The Changing Landscape of Tax Audits in the United States, Canada, and Europe
by Marc Levey, Imke Gerdes, Giuliana Polacco, James Wilson and Mark Tonkovich,

The United States Perspective

Background

There are a number of recent significant events that have prompted a change in the tenor and approach of audits in the United States, particularly transfer pricing audits. One key element, though not of recent vintage itself, is the so-called "Great Recession." All taxing authorities, including the IRS, are now aggressively searching for enforcement revenue in a time of diminishing resources, both human and financial. Transfer pricing is a fertile ground due to its inherent subjectivity and the vast potential for revenue.

Another key element is the Organization for Economic Cooperation and Development's ("OECD") Base Erosion and Profit Shifting ("BEPS") project, which is addressing the definition of intangibles and how they should be treated for tax purposes, transfer pricing risk assessment, transfer pricing documentation, permanent establishment definitions and determinations, and business restructurings. While these OECD undertakings are in different stages of development, the concepts have been woven into the thought processes and fabric of tax audits globally, and the United States is no exception. These projects have also been highly publicized, drawing the deep attention of the G-20 and the press. The press has been most active? with sound bites and headline-grabbing stories, which are often less-than-informed or purely erroneous. These sound bites and stories have engendered strong political attitudes and a sense of social responsibility that have added fuel to the fire of transfer pricing examinations. Indeed, they have given rise to the notion of

---

1 Marc Levey, Imke Gerdes and James Wilson are partners in Baker & McKenzie LLP (New York). Mr. Levey is a frequent contributor to JOIT and a member of its Board of Advisors. Mr. Levey had a previous career at the Department of Justice. Ms. Gerdes and Mr. Wilson are members of the firm's Foreign Legal Team. Giuliana Polacco is a partner in the firm's Milan office. Mark Tonkovich, a senior associate in the firm's Toronto office. The authors would like to thank Jessica Eden and Paula Ruffell, both senior associates in Baker & McKenzie's London office, and Jacques Bernier, a Partner in the firm's Toronto office for their input.
Finally, and most prominently, the element most critical to U.S. transfer pricing examinations has been the role of Transfer Pricing Director. That position came into existence at the time when the IRS reorganized the advanced pricing agreement ("APA") program and the role of Competent Authority into the new Advanced Pricing and Mutual Agreement ("APMA") program. In APMA, the IRS relocated its responsibility for the APA program to its Large Business and International Division ("LB&I") from the IRS Office of Chief Counsel, and combined the APA program with the Competent Authority function. This new group reports to the Transfer Pricing Director, who in turn reports to the IRS Deputy Commissioner (International).

This reorganization was generally designed to bring together all the transfer pricing resources previously spread throughout the IRS and the IRS Office of Chief Counsel. The Transfer Pricing Director's stated goals were (1) to conduct robust factual development at the examination level, so that cases were properly developed and understood for resolution or further administrative review; (2) to resolve cases at the lowest administrative level; and (3) to target appropriate cases for litigation. These are noble goals; historically, cases with poor factual development and often unrealistic and untenable adjustments were pushed through the administrative system (and occasionally to litigation). The result was hardly surprising: transfer pricing cases often got bogged down in Appeals and returned to audit for further development. Not only did this slow down the ability to resolve cases promptly, it often caused both the taxpayer and the IRS to reach resolutions that were based upon expediency, not principle. For those transfer pricing cases that proceeded to litigation, the Service's win record was poor, at best.²

To effectuate his goals, the Transfer Pricing Director pursued a two-pronged approach:

First, the IRS hired numerous personnel, nationwide, for a new Transfer Pricing

² E.g., Xilinx, Inc., 105 AFTR 2d 2010-1490 598 F.3d 1191 2010-1 USTC ¶50302 (CA-9, 2010); Compaq Computer Corp., 78 T.C.M. 20 (1999)
Practice ("TPP") that reported to him. Rules of engagement for TPP's involvement in transfer pricing examinations were issued years after the program commenced. These rules of engagement, although quite different than originally proposed by the TPP program, established shared responsibility for the selection, identification, development, and resolution of transfer pricing issues. Neither TPP nor the LB&I international field examiners appear to "control" transfer pricing issues, and the rules of engagement establish a process for resolving disputes between these functions so that the agency speaks with one voice to the taxpayer.

Second, the IRS issued the "Transfer Pricing Roadmap" ("Roadmap") to provide TPP and the LB&I international field auditors with audit techniques and tools to assist with the planning, execution, and resolution of transfer pricing examinations. The Roadmap focuses upon upfront planning, factual development, reasonableness of results, and effective presentation. A key element of the Roadmap is its focus upon establishing a transfer pricing hypothesis at the outset, which is then proven, refined, or discarded as a result of subsequent factual development.

---

3 IBC and TPP Rules of Engagement (9/30/13), http://www.irs.gov/Businesses/International-Businesses/IBC-TPP-Rules-of-Engagement (retrieved 8/24/14). Curiously, these rules of engagement were issued in September 2013, but were not released to the public until August 2014.

The Results

For taxpayers and their representatives, the first (and most visible sign) of these changes was the number of personnel who comprised the examination team. In addition to the case manager, one or more domestic and international examiners, a transfer pricing economist, and an industry expert (as well as other internal "experts," such as tax law specialists), team members typically include a TPP representative and one or more LB&I field attorneys. While the rules of engagement require the IRS to speak with one voice, the addition of TPP has often revealed jurisdictional disputes within the audit team as to who has ultimate responsibility for the transfer pricing issues under examination. Also, the sheer size of the team often makes it difficult to get matters closed, as the opinions and views of the team members vary, often significantly. Moreover, TPP's late entry into transfer pricing examinations has led, on several occasions, to revamped theories and delayed audit closings.

