, guidance by the Federal Ministry of Finance has been issued.\(^6\) A detailed analysis of the benefits of joint audits, including an analysis of which countries benefit most from joint audits, has been provided by Burgers and Criclivaia (2016).\(^7\)

Another programme, which is aimed at better coordination for the tax administration, is the ICAP. The pilot version of this programme was introduced in January 2018. It is designed to be a coordinated approach to providing multinational groups with increased tax certainty, where possible, while identifying areas that require further attention. During the ICAP process, a collaborative working relationship between the multinational group and tax administrations is established.\(^8\) The ICAP is explained in more detail in section 3.

### 3. ICAP\(^9\)

#### 3.1. Overview

The ICAP pilot commences in January 2018 in the following eight jurisdictions: Australia, Canada, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States. Seven MNEs will participate in the ICAP pilot, but the companies are not publicly known. Only MNEs with headquarters in one of these states are allowed to participate in the programme. The periods covered by the pilot version are fiscal years commencing 1 January 2016 and 1 January 2017. Since ICAP is also forward looking, participating tax authorities will attempt to provide tax assurance to MNEs at the conclusion of the ICAP risk assessment with respect to the covered risks for the next two succeeding tax filing periods. The risks covered under the ICAP pilot will be transfer pricing risks and permanent establishment risks.

#### 3.2. Process

The ICAP is structured into an initial phase, a level 1 risk assessment, possibly a level 2 risk assessment and an outcome letter.

*Initial phase:* At the beginning of the ICAP risk assessment, a standard package of documentation has to be provided to the covered tax authorities. Approximately five weeks after providing the documentation, the covered tax administrations will hold a pre-risk assessment workshop in which the contents of the package and any questions of the respective tax administrations will be discussed.

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Afterwards, a kick-off meeting will be held between the MNE group and all covered tax administrations. During this meeting, the documentation package will be discussed in order to ensure a common understanding of its content and the process to be followed. The time frame for this phase is approximately six weeks.

**Level 1 risk assessment:** After the kick-off meeting of the initial phase, the tax administrations will hold a joint workshop to discuss the presentations and review the documentation package. Further information already available to the tax authorities such as tax filing history, tax returns, financial statements, ownership and group structure, rulings, publicly available information, information from other government agencies, tax audit and compliance history, and relevant correspondence with the group will also be considered in the analysis.

There are two main possible outcomes from a level 1 risk assessment. The first possible outcome is that the covered tax administrations assess and assure the covered risks as low or no risk within the target time frame. The second possible outcome is that the covered tax administrations are not able to define the covered risks as low risk or no risk. In that case, the process will progress to a level 2 risk assessment. The time frame for the level 1 risk assessment is approximately eight weeks, plus an additional four weeks if additional time is needed, or an additional eight weeks if additional documentation is needed, plus a further three weeks if a risk assurance phase is required.

**Level 2 risk assessment:** In cases where the covered risks could not be defined as low risk or no risk during level 1, the process will proceed with the level 2 risk assessment. During the level 2 risk assessment, a more detailed and comprehensive review will be performed. There are three broad possible outcomes to a level 2 risk assessment. The first possible outcome is that the covered tax administrations assess and assure the covered risks as low or no risk. The second possible outcome is that the covered tax administrations identify aspects of the MNE group’s tax filings where changes are needed in order for them to assess and assure the covered risks as low or no risk. The third possible outcome is that the covered tax administrations identify aspects of the MNE group’s tax filings where it is not possible to assess and assure the covered risks as low or no risk. The time frame for the level 2 risk assessment is approximately five months, plus an additional three weeks if a risk assurance phase is required.

**Outcome letter:** At the end of the risk assessment process, subject to domestic requirements and processes, each covered tax administration issues an outcome letter to the MNE group, which sets out each of the covered risks where the tax administration has been able to gain assurance and any identified tax risks that remain. The outcome letter should be provided to the MNEs within three weeks after the end of the ICAP risk assessment process.

Depending on the additional time needed, the whole ICAP process will be completed somewhere between 17 weeks and 12 months after the start of the programme. Figure 2 shows the ICAP process in cases with a level 2 risk assessment.

