



Chambers Global Practice Guides

Definitive global law guides offering
comparative analysis from top-ranked lawyers

Tax Controversy 2022

Contributing Editor
Francisco de Sousa da Câmara
Morais Leitão, Galvão Teles, Soares da Silva & Associados

practiceguides.chambers.com

Chambers

Global Practice Guides

Tax Controversy

Contributing Editor

Francisco de Sousa da Câmara

**Morais Leitão, Galvão Teles,
Soares da Silva & Associados**

2022

Chambers Global Practice Guides

For more than 20 years, Chambers Global Guides have ranked lawyers and law firms across the world. Chambers now offer clients a new series of Global Practice Guides, which contain practical guidance on doing legal business in key jurisdictions. We use our knowledge of the world's best lawyers to select leading law firms in each jurisdiction to write the 'Law & Practice' sections. In addition, the 'Trends & Developments' sections analyse trends and developments in local legal markets.

Disclaimer: The information in this guide is provided for general reference only, not as specific legal advice. Views expressed by the authors are not necessarily the views of the law firms in which they practise. For specific legal advice, a lawyer should be consulted.

GPG Director Katie Burrington
Managing Editor Claire Oxborrow
Deputy Editor Philip Myers
Copy Editors Shelagh Onn, Kevan Johnson, Sally McGonigal,
Ethne Withers, Jonathan Mendelowitz, Marianne Page
Publishing Manager Nancy Laidler
Editorial Assistants Carla Cagnina, Eleanor Smith
Production Manager Jasper John
Production Coordinator Genevieve Sibayan

Published by
Chambers and Partners
165 Fleet Street
London
EC4A 2AE
Tel +44 20 7606 8844
Fax +44 20 7831 5662
Web www.chambers.com

Copyright © 2022
Chambers and Partners

INTRODUCTION

Contributed by Francisco de Sousa da Câmara, Morais Leitão, Galvão Teles, Soares da Silva & Associados p.5

AUSTRIA

Law and Practice p.11

Contributed by bpv Huegel

BELGIUM

Law and Practice p.33

Contributed by Arteo

BRAZIL

Law and Practice p.49

Contributed by Pinheiro Neto Advogados

Trends and Developments p.66

Contributed by Machado Meyer Advogados

CHILE

Law and Practice p.75

Contributed by Recabarren & Asociados

Trends and Developments p.94

Contributed by Recabarren & Asociados

CHINA

Law and Practice p.99

Contributed by King & Wood Mallesons

COLOMBIA

Trends and Developments p.121

Contributed by Posse Herrera Ruiz

COSTA RICA

Law and Practice p.129

Contributed by Deloitte Tax & Legal Costa Rica

FRANCE

Law and Practice p.145

Contributed by Baker McKenzie AARPI

GREECE

Law and Practice p.169

Contributed by Zepos & Yannopoulos

Trends and Developments p.190

Contributed by Zepos & Yannopoulos

INDIA

Law and Practice p.195

Contributed by BMR Legal Advocates

Trends and Developments p.213

Contributed by BMR Legal Advocates

ISRAEL

Law and Practice p.219

Contributed by Herzog Fox & Neeman

Trends and Developments p.240

Contributed by Raveh Haber & Co.

ITALY

Law and Practice p.247

Contributed by Gatti Pavesi Bianchi Ludovici

Trends and Developments p.268

Contributed by Gatti Pavesi Bianchi Ludovici

JAPAN

Law and Practice p.273

Contributed by Nagashima Ohno & Tsunematsu

Trends and Developments p.292

Contributed by Nagashima Ohno & Tsunematsu

LUXEMBOURG

Law and Practice p.301

Contributed by GSK Stockmann

Trends and Developments p.322

Contributed by Arendt & Medernach

MACAU

Law and Practice p.329

Contributed by MdME Lawyers

Trends and Developments p.349

Contributed by MdME Lawyers

MALAYSIA

Law and Practice p.361

Contributed by Rosli Dahlan Saravana Partnership

MEXICO

Law and Practice p.383

Contributed by Ortiz Abogados Tributarios

Trends and Developments p.408

Contributed by Sánchez DeVanny

CONTENTS

NETHERLANDS

Law and Practice p.417

Contributed by Stibbe

NEW ZEALAND

Law and Practice p.441

Contributed by Old South British Chambers

NORWAY

Law and Practice p.465

Contributed by KPMG Law Advokatfirma AS

PHILIPPINES

Law and Practice p.483

Contributed by SyCip Salazar Hernandez & Gatmaitan

POLAND

Law and Practice p.505

Contributed by Sołtysiński Kawecki & Szlęzak

Trends and Developments p.526

Contributed by Sołtysiński Kawecki & Szlęzak

PORTUGAL

Law and Practice p.533

Contributed by Morais Leitão, Galvão Teles, Soares da Silva & Associados

Trends and Developments p.562

Contributed by Morais Leitão, Galvão Teles, Soares da Silva & Associados

ROMANIA

Law and Practice p.571

Contributed by Țuca Zbârcea & Asociații Tax

SOUTH KOREA

Law and Practice p.589

Contributed by Lee & Ko

SPAIN

Law and Practice p.613

Contributed by GTA Villamagna

Trends and Developments p.638

Contributed by GTA Villamagna

SWITZERLAND

Law and Practice p.643

Contributed by Lenz & Staehelin

UKRAINE

Law and Practice p.661

Contributed by Vasil Kisil & Partners

USA

Law and Practice p.679

Contributed by Morgan, Lewis & Bockius LLP

Trends and Developments p.704

Contributed by Mayer Brown LLP

INTRODUCTION

Contributed by: Francisco de Sousa da Câmara, Morais Leitão, Galvão Teles, Soares da Silva & Associados

Conflict in Ukraine and COVID-19: Uncertain Times Ahead

Recent years have seen great unpredictability affecting the global economy and financial markets with a clear impact, both now and for the years to come, on states' budgets and in the legal environment.

Given the ongoing, albeit less severe in much of the world, pandemic situation, governments have adopted unprecedented measures, along similar lines, to protect the health of individuals and to sustain their economies, whilst supporting families and companies to enable them to resist the economic slowdown. Strict quarantine requirements were applied everywhere: closed borders, travel bans, shuttered businesses and restrictions on the right to go out. Teleworking, whenever possible, became the norm almost globally, with few exceptions. Courts were closed or not, depending on the countries in question, but many activities including hearings started being held by videoconference, and deadlines and terms related to pending or new cases were suspended – at least for a while.

Now, aside from its considerable impact on the lives of millions directly affected by it, the conflict between Russia and Ukraine is increasingly affecting the global economy and financial markets; resulting in increasing prices for energy and other products, the rise of inflation and global supply chain disruptions.

All these events and circumstances will have a huge impact on budgets, taxes and, given the additional stress put on the different players, probably – more than possibly – on controversies in the years to come.

During the last years, governments have been supporting individuals and companies in need with measures that postpone tax payments or embrace flexible approaches towards compliance with specific obligations. Public spending has increased substantially, and it is expected that the pandemic crisis and the Russia/Ukraine war will leave the world deeply in debt. The situation is naturally different in each country, but some fear new taxes will be created and at the same time predict that the tax authorities will be inclined to be stricter and/or carry out more extensive audits.

More than ever, the management and control of tax risks is a primary goal for both tax authorities and taxpayers. For the former, it is disastrous if the State is unable to collect the expected level of revenue. For the latter, tax is a significant cost for business and an incorrect estimate can jeopardise a company's level of profitability and damage its reputation, not to mention cause egregious disadvantages and losses. However, it is now almost certain that, in the short term, debt and public expenses will increase while tax collection levels will drop due to the economic contraction.

It might be debatable whether, as some have argued, taxes are a prime mover of history. One cannot ignore facts, however. The American experience after the 2008 crisis, when both tax authorities and MNEs were in need of revenue and neither was prepared to compromise easily, should be borne in mind. Currently, it seems that the IRS, as well as several other tax authorities, is focusing more of its attention on international tax issues and, more specifically, transfer pricing. It is interesting that, due to a lack of resources, there is a move towards concentrating activity under a new strategy: the “campaign”, whereby

INTRODUCTION

*Contributed by: Francisco de Sousa da Câmara,
Morais Leitão, Galvão Teles, Soares da Silva & Associados*

the IRS's Large Business and International Division selects a tax issue for audit, rather than auditing every potential issue on a taxpayer's return.

Anticipated Increase in Tax Litigation

Inevitably, no one can anticipate and eliminate entirely all adverse situations that might lead to disputes. Although disagreements may emerge suddenly and in relation to all type of taxes, the majority of chapters in this Guide refer to the many international, complex and controversial substantive tax matters around the BEPS Recommendations and the legislation created afterwards, the MLI, digital taxation and the use of the general anti-abuse rule (GAAR) to challenge cross-border transactions, although many of them cannot ascertain whether these have so far contributed to an increase in the level of tax controversies. But there are already many authors anticipating more litigation. The same expectation exists with respect to the impact of the EU Mandatory Disclosure Directive (DAC 6) and many jurisdictions within the European Union mentioned this possibility.

The amount of new legislation everywhere, and the appearance of new and open concepts applied worldwide in a context of states struggling for financial resources, creates an expectation of increased litigation, as several chapters suggest. Whether new Conventions and/or EU Directives that are expected to implement Pillars One and Two will effectively contribute to mitigating tax disputes is still to be seen. The recent new international instruments such as DAC 6 and the MLI are still expected to have a significant impact on how anti-abuse rules will be applied, which will probably increase litigation.

The tax authorities of each jurisdiction might have different perspectives on and approaches to combatting non-compliance with tax obliga-

tions or tax avoidance. Nevertheless, they are all undoubtedly better equipped and prepared, with substantially more information at their disposal about taxpayers, as well as their own activity, and they are much more integrated internationally, as several chapters mention.

Audit Strategy and the Road Ahead

Perusing the chapters in this Guide, it is noticeable that taxpayers, even multinational enterprises (MNEs) and high net worth individuals (HNWIs), are often caught in the crossfire created by the competition between states for capital and investment, and suffer from a changing and uncertain compliance landscape. It is therefore extremely valuable to know how to anticipate, prepare for and manage possible audits or to verify whether it is possible to eliminate or mitigate tax risks, either before or during a specific controversy.

This Guide presents an excellent overview of the main aspects of the tax controversies that are common and distinct in 28 very different jurisdictions (from Brazil to Switzerland and New Zealand but also covering several EU member states, Israel, the USA and China), providing a very interesting global analysis of trends, including:

- the origin and causes of tax controversies;
- the continuous efforts to combat tax avoidance and evasion;
- the means to mitigate and manage tax risks and to stay up to date with the best ways to settle cases; and
- the strategies to employ in the context of administrative or judicial litigation.

The reader will also be able to gather comparative information on all the phases of tax litigation in each jurisdiction, either in domestic or cross-border disputes, and will be able to garner an idea of costs and statistics in the area of tax

litigation, including the number of cases and the likelihood of a successful outcome for either the tax authorities or taxpayers.

International Tax Authority Co-operation

It is clear from all the chapters that tax authorities are collecting more and more information concerning taxpayers, and their businesses and cross-border activities; either through exchanges of information and mutual assistance or through the country-by-country (CbC) reports, the common reporting standard (CRS) or other mechanisms or groups (eg, the Joint International Taskforce on Shared Intelligence and Collaboration). Soon the reporting obligations foreseen in DAC 6 will also be automatically exchanged in the EU. Whether one is in Italy, China, Brazil or the USA, the tax authorities now know more than in previous years. Given the specific circumstances, culture and approaches in each jurisdiction, there is no unanimity as to whether this has been leading, or will lead, to an increase in tax controversies but several assertions and hints suggest so, at least in some countries.

Litigation and Tax Authority Approaches

According to the chapters in this Guide, it seems that some tax authorities are investing in minimising tax disputes, either helping taxpayers effectively via direct contact, tax rulings or through the use of alternative dispute resolution mechanisms. It seems that this open approach pays off, considering that when litigation occurs, the tax authorities claim a higher success rate before the tax tribunals or higher courts, as emphasised by the New Zealand and Switzerland Law & Practice chapters.

In countries where the tax authorities seem more reluctant to invest in assisting taxpayers dealing with complex legislation and ambiguous matters, additional tax assessments have grown significantly, which also gives rise to an increase in the number of controversies. Unsurprisingly,

this reflects negatively on how investors evaluate the “tax element” when researching the different aspects of doing business in that specific jurisdiction. The case of Brazil seems to be an example. In these countries, taxpayers can prevail more often.

The tax legislation and the tax authorities’ approach in some other countries, meanwhile, seem to occupy a middle ground between the types of patterns described above. Statistics regarding the success of the tax authorities in litigation seem to be in line with this, for instance in Portugal.

Efficient alternative dispute resolution (ADR) mechanisms may also be very helpful in preventing/reducing disputes, or at least resolving them quickly, as the Portuguese domestic arbitration system shows. But the administrative attitude and the taxpayer culture still seem to be the crucial elements; ie, without a willingness on the part of both the authorities and taxpayers to work collaboratively, and with reasonable alacrity, ADR mechanisms may not be sufficient.

Criminal Tax Controversies

This Guide also illustrates the way tensions may be avoided as they arise and may evolve from tax audits up to the higher tribunals, either through administrative and civil discussions where anti-avoidance rules, including transfer pricing, still play an important role; or in the context of tax evasion or fraud – involving, for example, dishonest conduct and false accounting – when such matters will usually be treated as crimes, and where the proceedings and the investigations are conceptually separate and evolve independently. The Guide explains the differences, the possible interactions between tax assessments and tax infringements and the possibilities to reduce fines and/or to initiate and conclude settlements. In some countries we notice that there is an increased risk of criminal

INTRODUCTION

*Contributed by: Francisco de Sousa da Câmara,
Morais Leitão, Galvão Teles, Soares da Silva & Associados*

liability, not only for the taxpayers themselves but also for the so-called facilitators.

Litigation Strategy

At the same time, the reader is guided by each author through different geographies along the administrative and judicial routes, from the first to the final stages (that is, considering administrative hierarchical or judicial appeals), considering deadlines, intricate proceedings and rules and principles that reveal how disputes may be settled in the most appropriate manner.

Despite the existence of absolutely different procedural rules and ways to settle tax disputes, we observe several important common features that contribute to taxpayers' best interests, which are stressed by the majority of authors.

These include:

- the importance of being prepared before an audit has even started and of being assisted by a legal adviser from the first hour;
- the need to be fully conversant with all the relevant facts around the potential controversy and to evaluate the risks and associated contingencies in order to minimise them;
- supporting the facts and bolstering the substance of the case, disclosing documentation and engaging expert assistance, or any other necessary support;
- verifying if the dispute may be narrowed, either by settling or abandoning any of the issues, but making wise use of all procedural and material rights; and
- the importance of an awareness of previous case law, even in civil law jurisdictions where precedent does not have the same strength as in common law systems, an importance that increases with the need to know international jurisprudence from the ECJ or the ECHR and even being aware of comparative jurisprudence or doctrine.

Naturally, in-depth analysis of a case, its facts and the applicable rules of law are crucial to mastering tailor-made strategies for individual cases, as this Guide repeatedly emphasises. The reader will certainly understand that, in spite of globalisation and of similar concepts/substantive tax issues (such as transfer pricing matters, hybrid mismatches, recharacterisation issues or cross-border disputes after BEPS) or procedural rules and principles, the way disputes may best be settled in each country is still part of the expertise and art of practitioners in the respective jurisdictions.