The results of these changes have been influenced by broader developments at the IRS. At the examination level, the information document request ("IDR") process has significantly changed. LB&I has become more reluctant to give long extensions on IDRs. Usually, LB&I requests responses in 15 to 30 days and frequently seeks memorandums of understanding on the timing and content of IDRs. A relatively new procedure, effective 3/3/14, brings even more rigidity to the IDR process: if IDRs remain unanswered for more than 15 days after the set due date, the IDRs will go to a pre-summons phase to compel a response through a judicial process. Specifically, the audit team will now have an initial meeting with the taxpayer, with draft IDRs provided, to discuss the scope of the formalized IDRs, and the substance and timing of the taxpayer's responses. Having come to an understanding (hopefully) on these issues, the IRS will issue the IDRs with agreed-upon scope and response dates. Achieving this understanding, however, is often not without dispute. These disagreements frequently arise in trying to determine what the IRS is seeking

---

5 An IDR is a tool the IRS uses during an audit to gather documents and other information from a taxpayer.
or whether the IRS is requesting that documents or analyses be created. Taxpayers are expected to comply with the times as agreed. Extensions are only within the discretion of the LB&I territory manager and his or her leeway is only 15 days. Failure to meet this deadline will result in the IRS seeking enforcement through the issuance of a formal summons.

The IRS has shown an increased willingness to resort to the summons process to secure documents and information, including the designated summons. The designated summons is a potent weapon as it can serve to unilaterally suspend the statute of limitations on assessment. The IRS is currently embroiled in litigation over its use of the designated summons in connection with the IRS’s unprecedented retention of a private law firm in a large corporate transfer pricing examination.

For foreign-held multinationals, the IRS plans, as we understand, to amend its October 2013 IDR directive to require all foreign-held multinationals doing business in the United States to submit to a Section 6038A designation letter. Section 6038A requires a "Reporting Corporation" that is (i) a domestic corporation and (ii) is 25 percent foreign owned, to furnish relevant information as described by the regulations thereunder and to maintain in location such records as may be appropriate to determine the correct investment of "transactions with related parties." The "transactions with related parties" concept is directly tied to Form 5472 which requires an identification of each intercompany transaction by and between the Reporting Company and the identified foreign corporation. With the Section 6038A designation in place the IRS can now move expeditiously to issue a summons to compel document production. This dynamic, of course, may significantly impair the spirit of cooperation typically sought in an audit in addition to the production of voluminous data, much of which may not be directly relevant to the issues at hand.

A Reporting Corporation must maintain or cause to maintain certain records within

---

7 I.R.C. § 6503(j); Treas. Reg. § 301.6503(j)-1.
8 United States v. Microsoft, No. 2:15-cv-00102 (W.D. Wash); United States v. Mundie, No. 2:15-cv-00103 (W.D. Wash.).
the United States absent a negotiated record maintenance agreement with the LB&I Director of Field Operations or the Area Director that has audit jurisdiction. This agreement should establish which records must be maintained, by whom, how they will be maintained and the period of retention. To put this in perspective, the essence of Section 6038A is to provide the IRS with product line profit and loss statements for all entities along the supply chain for United States destined products or services.\(^9\) In some circumstances, however, a Reporting Corporation can maintain this information outside the United States with the concurrence of the Director, LB&I.\(^10\)

Maintenance requirements include:

1. **Related records.** The record maintenance requirements apply to records that are directly or indirectly related to transactions between the reporting corporation and foreign related parties.\(^11\) For example, a record that is indirectly related is one that is possessed by the foreign subsidiary of a foreign related party documenting the raw materials or component costs of a product that is manufactured or assembled by the subsidiary and sold as a finished product by the foreign related party to the reporting corporation.\(^12\)

2. **Foreign related or third-party records.** Under Section 6038A, records that are in the control of the foreign related party may be obtained or compiled under the direction of the reporting corporation and then maintained by the reporting corporation, the foreign related party or a third party.\(^13\) If the Service makes a request to examine such records, a foreign related party or third party can arrange to forward the records directly to the District Director, rather than through the reporting corporation.\(^14\)

3. **Translation of records.** If the Service requests any records and those records are not in the English language, they must be translated into English within thirty days of a

---

\(^9\) Treas. Reg. § 1.6038A-3(c)(2)(ii).
\(^10\) I.R.M. Part 4.60.8.3.5.2.
\(^11\) Treas. Reg. § 1.6038A-3(b)(1).
\(^12\) Id.
\(^13\) Treas. Reg. § 1.6038A-3(b)(2).
\(^14\) Id.
request by the District Director for a translation. The reporting corporation can request an extension of time to produce the records in English, and such extensions are to be liberally granted where the circumstances warrant.

On a positive note, the pre-issuance consultative process has the potential to foster a better spirit of cooperation, and could avoid post-issuance arguments over IDR relevance and clarity. That said, IDRs issued under the new procedure have often been more detailed, probing, and at times, overreaching.

As an example, we have seen references to customs data in recent IDRs, where the IRS is presumably searching for third-party comparables, consistency in the values reported for customs and transfer pricing, or ensuring that the U.S. entity is properly compensated for any direct sales that a foreign affiliate may make to the U.S. market. Often, the data cannot be reconciled with booked transactions, for example, when an importer marks an item for consumption even though it is a returned item to avoid customs scrutiny. Simply put, this customs data is largely irrelevant, but it is immensely time-consuming to provide a clarifying response. The point is that the IRS is looking at all possible avenues to support its proposed adjustments.

Another recent example is IDRs seeking transfer pricing valuation and branding studies for all entities (with English translations) within the supply chain. Sometimes the IRS even seeks this data from outside the supply chain under the notion that they merely "want to understand the business." At times, IDRs have even asked for global transfer pricing, valuation, and branding studies, also under the auspices of "we want to understand the business." Needless to say, responses to these types of IDRs were negotiated down (or away), but they do serve to illustrate the added depths of the IRS pursuits.