### 4. Outlook and Recommendations

Quite often, traditional transfer pricing audits end with a conflict resulting in double taxation. This could be the result of different interpretations of the factual background and long discussions. Mitigating double taxation after a tax audit, e.g. by means of a MAP, can be time-consuming and costly for tax authorities and taxpayers alike. As such, all measures to avoid double taxation within the tax audit are welcomed.

Both joint audits and the ICAP are ways to reduce conflicts within tax audits. The joint audit programme involves both (or more) tax authorities within the audit. Either both (or the multiple) tax authorities audit together
in the respective countries and exchange information or they audit jointly by means of a physical presence in the other country(ies). Ideally, they reach a consensus and double taxation can be avoided. As they are not obliged to solve the double taxation and come to the same assessment, double taxation can still be the result of the audit. However, as both (or multiple) tax authorities were already involved in the joint audit, following a MAP could be faster. In contrast to the joint audit, the ICAP is not a formal tax audit. It is rather a tax risk assessment by the tax authorities involved prior to the tax audit. However, it helps taxpayers to understand those transfer pricing items that will not be analysed in more detail by the tax authorities in the event of a tax audit (low-risk items). It also highlights items where adjustments would be necessary to reduce the tax risk. As such, the ICAP helps taxpayers to increase legal certainty on the analysed items. In addition, by the involvement of both (or more) tax authorities, it can help to reduce double taxation in the event of a tax audit or reduce the length of a MAP.

Both ways, the joint audit and the ICAP are positive developments as they aim to reduce the risk of double taxation. In particular, the ICAP helps to increase legal certainty before an official tax audit. However, a few items should be considered in further improving joint audits in the future and establishing a well-working ICAP after the current pilot phase with seven multinationals:

1. **Application by taxpayers:** Taxpayers should get the opportunity to apply for a joint audit and an ICAP assessment.

2. **APA:** To get legal certainty after a joint audit for the following years, a fast-track advanced pricing agreement (APA) should be possible. Similarly, the ICAP is not binding for the future. As such, the transformation of an ICAP assessment into an APA should be straightforward. As the APA is more common than an ICAP, this could also help to get global acceptance and inform other tax administrations of the result.

3. **Effort:** It should be further analysed how a joint audit, but in the future also the ICAP, could be as efficient as possible. The idea of a kick-off meeting including a presentation by the taxpayer with an upfront information package seems to be a good way to give everybody involved a very fast overview of the factual background.

4. **Commitment:** In several jurisdictions, the involved parties on the tax authority’s side in the ICAP/joint audit are not the same as in a MAP. The joint audit/ICAP lies with the local tax authorities, whereas the MAP is negotiated between the highest tax authorities in the respective countries. Nevertheless, the local tax inspector should also have the commitment to avoid double taxation at this stage already, especially when the taxpayer shows his commitment to a more time-consuming and costly joint audit/ICAP than a traditional one.

5. **Managing emotions:** A tax audit is an emotional and fact-based process alike. The illustration at the beginning of this article shows that both parties believe they are right – and could actually be right under a phenomenological world view. To route the emotions in a positive way, it could be helpful to involve moderators within the joint audits and ICAP, which are neutral. They should summarize the key facts and mitigate if any emotion pops up.

6. **Primacy of facts:** It might be wishful thinking, but should the ultimate goal of a tax audit not be the right taxation? If that is the case, debates on the factual background and applying the arm’s length principle in the right way should be the main focus of any tax audit – of a joint audit/ICAP even more.

7. **Taxpayer involvement:** Early involvement of the taxpayer could mitigate misunderstandings on the factual background.

8. **Taxpayer rights:** Even though a joint audit and an ICAP could have positive effects for a taxpayer, the taxpayer’s rights need to be sheltered. As such, if the taxpayer does not agree to participate in one of the two programmes, he should have the option of withdrawing from the programme.

If these more practical items will be considered in the future, the authors are convinced that joint audits and the ICAP will demarcate the future of tax audits. Instead of having, as a first step, the tax authorities and the taxpayer in one jurisdiction argue over the right assessment whereas in a second step the tax authorities in both countries discuss it while reaching out to local taxpayers, all mentioned parties are involved from the very beginning. If it could be managed in a professional and fact-driven way, a new epoch of tax audits by coordination and collaboration, instead of confrontation, could be a bright future. If, however, emotions and positions characterize the environment of a joint audit/ICAP, they will only lead to another time-consuming step within a tax audit on the way to a MAP.