International Issues

The different chapters also emphasise the use of domestic or international tools, such as the mutual agreement procedure, to solve cross-border disputes, indicating how they usually interact. Some of the chapters allude to the MLI, considering that it is already in force in several countries, and provide an idea of the crucial matters.

State aid disputes involving taxes is naturally an issue that does not apply to all jurisdictions, but within the EU area it is a hot topic to which member states and taxpayers should pay great attention for their practical impact on sensitive matters (where exemptions and incentives could be withdrawn and turn around in the recovery of taxes and interest is a real possibility), as some of the EU chapters show.

It is also interesting to observe that GAAR (general anti-abuse rule) and SAAR (specific anti-abuse rule) application in a treaty context have already been challenged in several court cases. However, the majority of chapters choose to stress the confidence in their compatibility that the tax authorities and states have repeatedly invoked (along with the OECD Model Tax Convention commentaries), suggesting that taxpayers should, if not must, adopt conservative

approaches in exploiting DTT opportunities. The MLI also contributes to changing the situation, in particular considering the “saving clause” (Article 11).

The fight for income from international taxation ignites intense discussion, not only among taxpayers but also among different tax authorities and states. The appearance of so many new tools and weapons to combat tax avoidance allows us to predict that tax disputes will increase, unless a great investment is made in assisting taxpayers on a daily basis and in creating ADR mechanisms. Ironically, it seems that at the same time that an avalanche of new measures have been created to combat taxpayers’ abuses (BEPS, DAC 6, etc), states have felt the need to create quick arbitration mechanisms to settle tax disputes between themselves (eg, the MLI and the EU Arbitration Directive).

Conclusion

Authors from several jurisdictions predict, in the near future, stricter audits and additional tax assessments, and possibly even more taxes. Once the Russia-Ukraine conflict (although predictions of its conclusion are still pure speculation at this point) and COVID-19 crisis recede, however, the authorities will have to consider the approach to “recovery” when states will want to preserve their business sectors considering the need for long-term economic growth. In any case, given the current status quo, taxpayers should clearly be more proactive in their internal audits, and the analysis and management of their tax risks.

Considering that every move takes time and that the state of the art in each jurisdiction is at a different stage of development, the present guide is an excellent tool for professionals – tax lawyers, barristers, and in-house lawyers, but also company CFOs and members of their departments, tax consultants, judges, or other professionals – providing a compass with which to find the right path forward when preparing and handling a tax audit or controversy; either to assist in managing a good settlement or, if this proves unworkable, conducting a successful dispute.

INTRODUCTION

*Contributed by: Francisco de Sousa da Câmara,
Morais Leitão, Galvão Teles, Soares da Silva & Associados*

Morais Leitão, Galvão Teles, Soares da Silva & Associados (Morais Leitão) is a leading full-service law firm in Portugal, with a solid background and decades of experience. Widely recognised, Morais Leitão is a reference in several branches and sectors of the law at the national and international level. The firm's reputation amongst both peers and clients stems from the excellence of the legal services provided. Morais Leitão's work is characterised by its unique technical expertise, combined with a distinc-

tive approach and cutting-edge solutions that often challenge some of the most conventional practices. With a team comprising over 250 lawyers at its clients' disposal, Morais Leitão is headquartered in Lisbon and has additional offices in Porto and Funchal. Due to its network of associations and alliances with local firms and the creation of the Morais Leitão Legal Circle in 2010, the firm can also offer support through offices in Angola (ALC Advogados) and Mozambique (HRA Advogados).

CONTRIBUTING EDITOR



Francisco de Sousa da Câmara is a senior partner at Morais Leitão who has headed the tax teams in Lisbon and Madeira for more than two decades. He specialises in complex tax litigation involving domestic and international tax issues, and focuses on handling files before all types of courts. He is

also a CAA-recognised arbitrator. Francisco advises high net worth individuals and family office businesses and structures. He has been involved in drafting tax legislation, including the General Tax Law, the Tax Procedure and Process Code, and a project for a wealth tax reform. Francisco regularly contributes to a range of tax-focused publications, both in Portugal and internationally.

Morais Leitão, Galvão Teles, Soares da Silva & Associados

Rua Castilho 165
1070-050 Lisbon
Portugal

Tel: +351 21 381 74 00
Fax: +351 21 381 74 99
Email: mlgtslisboa@mlgts.pt
Web: www.mlgts.pt



Law and Practice

Contributed by:

Gerald Schachner, Kornelia Wittmann, Nicolas D Wolski
and Lucas Hora

bpv Huegel see p.30



CONTENTS

1. Tax Controversies	p.13	6. Alternative Dispute Resolution (ADR) Mechanisms	p.22
1.1 Tax Controversies in this Jurisdiction	p.13	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.22
1.2 Causes of Tax Controversies	p.13	6.2 Settlement of Tax Disputes by Means of ADR	p.22
1.3 Avoidance of Tax Controversies	p.13	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.22
1.4 Efforts to Combat Tax Avoidance	p.14	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.23
1.5 Additional Tax Assessments	p.14	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.23
2. Tax Audits	p.15	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.23
2.1 Main Rules Determining Tax Audits	p.15	7. Administrative and Criminal Tax Offences	p.23
2.2 Initiation and Duration of a Tax Audit	p.15	7.1 Interaction of Tax Assessments with Tax Infringements	p.23
2.3 Location and Procedure of Tax Audits	p.15	7.2 Relationship between Administrative and Criminal Processes	p.24
2.4 Areas of Special Attention in Tax Audits	p.16	7.3 Initiation of Administrative Processes and Criminal Cases	p.24
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.16	7.4 Stages of Administrative Processes and Criminal Cases	p.24
2.6 Strategic Points for Consideration during Tax Audits	p.16	7.5 Possibility of Fine Reductions	p.25
3. Administrative Litigation	p.17	7.6 Possibility of Agreements to Prevent Trial	p.25
3.1 Administrative Claim Phase	p.17	7.7 Appeals against Criminal Tax Decisions	p.25
3.2 Deadline for Administrative Claims	p.17	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.26
4. Judicial Litigation: First Instance	p.18	8. Cross-Border Tax Disputes	p.26
4.1 Initiation of Judicial Tax Litigation	p.18	8.1 Mechanisms to Deal with Double Taxation	p.26
4.2 Procedure of Judicial Tax Litigation	p.18	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.26
4.3 Relevance of Evidence in Judicial Tax Litigation	p.18	8.3 Challenges to International Transfer Pricing Adjustments	p.26
4.4 Burden of Proof in Judicial Tax Litigation	p.19		
4.5 Strategic Options in Judicial Tax Litigation	p.19		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.19		
5. Judicial Litigation: Appeals	p.20		
5.1 System for Appealing Judicial Tax Litigation	p.20		
5.2 Stages in the Tax Appeal Procedure	p.20		
5.3 Judges and Decisions in Tax Appeals	p.21		

8.4	Unilateral/Bilateral Advance Pricing Agreements	p.26		
8.5	Litigation Relating to Cross-Border Situations	p.27		
9.	State Aid Disputes	p.27		
9.1	State Aid Disputes Involving Taxes	p.27		
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.27		
9.3	Challenges by Taxpayers	p.27		
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.27		
10.	International Tax Arbitration Options and Procedures	p.27		
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.27		
10.2	Types of Matters that Can Be Submitted to Arbitration	p.27		
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.27		
10.4	Implementation of the EU Directive on Arbitration	p.28		
10.5	Existing Use of Recent International and EU Legal Instruments	p.28		
10.6	New Procedures for New Developments under Pillar One and Two	p.28		
10.7	Publication of Decisions	p.28		
10.8	Most Common Legal Instruments to Settle Tax Disputes	p.28		
10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.28		
11.	Costs/Fees	p.28		
11.1	Costs/Fees Relating to Administrative Litigation	p.28		
11.2	Judicial Court Fees	p.28		
11.3	Indemnities	p.29		
11.4	Costs of ADR	p.29		
12.	Statistics	p.29		
12.1	Pending Tax Court Cases	p.29		
12.2	Cases Relating to Different Taxes	p.29		
12.3	Parties Succeeding in Litigation	p.29		
13.	Strategies	p.29		
13.1	Strategic Guidelines in Tax Controversies	p.29		

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

To begin with, the Austrian system of tax procedures is, in principle, assessment-based. Therefore, taxpayers are usually required to file tax returns. Tax controversies may arise any time that an assessment by the Austrian tax authorities deviates from the corresponding return filed by the taxpayer. However, in certain cases, tax controversies can even arise if the tax authorities make an assessment fully compliant with the tax return filed by the taxpayer, or if no tax return has been filed.

Tax Controversies following a Tax Return

Any tax return that is filed with the Austrian tax authorities is subjected to a (in practice, plausibility) check before a tax decree is issued. Generally, the information provided by the taxpayer in the tax return is reviewed in more detail only if certain aspects are unclear and if and to the extent that no tax decree can be issued without further investigation. However, the tax authorities may investigate the facts and/or disagree with the taxpayer and issue a tax decree determining and/or assessing the due tax deviating from the tax return.

In practice, the Austrian tax authorities do not review tax returns in detail before issuing the tax decree. Rather, Austrian procedural law allows the Austrian tax authorities to correct any tax decree without further reasoning within one year of the issuance of the tax decree. Therefore, the tax authorities may issue an amended tax decree within this period that may deviate from the tax return filed by the taxpayer.

Tax Controversies following a Tax Audit

Tax controversies may also arise from the reassessment/amendment of a tax decree as a consequence of a tax audit. Such reassessments

may happen within the statute of limitations, which generally is six years after the year for which the tax return was filed (this results from a standard five years plus one year for the investigative actions performed by the tax authorities). In the case of tax evasion, the statute of limitations is extended to ten years. If the Austrian tax authorities undertake investigative actions within the respective last year, the statute of limitations is extended by one year. In any case, the statute of limitations bars the tax authorities from any tax (re)assessments for ten years at the latest after the tax claim arises.

Other

Additionally, tax controversies commonly arise in refund procedures regarding withholding taxes or self-assessed taxes (eg, real estate transfer tax or stamp duty).

1.2 Causes of Tax Controversies

Tax controversies may arise from all kinds of tax matters. Although it is not possible to exactly allocate the disputes to the different types of tax matters, it is possible to derive ballpark trends from the number of cases decided by the Federal Fiscal Court (the court of first instance in tax matters).

1.3 Avoidance of Tax Controversies

As possible mitigations of future tax controversy, there is also the possibility for informal answers and rulings in tax matters and in some cases even for binding advance rulings (reorganisations, tax groups, international tax law, VAT law or abuse of law). Furthermore, since September 2019 there has been a dispute settlement mechanism regarding the interpretation and application of double taxation treaties in effect. In this respect, taxpayers facing intra-EU tax disputes may submit a request to initiate a dispute settlement procedure (for further details, see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**).

Recently, Austria introduced a horizontal monitoring regime for large companies (for details, please see **2.1 Main Rules Determining Tax Audits**).

1.4 Efforts to Combat Tax Avoidance

In recent years, Austrian tax legislation has been heavily influenced by international developments and foremost by the OECD's efforts to combat base erosion and profit shifting (BEPS). This equalised inter-state tax competition has, to a certain extent, prevented a "race to the bottom". On the other hand, this has contributed to a greatly expanded range of applicable rules. As with every substantial extension of the legal basis, also in this event, this has most likely led to an increase in the number of tax controversies.

In the following are two examples of Austrian reactions to the OECD BEPS Actions or the ATAD (Anti-Tax Avoidance Directive) on an EU level, respectively, that may have an impact on the number of tax controversies.

With regards to BEPS Action 3 (controlled foreign companies, or CFC), Austria has implemented CFC rules, which entered into force on 1 January 2019. These rules provide for an allocation of non-distributed low-taxed passive income of foreign subsidiaries to the Austrian parent company corresponding to the percentage of the shares directly and indirectly held in the foreign subsidiary. The CFC rules apply if the Austrian parent company holds – directly or indirectly, alone or together with associated companies – more than 50% of the nominal share capital, voting rights or profit participating rights of a foreign corporation, and if the foreign corporation is low-taxed (effective tax rate of 12.5% or below) and earns passive income. The regime also applies to non-Austrian permanent establishments.

BEPS Action 12 (mandatory disclosure rules) was implemented by the Austrian legislature in September 2019. Within the framework of this regulation, certain cross-border structures and transactions must be reported to the tax authorities starting from 1 July 2020 on an ad hoc basis within 30 days after the triggering event.

These events that are (conditionally or unconditionally) subject to reporting are defined based on certain hallmarks. In this respect, transactions potentially reportable comprise, for example, cross-border intra-group transfers of hard-to-value intangibles, debt-equity swaps or transfer pricing arrangements using unilateral safe harbour rules.

1.5 Additional Tax Assessments

In Austria, appeals against tax decrees generally do not have a suspending effect, which means that the disputed amount must be paid, even if an appeal is filed.

There is, however, the possibility of an application for suspension of execution regarding the whole disputed amount or parts of it. Such a suspension has to be granted unless:

- the appeal appears to be certainly unsuccessful; or
- the appealed decree does not, in principle, deviate from the tax return or other requests made by the taxpayer; or
- the taxpayer's conduct is aimed at jeopardising the tax collectability.

If a suspension of execution was granted and the appeal finally turns out to be unsuccessful, interest at a rate of 2% over the base interest rate (currently resulting in 1.38%) is due for the period of suspension. In contrast, if the taxpayer initially decided to pay the disputed amount and consequently the appeal is successful, the tax-

payer is also entitled to interest at a rate of 2% over the base interest rate.

A suspension of execution may not be requested before an administrative appeal has been filed.

Furthermore, there is also the possibility of an application for a deferral of tax payment before an appeal might be filed, if the immediate full payment of the tax would result in considerable hardship for the taxpayer and if the collectability of the tax is not jeopardised by the deferral. For deferred taxes exceeding the total amount of EUR750, interest at a rate of 4% over the base interest rate (currently resulting in 3.38%) is payable.

If an additional tax is assessed against the taxpayer, this may result in fiscal criminal proceedings being introduced against the taxpayer if there is an indication that the taxpayer wilfully or negligently did not (fully) comply with his obligation to disclose all facts relevant for the tax assessment.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

There is no fixed audit cycle prescribed by Austrian tax law. The frequency of tax audits depends on various factors, the most important of which are business size and general tax compliance. While smaller businesses may be audited in the range of every five years (or not at all), large businesses are often audited on a permanent basis.

In this context it is worth mentioning that in 2019 a new system of “horizontal monitoring” entered into force. This regime is available for large companies whose annual turnover exceeds EUR40 million, as well as for banking institutions and insurance companies. If an enterprise decides

to opt for the horizontal monitoring mechanism, it will not be subject to tax audits anymore, but will be in constant communication with the tax authorities, with its activities being reviewed on an ongoing basis. There are further conditions that need to be met in order to participate in the system. In particular, the previous tax behaviour of the applicant must meet certain standards of compliance (eg, no criminal tax evasion in the past five years and implementation of an effective internal tax-control system).