IDRs requests for interviews and plant tours in transfer pricing examinations are not new, but the current practice and detail have taken on a new element. While the IRS

15 Treas. Reg. § 1.6038A-3-(b)(3).
16 Id.
historically sought interviews in connection with plant tours, we are now regularly seeing requests to interview key personnel from all entities in the supply chain. The number of proposed interviewees is not insubstantial, and the effort is both time-consuming and disruptive to the taxpayer's business operations. Given that the IRS has a limited travel budget, it has, on occasion, made good use of videoconferencing (although for large cases in designated industries, travel budgets do exist). Moreover, we have seen an expansion in the use of formal transcribed interviews in transfer pricing audits, as well as a broadening of the number of IRS interviewers.

Often the scope and determination of witnesses is resolved at the IDR stage. Generally, however, witnesses can include teams from sourcing and logistics, distribution and sub-distribution, finance and treasury, branding, marketing, sales, R&D, manufacturing and processing, strategic budgeting and planning, human resources, and more. While it is questionable whether all these people are necessary to address the issues at hand, the IRS's standard practice, as set forth above, is to "understand the business." This can be good and bad. The good side is obvious: an informed examiner can eliminate unnecessary steps and expedite the identification and resolution of technical tax issues. The bad side is less obvious: the IRS team may not be able to absorb, understand, and appreciate all the information that they seek in a meaningful and practical way. Too often, misinformed teams engage in a form of game theory that can be very disruptive and preclude the pursuit of a realistic compromise. Equally disturbing is where the IRS is merely searching for avenues of potential dispute.

Without a doubt, the increased audit focus upon transfer pricing has the potential to lead to double taxation. Simply looking at the plethora of issues vented in the press today - where taxing authorities are seeking the same revenues within a supply chain - it is inevitable that these issues will come before the respective Competent Authorities. Academically, this sounds acceptable; practically, it can be catastrophic. Can the staffing at Competent Authorities handle this workload? How long will it take to seek some form of resolution?
Will Competent Authorities become selective (or more selective) in the cases that they accept? How will delayed resolutions affect taxpayers' financial statements or the ability to close their books? Notwithstanding all of these concerns, how efficient will the resolution process be where Competent Authorities have different conceptual views for the issues involved? Indeed, recent experiences with the Indian Competent Authority are illustrative of this point, as there are hundreds of unresolved cases pending today.

**Appeals Developments**

Recent developments at Appeals will also affect the results of these changes, particularly the Appeals Judicial Attitude and Culture Project ("AJAC"). With AJAC, the IRS seeks to position Appeals as a quasi-judicial forum for resolving tax disputes, at a time when resources are strained, with the stated purpose of enhancing internal and external perceptions of a fair, impartial, and independent Appeals function.

AJAC Phase I, implemented on July 18, 2013, eliminated the prior Appeals practice of returning insufficiently developed cases to examination and severely curtailed the circumstances when Appeals will consider new facts presented by a taxpayer.\(^\text{17}\) AJAC Phase II was announced by the IRS on July 2, 2014, and is effective for all new Appeals case receipts on or after September 2, 2014.\(^\text{18}\)

AJAC Phase II primarily addresses the timing of the receipt of matters in Appeals. Specifically, Appeals will not accept a new case unless there are at least 365 days remaining on the statute of limitations, nor will Appeals solicit a statute extension from a taxpayer who protests a case to Appeals with less than 365 days remaining on the statute of limitations. In the past, only 180 days were needed to secure Appeals consideration in a new case, and Appeals previously had discretion to offer a statute extension to a protesting taxpayer whose statute of limitations was less than 180 days from expiration.

---


\(^{18}\) In addition to Fast Track Settlement and traditional Appeals consideration, Appeals offers other programs designed to settle cases without litigation, including the Rapid Appeals Process and Post-Appeals Mediation.
While AJAC has the potential to enhance both the perception and reality of independence at Appeals and speed the resolution of cases in Appeals’ jurisdiction, it remains to be seen whether AJAC will achieve its intended results. One concern is that the 365-day rule discussed above may wind up increasing the number of transfer pricing cases proceeding to litigation. Under AJAC, the examination team can dictate whether the taxpayer gets pre-litigation Appeals consideration by controlling the timing of the audit’s completion: the taxpayer is at the mercy of the IRS examination team to offer an extension to the statute of limitations in this case. However, a taxpayer is not legally entitled to an extended statute of limitations, and the IRS is under no legal obligation to acquiesce to a taxpayer’s request for an extension.

Taken together, these recent developments at Examination and Appeals mandate a new thought process for plotting a transfer pricing audit strategy. Under the new IDR process, the IRS plans to develop cases well at the examination level, which will either aid settlement at that level or assure a detailed understanding of the case as it proceeds as an unresolved controversy, possibly to litigation. Settling a fully developed and unresolved transfer pricing case in Appeals or litigation may now be more difficult, absent the examination team simply being wrong or overreaching.

Under AJAC, however, Appeals will now attempt to settle poorly developed cases based upon the existing examination record, in lieu of returning these cases to the examination level for further development. In the past, frustrating examination’s fact finding to garner a better settlement in Appeals was often a fool’s errand: Appeals would simply return the case to examination for further development. Given the Service’s poor historical results in transfer pricing litigation, AJAC may serve as a disincentive for taxpayers to be cooperative with IRS fact gathering on audit, which may lead to more summons enforcement actions under the new IDR process. Perversely, this could lead to more issues, not less, proceeding on an unagreed basis to Appeals or litigation. While the IRS should be commended for attempting to preserve Appeals’ role as an independent arbiter of tax
disputes in an era of diminished resources, it should carefully monitor the program to ensure that its stated goals are being met, and be willing to make the necessary adjustments to ensure that AJAC does not replace one set of tax administration problems with another.

Taxpayers may also choose to proceed to Fast Track Settlement,\textsuperscript{19} which is a form of mediation. The time to consider this alternative dispute resolution vehicle is when the IRS issues its notice of proposed adjustment, or Form 5701. Of course, in the current environment this may not occur until the time that the examination team has reasonably developed its case. If a taxpayer waits until the receipt of the Notice of Adjustment, or the "30-Day letter," it is precluded from using the mediation alternative. Fast Track Settlement requires both the agreement of the taxpayer and the examination team, as well as acceptance by Appeals. The approval by the examination team is not simply because they participate in the actual mediation, but because the case is in their jurisdiction. However, hazards of litigation can be considered in resolving the case, which the examination team otherwise is not supposed to consider during the course of a taxpayer audit. The attractiveness of this process is that cases get concluded, if both sides agree, within 120 days of the acceptance into the program. One question is whether the examination team will agree to Fast Track Settlement if, during the audit, they have become entrenched in their position, right or wrong.

Fast Track Settlement has been quite successful in resolving cases amicably, assuming there are willing participants. Full factual development by the examination team should not be a deterrent to this process because neither the examination team nor Appeals would likely accept a "half baked" case for mediation. The strategy to be considered by taxpayers here is how willing the IRS would be to mediate. If the examination team and/or TPP is well entrenched in their position(s), Fast Track Settlement may not work effectively.

If applicable, Fast Track Settlement provides for a "mini trial" in which both the IRS and the taxpayer present their cases to the Appeals Officers. The Appeals team may include the Appeals team case leader, international experts, economists, and/or industry specialists.

\textsuperscript{19} [NEED CITE]
The parties may have presentations by experts, company representatives, economists, or any professional that may advance their respective case. Time is allowed for questions because the IRS and the taxpayer retreat to separate caucus rooms wherein the Appeals officers separately meet with each team to mediate until either a resolution occurs or a stalemate exists. If successful, the teams then gather to work up their agreement, which is ultimately set forth in an IRS formal document.

**Canada: Looking North of the Border**

With its significant position in the G-20, Canada is a longstanding supporter and ongoing participant in the BEPS project. Although a number of Canada's planned income tax changes have been put on hold pending the conclusion of related work on several BEPS action items (including, for example, a made-in-Canada anti-treaty shopping rule), others have proceeded in the interim. These include changes to the Canadian foreign accrual property income regime,\(^\text{20}\) as well targeted changes to the thin-capitalization\(^\text{21}\) and the foreign affiliate dumping rules.\(^\text{22}\) While remaining committed to the BEPS project and to exploring the implementation of that project's conclusions with various stakeholders, the Canadian government frequently espouses the need to proceed in a manner that balances tax integrity and fairness with the competitiveness of Canada's tax system. Thus, the implementation of the BEPS project's conclusions in Canada depends on both domestic and international buy-in on the project's various substantive recommendations, which support is not a foregone conclusion.

This is not to say that the BEPS project has had little or no impact on the Canadian tax system as of yet. Increased dialogue in Canada on international tax issues has both fueled and been fueled by the BEPS project. That dialogue, of course, is not new: Canadian policymakers, administrators, taxpayers, and judges have for many years dealt with related

\(^{20}\) Which taxes certain investment and property income earned by Canadian taxpayers' foreign affiliates.  
\(^{21}\) Which limits interest deductions that can be taken in respect of debt used to capitalize Canadian corporations by their non-resident owners.  
\(^{22}\) Which imposes Canadian tax consequences when foreign-controlled Canadian companies invest in foreign affiliates.
issues pertaining to international tax arbitrage. But the current discourse is somewhat different in that it is being readily consumed by the public. Canadian media has substantially increased its coverage of international tax planning and avoidance stories in recent years, and the average taxpayer's (sometimes misinformed) sentiments toward international businesses have caused them to speak with their wallets in new and powerful ways. In turn, this culture shift has given Canadian legislators the motivation to refocus resources on international tax issues that would have seemed significantly more obscure to the voting public a decade ago.

It has now been many years since a Canadian federal budget did not announce legislative changes, new administrative initiatives, or shifts in Canada Revenue Agency ("CRA") funding aimed at combatting perceived gaps in Canada's international tax system. In 2015, the Canadian government announced an additional $25.3 million to expand the CRA's ability to combat international tax evasion and aggressive tax avoidance, and a further $58.2 million commitment to combat aggressive tax avoidance by the largest and most complex business entities (many of which are likely Canadian arms of multinational enterprises). The Department of Finance and the Canada Revenue Agency have also introduced several new initiatives which have themselves attracted significant press coverage. For example, the CRA launched the Offshore Tax Informant Program in 2014 - a program that pays whistleblowers a percentage of the federal tax collected from tips concerning major international tax noncompliance. At the same time, Finance introduced new rules that require financial intermediaries to report cross-border electronic fund transfers of $10,000 or more. And more recently, on the heels of the United States' Foreign Account Tax Compliance Act, Canada entered into an intergovernmental agreement with the United States for reporting accounts held by one country's taxpayers in the other country's financial institutions.

The expanded focus on international tax issues can also be seen on the audit frontlines, with more and more clients - both large and small - being caught up in project-based audits
focusing on any number of cross-border issues. In recent years, the CRA has devoted extensive resources to scrutinizing activities involving particular offshore jurisdictions (e.g. Barbados), all manner of transfer pricing issues, so-called hybrid entities and hybrid financing structures, and surplus-stripping. This reflects the same "bang for the buck" approach seen in other jurisdictions: because international tax planning has the potential to achieve large-scale tax efficiencies, it is also an area ripe for audit due to the sheer quantum of potential tax revenues. The risk-based assessment approach has become a mainstay of CRA strategy.

Since 2010, the CRA has been ranking Canada's largest business into high-, medium-, and low-risk categories, which ranking determines the type and frequency of audit review faced by those taxpayers going forward; participation in international transactions is an identified risk factor in that program. The CRA's increased emphasis on risk assessment appears to be paying dividends: the CRA's most recent annual report to Parliament indicates that 85% of risk-assessed audit activities in the International and Large Business space have detected income tax non-compliance, leading to $6.1 billion of positive fiscal impact for the CRA.  