2.2 Initiation and Duration of a Tax Audit

As mentioned above, Austrian tax law does not provide for fixed audit cycles. There is also no regulation prescribing the maximum duration of an audit. The duration heavily depends on the workload of the competent tax authority, the complexity of the reviewed matters and the taxpayer’s co-operation. The audit of a small business may be finished within a few days, whereas the audit of a multinational enterprise might take several months. The duration may be influenced by the taxpayer to a certain degree by his level of preparation for the audit and co-operation during the audit.

As stated above, the findings of a tax audit may result in amended tax assessments until the statute of limitations, which in general is six years, but ten years in the case of tax evasion. This period starts with the lapse of the year for which the assessment was filed. The limitation period is extended by one year if investigative actions are undertaken in the year of the expiry (which may apply more than once).

2.3 Location and Procedure of Tax Audits

In principle, tax audits are carried out on the premises of the taxpayer. Only in cases where this is not possible or exceptionally unreasonable may audits take place at the competent

tax office or at the office of the taxpayer's legal representative. During the COVID-19 crisis, tax audits were made online to the extent possible.

The type of reviewed data heavily depends on the taxpayer. Austrian law does not set out a mandatory way to submit the relevant documents. Those may therefore be handed in both in physical and/or digital form. The tax authority may also interview the taxpayer's employees or other ultimately third parties if this is necessary to clarify the provided data.

2.4 Areas of Special Attention in Tax Audits

Ordinary tax audits of companies usually comprise corporate income tax, VAT and withholding tax matters. Lately, auditors have especially focused on international activities, such as reorganisations, intra-group cross-border transactions or transfer pricing matters. It is expected that tax audits will focus even more on such international transactions in the future due to the international efforts to combat tax evasion and prevent base erosion and profit shifting.

Apart from this, there are so-called audits on wage-related charges (ie, wage tax and several social security contributions). These audits are carried out by the competent tax authorities or by auditors of the social security institutions.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Austria fully participates in the OECD's system of automatic international exchange of tax information and has implemented all six EU Directives on Administrative Cooperation (DAC 1–6). The shared data includes information on five categories of non-financial income (DAC 1), on financial accounts (DAC 2), on advance tax rulings (DAC 3), on country-by-country reports (DAC 4),

on beneficial ownership (DAC 5) and on certain cross-border arrangements (DAC 6).

As most of these rules have only been in force for a relatively short period of time, it cannot be clearly said whether they are going to lead to an overall increase in tax audit activities. However, they certainly contribute to a shift in audits towards international matters, as outlined above.

As regards joint cross-border tax audits, it has to be pointed out that Austria transposed Directive 2011/16/EU on administrative co-operation in the field of taxation, thus creating a legal basis for joint cross-border tax audits. Particularly common in this respect are joint audits with the German tax authorities.

2.6 Strategic Points for Consideration during Tax Audits

The taxpayer is obliged to co-operate with the tax authorities during a tax audit to the extent necessary to allow for an appropriate audit procedure. Unjustified refusal to provide requested documents or attempts to complicate or delay the audit may constitute a violation of that obligation. Such violations may entitle the tax authorities to estimate the relevant tax base and may include a safety margin to the detriment of the taxpayer. From a practical point of view, it is therefore advisable for the taxpayer to co-operate with the auditors, to clarify their arguments, prove the content of their documentation and declarations, and generally supply to the auditor all the information that is needed to ascertain the facts relevant for taxation.

It is also advisable to properly prepare for an announced audit, simply to facilitate the auditor's work and thus keep the audit's duration as short as possible. Preparatory measures in this respect are, for example, the proper filing and, above all, storage of (physical or digital) vouchers and accounting documents or the setting up

of suitable workplaces for the auditors in charge at the taxpayer's premises as soon as a tax audit has been announced.

The authors' experience is that taxpayers and tax counsel should not underestimate the attention necessary for answering tax audit questions and/or document requests adequately. They have seen far too many situations where the tax auditors were provided with incorrect/incomprehensive information (possibly several times) and the mere fact that from the tax auditor's perspective the taxpayer told different stories of the same transaction resulted in the tax audit disregarding the taxpayer's explanations. The authors have seen cases where this was even upheld in court.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

If the Austrian tax authorities have issued a tax decree that the taxpayer considers as infringing their rights, the taxpayer may file an administrative appeal within one month after the delivery of the tax decree – to be filed with the issuing tax authority. This deadline may, upon the request of the taxpayer, be (if necessary, also repeatedly) extended by the Austrian tax authorities for reasons worth considering.

The administrative appeal must comprise the following elements:

- the decree against which it is directed;
- a statement of the points on which the decree is contested;
- a statement of the requested changes; and
- a statement of reasons.

The Austrian tax authority will review the case and, after carrying out any further investigations

necessary, render an administrative appeal decision. The Austrian tax authority will not render an administrative appeal decision if:

- the taxpayer has requested so in the administrative appeal and the tax authorities refer the administrative appeal to the Federal Fiscal Court within three months of receipt;
- the taxpayer only claims that a regulation is not in line with the statutory law, a statutory law is unconstitutional or that international conventions are unlawful; or
- the tax decree that is appealed has been issued by the Federal Ministry of Finance.

The underlying objective of this procedure is the establishment of a system of administrative self-control that may potentially handle taxpayers' claims at an early stage.

Because a taxpayer and the tax authorities can (jointly) effectively waive the administrative appeal decision, it can be said that the Austrian administrative claim phase in tax procedures is an optional one.

3.2 Deadline for Administrative Claims

If the Austrian tax authorities do not render their administrative appeal decision within six months after the filing of the administrative appeal for reasons for which the tax authorities are overwhelmingly responsible, the taxpayer may file a complaint of delay with the Federal Fiscal Court.

The Federal Fiscal Court may grant the competent tax authority an additional period of three months (which can be extended once for reasons specifically related to the case), after which the administrative appeal automatically changes into a judicial appeal and the Federal Fiscal Court becomes competent to decide the case.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

If the taxpayer is not satisfied with the administrative appeal, they may file a judicial appeal (a so-called request for submission of the appeal to the Federal Fiscal Court) within one month after the delivery of the administrative appeal decision. If the judicial appeal is made in time, the appeal process is deemed undecided, the appeal changes into a judicial appeal and the Federal Fiscal Court becomes competent for the case.

If the request for the appeal is not submitted by the tax authority to the Federal Fiscal Court within two months, the taxpayer may submit a reminder directly to the Federal Fiscal Court, which has the same effect as a submission of the appeal.

In certain situations (see **3.2 Deadline for Administrative Claims**), there is no administrative appeal decision but the Federal Fiscal Court is directly competent.

4.2 Procedure of Judicial Tax Litigation

Unless one of the aforementioned specific cases applies in which the Federal Fiscal Court is directly competent, court procedures are started by the taxpayer filing an administrative appeal.

Under Austrian procedural law, taxpayers may represent themselves in Federal Fiscal Court procedures. Alternatively, they may have themselves represented by a professional representative such as an attorney-at-law, a tax adviser or an auditor. It is strongly suggested to retain professional counsel.

After the Federal Fiscal Court has become competent for the case, the tax authorities may generally neither amend nor revoke the contested

decree. Procedures at the Federal Fiscal Court follow the principle of official investigation. The Federal Fiscal Court will thus investigate the facts and circumstances *ex officio*. Both the taxpayer and the Austrian tax authorities may present new facts.

The Federal Fiscal Court may dismiss or allow the appeal and thereby revoke or amend the contested tax decree. Amendments to the tax decree may also be to the disadvantage of the taxpayer.

A public hearing is held only if requested by the taxpayer or deemed necessary by the court.

The Federal Fiscal Court generally decides on the matter itself, but may also refer the case back to the tax authorities if extensive additional investigations are deemed necessary. The tax authorities are then bound by the legal view set out in the court's decision.

The Austrian tax authorities generally publish court decisions online in the so-called Fiscal Documentation (*findok*) in anonymised form.

4.3 Relevance of Evidence in Judicial Tax Litigation

There is no limit as to what is allowed as evidence. Anything that is appropriate to prove the taxpayer's case may be provided as evidence. Mostly, documentary evidence and witness testimony are used; however, site visits, expert opinions or reports are possible as well. Furthermore, taxpayer's testimony is generally considered by the court to be of great importance, although formally the taxpayer is not allowed as a witness. Witnesses are usually summoned by the court, unless their whereabouts are unknown. Witnesses are required by law to make a testimony unless they are allowed to refuse to give testimony by law (eg, a relative of the taxpayer).

Evidence must be presented until the end of the oral hearing, if any, or by a deadline set by the court. Austria has a two-level judicial appeal system. New facts and evidence may only be presented in the first level (Federal Fiscal Court).

4.4 Burden of Proof in Judicial Tax Litigation

As Austrian tax proceedings follow the principle of official investigation, there are no statutory provisions regarding the burden of proof. That means the tax authorities and ultimately the Federal Fiscal Court must investigate the facts both in favour of and to the detriment of the taxpayer. The result must be shared with the taxpayer.

However, under general procedural tax law, the tax authorities must prove all facts and circumstances necessary to justify a tax claim against the taxpayer. The taxpayer, on the other hand, is required to present their position and provide substantiated evidence against the facts presented by the tax authorities. In circumstances where it cannot be expected that the taxpayer can provide substantial proof, they must at least show that their position is plausible.

Generally, the taxpayer is obliged to co-operate with the tax authorities. In cross-border situations, the taxpayer's obligation to co-operate is increased. Also, the taxpayer is subject to a number of tax and non-tax documentation obligations. If the taxpayer fails to meet any of these obligations, the tax authorities may draw conclusions about the existence or non-existence of a certain fact based on the principle of free assessment of evidence. This may be to the detriment of the taxpayer.

In fiscal criminal proceedings, the burden of proof rests with the fiscal criminal authorities. This results from the fact that any doubt arising should benefit the accused (principle of benefit of doubt).

4.5 Strategic Options in Judicial Tax Litigation

The strategy pursued has to be adapted to each individual case and there are no general guidelines suitable for every case.

However, there may be certain recommendations that are applicable for a larger number of matters.

Regarding the timing to file evidential documents during court proceedings, for example, it is always advisable to file favourable evidence at the beginning of the proceedings, so that the court has enough time to properly take the presented facts into consideration. This applies even more the bigger the case.

Taxpayers should also not only present the facts, but should embed these facts into their substantiated legal argumentation. As a result, representation through a legal representative is highly advisable, even if not mandatory.

With respect to settlements, it should be stated that depending on the case and the current state of the proceedings, the Austrian tax authorities might be open to out-of-court settlements.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

It is necessary to substantiate the administrative appeal and all further inputs with legal arguments. These may be derived either from legal literature (eg, commentaries or articles) or previous jurisprudence. Of particular importance in this respect is the case law of the Austrian Supreme Administrative Court (the supreme authority in tax matters – see **5. Judicial Litigation: Appeals**).

Although neither the tax authorities nor the Federal Fiscal Court are bound by the Supreme Administrative Court's previous case law, their

decisions very rarely deviate from the Supreme Administrative Court's legal views (such deviation, while possible, would be grounds for a second-level judicial appeal to the Supreme Administrative Court). Depending on the case, the citation of the European Court of Justice's or the Austrian Constitutional Court's jurisprudence may also be of great importance.

International guidelines such as the OECD Transfer Pricing Guidelines or the OECD Model Tax Convention are usually followed by the tax authorities and may also be used as a basis for argumentation in tax court proceedings.

The Austrian Federal Ministry of Finance has issued administrative guidelines (eg, for income taxes, corporate income taxes or transfer pricing). These guidelines have no binding effect on the courts. In practice, however, their mention may strengthen the taxpayer's argumentation.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

A decision by the Federal Fiscal Court can be appealed to the Austrian Supreme Administrative Court (the second and supreme instance in tax matters in Austria) both by the taxpayer and/or the tax authorities if the decision concerns legal issues of fundamental importance. A legal issue is considered to be of fundamental importance if the contested court ruling deviates from the Supreme Administrative Court's past decisions, or if there is no (or no consistent) case law on the issue in question. Appeals in tax matters to the Supreme Administrative Court may only be submitted by an attorney-at-law, a tax adviser or an auditor. No minimum value threshold applies. Most of the submissions to

the Supreme Administrative Court are subject to a filing charge of EUR240.

If taxpayers are of the opinion that a decision of the Federal Fiscal Court violates their constitutional rights or is based on an unconstitutional or otherwise unlawful statute, they may address the Austrian Constitutional Court (within a period of six weeks after the Federal Fiscal Court's decision).

The taxpayer may also request that the Constitutional Court forward the case to the Supreme Administrative Court if the Constitutional Court holds that actually no constitutional rights of the taxpayer have been violated (so-called successive judicial appeal). Furthermore, there is the possibility to address both the Constitutional Court and Supreme Administrative Court simultaneously on different grounds (so-called parallel appeal).

5.2 Stages in the Tax Appeal Procedure

The appeal to the Austrian Supreme Administrative Court must be filed within a non-extendable period of six weeks after the Federal Fiscal Court's decision. The appeal must be addressed to the Federal Fiscal Court, which assesses whether the procedural requirements are met.

In order to be admissible, the matters brought before the Supreme Administrative Court must address fundamental questions regarding the application or uniformity of Austrian law. The Federal Fiscal Court must decide on the admissibility of the appeal based on these criteria in its decision. The Supreme Administrative Court is, however, not bound by this decision. Therefore, an appeal to the Supreme Administrative Court may be admitted by the Supreme Administrative Court even if held inadmissible by the Federal Fiscal Court or vice versa.

The Supreme Administrative Court only rules on questions of law and on errors of law or procedure, which might have influenced the wrong determination of facts. The Supreme Administrative Court will not perform any investigations of the underlying facts on its own, nor will it review the facts and circumstances provided by the Federal Fiscal Court. Also, the Supreme Administrative Court will not consider any new facts brought forward.

The Supreme Administrative Court may either lift the contested decision or dismiss the second-level judicial appeal. Alternatively, the Supreme Administrative Court may refer the case back to the Federal Fiscal Court if the Federal Fiscal Court has violated procedural rules, which, if observed, would have led to a different set of facts. In rare cases, where there is no need for further investigation of the facts and circumstances, the Supreme Administrative Court may also rule on the merits of the case on its own. Additionally, the Supreme Administrative Court may be obliged to refer a case to:

- the Austrian Constitutional Court if it considers a legal provision to be incompatible with the Austrian Constitution; or
- the European Court of Justice if a question arises that needs to be interpreted under EU law or if doubt arises about the compatibility of an Austrian provision with EU law.

5.3 Judges and Decisions in Tax Appeals

Austrian law comprises the principle of the lawful judge. This principle requires that the judge (relating to the court, the body of the court and the individuals of whom that body consists) must be determined before a case is brought to the court. Therefore, the competent court and the body of the court hearing a case are determined by statutory law. The individuals deciding on a specific case are generally determined based on

a plan of distribution of responsibilities resolved by a committee consisting of and elected by the judges of the respective court before the beginning of the respective business year.

At the Federal Fiscal Court, cases are heard by a single judge unless the taxpayer requests otherwise or the single judge deems that the decision of the case will have a significance that goes beyond the specific case. In these cases, the court will hear the case as a senate of two professional judges and two lay judges.