A broad array of information gathering powers assists the CRA in its audit work. Those powers have been generously interpreted by Canadian courts, and they allow the CRA to compel the production of a wide range of information and documentation about multinational enterprises. They include the ability to compel the disclosure of information or documentation by taxpayers or by third party custodians, and they are enforceable by streamlined compliance proceedings. Certain of these powers were reactionary measures introduced in response to taxpayer wins in court cases involving transfer pricing and BEPS-like disputes (well before the OECD coined that particular acronym). The CRA now has the ability to require production of information only available outside of Canada (whether or not

23 Namely: tax assessed, tax refunds reduced, interest and penalties, and the present value of future federal tax assessable arising from compliance actions. Importantly, because this figure does not include the impact of assessment reversals by the CRA's Appeals Division or by the courts, and does not include amounts determined to be uncollectible, the CRA's statistics only tell part of the story.
held by an entity controlled by the taxpayer under audit), and the Canadian taxpayer will be prevented from relying on the requested information if it fails to disclose it to the CRA when so required.

In the transfer pricing context, a taxpayer is deemed to have failed to make reasonable efforts to determine arm's-length transfer prices (and stands liable for significant penalties) where it fails to produce detailed contemporaneous documentation to the CRA within three months of a written request for that information. In recent years, the CRA has also increased the frequency, volume, and pace of these various types of information demands in the international context, and there appears to be a similar increase in enforcement actions where a taxpayer initially fails to comply with audit requirements. Of course, the CRA's broad powers must still be exercised reasonably, in line with the applicable legal requirements. Taxpayers should keep this in mind, particularly when considering information requests that appear unnecessarily broad or burdensome on their face (e.g. because they aim at foreign-based information about a taxpayer's affiliates with little actual connection to the Canadian taxpayer). Prudent taxpayers will carefully consider such information requests and may attempt to negotiate their terms or make strategic decisions about when and how to formally challenge the CRA's demands.

Finally, because solicitor-client privilege continues to be zealously guarded by Canadian courts, it remains one of the last vestiges of protection for confidential information as against Canadian tax authorities. In contrast to protections available in certain other jurisdictions, Canadian jurisprudence emphasizes the continuing divide between tax lawyers (whose advice is prima facie protected) and tax accountants (whose advice does not enjoy any form of legal privilege in Canada). Multinational groups should be particularly sensitive to the intricacies of Canadian privilege rules in the current audit environment when organizing their global information networks and document management policies.

In addition to the CRA's statutory information gathering powers, the growing focus on international tax issues has drastically increased systems for international exchange of tax
information and cooperation with foreign tax authorities. On the information exchange side, Canada has one of the world’s largest tax treaty networks, which includes 92 tax treaties based on the OECD’s model convention as well as an additional 22 tax information exchange agreements. As well, the *Convention on Mutual Administrative Assistance in Tax Matters* entered into force in respect of Canada in 2014. That multilateral convention provides for information exchange and additional forms of administrative assistance between the convention’s signatories (which include a number of countries with which Canada does not have a bilateral tax treaty). Canada also signed on to that convention’s multilateral competent authority agreement in 2015, which will allow for the automatic exchange of financial account information with treaty partners. Canada’s tax information exchange practices have been positively reviewed by the Global Forum on Transparency and Exchange of Information for Tax Purposes, and Canada appears to be a very active participant in global tax information exchange with its many international partners. For other forms of international cooperation, in addition to its own audits on foreign soil (with the taxpayer’s consent), the CRA reports positive experiences with simultaneous (but independent) audits conducted at the same time as foreign audits, and it completed its first joint audit (working directly with the IRS) as a pilot project in 2013. All signs suggest that this level of cooperation will continue in the years to come. This stands to significantly benefit tax administrations, but it may also present additional challenges to global enterprises in connection with the loss of confidentiality in their global tax information. In Canada, maintaining the confidentiality of taxpayer information is sacrosanct, and the unauthorized disclosure of taxpayer information is a criminal offence. However, we have recently seen the potential for information leaks when working with the CRA’s foreign partners lead to senior-level discussions with the CRA concerning the scope of treaty-based information exchange. We have also advised on potential judicial challenges to the CRA’s information exchange practices based on Canadian administrative law principles.

24 For example, where taxpayer information is to be communicated to a foreign authority without sufficient legal protection in the foreign jurisdiction, or where there may be practical gaps in the system for maintaining tax secrecy outside Canada.
Unless sufficient protections are consistently maintained - not only in Canada but across the whole of Canada's tax information exchange network - this issue may demand a more formal (and litigious) response in the future.

Taking stock of current Canadian audit trends and the CRA's continuing focus on international tax issues, one sees a theme emerging. As the world becomes a smaller place, growing sensitivities about base erosion and profit shifting will continue to affect both the policy and procedure underlying today's tax systems. Canada is no exception to the rule that legislators and modern tax authorities stand committed to capturing what they perceive to be their respective share of global tax revenues. It is not yet clear whether Canada will decide to fully implement the substantive tax principles suggested by the BEPS action items, or whether it will instead proceed down a somewhat different path that may be better aligned with its own historical tax policies and national identity. But there is greater certainty about one aspect of this movement: however Canada's tax rules will look in the next decade, the administration of the Canadian tax system is very unlikely to return to the narrower system that was in place a decade ago. International cooperation between tax authorities and vast increases in the worldwide exchange of tax information are not policy proposals merely under consideration; those practices are here, and they are here to stay. Multinationals with operations in Canada would do well to keep in mind that their activities in other jurisdictions and the positions they take before foreign tax authorities in respect of their Canadian operations may already be known to the CRA (and if not, chances are that they soon will be).