All judges at the Austrian Supreme Administrative Court are professional judges, independent in exercising their office. The Administrative Court decides in senates with three, five or nine judges. Most of the time the senates comprise five members, except in cases that are particularly simple or have been clarified by previous case law – then the decision is taken by only three judges. In rare cases, where the decision would mean a deviation from previous case law or if the legal question is not uniformly answered in previous case law, a senate of nine judges is formed (a so-called reinforced senate). The judges are appointed by the Austrian Federal President on recommendation of the Austrian Federal Government. Each member must hold a degree in law and must have gained at least ten years of professional experience in the legal profession.

The members of the Austrian Constitutional Court come from different professions (eg, judges, university professors, civil servants or attorneys-at-law) and must be qualified for the office by a degree in law and many years of relevant professional experience. There are, however, no full-time judges because the judges of the Austrian Constitutional Court may continue to exercise their out-of-court profession. Only civil servants must resign from their office due to incompatibility reasons. The sessions of

the Austrian Constitutional Court are held as required, which means the court does not meet on a permanent basis, but usually four times a year for three weeks each (usually in March, June, October and December). In most cases, the Austrian Constitutional Court hears cases as a senate of all 12 members. Cases whose importance does not go beyond the specific individual case or that have already been resolved in earlier decisions are, however, heard by a senate comprising only six members (a so-called small formation). The members and substitute members are appointed by the Austrian Federal President on recommendations of the Austrian Federal Government, or either of the two houses of the Austrian Parliament.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

In Austria there are no actual domestic ADR mechanisms available. At almost any stage of the tax procedure the taxpayer may, however, contact the competent tax authorities and ask if there is room for negotiations.

There is also the possibility for binding rulings that may be requested from the tax authorities on issues of group taxation, transfer pricing or tax-neutral reorganisations and, new since 2019 and partly 2020, regarding other fields of international tax law, questions regarding the general anti-abuse rule (GAAR) and VAT (for more details, see **7.8 Rules Challenging Transactions and Operations in this Jurisdiction** and **8.2 Application of GAAR/SAAR to Cross-Border Situations**).

Austria has, however, concluded several double taxation treaties – comprising mutual agreement procedures.

In addition to the dispute settlements set out in individual double taxation treaties, there is, in the implementation of Directive EU 2017/1852, the possibility for lodging dispute settlement complaints regarding the interpretation and application of double taxation treaties. Since September 2019, taxpayers facing intra-EU tax disputes may, within three years of the first notification of the tax dispute, submit a request to initiate a dispute settlement procedure to the tax authorities. During this procedure, the member states involved are encouraged to find a common solution within two years. If an agreement is reached between the member states, it constitutes an enforceable decision for the taxable person concerned. If, on the other hand, the member states involved do not reach an agreement on the complaint within two years (with a possible extension of up to one year), arbitration proceedings must be carried out. The final decision by the Advisory Committee then binds the member states involved, if no agreement can be reached within a further six months.

6.2 Settlement of Tax Disputes by Means of ADR

As stated above, there are no domestic ADR mechanisms available in Austria.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

As stated above, there are no domestic ADR mechanisms available in Austria.

Austrian fiscal criminal law provides for the possibility of voluntary disclosure in order to avoid sanctions for fiscal offences (for details, see **7.6 Possibility of Agreements to Prevent Trial**).

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

In addition to informal non-binding statements by the tax authorities, taxpayers may apply for formal advance tax rulings. While the tax authorities may have discretion as to whether to issue an informal statement, they are obliged to issue a binding ruling if the taxpayer is able to show a specific interest in this.

A binding ruling may only be applied for regarding a limited scope of matters. As of 2020, the catalogue of these matters comprises reorganisations, tax groups, international tax law, and questions regarding the GAAR and VAT. The ruling is to be issued within two months of the application.

The application for a binding ruling is subject to a fee. The fee amounts to EUR500 if the binding ruling request is denied or withdrawn in time. Otherwise, the fee depends on the taxpayer's annual turnover, with a base fee of EUR1,500. If the taxpayer's annual turnover exceeds EUR400,000, the base fee is gradually increased to a maximum of EUR20,000 (for companies whose turnover exceeds EUR40 million). The Austrian tax authorities, however, do not charge any fee for the issuance of informal rulings.

A ruling reduces the risk that the Austrian tax authorities take a divergent view. For a ruling to be binding, the actual facts and circumstances must not deviate from the facts and circumstances presented in the application for the ruling. If this is the case, the Austrian tax authorities are bound by the ruling and must base their assessment upon this view. The taxpayer may, however, also be protected against the deviation from informal statements, based on the protection of good faith.

6.5 Further Particulars Concerning Tax ADR Mechanisms

As stated above, there are no domestic ADR mechanisms available in Austria.

The application for binding advance rulings is only possible regarding the limited scope of matters previously stated. For informal rulings, no such restrictions apply (for details on rulings, see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**).

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

Cross-border advance pricing agreements may be applied for on the basis of double taxation treaties containing a provision based on Article 25 of the OECD's Model Tax Convention. Those arrangements are negotiated between the Austrian Ministry of Finance and foreign tax authorities on a bilateral or multilateral basis (the taxpayer is not involved in this procedure). Within the European Union, the outcome of such arrangements is subjected to a mandatory automatic information exchange system. However, advance pricing agreements are intended to clarify specific issues of the interpretation of double taxation treaties only on a rather generic level.

Taxpayers may also apply for dispute settlement regarding the interpretation and application of a double taxation treaty under the implementing provision of Directive EU 2017/1852 since September 2019.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

It is important to distinguish between two types of tax audits in Austria:

- “regular” tax audits as a part of administrative tax proceedings; and
- fiscal criminal audits.

While all Austrian businesses are subject to tax audits on a regular basis, usually every three to five years (for details, see **2. Tax Audits**), fiscal criminal audits are only carried out if there is a concrete indication of a fiscal criminal offence. However, “regular” tax audits may lead to the initiation of fiscal criminal proceedings and therefore potentially to the conducting of further fiscal criminal audits. Every “regular” tax audit report is reviewed and assessed by a competent fiscal criminal tax officer from the perspective of fiscal criminal law. If the fiscal criminal tax officer sees an indication of a fiscal criminal offence, he may initiate fiscal criminal proceedings.

Not only individuals but also legal entities may be subject to fiscal criminal proceedings if:

- an offence is committed to the benefit of the legal entity or in violation of obligations of the legal entity; and
- such an offence is committed by a high-ranking officer (a so-called decision-maker); or
- an employee and decision-makers have violated their duties of supervision.

7.2 Relationship between Administrative and Criminal Processes

In Austria there are two possible types of fiscal criminal proceedings: administrative fiscal criminal proceedings and judicial fiscal criminal proceedings. The first type is handled by the tax authorities as fiscal criminal authorities, whereas the second type is handled by ordinary criminal courts.

The principle applies that the tax authorities are competent for less severe offences and the courts for major offences. In particular, the tax authorities are competent for negligent offences

and intentional offences where the amount of evaded taxes does not exceed EUR100,000. The ordinary courts, on the other hand, are competent for intentional offences where the amount of evaded taxes exceeds EUR100,000 (in some cases, an overall perspective may result in several offences being considered collectively with respect to this threshold) and for certain qualified offences (eg, involving the smuggling of goods).

After the initiation of fiscal criminal proceedings, a change of competence may occur in both directions, from the tax authorities to the ordinary courts, and vice versa. This may happen, for example, if additional offences are discovered or initially reached thresholds are undercut.

7.3 Initiation of Administrative Processes and Criminal Cases

As outlined above, every tax audit report is also reviewed and assessed by a competent fiscal criminal tax officer from the perspective of fiscal criminal law. Thus, (external) tax audits may result in fiscal criminal proceedings being initiated.

Fiscal criminal proceedings may also be initiated if a suspicious case has been reported to the authorities and first investigations showed that there are sufficient grounds for suspicion to initiate proceedings. Furthermore, most public authorities and courts are obliged to notify the competent fiscal criminal authority of offences that come to their attention.

7.4 Stages of Administrative Processes and Criminal Cases

Administrative Fiscal Criminal Proceedings

After the initiation of the fiscal criminal proceedings, the fiscal criminal authority carries out investigations; for example, by questioning the accused or witnesses or by dawn raids. If in the opinion of the fiscal criminal authority the facts of the case have been sufficiently clarified, the

fiscal criminal authority is convinced that the accused has committed a fiscal offence and the accused had the opportunity to comment on the accusation, the fiscal criminal authority may issue a so-called penalty order, which constitutes a simplified procedure without a hearing.

If such a simplified procedure is not possible or if the accused files an objection against the penalty order in due time, a hearing must be held. During this hearing, the accused may present any evidence that has not yet been taken into account, or submit additional requests for evidence. If all further investigations are conducted, the fiscal criminal authority will issue a decision either to discontinue the proceedings or to impose sanctions.

Judicial Fiscal Criminal Proceedings

Fiscal criminal court proceedings are carried out according to the principles of ordinary criminal proceedings, supplemented by specific fiscal criminal provisions. Therefore, the public prosecution is the authority in charge and the fiscal criminal authority only carries out investigative tasks on behalf of the public prosecution. There is no possibility of simplified procedures.

Regarding possible penalties, intentional tax evasion is sanctioned with a fine of up to twice (or up to three times in the case of commercial tax evasion) the evaded tax amount or up to two (respectively three) years of imprisonment. In the case of qualified forms of tax evasion (eg, under the use of falsified documents or fictitious structures), penalties of up to ten years of imprisonment are possible.

7.5 Possibility of Fine Reductions

During the assessment of the penalty, mitigating factors must be taken into consideration that may potentially reduce the amount due. Such factors include, for example, repentant confession or previous integrity of the accused.

Apart from that, there is the possibility that penalties may be (partially) indulged under certain conditions (eg, if it is not necessary to enforce the complete penalty in order to counteract the commission of further offences). This, however, only applies in the case of court proceedings.

7.6 Possibility of Agreements to Prevent Trial

The Austrian fiscal criminal law provides for the possibility of voluntary self-disclosure in order to avoid sanctions for fiscal offences. This applies to all kinds of fiscal offences. The taxpayer must voluntarily disclose all facts and circumstances related to the fiscal offences committed before the offence has been fully or partially detected by the Austrian authorities, and pay the amount of tax evaded within one month after the submission of the voluntary self-disclosure, or at least apply for payment reliefs within this month. If a voluntary disclosure is made at the beginning of a tax audit, a surcharge of 20% of the tax evaded must be paid. Furthermore, only the persons actually included in the voluntary self-disclosure will benefit from the waiver of sanctions.

7.7 Appeals against Criminal Tax Decisions

As mentioned above, a simplified penalty order can be appealed against in written form within one month with the issuing fiscal criminal authority. The penalty order is then suspended and the criminal proceedings will be continued with a hearing.

Regular decrees of the Austrian tax authorities in fiscal criminal matters can be appealed to the Federal Fiscal Court and ultimately to the Supreme Administrative Court.

Court decisions in a fiscal criminal case can be appealed to the court of second instance and further (in certain cases) to the Austrian Supreme Court of Justice.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Fiscal criminal penalties result from a (deliberate/negligent) reduction of tax together with a breach of the taxpayer's obligation to notify the tax authorities and fully disclose all information relevant for matters of their taxation.

The tax authorities quite regularly refer to tax evasion in connection with the GAAR because the statute of limitations under Austrian procedural tax law is extended to ten years in the case of tax evasion.

While the authors' impression is that the courts seem more reluctant to apply the GAAR in fiscal criminal proceedings, there are a number of cases where a court has applied the GAAR in fiscal criminal proceedings. For instance, in October 2018, the Austrian Constitutional Court upheld a decision by the District Court of Vienna in which someone was convicted as having contributed to a tax evasion based on the Austrian GAAR provision (Section 22, Austrian Federal Fiscal Code).

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Whether a cross-border double taxation is (better) remedied by means of domestic litigation or an available mechanism under the respective double taxation treaty, if any, will depend entirely on the specifics of the case at hand.

However, it is probably more common to try to use domestic litigation.

It is not yet possible to determine what effects the newly implemented measures under the Multilateral Instrument (MLI) or under the imple-

menting provision for Directive EU 2017/1852 have on cross-border tax litigation.

8.2 Application of GAAR/SAAR to Cross-Border Situations

According to predominant jurisprudence in Austria, the GAAR and specific anti-avoidance rule (SAAR) apply in cross-border situations covered by bilateral treaties. The Supreme Administrative Court's constant case law is that this is in line with the objective of bilateral tax treaties.

Since the principal purpose test provision (PPT) introduced with the MLI is yet to enter into force for many of the major Austrian double taxation treaties (or has only been in force since 1 January 2020), it remains to be seen how it will affect the way tax authorities combat BEPS in cross-border situations.

8.3 Challenges to International Transfer Pricing Adjustments

There is no official data available; however, it appears that the majority of transfer pricing cases are challenged domestically.

8.4 Unilateral/Bilateral Advance Pricing Agreements

On the basis of double taxation treaties containing a provision that reflects Article 25 of the OECD Model Tax Convention (and including the standards stipulated in Articles 16 to 26 of the Multilateral Instrument), cross-border advance pricing agreements can be negotiated by the Ministry of Finance. Both unilateral and bilateral/multilateral agreements are possible; however, unilateral agreements bear the risk of not eliminating the threat of double taxation if the other state involved does not share the legal opinion expressed in the Austrian ruling.

8.5 Litigation Relating to Cross-Border Situations

There is no official data available, but it is likely that matters of withholding tax, tax grouping and transfer pricing are among those with the highest rates of cross-border tax litigation.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

In general, there are not many state aid disputes involving taxes in Austria. Rather recent examples include the following disputes:

- on a provision enabling the amortisation of goodwill on the acquisition of shares in a domestic company within tax groups under certain conditions; and
- on an ordinance setting up flat rates for the taxable profits of certain restaurants.

It is yet unclear if these numbers will increase, eg, due to the various state aids implemented by the Austrian legislature to combat the economic effects of the COVID-19 pandemic. Austria takes the point that those measures are enacted in line with corresponding EU frameworks (see for example Communication from the Commission 2020/C 91 I/01).

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

The Austrian tax authorities may reclaim unlawfully granted fiscal state aid either by means of ex officio amendment/revocation of the respective decree or during reopened proceedings.

9.3 Challenges by Taxpayers

Due to the limited number of state aid recoveries, there are no significant cases at hand where taxpayers have challenged tax assessments recovering unlawfully granted state aid.

9.4 Refunds Invoking Extra-Contractual Civil Liability

See **9.3 Challenges by Taxpayers**.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Austria opted to apply Part VI of the MLI.

As a result, a corresponding arbitration clause must be/has been included in 14 Austrian double taxation treaties. These are the treaties with Belgium, Finland, France, Greece, Ireland, Italy, Canada, Luxembourg, Malta, the Netherlands, Portugal, Singapore, Slovenia and Spain.

10.2 Types of Matters that Can Be Submitted to Arbitration

Generally, no particular restrictions regarding legal matters apply. All tax matters subject to the respective double taxation treaty may be submitted to arbitration.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

The following of Austria's covered tax agreements contain/are going to contain last best offer or baseball arbitration procedures pursuant to Article 23 paragraph 1 of the MLI: Belgium, Finland, France, Ireland, Italy, Canada, Luxembourg, the Netherlands, Singapore and Spain.

The following of Austria's covered tax agreements contain/are going to contain independent opinion procedures pursuant to Article 23 paragraph 2 of the MLI: Greece, Malta, Portugal and Slovenia.

10.4 Implementation of the EU Directive on Arbitration

Directive 2017/1852/EU was implemented in September 2019. For details on the procedure, see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

10.5 Existing Use of Recent International and EU Legal Instruments

As these measures have been implemented very recently, no reliable information is available in this regard.

10.6 New Procedures for New Developments under Pillar One and Two

Due to Pillar One's high thresholds, it appears that the envisaged measures might not be of significant importance for Austrian companies. From today's perspective, it is discussed that (up to) around 100 groups with an Austrian ultimate parent entity and a considerable number of Austrian business units of foreign groups potentially fall within the scope of Pillar Two.

As with all measures developed at the OECD level, a reliable guess on the actual impact can only be made after the final implementation at the EU level, which still remains to be seen.

10.7 Publication of Decisions

Decisions in arbitration proceedings are generally not to be published.

Exceptional to this are the arbitration proceedings provided for in the double taxation treaty with Germany, which declares the European Court of Justice arbitration tribunal. Decisions of the European Court of Justice are published online.

10.8 Most Common Legal Instruments to Settle Tax Disputes

As the Austrian tax authorities do not provide public figures regarding the exact number of

disputes solved through any of the available measures, no reliable information is available in this regard.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Due to the overall complexity of international tax law matters subject to arbitration proceedings, it is generally highly advisable for taxpayers to obtain professional legal advice (either from an attorney-at-law or tax adviser).

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

The Austrian tax authorities do not charge administrative fees for lodging an appeal.

However, it should be noted that on the administrative level, costs for legal advice may occur, though there is no obligation to be represented by a legal representative.

11.2 Judicial Court Fees

The proceedings at the Federal Fiscal Court are free of administrative charges and legal representation is, as in administrative proceedings, not required (although highly advisable).

Both the Austrian Supreme Administrative Court and the Constitutional Court charge administrative fees in the amount of EUR240 when lodging an appeal.

If a taxpayer is not able to cover the costs of the proceedings due to their precarious economic situation, they may apply for so-called procedural assistance. Procedural assistance is understood to mean exemption from any costs that may incur during the proceedings, which, in

particular, also means free representation by an attorney-at-law or tax adviser.

11.3 Indemnities

There is no compensation claimable by the taxpayer if the court decides that the initial additional tax assessment is absolutely null and void. However, tax amounts already paid must be reimbursed and the taxpayer may claim interest.

11.4 Costs of ADR

As mentioned above, the application for a binding advance ruling is subject to an administrative fee. The fee ranges from EUR1,500 to EUR20,000 depending on the annual turnover of the taxpayer. Informal rulings, however, are free of charge.

12. STATISTICS

12.1 Pending Tax Court Cases

The only numbers publicly available in relation to tax proceedings can be derived from the Austrian Federal Fiscal Court's annual reports. In 2020, 11,272 cases were closed at the Federal Fiscal Court. The number of pending cases, however, is unknown.

Furthermore, in 2.95% of cases in 2020, the decision of the Federal Fiscal Court was appealed to the Austrian Supreme Administrative Court or to the Austrian Constitutional Courts. The total numbers of pending and closed cases at both supreme courts, however, are unknown.

12.2 Cases Relating to Different Taxes

Of the total number of closed cases at the Federal Fiscal Court in 2020:

- 19.1% related to income tax matters of self-employed persons and entrepreneurs;
- 15.8% related to VAT matters;

- 13.7% related to income tax matters of employed persons;
- 9.9% related to other tax matters (eg, motor vehicle tax);
- 8.7% related to appeals against decrees resulting from wage tax audits;
- 8.1% related to corporate income tax matters;
- 7.4% related to real estate transfer tax and stamp duty matters;
- 6.7% related to matters of tax collection;
- 5.5% related to family allowance and other matters of allowances;
- 4.3% related to the determination of income;
- 0.7% related to matters of unitary values; and
- 0.1% related to appeals against administrative measures taken by the tax authorities.

12.3 Parties Succeeding in Litigation

The total number of successful litigations can only be roughly derived from the Federal Fiscal Court's annual report. In 2020, taxpayers (partially) succeeded in around 27% of closed cases.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

It is vital that tax controversies are thoroughly prepared. The taxpayer should retain counsel in a timely fashion to review and summarise the facts and to prepare legal arguments. Also, it must not be forgotten that new facts and evidence can only be brought forward while the case is pending with the Federal Fiscal Court. It is also generally advisable to request an oral hearing.

bpv Huegel is among the leading law firms in Austria, and is regarded as the primary Austrian firm for highly complex matters that require specialised tax and legal knowledge. The tax team is one of the largest in the Austrian legal market. With dual-qualified members (being qualified as both tax advisers and attorneys-at-law), its seasoned team offers the full range of tax services, including obtaining rulings, assistance in tax audits, tax litigations, arbitration proceedings, evaluation of tax risks, voluntary

disclosures with penal waiver effect, fiscal criminal law matters, internal investigations and accounting issues. Strong-minded commitment to clients, excellent know-how and results-driven efficiency make bpv Huegel the first choice for challenging legal issues, significant transactions and critical tax litigations. The firm strives to provide the highest standard of advice in everything it does. As a result, it has been one of the leading legal tax providers in Austria for decades running.

AUTHORS



Gerald Schachner is a partner at bpv Huegel, head of the firm's tax law practice group and co-head of the tax litigation department. Gerald is dual-qualified as an attorney-at-law

and tax adviser. After gaining profound experience in tax law while working several years with Arthur Andersen, Deloitte and Norton Rose, Gerald joined bpv Huegel in 2010. Gerald is highly regarded in numerous national and international rankings. His practice focuses on corporate tax law, tax restructuring and tax controversy, including fiscal criminal tax law, and combines comprehensive corporate and M&A experience with in-depth tax knowledge that enables clients to achieve positive outcomes.



Kornelia Wittmann is a partner at bpv Huegel and co-heads bpv Huegel's tax litigation department. She holds a double degree in economics and law and an LLM in international tax

law. Kornelia is dual-qualified as an attorney-at-law and as an Austrian and Hungarian tax adviser. Before joining bpv Huegel, she worked with PwC for several years. Kornelia is recognised in numerous national and international rankings. Her main areas of practice are tax litigation, including fiscal criminal law, corporate, international and M&A tax law. Furthermore, Kornelia provides advice in national and international accounting law and in banking supervisory law.



Nicolas D Wolski is a partner at bpv Huegel and qualified both as an attorney-at-law and a tax adviser (in each case with qualifications in Germany and Austria). Before joining bpv

Huegel, Nicolas worked for several years with major international law firms abroad, lastly as counsel with Willkie Farr & Gallagher's Frankfurt office. Nicolas focuses on tax advice in M&A transactions and specialises in the tax aspects of international reorganisations and financings, and tax controversies (tax audits, administrative and judicial appeals). He also conducts tax-driven internal investigations and advises on how to deal with the findings (eg, voluntary disclosure with the objective to avoid sanctions).



Lucas Hora has been an associate with bpv Huegel since 2019. He mainly specialises in tax and tax procedural law (including tax controversies) and in addition deals with fiscal

criminal law, corporate law and accounting law issues. Prior to his engagement at bpv Huegel, Lucas gained experience at PwC and at the Federal Fiscal Court. Lucas graduated from the University of Vienna and the Vienna University of Economics and Business and holds degrees in law, business law, and business administration.

bpv Huegel

Enzersdorferstraße 4
2340 Mödling
Austria

Tel: +43 2236 8933 77
Fax: +43 2236 8933 77 40
Email: gerald.schachner@bpv-huegel.com
Web: www.bpv-huegel.com

bpv HÜGEL

Law and Practice

Contributed by:

Daniel Garabedian, Jean-Michel Degée, Steven Peeters
and Xavier Pace

Arteo see p.46



CONTENTS

1. Tax Controversies	p.35	6. Alternative Dispute Resolution (ADR) Mechanisms	p.38
1.1 Tax Controversies in this Jurisdiction	p.35	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.38
1.2 Causes of Tax Controversies	p.35	6.2 Settlement of Tax Disputes by Means of ADR	p.39
1.3 Avoidance of Tax Controversies	p.35	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.39
1.4 Efforts to Combat Tax Avoidance	p.35	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.39
1.5 Additional Tax Assessments	p.35	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.39
2. Tax Audits	p.35	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.39
2.1 Main Rules Determining Tax Audits	p.35	7. Administrative and Criminal Tax Offences	p.39
2.2 Initiation and Duration of a Tax Audit	p.35	7.1 Interaction of Tax Assessments with Tax Infringements	p.39
2.3 Location and Procedure of Tax Audits	p.36	7.2 Relationship between Administrative and Criminal Processes	p.40
2.4 Areas of Special Attention in Tax Audits	p.36	7.3 Initiation of Administrative Processes and Criminal Cases	p.40
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.36	7.4 Stages of Administrative Processes and Criminal Cases	p.40
2.6 Strategic Points for Consideration during Tax Audits	p.36	7.5 Possibility of Fine Reductions	p.40
3. Administrative Litigation	p.37	7.6 Possibility of Agreements to Prevent Trial	p.41
3.1 Administrative Claim Phase	p.37	7.7 Appeals against Criminal Tax Decisions	p.41
3.2 Deadline for Administrative Claims	p.37	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.41
4. Judicial Litigation: First Instance	p.37	8. Cross-Border Tax Disputes	p.41
4.1 Initiation of Judicial Tax Litigation	p.37	8.1 Mechanisms to Deal with Double Taxation	p.41
4.2 Procedure of Judicial Tax Litigation	p.37	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.41
4.3 Relevance of Evidence in Judicial Tax Litigation	p.37	8.3 Challenges to International Transfer Pricing Adjustments	p.41
4.4 Burden of Proof in Judicial Tax Litigation	p.37		
4.5 Strategic Options in Judicial Tax Litigation	p.38		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.38		
5. Judicial Litigation: Appeals	p.38		
5.1 System for Appealing Judicial Tax Litigation	p.38		
5.2 Stages in the Tax Appeal Procedure	p.38		
5.3 Judges and Decisions in Tax Appeals	p.38		

8.4	Unilateral/Bilateral Advance Pricing Agreements	p.42	10.6	New Procedures for New Developments under Pillar One and Two	p.44
8.5	Litigation Relating to Cross-Border Situations	p.42	10.7	Publication of Decisions	p.44
9. State Aid Disputes		p.42	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.44
9.1	State Aid Disputes Involving Taxes	p.42	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.44
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.43	11. Costs/Fees		p.44
9.3	Challenges by Taxpayers	p.43	11.1	Costs/Fees Relating to Administrative Litigation	p.44
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.43	11.2	Judicial Court Fees	p.44
10. International Tax Arbitration Options and Procedures		p.43	11.3	Indemnities	p.44
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.43	11.4	Costs of ADR	p.45
10.2	Types of Matters that Can Be Submitted to Arbitration	p.43	12. Statistics		p.45
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.43	12.1	Pending Tax Court Cases	p.45
10.4	Implementation of the EU Directive on Arbitration	p.44	12.2	Cases Relating to Different Taxes	p.45
10.5	Existing Use of Recent International and EU Legal Instruments	p.44	12.3	Parties Succeeding in Litigation	p.45
			13. Strategies		p.45
			13.1	Strategic Guidelines in Tax Controversies	p.45

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In Belgium, tax disputes usually arise following a tax audit of an individual taxpayer, either routine or targeted. They can also arise following tax audits targeted on a specific topic (eg, a standard transfer pricing questionnaire or where the existence of a foreign bank account is revealed by an automatic exchange of information) or towards a specific economic sector.

Taxpayers might also choose to file their tax return to accord with the tax authorities' views and subsequently appeal their own tax assessment, thereby avoiding incurring penalties. This strategy rules out the taxpayer being denied the facility of offsetting the additional tax base with existing tax assets (since there is now a rule against doing so if a post-audit penalty of 10% or more is imposed).

1.2 Causes of Tax Controversies

Most tax disputes involve federal income tax (including withholding taxes). Though small in money terms, local taxes (municipal and provincial) also constitute a large proportion of the judicial caseload.

1.3 Avoidance of Tax Controversies

Taxpayers can exclude the chance of ending up in a dispute regarding federal income tax and other taxes levied or administered by the federal tax authorities (eg, VAT) by applying for an advance tax ruling (which provides legal certainty except in certain circumstances; see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**).

1.4 Efforts to Combat Tax Avoidance

The BEPS recommendations, the EU's recent measures to combat tax avoidance and any subsequent amendments to double tax treaties

or domestic legislation in line with them, and the recent ECJ case law on abuse, are beginning to translate into tax disputes in Belgium. As a result, the number of disputes and the focus on the above-mentioned developments appear to have increased, but it is currently too early to tell. In particular, the impact of the DAC6 reporting requirements on the number of tax audits has also to be monitored.

1.5 Additional Tax Assessments

Other than in a limited number of cases, taxpayers are not obliged to pay disputed tax nor provide a guarantee to do so before bringing a challenge or whilst litigation is pending but can choose to do so and thus stop the accrual of interest in the eventuality that the challenge fails.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

In recent years, the tax authorities have developed their data-mining capabilities to identify which individual taxpayers and groups of taxpayers are worth auditing; their algorithms are a closely held secret. Tax audits can also be launched upon another basis. Recently, many audits are initiated following international exchange of information (eg, Common Reporting Standard).

2.2 Initiation and Duration of a Tax Audit

Income Tax

A tax audit can be performed in a given financial year (the taxable period) and during the three following years. In cases of suspected fraud, four years are added to this time span, though the tax authorities must give the taxpayer due notice in writing of what cause they have to suspect it. The authorities can exercise their powers for ten years if the taxpayer uses a legal construction in a jurisdiction that is not bound to exchange

information on tax matters with Belgium and that is listed as having no or low tax, in order to conceal the origin or existence of assets.

If the tax authorities receive information from a foreign tax authority showing unreported income from one of the six previous financial years, they have two additional years from the time the information is received to conduct a tax audit pertaining to this information and to assess the tax.

Furthermore, the tax authorities have an additional one-year investigation and assessment period in case a tax audit reveals that a taxpayer has committed an infringement of their withholding tax obligations during the five years preceding the finding of such an infringement. In such cases, the tax authorities can conduct an in-depth tax audit of the fulfilment by the taxpayer concerned of their withholding tax obligations during the five-year period in question.

A tax audit does not suspend or interrupt the limitation period.

According to a recent press release from the Minister of Finance, the Belgian government aims to extend the assessment and investigation periods (up to ten years), namely in case of suspected fraud in “complex cases” (which have not yet been properly defined).

2.3 Location and Procedure of Tax Audits

Tax audits can be performed remotely (by means of requests for information or videoconference), at taxpayers’ or their accountants’ premises, or at the office of the tax official doing the audit. The right to access company premises (also called “visitation” or a site inspection), whether announced or unannounced, is one of the general investigative powers available to the tax authorities. Documents are made available to them in either hard or soft copy.

As of 1 January 2025, all communication with the tax administration will be done in principle electronically (through a secure platform).

2.4 Areas of Special Attention in Tax Audits

Lately, tax auditors have been very much on the lookout for transfer pricing and international transactions generally. They are helped by a number of transfer pricing documentation requirements (namely local file, master file and country-by-country reporting) and a special schedule attached to the corporate tax return listing payments made directly or indirectly to entities established in tax havens. Also, cross-border withholding tax matters attract increased attention since the ECJ issued its judgments in the so-called Danish cases. The updated withholding tax declaration forms undoubtedly increase data-mining opportunities.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The rules concerning cross-border exchanges of information and mutual assistance between tax authorities have given rise to an increase in tax audits in Belgium, with information received from foreign tax authorities triggering tax audits here (eg, revealing the existence of undeclared bank accounts).