The European Union: A Look Across the Pond

Introduction

Though the member states of the European Union ("EU") lack the IRS's Roadmap, there are other developments that influence the audit landscape. As in the United States, the OECD's BEPS project was received with much interest by the member states of the EU as
most action items seem to give these countries powerful means to target local operations of large multinationals. The European Commission has fully embraced BEPS and has already made or plans to make changes to the European secondary law (such as the Parent-Subsidiary-Directive\(^{25}\) or the Interest and Royalty Directive\(^{26}\)), to enable Member States to pass domestic legislation implementing the OECD’s suggestion to combat hybrid mismatch arrangements and deny the application of the participation exemption if the payment was deductible as a business expense in the country of the payor. Accordingly, many member states including Austria, Germany, France, Spain and the United Kingdom already changed their domestic law even before the OECD’s Committee on Fiscal Affairs officially adopted the recommended rules. Most prominent is the UK’s Diverted Profits Tax.\(^{27}\)

Further, the European Commission has also launched its own initiatives that resemble the BEPS spirit. On March 18, 2015, a proposal for amending Council Directive 2011/16/EU on the exchange of information was published, requiring the Member States to automatically exchange information on advance cross border rulings granted to their taxpayers. The amendment, if passed in its current wording, requires Member States to communicate by way of automatic exchange of information to all Member States as well as to the European Commission advance cross border rulings and advance pricing arrangements. The information to be provided includes, \textit{inter alia}, the identification of the taxpayer and the group it belongs to, the content of the ruling or pricing arrangement, a description of the set of criteria used for the determination of the transfer pricing and the Member States likely to be concerned. The Member States are required to implement the Directive - if passed - into

\(^{27}\) Diverted Profit Tax, Section 88 to 91.
domestic law by December 31, 2015. The reporting obligation commences on January 1, 2016 and has retroactive effect for 10 years and thus covers any ruling issued on or after January 1, 2006. This proposal is the key element of the European Commission’s Tax Transparency Package and marks "the start of a new era of transparency" and fits nicely into the EU legislation concerning the enhanced administrative cooperation in the field of taxation establishing necessary procedures for a better cooperation between tax administrations, such as participation in audits and the conduct of simultaneous audits. The most recent EU initiative concerns Country-by-Country reporting ("CbC"). While the European Commission follows the OECD development with much interest, it felt that European actions were warranted. On June 18, 2015, the Commission issued a public consultation paper on further corporate tax transparency testing the appetite for introducing an EU wide CbC legislation. One of the issues the Commission seeks input on is whether the reporting threshold of EUR 750 million suggested by the OECD shall be adhered to, or whether the EU should come up with their own threshold. Given that countries and their tax administrations are immensely interested in obtaining the information to be disclosed under CbC, it would not be surprising if the EU ended up demanding a lower threshold.

In view of all these developments, and especially supported by the political direction the EU is taking, many EU Member States already embraced the spirit of BEPS. An increased number of information exchange requests can be seen which are geared at obtaining information that relates to the transfer pricing position of the taxpayer. The requests are typically broad and European tax administrations seem to be less willing to defy

---

the request than they have been in the past. Specifically, for example, Austrian tax
administrations do not only try to obtain the requested information from the taxpayer that
belongs to the group of companies the request relates to, but they refuse to tell the taxpayer
which country is requesting the information and additionally, approach customers of the
domestic company asking them for documents, such as agreements. This increased interest
for information also applies vice versa and can be witnessed in audit situations. Tax
authorities increasingly are looking for CbC type of information and where the taxpayer
refuses to disclose that information for lack of a legal basis, the authorities increasingly send
out exchange of information requests. Sometimes, those requests lead to the initiation of a
simultaneous audit in another Member State and sometimes the tax authorities actively
encourage other EU Member States to join the audit. Also, tax authorities have discovered
the merits of questioning witnesses, which makes it even more important to manage the audit
not only locally, but to keep oversight on the level of the ultimate parent company. All in all,
supported by the developments on the level of the OECD and the European Union, European
tax administrations are getting more and more aggressive when conducting tax audits.

**Germany and Austria**

Germany and Austria, for example, are both in favor of the BEPS project and support
the introduction of EU laws addressing these issues. EU laws would enable the EU Member
States to take unilateral measures that might go even further than the BEPS project and it
allows them also to cover countries unilaterally with which particular Member States do not
have a tax treaty. Thus, in a transfer pricing audit, German and Austrian authorities will
place specific emphasis on (i) the substance of the companies involved in intercompany
transactions, (ii) the net margin of other group companies that perform comparable transactions, and (iii) the entire value chain and identification of "profit centers" that generate the profit in the value chain while companies in Germany and Austria might be running on losses. Where a German or Austrian company derives losses for a substantial period of time (i.e. for more than three years), the authorities now follow the theory that no unrelated party would continue such a loss making business and assess that the German/Austrian entity is providing a service to its (in)direct parent company, namely, keeping the business active and the name in the local market. The approach is simple and seemingly effective - the authorities apply a cost plus approach basically requiring the (in)direct parent company to pay a service fee to the German/Austrian entity, thereby cancelling the losses.

Also, where commissionaire structures are involved, the authorities will almost always raise permanent establishment issues. In many cases this is a difficult discussion and the authorities are of the opinion that a commissionaire is almost inevitably a permanent establishment of the principal. For example, the Austrian authorities typically apply this approach to limited risk distributors. Tax administrations in both countries feel validated in their approach by the OECD's Revised Discussion Draft on BEPS Action 7 and apply the same to pre-BEPS facts as well.

Lastly, transfer pricing audits often also lead to VAT and potentially customs audits and adjustments, where the price paid for a good is in fact adjusted. Given that tax authorities in the BEPS world are now looking at everything, these issues will also come into focus. For example, if the purchase price for a good was considered to be too high and is adjusted to the arm's length value, the VAT is still payable on the entire purchase price,
however, the VAT attributable to the excess amount might no longer be deductible as a business expense. So far, VAT has not been the center of attention, but especially where businesses are concerned that they are not entitled to a full input VAT deduction, this poses a substantial risk. The treatment of price adjustments for customs purposes is inconsistent in the EU. Some customs administrations consider upwards and downwards adjustments and make corresponding adjustments to the import duty, others disregard downward adjustments. Also, there is an inconsistent treatment of tax only adjustments and actual price adjustments.

It should be noted that the World Customs Organization published a "WCO Guide to Customs Valuation and Transfer Pricing" in June 2015 urging a consistent treatment of transfer pricing adjustments for customs purposes. The WCO proposes the application of a weighted average customs duty rate which should include the possibility to a lump sum adjustment at the end of the year. The example given in the guide is: suppose the transfer pricing adjustments result in an additional payment to the seller, the importer should be able to report this lump-sum amount and customs will allocate it to all entries declared within the year. The duty adjustment will then be the weighted average duty rate. However, this is only a guide and, to date, no consistent treatment exists. This means that customs adds additional risks to transfer pricing audits as usually custom adjustments and the related penalties are usually a final burden to the taxpayer and cannot be passed on.

Historically, in neither country have transfer pricing cases made it to the Tax Court often. In most audits, the taxpayer settles the case after lengthy discussions with the authorities. One reason for this is that many taxpayers do not have the confidence in the Tax Courts that they can deal appropriately with the economic side of transfer pricing cases.
However, given the increasing aggressiveness with which the authorities pursue audits, the limit of what can be accepted has oftentimes been reached or overstepped. Especially because the proposed settlement options tend to now have a long lasting affect on the general transfer pricing structure employed and potentially impact the tax situation in other countries as well, tax authorities are less likely to agree to a "one off" payment but instead want to see structural changes going forward. Taxpayers sometimes believe that the goal is not to find just taxation based on an arm's length price but to generate additional revenue for the fisc, no matter how, and oftentimes leaving aside the profit and loss situation of the group of companies in other countries.

It is noteworthy that most European countries do not provide for an appeals process similar to the US system. Generally, if negotiations with the authorities fail, the taxpayer has to appeal against the assessment and the case is immediately referred to the competent Tax Court. This decision can be appealed as well and will then be decided by the highest court (in Germany, the Federal Fiscal High Court - Bundesfinanzgericht, and in Austria, the Federal Administrative Court - Verwaltungsgerichtshof), which decision is final. However, because German and Austrian courts have actually quite often ruled in favor of the taxpayer, it might be worthwhile going through the burdensome and time consuming process of filing an appeal in many cases.

**Italy**

Italian Tax Authorities have always been notorious for focusing on tax audits in a very aggressive manner within the scope of reinforcing the fight against tax evasion and tax avoidance. Tax audits are still carried out not only by the Revenue Agency, but also by the
Tax Police which has significant investigative powers. The consequence is that the documentation collected in the context of audits normally represents strong evidence to identify actual functions performed by the Italian company, especially with reference to permanent establishment audits or audits aimed at identifying the actual residence of enterprises.

As a result, the discussion on BEPS and at the OECD level has not significantly changed the way Italian Tax Authorities conduct their audits, but it has certainly offered additional support to the approach already taken to large enterprises, i.e., enterprises with turnover higher than 100M Euro which normally includes companies belonging to multinational groups. In particular, the BEPS discussion on permanent establishments seems to be aligned with the conclusions taken by the Italian Supreme Court in the Philip Morris case, that is, where the mere involvement in negotiations was considered triggering the permanent establishment risk. Further, the CbC Transfer Pricing report is in line with the attitude of Italian Tax Authorities to better understand the profitability at group level to detect whether revenues were illegitimately shifted out of Italy, transactions qualifying as aggressive tax planning schemes which already the object of analysis after the issuance of the OECD report on "Aggressive Tax Planning based on After-Tax hedging 2013." In addition, there is a specific focus on transfer pricing audits where the position of the Italian Tax Authorities is not always justified from a technical standpoint, yet it can result in very significant adjustments. The presence of an adequate Country File may help to prevent the application of penalties, but the concept of whether transfer pricing documentation may be considered adequate or not is left to the decision of tax auditors which tend to raise
exceptions regarding the correct representation of the functions performed by the Italian entity. Thus, the Country File is not necessarily sufficient to obtain the penalty protection.

The magnitude of the adjustments proposed by the Italian Tax Authorities especially against multinational groups also brings serious consequences on the criminal tax side. Indeed, when certain thresholds are exceeded (i.e., 2M Euro of adjustment), the case is automatically transferred to the competent Public Prosecutor who has to identify the presence of the subjective element, i.e., to check whether the legal representatives of the company have acted with malice and wanted to evade taxes. The simple notification of a notice of crime to the Public Prosecutor office for a certain year entitles the Tax Authorities to extend the statute of limitation for the audit. In particular, while the regular statute of limitation is five years (six years in case the tax return is not filed), the presence of a notice of crime doubles the statute of limitation, with the consequence that currently tax assessments going back to 2005 are served to enterprises.

The criminal ramifications of tax audits often brings taxpayers to conclude settlements with the Tax Authorities for the purposes of reducing/eliminating the liability on the criminal side. Indeed, the settlement on the administrative side is often considered by Public Prosecutors as an expression of the willingness of eliminating possible damages to the Italian Tax Administration with the consequence that there is a greater likelihood of having the criminal case dropped.

Recourse to litigation is seen as last resort given the length of the procedure and the associated risks. Most tax cases, including transfer pricing cases, are normally brought to the
Supreme Court where a proceeding may remain pending for 3 to 4 years before being concluded, creating a condition of utmost uncertainty. Moreover, while in a settlement procedure, penalties -, where the minimum amount is 100% - may be reduced to one sixth; for a negative decision, however, full penalties are due.