Some joint audits are occurring with the authorities of foreign States, but they are still very rare.

2.6 Strategic Points for Consideration during Tax Audits

The main point is to be clear on what the tax authorities can and cannot legally ask for. Experience shows that the tax authorities do not infrequently ask for things that fall outside their investigative powers, but do not raise a protest when they are reminded of the boundaries thereof.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

In income tax matters (and some other tax matters), an administrative claim must be lodged against the tax assessment before court action can be launched. Such claims are dealt with at an administrative level higher than that of the tax inspector who assessed the tax. There is no centralisation of such administrative claims.

Taxpayers have an opportunity to discuss their file with the official in charge of investigating the claim and, if they wish, can call in the tax authorities' internal reconciliation service to try and find common ground between the positions of the taxpayer and the tax inspector.

A special administrative procedure applies for the remission of penalties and late payment interest.

3.2 Deadline for Administrative Claims

In income tax matters the administrative claim should be lodged within six months of the tax assessment, and the tax authorities should issue their decision within six months (extended to nine months if the disputed tax was assessed "ex officio", and extended to ten months if the special reconciliation service is asked to intervene); in the absence of a decision at the end of this waiting period, taxpayers can choose to still wait for a decision or submit the dispute to the Court of First Instance, thereby ending the administrative claim phase.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Tax litigation is always initiated by the taxpayer filing an appeal with the registrar of the Court

of First Instance, in income tax matters no later than three months after an administrative decision on the administrative claim has been issued (and in the absence of such decision, any time after the administrative claim has been pending for the waiting period, see 3.2 Deadline for Administrative Claims).

4.2 Procedure of Judicial Tax Litigation

Taxpayers challenge their tax assessment before a specialised chamber of the Civil Division of the Court of First instance. The proceedings follow the rules of civil procedure. The taxpayer is usually represented by an attorney, the tax authorities often by a tax official.

They exchange submissions and then the court hears oral arguments at a hearing that lasts generally one or two hours, less often somewhat longer or shorter, depending on the complexity of the case. A few months after oral arguments, the court issues its written judgment. Both the taxpayer and the tax administration can then lodge an appeal before the Court of Appeal.

4.3 Relevance of Evidence in Judicial Tax Litigation

As in most civil cases, witness testimony in tax cases is very rare (if not non-existent). The court relies on documentary evidence, including – sometimes – transcripts of interviews conducted with the taxpayer or third parties by the authorities during the tax audit. New documentary evidence can be submitted and expanded on during the appellate phase.

4.4 Burden of Proof in Judicial Tax Litigation

As a rule, the burden of proof rests with the tax authorities, although it rests with the taxpayer where a deduction, exemption or credit is claimed. The burden of proving criminal intent always rests with the tax authorities – ie, in alle-

gations that the taxpayer knowingly and wilfully evaded tax.

4.5 Strategic Options in Judicial Tax Litigation

See **13.1 Strategic Guidelines in Tax Controversies**.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Regarding jurisprudence, international guidelines, etc, all such sources are relevant, but case law plays the greatest role by far (despite the absence of a stare decisis principle in Belgian law). In practice, Belgium's courts defer to rulings by the ECJ and ECHR, as well as judgments handed down by the Constitutional Court and the Court of Cassation; they regularly submit requests for preliminary rulings to the ECJ and the Belgian Constitutional Court.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Once the Court of First Instance has ruled, both the taxpayer and the tax authority can appeal to the Court of Appeal, where the process is essentially the same as at first instance. Appeal courts have full jurisdiction to rule on law and fact. Both the taxpayer and the tax authority can then take the appeal judgment to the Court of Cassation, whose jurisdiction is nevertheless limited to issues of law; if it quashes the appeal judgment, the Court of Cassation will remit the case in principle to another Court of Appeal.

5.2 Stages in the Tax Appeal Procedure

The procedure in tax appeals is the same as at first instance; see **4.2 Procedure of Judicial Tax Litigation**.

The procedure differs before the Court of Cassation, commencing with a writ setting out the objections to the appeal judgment. This writ may only embody legal issues. The purview of the Court of Cassation may not extend beyond the objections set out in the writ. The respondent has three months to respond to them. Subsequently, an opinion is issued by one of the advocates-general, either in written form or orally at the hearing. It is customary not to present oral arguments at the hearing (other than in exceptional circumstances) and merely to refer to the written submissions.

5.3 Judges and Decisions in Tax Appeals

Tax matters are heard before the Court of First Instance, the Court of Appeal and the Court of Cassation, by independent professional judges with a legal background and experience usually broader than just tax. In the Court of First Instance and the Court of Appeal they usually sit alone, in a chamber that specialises in tax matters. Neither party has any say in which judge(s) will hear the case.

In the Court of Cassation, tax cases are generally handled by a bench of five judges sitting in the Civil Division, the procedure being similar to that in the ECJ with an advocate-general issuing an opinion and one of the five judges acting as judge-rapporteur, who studies the case in depth and drafts the judgment of the court.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Belgium is bound under the competent authority procedure provided for in its wide network of double taxation treaties (DTTs) and the EU

Directive on tax dispute resolution mechanisms in the European Union. The Arbitration Convention, which is binding on all EU member states, the above-mentioned EU Directive and some Belgian DTTs include arbitration provisions.

At a domestic level, the only ADR mechanism available to taxpayers is to request the reconciliation service within the tax administration to investigate disputes in an endeavour to reconcile the positions of the taxpayer and the tax inspector, but such service

6.2 Settlement of Tax Disputes by Means of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Advance tax rulings (officially named “advance decisions in tax matters”) are issued by the Rulings Service, an autonomous section of the tax authority. Tax rulings cannot depart from the provisions of law (no “sweet deals”) but do provide taxpayers with legal certainty as to the interpretation of facts and law relative to transactions contemplated by them as described in their ruling applications.

Rulings are binding on the tax authorities provided: the conditions governing them are adhered to; the situation or the transactions are fully and correctly described by the applicant and their essential elements are carried out as described; and essential consequences of the situation or the transactions are not affected by one or more related or subsequent elements due directly or indirectly to the applicant.

Whether the tax authorities are bound by other published or individual administrative guidance on which taxpayers might reasonably rely in good faith is currently a matter of controversy, unless

the tax provisions at issue are in the implementation of EU law, in which case the overriding EU principle of legitimate expectation applies.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Administrative fines are often imposed by the tax authorities, together with tax assessments. For instance, in income tax matters, the tax due on unreported income is increased with a penalty ranging from 0% to 200%, depending on the seriousness of the infringement and the taxpayer’s previous conduct; an increase of 50% or more is only charged in cases of fraud – ie, where the tax authorities can prove that the taxpayer acted knowingly and wilfully in failing to report income (not for tax assessments based exclusively on the general anti-avoidance rules (GAAR)).

In addition to ad valorem tax increases, lump-sum fines can also apply (eg, general administrative fines ranging from EUR50 to EUR1,250; a fine of EUR6,250 per year for non-disclosure

of a reportable foreign entity or trust; fines of EUR1,250 to EUR25,000 for failure to comply with the transfer pricing documentation requirements or fines of EUR1,250 to EUR100,000 for non-compliance with DAC6 rules).

7.2 Relationship between Administrative and Criminal Processes

Administrative fines are imposed by the tax authorities, and such fines are reviewed by the same courts as verify whether (and how much) tax is due. Criminal penalties are demanded by the public prosecutor and imposed by the criminal courts.

Under the *una via* principle, tax infringements may be prosecuted only once, by either administrative or criminal penalty. The principle is that taxpayers may not be prosecuted twice for the same set of facts (non bis in idem, or double jeopardy). According to this *una via* principle, a consultation between the tax administration and the public prosecutor must be held in certain circumstances to decide whether the case will be subject to public prosecution or to the administrative procedure. The public prosecutor has the final say. In the case of criminal prosecution, the judge who is handling the criminal procedure is also competent to decide on the civil tax claim (including administrative fines). When determining the criminal penalty, the judge will then have to take into account the imposed administrative sanction.

A recent reform provides for a closer collaboration between tax and judicial authorities through specialised joint investigation teams (the so-called “MOTEMS”). Such cooperation will allow tax officers to temporarily provide assistance in criminal investigations under the direction of the public prosecutors. Evidence collected by tax agents may be used for both criminal investigations and tax assessments.

7.3 Initiation of Administrative Processes and Criminal Cases

Whether a particular case warrants raising a criminal prosecution is at the discretion of the public prosecutor (in certain circumstances after consultation with the tax authorities), who is obliged to inform the tax authorities if a criminal investigation reveals indications of tax fraud. Criminal prosecution of tax infringements is rare because of the complexity of the investigations and also due to the possibility for the public prosecutor to terminate the criminal tax prosecution by means of a “penal transaction” settled with the contravener – see **7.6 Possibility of Agreements to Prevent Trial**. In most cases, only administrative fiscal surcharges are imposed to the contravener (in amounts up to 200% of the tax evaded).

Twice a year, the tax authorities and the College of the General Prosecutors hold a strategic meeting to determine priorities.

7.4 Stages of Administrative Processes and Criminal Cases

The stages in the administrative tax infringement process mirror those in the tax assessment process. The fiscal criminal procedure follows the general rules of criminal procedure. In first instance, the criminal Court usually sits with a single judge specialised in criminal tax law.

In the case of criminal prosecution, the judge who is handling the criminal procedure is also competent to decide on the civil tax claim (including administrative fines).

7.5 Possibility of Fine Reductions

Upfront payment of an additional tax assessment does not qualify the taxpayer for a reduction in any fine charged for the relevant tax offence. Administrative fines can, however, be reduced by courts where the amount is disproportionate to the offence or where there is a breach of the

taxpayer's right to a fair trial within a reasonable time. The tax authorities have broad discretion to reduce or remit administrative fines.

7.6 Possibility of Agreements to Prevent Trial

At its own discretion, the public prosecutor may decide (with the agreement of the tax authorities) to prevent criminal tax prosecution or to stop the criminal tax prosecution by settling a "penal transaction" with the contravener(s). The penal transaction takes the form of a payment of a sum of money, including the payment of the evaded taxes.

It is not possible for the contravener to constraint the public prosecutor to opt for the penal transaction.

7.7 Appeals against Criminal Tax Decisions

Once the Court of First Instance issues its judgment, both the taxpayer and the public prosecutor can appeal to the Court of Appeal, where the process mirrors that at first instance (the Court of Appeal usually sits with a bench of three judges). Courts of Appeal have full jurisdiction as to law and fact. Either the taxpayer or the prosecutor can then appeal a Court of Appeal judgment to the Court of Cassation, whose jurisdiction is nonetheless limited to issues of law; if it quashes the judgment, the Court of Cassation remits the case in principle to another Court of Appeal.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Tax avoidance that is only open to challenge under the GAAR is not classed as fraud, and therefore attracts only limited administrative penalties (eg, 10% tax increase). This is, in general, not applicable where a specific anti-abuse rule applies. In purely transfer pricing disputes, any administrative fine charged by the tax authorities is usually only minor.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In cases of double taxation due to duplicated tax assessments or adjustments in cross-border situations, is it common to apply both domestic litigation and the available mechanisms under the relevant double taxation treaty. With the entry into force of the MLI and the EU Tax Disputes Directive, it is expected that binding arbitration, in particular, will become a more common option to resolve international tax disputes.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The tax authorities take the view that anti-abuse rules can also be applied in cross-border situations covered by bilateral tax treaties. Given the primacy of bilateral tax treaties, this may be controversial in certain circumstances if the tax authority claim is inconsistent with the applicable treaty. In addition, the language of the GAAR seems to restrict its scope to abuse of domestic provisions. Case law provides no clear guidance in this respect. It is too early to tell how the PPT test introduced by the MLI and the amendment of the DTT preamble will affect the way tax authorities combat BEPS, as the tax authorities already apply the Belgian GAAR on cross-border situations. At this point in time, the authors' experience is that the tax authorities are mainly focusing on the impact of the judgments of the ECJ in the so-called Danish cases in 2019 and the anti-abuse provision in the Anti-Tax Avoidance Directive.

8.3 Challenges to International Transfer Pricing Adjustments

The main transfer pricing adjustments are traditionally challenged under domestic law, especially the Belgian concept of "abnormal or gratuitous benefits" or the general rules on allowable

expenses. In 2004, Belgium explicitly introduced the arm's length principle into its domestic law (inspired by Article 9 of the OECD Model Convention).

8.4 Unilateral/Bilateral Advance Pricing Agreements

It is common to apply to the Rulings Service for a unilateral advance pricing agreement in the form of a tax ruling; see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**. The process usually starts with a pre-filing phase, in which the envisaged structure is explained and discussed. In the second phase, a written ruling application is submitted in which the facts and circumstances and tax analysis are set out in detail (together with supporting documents, such as benchmarking studies), and the decision is rendered based on this. The entire process generally takes four to six months. An anonymised version of the ruling is subsequently published.

Rulings are valid for a period not exceeding five years. No fee is charged.

Bilateral advance pricing agreements are infrequent. Applications go to the tax authorities' International Relations Department and need to be submitted before the end of the first year intended to be covered. The International Relations Department co-ordinates applications with the other relevant jurisdictions. Bilateral APAs are not published. The time taken for the process varies and can extend over several years in complex files. No fee is charged in Belgium.

8.5 Litigation Relating to Cross-Border Situations

Tax litigation arises in the standard cross-border domains (eg, withholding tax, permanent/fixed establishments, transfer pricing). There has been a substantial increase in transfer pricing litigation in Belgium as a consequence of the

government's development of its transfer pricing unit, a specialist team within the federal tax authority. Recently, specialised teams have been created within the federal tax authority that focus on restructurings, complex cross-border group structures and outbound passive income. Litigation is also on the up concerning the tax residence of corporate and individual taxpayers, as well as regarding withholding taxes.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

Belgium has been involved in several "fiscal" State aid disputes.

In the recent past, the most notable case relates to the so-called "excess profit tax rulings" that the European Commission of 11 January 2016 decided was an incompatible State aid to be recovered from the beneficiaries.

This ruling offered Belgian resident companies that are part of a multinational group and Belgian permanent companies established abroad that are part of a multinational group, the benefit of deducting an "excess profit" (ie, exceeding an arm's-length profit) from their taxable base in Belgium.

In first instance, the Commission's decision was annulled by the General Court of the European Union which ruled that the Commission had erred in treating the different tax rulings granted as the implementation of a "scheme".

Following an appeal filed by the European Commission, the European Court of justice annulled the General Court's judgment and referred the case back to the General Court which will have to decide on the open questions.

Other Belgian tax rules that were considered as incompatible State aids include the corporate tax exemption granted to Belgian ports (2017) and the so-called “coordination centres tax regime” (2003). It is worth mentioning that in both cases, the European Commission did not order that tax be recovered from the beneficiaries.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

Since there is no general legal framework regarding the recovery of fiscal or non-fiscal State aid, Belgium implemented an ad hoc procedure to recover the State aid granted through the excess profit tax rulings (Programme Law of 25 December 2016).

This ad hoc procedure has been mainly inspired by the common tax procedure under which the recovery of the incompatible State aid is entrusted to the tax administration through the issuance of an additional tax assessment.

9.3 Challenges by Taxpayers

In the framework of the ad hoc procedure regarding the excess profit tax rulings, the same remedies as those provided for by the income tax procedure have been made applicable mutatis mutandis (see **3.1 Administrative Claim Phase** and **4.1 Initiation of Judicial Tax Litigation**).

The taxpayers who had received an excess profit tax ruling (or most of them) have lodged an administrative claim against the recovery and most of these claims are still awaiting a final decision of the EU Courts.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Although the introduction of such an action is not inconceivable, there is no precedent in case law of the recognition of the extra-contractual civil liability of the Belgian State in relation to the

refund by a taxpayer of an incompatible State aid.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Belgium has opted for mandatory binding arbitration as provided for in Article 18 of the MLI. In the Belgian Model Convention, a binding arbitration clause is included that is almost identical to the arbitration clause in the OECD Model Convention. Although arbitration clauses are included in a number of DTTs, this is not always the case. In particular, no arbitration clauses are currently included in the tax treaties in force with the neighbouring countries (France, Germany, the Netherlands and Luxembourg).

10.2 Types of Matters that Can Be Submitted to Arbitration

Belgium has chosen to make the mandatory binding arbitration under the MLI feasible in as many cases as possible. It has not made a reservation to limit their scope and does not object to limitations of scope made by the treaty partner jurisdiction. However, mandatory binding arbitration is not available if a final court decision has been rendered regarding the dispute in one of the concerned jurisdictions.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Belgium opts for Baseball Arbitration. In the explanatory memorandum of the Belgian law approving the MLI, it is clear that the majority of the parties to the MLI that chose arbitration preferred this option, which is quicker and easier. In addition, given that Baseball Arbitration limits

the arbitration panel to the viewpoint of one of the competent authorities, these authorities are encouraged to take more reasonable positions, often making it possible to reach a mutual agreement without going to the arbitration stage. Belgium has, however, not made a reservation with regard to treaty partner jurisdictions which have opted for the Independent Opinion Procedure.

The Memorandum of Understanding regarding the application of mandatory binding arbitration between Australia and Belgium, signed on 3 March 2021, provides for Baseball Arbitration.

This option differs from the EU Arbitration Convention and the EU Tax Disputes Directive, that provide an Independent Opinion Procedure. Also, in the Belgium–Japan DTT, which was concluded in 2016, the treaty partners opted for the Independent Opinion Procedure.

10.4 Implementation of the EU Directive on Arbitration

Belgium implemented the EU Directive on Arbitration with the Act of 2 May 2019.

10.5 Existing Use of Recent International and EU Legal Instruments

The authors are not aware of cases in which the recent international and EU arbitration procedures have been used to settle tax disputes.

10.6 New Procedures for New Developments under Pillar One and Two

Belgium has opted not to apply the confidentiality obligation in the MLI and has not made a reservation in relation to it.

10.7 Publication of Decisions

Belgium has opted not to apply the confidentiality obligation in the MLI and has not made a reservation in relation thereto.

10.8 Most Common Legal Instruments to Settle Tax Disputes

The mutual agreement procedures based on the existing DTTs or the EU Arbitration Convention are most often used to settle international tax disputes. It is anticipated that the new instruments (MLI and EU Dispute Resolution Directive) will rapidly gain importance.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Taxpayers generally hire independent professionals (either tax consultants or tax lawyers) to assist them to settle their international tax disputes.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

There are no costs to challenge an assessment at the administrative level.

11.2 Judicial Court Fees

There is no court fee in tax matters. Appeals to the Court of Cassation, however, must be served by a bailiff, which involves a cost of about EUR500, which can be recovered against the other party in the event of success.

11.3 Indemnities

Taxpayers represented by counsel – as they generally are – who win in court are awarded lump-sum representation costs, to be paid by the losing tax authorities. The amount is based on an official tariff, and mainly depends on the money value of the litigation; it rarely covers the attorney's actual fees. If the tax assessment is ruled to be reckless, the taxpayer may also be awarded damages in tort, though this is rare.

11.4 Costs of ADR

The procedures to obtain advance rulings and bilateral advance pricing agreements entail no official charge.

12. STATISTICS

12.1 Pending Tax Court Cases

No general statistics are available encompassing all court tax cases in Belgium and stating their values. At the beginning of 2020:

- 6,369 cases were pending regarding personal income tax (of which 5,003 were at first instance);
- 594 regarding non-resident individuals (of which 513 were at first instance);
- 2,844 regarding corporate income tax (of which 2,085 were at first instance);
- 45 regarding non-resident companies (of which 38 were at first instance);
- 275 regarding withholding tax on movable income (of which 201 were at first instance); and
- 1,365 regarding VAT (of which 1,029 were at first instance).

12.2 Cases Relating to Different Taxes

See **12.1 Pending Tax Court Cases**.

12.3 Parties Succeeding in Litigation

In federal income tax matters (which exceed all others, at least in terms of monetary value), taxpayers win completely at the administrative level in about 36% of introduced cases and partially in about 9% (based on official statistics for decisions in 2018). Taxpayers who do not fully succeed at the administrative level win in court in about 42% of cases; in VAT matters, taxpayers win in court in about 31% of cases (based on official statistics for decisions in 2020).

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The key point for consideration in tax disputes in Belgium is timing: the timing for filing an administrative challenge against a tax assessment and for going to court, the time at which it is appropriate to raise certain legal arguments and the time at which to pay disputed tax.

Since Belgium is a small country with much inbound investment, due consideration must be paid to whether the Belgian tax is creditable against a foreign tax and what requirements exist for it to be so.

Where the first stage for any challenge is administrative, as in income tax matters, the argumentation should be presented that takes into account the fact that the review is not necessarily performed by a civil servant with a legal background. A variety of different avenues may be open to a taxpayer wanting to challenge a tax assessment and, perhaps, a fiscal penalty, therefore strategic considerations are obviously important in deciding which avenue to choose and when.

Such aspects aside, in a legal system where fiscal disputes are decided in courts under rules of civil procedure by a professional judiciary with legal background and experience usually broader than tax, the strategy in such disputes will not differ greatly from that in any civil cause, which means that the legal arguments are important.

The prime strategy is to refrain from litigating where, on an in-depth assessment, the case lacks merit. When it is decided to pursue a court action, the core task of the litigators is to discover the essence of the case and then effectively communicate it to the bench.

Arteo is a Brussels-based independent law firm founded in 2020 by the members of the tax department of a large, full-service Belgian law firm. Arteo focuses on three areas of expertise: tax advice and tax litigation, primarily for large corporations; advice on wealth and estate planning; and Supreme Court (Court of Cassation) procedures. A number of the firm's members hold positions as leading academics. The team is recognised, among others, for its far-reaching

experience in the broad spectrum of tax dispute resolution and litigation before the tax authorities, the Belgian courts (including the Court of Cassation and the Constitutional Court) and the Court of Justice of the European Union. It has seen a steady, substantial influx of new tax litigation cases (particularly regarding transfer pricing matters) and secured a number of victories in landmark cases. Arteo is the Belgian member of the Taxand network.

AUTHORS



Daniel Garabedian has specialised in advising in tax law, primarily for major corporations, for over 30 years, and has assisted clients in numerous complex tax disputes.

He is one of 20 lawyers admitted to the Court of Cassation Bar. Daniel has published numerous articles on tax-related topics and spoken at many conferences in Belgium and abroad. He lectures on corporate tax at the Université Libre de Bruxelles and heads the Master in Tax Law programme there. He is a former member of the Permanent Scientific Committee of the International Fiscal Association (IFA) and a former president of the Belgian branch of the IFA.



Jean-Michel Degée has over 20 years' experience in tax law. He advises on corporate taxation, and more specifically regarding corporate reorganisations, international tax

planning and taxation of remunerations. He has solid experience in tax litigation. Jean-Michel has intervened in many important and complex tax disputes, including on transfer pricing and sectorial taxes. He lectures on corporate tax at the Solvay Business School and on the tax aspects of corporate reorganisations at the University of Liège. Jean-Michel is the former Secretary-General of the Belgian branch of the International Fiscal Association.

Contributed by: Daniel Garabedian, Jean-Michel Degée, Steven Peeters and Xavier Pace, Arteo



Steven Peeters has over ten years' experience in assisting clients regarding the tax aspects of transactions and dealing with tax disputes. He has represented clients at the

administrative and judicial levels and the Supreme Court regarding transfer pricing or the tax consequences of transactions. Steven holds a Master's degree in Law from the University of Leuven and an LLM from Harvard Law School. He is admitted to the Bars of Brussels and New York. He lectures on personal income tax and withholding taxes at the Brussels Tax School and is active as an affiliated researcher at the Institute for Tax Law of KU Leuven.



Xavier Pace advises clients on corporate tax, including the tax aspects of various types of transactions and fiscal and financial criminal law. He also assists clients in their disputes

with the tax authorities and in criminal proceedings in tax and financial matters. As a former magistrate, Xavier has an in-depth knowledge of the judicial environment. This is an asset, particularly in the context of the prevention of tax and criminal risks for companies and in handling judicial and criminal proceedings. Xavier is an affiliated researcher in tax law at the University of Liège.

Arteo

Rue de la Bonté 5 / Goedheidsstraat 5
1000 Brussels
Belgium

Tel: +32 2 392 81 00
Email: info@arteo.law
Web: www.arteo.law

ARTEO

Law and Practice

Contributed by:

Luiz Roberto Peroba Barbosa, Tércio Chiavassa and

Guilherme Villas Bôas

Pinheiro Neto Advogados see p.65



CONTENTS

1. Tax Controversies	p.51	6. Alternative Dispute Resolution (ADR) Mechanisms	p.58
1.1 Tax Controversies in this Jurisdiction	p.51	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.58
1.2 Causes of Tax Controversies	p.51	6.2 Settlement of Tax Disputes by Means of ADR	p.58
1.3 Avoidance of Tax Controversies	p.52	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.58
1.4 Efforts to Combat Tax Avoidance	p.52	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.58
1.5 Additional Tax Assessments	p.52	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.59
2. Tax Audits	p.53	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.59
2.1 Main Rules Determining Tax Audits	p.53	7. Administrative and Criminal Tax Offences	p.59
2.2 Initiation and Duration of a Tax Audit	p.53	7.1 Interaction of Tax Assessments with Tax Infringements	p.59
2.3 Location and Procedure of Tax Audits	p.53	7.2 Relationship between Administrative and Criminal Processes	p.59
2.4 Areas of Special Attention in Tax Audits	p.54	7.3 Initiation of Administrative Processes and Criminal Cases	p.59
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.54	7.4 Stages of Administrative Processes and Criminal Cases	p.60
2.6 Strategic Points for Consideration during Tax Audits	p.54	7.5 Possibility of Fine Reductions	p.60
3. Administrative Litigation	p.54	7.6 Possibility of Agreements to Prevent Trial	p.60
3.1 Administrative Claim Phase	p.54	7.7 Appeals against Criminal Tax Decisions	p.60
3.2 Deadline for Administrative Claims	p.55	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.60
4. Judicial Litigation: First Instance	p.55	8. Cross-Border Tax Disputes	p.61
4.1 Initiation of Judicial Tax Litigation	p.55	8.1 Mechanisms to Deal with Double Taxation	p.61
4.2 Procedure of Judicial Tax Litigation	p.55	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.61
4.3 Relevance of Evidence in Judicial Tax Litigation	p.55	8.3 Challenges to International Transfer Pricing Adjustments	p.61
4.4 Burden of Proof in Judicial Tax Litigation	p.56		
4.5 Strategic Options in Judicial Tax Litigation	p.56		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.56		
5. Judicial Litigation: Appeals	p.56		
5.1 System for Appealing Judicial Tax Litigation	p.56		
5.2 Stages in the Tax Appeal Procedure	p.57		
5.3 Judges and Decisions in Tax Appeals	p.57		

8.4	Unilateral/Bilateral Advance Pricing Agreements	p.61	10.6	New Procedures for New Developments under Pillar One and Two	p.62
8.5	Litigation Relating to Cross-Border Situations	p.61	10.7	Publication of Decisions	p.62
9. State Aid Disputes		p.62	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.62
9.1	State Aid Disputes Involving Taxes	p.62	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.62
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.62	11. Costs/Fees		p.62
9.3	Challenges by Taxpayers	p.62	11.1	Costs/Fees Relating to Administrative Litigation	p.62
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.62	11.2	Judicial Court Fees	p.62
10. International Tax Arbitration Options and Procedures		p.62	11.3	Indemnities	p.62
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.62	11.4	Costs of ADR	p.63
10.2	Types of Matters that Can Be Submitted to Arbitration	p.62	12. Statistics		p.63
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.62	12.1	Pending Tax Court Cases	p.63
10.4	Implementation of the EU Directive on Arbitration	p.62	12.2	Cases Relating to Different Taxes	p.63
10.5	Existing Use of Recent International and EU Legal Instruments	p.62	12.3	Parties Succeeding in Litigation	p.63
			13. Strategies		p.63
			13.1	Strategic Guidelines in Tax Controversies	p.63

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Brazilian tax controversies mainly arise from tax authorities' or taxpayers' initiatives.

Tax Authorities

From the tax authorities' standpoint, tax controversies usually arise as a result of tax audits or mismatches involving ancillary obligations.

With respect to the Brazilian ancillary obligations, it is worth stressing that the Brazilian tax system is very connected to electronic platforms. This means that any mismatch of information involving ancillary obligations could lead to (i) an infraction notice (administrative sphere), or (ii) a tax foreclosure (judicial sphere) by the tax authorities.

Taxpayers

From a taxpayers' standpoint, tax controversies arise whenever a taxpayer decides to challenge any tax assessment, which could be formalised through:

- fillings and claims against formalised/materialised contingencies, such as infraction notices (administrative sphere) or tax foreclosures (judicial sphere); and
- judicial claims aiming at the recognition of any non-assessment (for future tax triggering events), with the possibility of, additionally, requesting the recovery of amounts unduly paid over the last five years, counted as from the filing of such a claim.

With regard to the possibility of requesting the recovery of amounts unduly paid over the last five years, it is worth mentioning that the Brazilian Supreme Court can establish a prospective overruling under a leading case (*modulação de efeitos*), which means that the effects of such

a decision would only be applicable to future events (instead of retroactively). Consequently, it would void the recovery of excess payments made in the past. However, the Brazilian Supreme Court's precedents have also recognised that this prospective overruling should not be applicable to prior lawsuits.

1.2 Causes of Tax Controversies

Brazil is a federal republic composed of the Federal Union, states and municipalities, where power is exercised by distinct and independent bodies.

Consequently, taxes could be claimed by the Federal Union, states (there are 27 in Brazil) and municipalities (there are more than 5,000 in Brazil).

As for the taxes that give rise to the most tax controversies, PIS/COFINS (federal social contributions assessed over companies' revenues) generate a significant quantity of litigation in Brazil, since (i) its tax base is disputable (ie, the exclusion of amounts/taxes from its tax base), and (ii) the existence of cumulative and non-cumulative regimes raises disputes regarding the possibility of obtaining and maintaining tax credits.

At the state level, ICMS (state value-added tax assessed over sales of goods and some services) represents a significant portion of tax disputes, since its non-cumulative regime, regulated by 27 distinct legislations, also raises several tax controversies regarding the possibility of obtaining and maintaining tax credits.