To prevent aggressive audits and the relevant undesirable consequences, taxpayers are more frequently considering the APA program where transfer pricing analysis is made in advance as well as possibly reorganizing the functions of the group. The APA team is composed of transfer pricing experts who carry out a functional analysis in advance and are able to identify and agree with the taxpayer's appropriate transfer pricing methods. The APA team over the years has enlarged the scope of its competence, including the analysis of presence of permanent establishment with the relevant revenue allocation, the identification of the transfer pricing policy for the companies involved in collection of online advertisement, and the new patent box regime.

In parallel, the Italian Tax Administration is promoting a cooperative framework by launching the so called Co-operative Compliance Program ("CCP") aimed at encouraging large enterprises to implement internal tax control models to be compliant with the tax legislation and prevent audits and litigation. The CCP should align the Italian legislation to the guidelines issued by the OECD in "Co-operative Compliance: A Framework from Enhanced Relationship to Co-operative Compliance." The CCP should generally imply a commitment by large enterprises to adopt transparent behavior with the tax administration to solve possible issues before the launch of an audit.
The focus on these Italian issues shall continue in the coming months. The Government plans to implement a number of decrees which should bring significantly changes to important topics, in view of boosting the economy and attracting foreign investments. In particular, the new rules are supposed to be aimed at enlarging the competence of the APA office, redefining the concept of abuse of law and tax avoidance, bringing changes to the statute of limitation rules, clarifying issues on the penalty application and reinforcing the scope of the cooperative compliance program.

**The United Kingdom**

While the current UK government has stated that it fully supports the BEPS project, many consider that the UK has preempted a number of the expected reforms through its unilateral introduction of the Diverted Profits Tax ("DPT"). The timing of the introduction of the DPT, just prior to the last general election, suggests that it was politically motivated. A question remains as to whether the DPT will continue to be of relevance once the changes expected as a result of the OECD BEPS project are brought into force.

One impact of the DPT is that it gives more teeth to the UK’s existing transfer pricing regime and gives the UK tax authority a number of procedural weapons that provide it with the upper hand in transfer pricing enquiries. In many respects, the mechanics of calculating the DPT charge is no different to the existing transfer pricing regime, which looks to the substance of the companies involved in intercompany transactions, assesses the value of the business activities conducted globally and picks apart the global value chain to ensure that UK activities are properly rewarded.
While the obvious targets of the legislation are businesses with UK activities that have avoided having a UK permanent establishment and those that take advantage of entities that lack economic substance in low tax jurisdictions, the legislation, which was pushed through Parliament with little debate and is broadly and in places poorly drafted, potentially catches a much wider range of intercompany arrangements where an effective rate mismatch is triggered.

One of the key features of the DPT is the burden placed on companies to notify the UK tax authorities if they are potentially within the scope of DPT within three months after the end of the accounting period.\(^\text{29}\) This period is extended to six months for the first accounting periods affected by the introduction of DPT but is fast approaching, for example for a company with a 31 December 2015 year end the deadline for notification will be 31 June 2016. The legislation does not reward those who bury their heads in the sand and tax-geared penalties can be imposed on those who fail to notify.\(^\text{30}\)

Proactive companies are increasingly accepting that in a post-BEPS environment a review of the global value chain through a transfer pricing lens may soon be required and are voluntarily engaging the UK tax authority, HMRC, in advanced pricing agreement discussions. A note of caution here is that HMRC’s resources are limited, so although initial contact might give companies a sense of optimism as to the speed at which an agreement will be reached, in our experience discussions can be prolonged (often for years) and HMRC will ask companies for as much information as they try to understand the business during that time. Moreover, the maximum transparency that HMRC will demand is not always

\(^{29}\) Section 92, Finance Act 2015.

\(^{30}\) Section 104(4)-(6), Finance Act 2015 and paragraph 1, Schedule 41, Finance Act 2008.
reciprocated and companies should be circumspect in their interactions with HMRC, especially given the wide array of regimes that now enable information exchanges with other tax authorities.

The UK is party to numerous multilateral and bilateral international agreements and conventions providing for the exchange of information between the UK and overseas tax authorities. As a result, companies should consider their response to any requests for information by the UK authorities during an audit with care and assume that any information provided could be the subject of an exchange with another tax authority in a different jurisdiction. It is increasingly important for entities not only to manage local audits, but to be aware of the relevance of information that is being sought across audits and potential audits in different jurisdictions. As a result of this increasing exchange of information, it is anticipated that multinational groups will need to adopt a more centralized approach to the management of tax audits and disputes than they may have done in the past.

The UK tax authority has launched a number of consultations this year which continue a theme of the UK government seeking to bring taxation matters further into the boardroom, covering areas such as improving large business tax compliance and strengthening sanctions for tax avoidance. The proposals that are up for discussion include requiring company boards to publish the company's annual tax strategy, for example. These are indicators that the UK tax authority is hopeful that there is further behavioral change that could take place. If implemented, a rise in audits by reference to anomalies between the published tax strategy and the company's actual accounts is anticipated.
A large number of audits are still settled without recourse to the courts in the UK, particularly in the transfer pricing sphere. It is too early to tell whether HMRC's powers to recharacterize transactions for transfer pricing purposes under the DPT may lead to litigation. New internal governance processes have been implemented by the UK tax authority over the last four years in response to public criticism of settlements reached with large corporates. As a result of these new internal processes, most settlements must now progress through a number of compliance boards to be approved. This has added an element of delay and has taken some power away from the case team at the tax authority. However, on a positive note, as a result of these internal procedures more consistency of approach from HMRC in settling audits for example in particular sectors is being seen.

**Conclusion**

The changes described above regarding the tenor and approach of tax audits may seem subtle, but the impact of these efforts can give rise to greater taxpayer costs and the need for more precise strategies in resolving tax disputes. Although formal shifts in tax administration as a result of the BEPS project are relatively few and far between, a similar dialogue on international tax issues is occurring north of the border and across the pond. As a result, the impact and flow of tax information mandates a global view and a centralization of the process for taxpayers. While it sounds rather trite to say that greater care must be exercised to be successful in these matters going forward, that is the reality of today's changing tax audit landscape.