At the municipal level, ISS (municipal tax assessed over services) also represent a significant portion of tax disputes, since there are more than 5,000 municipalities enacting distinct laws and there are several disputes regarding such tax, such as (i) which municipality is entitled to

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

claim such tax (whenever services involve more than one municipality), and (ii) the definition of which cases/situations would be characterised as involving an import of services (under contracts involving companies abroad and Brazilian companies).

1.3 Avoidance of Tax Controversies

Tax controversy can be mitigated through a deep analysis of taxpayers' tax returns, books and ancillary obligations ("non-materialised tax contingencies"), which is usually performed in Brazil by the taxpayer, with a review by an audit/accountant firm.

This is because there are a number of situations – such as tax base calculation, use of credits, tax benefits, accordance with all rulings regarding ancillary obligations – that can be mitigated if some controls and procedures have previously been reviewed.

It is worth noting that the non-compliance with these procedures could not only lead to tax claims involving the non-payment of taxes, but also the imposition of fines that could surpass the amount of claimed taxes.

1.4 Efforts to Combat Tax Avoidance

Since Brazil has not adhered to a common international standard, Brazilian tax legislation does not replicate the OECD's Base Erosion and Profit Shifting (BEPS) recommendations or the EU's measures to combat tax avoidance.

Although Brazil is not an OECD member, it has requested to join that organisation and take a seat on debates involving the BEPS project. Brazil has attempted to reflect such strategies under local rules to as great an extent as possible, as illustrated by Provisional Measure No 685, of 21 July 2015 ("MP 685/15"); Normative Ruling No 1,681, of 28 December 28, 2016 ("IN 1,681/16"); and Normative Ruling No 1,669, of 9 November

2016 ("IN 1,669/16"), which, respectively, aimed at replicating locally BEPS Action Plans Nos 12 (Mandatory Disclosure Rules), 13 (Country-by-Country Reporting), and 14 (Making Dispute Resolution Mechanisms More Effective).

Despite these attempts, a "substance over form" approach was introduced into Brazilian legislation by Supplementary Law No 104, of 10 January 2001 ("LC 104/01"), which brought provisions intended to enable the tax authorities to disregard a taxpayer's acts or businesses and, consequently, impose taxes based on a substance over form perspective. The following sole paragraph was included in Article 116 of the Brazilian Tax Code, provided by Law No 5.172, dated of 25 October 1966 (*Código Tributário Nacional* – CTN): "Sole paragraph. The administrative authority shall be able to disregard juristic acts or transactions whose purpose is to disguise the occurrence of the triggering event of a law of the nature of the elements that make up a tax obligation, subject to the procedures defined in the ordinary laws".

It is worth mentioning that, on 11 April 2022, the Brazilian Supreme Court confirmed the constitutionality of this provision through its decision on Action for Declaration of Unconstitutionality No 2,446. Despite that, the Brazilian Supreme Court has decided that such provision would only be applicable to transactions in which there is evidence of fraud or simulation.

1.5 Additional Tax Assessments

In addition to the principal claimed amounts, tax authorities can also impose fines and interest calculated according to the SELIC rate (Brazil's base interest rate set by the Brazilian Central Bank and currently set at 11.75% per year).

As for the fines, there are two main types of penalty that could be applied by the federal tax

authorities in cases of issuance of a tax assessment:

- a 75% statutory penalty, applied in cases which the tax authorities believe that the taxpayer did not engage in any wilful misconduct, fraud or simulation; or
- a 150% aggravated penalty, which is imposed when the tax authorities believe that the taxpayer practised acts that should qualify as wilful misconduct, fraud or simulation.

Under Brazilian tax law, an aggravated penalty of 150% may only be imposed in cases in which the fraudulent/collusive intent is effectively evidenced.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

In general terms, the tax authorities have a five-year statute of limitation for initiating audits against Brazilian taxpayers, except in cases of simulation, fraud or wilful misconduct, in which case such term may be increased to six years.

In relation to accounting and tax matters, Brazilian companies are required to maintain accounting books and tax information required to support tax audits.

The federal tax audit procedures are ruled by Normative Ruling No 6478/2017, which prescribes, among other things, the different types of tax audit that can be carried out by the Brazilian Federal Revenue, such as:

- a regular tax audit proceeding (*Termo de Distribuição de Procedimento Fiscal de Fiscalização – TDPF-F*) aimed at the inspection of tax obligations (collection of taxes and fulfilment of ancillary obligations); or

- a special tax audit proceeding (*Termo de Distribuição de Procedimento Fiscal Especial – TDPF-E*), established in order to prevent the destruction of evidence.

According to Normative Ruling No 6478/2017, tax audits shall also meet some formal requirements, such as:

- the description of the nature of the tax audit proceeding (ie, regular or special);
- the period for the conclusion of the tax proceeding; and
- the taxes and respective period under analysis.

These requirements are important for the taxpayer to comprehend which tax obligations will be inspected by tax authorities.

2.2 Initiation and Duration of a Tax Audit

As a general rule, a regular tax audit proceeding starts with the issuance of a tax audit proceeding (*Termo de Distribuição do Procedimento Fiscal – TDPF*) and should be closed within a 120-day period, although the tax authorities could require an extension of that period to conclude a tax procedure.

2.3 Location and Procedure of Tax Audits

Tax audits are conducted through electronic proceedings, which means that requests and responses should be formally presented under such tax audit proceedings.

If necessary, tax authorities may schedule a virtual meeting with the taxpayer for further clarification.

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

2.4 Areas of Special Attention in Tax Audits

Since the Brazilian tax system is very connected to electronic platforms, especially regarding ancillary obligations, the cross-check confirmation of all stated values and pieces of information requires a special attention.

In addition to this, the inspection of tax credits resulting from distinct situations – such as resale of goods or inputs under the manufacturing process for PIS/COFINS purposes – could also result in some tax questionings.

Furthermore, the fulfilment of requirements to receive and maintain tax benefits may also be verified under a tax audit.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Over the last few years, Brazil has entered into tax information agreements (TIEAs) with several jurisdictions. In parallel, Brazil has also signed the Intergovernmental Agreement (IGA) with the USA in 2014, which implements the Foreign Account Tax Compliance Act (FATCA) in Brazil and which was subsequently approved by Presidential Decree No 8,506/2015.

In addition to that, Brazil has also implemented country-by-country reporting through Normative Ruling No 1,681/2015, based on the BEPS Action Plans, which obliges multinational groups, controlled by Brazilian entities, to present tax information regarding other jurisdictions.

2.6 Strategic Points for Consideration during Tax Audits

Some strategic measures should be adopted to avoid any issue involving tax audits, such as:

- responding to all queries from the tax authorities;
- providing responses focusing on the specific question/matter questioned; and
- keeping the tax authorities informed in case any difficulties may appear.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

When tax authorities find any deficiency, they issue an Infraction Notice (which includes penalties and interest) and the taxpayer is notified. Counting from this notification, there is a 30-day term to present a defence before the first level administrative court.

After that, the first level administrative court will analyse the defence and issue a decision (in most cases maintaining the assessment since the first level judges are tax inspectors themselves).

Once the first level decision is issued, if it is unfavourable, the taxpayer then has another 30 days to file an appeal to the Administrative Tax Court (CARF). If the decision is favourable to the taxpayer, the case is necessarily submitted to the second level analysis.

Depending on the nature of the decision rendered by the Panel of the Administrative Tax Court, there is a third level of jurisdiction. By means of an appeal known as a Special Appeal, both the taxpayer and the authorities can take the case to the Special Chamber of the Administrative Tax Court. This Special Appeal, however, is only applicable when there are conflicting decisions issued within the Administrative Tax Court related to the same matter.

During the administrative dispute, the requirement to pay the total amount is stayed and the taxpayer is able to litigate without offering any type of guarantee. This means that tax debts cannot be enforced during administrative litigation and the taxpayer is still entitled to a tax clearance certificate.

3.2 Deadline for Administrative Claims

Tax authorities have a five-year statute of limitation for the issuance of infraction notices against Brazilian taxpayers, except in cases of simulation, fraud or wilful misconduct, in which case such term may be increased to six years.

There is no deadline for the administrative tax proceeding to be decided and closed. However, a typical timeframe for the resolution of an administrative dispute is around three to four years.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

After the administrative discussion is finished and an unfavourable final decision is rendered (if that is the case), the taxpayer may either file for a lawsuit and start a new discussion in the judicial sphere or wait for the tax enforcement to be filed by the tax authorities, against which the taxpayer can then file a defence, if a guarantee is presented.

In the first case (filing a lawsuit – writ of mandamus or ordinary lawsuit), in order to stay the requirement to pay the debt, the company will need to present a guarantee to discuss the matter judicially if an injunction is not granted by the judge at the beginning of the judicial discussion.

If the taxpayer opts to wait for the enforcement, the federal debt will be classified as an Overdue

Tax Liability and the amounts are increased by 20% (related to the legal fees of the public attorney). However, the legislation foresees a broader range of guarantees that can be presented in a tax enforcement other than cash (ie, bank guarantees, insurance and attachment of assets).

If the taxpayer does not submit any guarantee, the Public Treasury will require the online attachment of the company's financial assets. This type of attachment is made directly in the company's current accounts, which are frozen up to the limit of the debt in dispute. If this measure is unsuccessful, the Public Treasury may require the attachment of the company's other assets or the partners and manager's personal assets, depending on the case.

4.2 Procedure of Judicial Tax Litigation

Regarding the proceeding itself, the first level decision is issued by a singular judge. Favourable first level decisions are subject to mandatory appeal and in the case of an unfavourable decision, the taxpayer is allowed to appeal to the Second Level Court.

After the second level, both the taxpayer and the authorities are allowed to file appeals to the Superior Courts. The Superior Court of Justice (STJ) reviews non-constitutional matters and the Supreme Federal Court (STF) reviews only constitutional matters. There is no analysis of evidence by the Superior Courts.

4.3 Relevance of Evidence in Judicial Tax Litigation

Evidence is important for tax disputes, since the misunderstanding of facts or documents may result in a distinct decision.

However, if there is any dispute regarding a fact, the judge may commission an expert to analyse and report on the facts and presented documents.

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

It is worth stressing that this expert should not interpret tax legislation, focusing exclusively on non-legal matters, such as the fulfilment of ancillary obligations or the analysis/confirmation of the facts and documents presented by the parties under dispute.

After this step, the judge – being as certain as possible regarding the facts/documents – will be able to interpret the tax legislation and render a final decision on the case.

4.4 Burden of Proof in Judicial Tax Litigation

As a general rule, the Brazilian Code of Civil Procedure (CPC) establishes that the burden of proof remains with the plaintiff. This means that if the taxpayer decides to file a judicial claim against any tax assessment, the burden of proof will remain with the taxpayer.

However, whenever a tax foreclosure is filed, the burden of proof remains with the defendant, which means that the taxpayer will need to prove that this tax foreclosure was wrongfully filed.

4.5 Strategic Options in Judicial Tax Litigation

Initially, taxpayers should previously prepare all required documents to file a judicial claim with no risk of a lack of documentation.

In addition to that, taxpayers should also verify whether the judge has already responded to all the arguments to be presented under a judicial dispute, since, in case there is a lack of analysis, the Brazilian Code of Civil Procedure (CPC) determines that this decision would be considered null.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

According to the Brazilian Code of Civil Procedure (CPC), the judicial courts and judges are

obliged to observe some decisions rendered by the STJ and the STF, such as:

- decisions rendered under a centralised constitutional review by the STF;
- same subject-matter claims (*recursos representativos de controvérsia*) considered by the STJ; and
- binding precedents (*súmulas vinculantes*) issued by the STF.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

If a decision in favour of a taxpayer is rendered at first instance, a mandatory appeal is automatically filed to a second level court.

Conversely, upon an unfavourable decision rendered by a judge, the taxpayer is allowed to appeal to the second level court.

It is worth stressing that this appeal filed by the taxpayer must meet some formal requirements, such as the presentation of previous facts and the arguments and legal grounds that sustain the review of this first instance decision.

After the second level instance, there is no mandatory appeal, which means that taxpayers and National Treasury/state/municipal attorneys shall fulfil the same requirements to file appeals and reach Superior Courts.

As a rule, appeals filed by the taxpayers could be presented within 15 working days, while National Treasury/state/municipal attorneys may present appeals within 30 working days.

5.2 Stages in the Tax Appeal Procedure

Once the appeals are filed, they are automatically distributed to a Second Level Panel, composed of five judges.

However, the appeal shall be analysed by a board of three judges (randomly chosen among that five) and one of them would be entitled to report the case to other judges.

Once the trial is scheduled, the parties are entitled to request oral statements during trial, which shall be concluded within 15 minutes.

After a decision is rendered by the second level instance, the parties can present a motion for clarifications or directly appeal to superior courts and, ultimately, the STJ and STF.

Since there is no analysis of facts or evidence by the Superior and Supreme Courts, a motion for clarification is commonly used by the parties previously to filing an appeal to a third level instance.

It is worth stressing that these appeals before the Superior and Supreme Courts must meet some formal requirements, such as the violation of a federal law for an appeal aiming at STJ review, and the violation of the Brazilian Constitution for an appeal aiming at STF review.

5.3 Judges and Decisions in Tax Appeals

Tax litigation cases are initially decided by a single judge, nominated through a public civil examination.

Second Instance

Second level judges are appointed by the full bench of the second level court through merit or seniority.

It is worth noting that in each five nominations for a second level judge, four should be selected from first level judges, while one should be nominated from either the Brazilian Bar Association (OAB) or the Public Prosecutors (*Ministério Público*).

Second level courts are composed of Civil and Criminal Panels, each composed of five second level judges. Tax appeals are analysed by Civil Panels.

Third Instance

The third level instance is composed by the STJ and the STF.

The STJ is formed by 33 Ministers appointed by the President of the Republic after approval of the Federal Senate.

The STJ is organised according to the specialisation of the case matter in three Sections, which by their turn are formed by two Panels each.

Sections are composed by ten Ministers each and Panels by five Ministers each. First and second Panels are responsible for analysing tax appeals. If there is a divergent interpretation among these Panels, the case shall be decided by the first Section (which encompasses the first and second Panels).

The STF is formed by 11 Ministers appointed by the President of the Republic after approval of the Federal Senate.

The STF is organised into two Panels of five Ministers each. Both Panels are responsible for analysing tax appeals related to any violation of the Brazilian Constitution. The Full Bench of the STF is composed of all 11 Ministers.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Although the Brazilian Tax Code has provided, since 1966 and in broad terms, the possibility of negotiating tax debts, this process had never been regulated, until the federal government recently enacted Law No 13.988/2020 and the Federal Treasury General Attorney (PGFN) has also recently enacted ordinances enabling the Ordinary Tax Transaction, and the Procedural Contract (“*Negócio Jurídico Processual – NJP*”).

In general terms, the Ordinary Tax Transaction, ruled by Ordinance PGFN No 9,917/2020, grants taxpayers the possibility of:

- discounts for credits considered difficult to recover or irrecoverable of up to 50% of the total amount of the debt, which can reach 70% in the case of an individual entrepreneur, microenterprise or small business undergoing judicial recovery;
- payment of the debt in instalments over up to 84 months, which can reach 100 months in the event of an individual entrepreneur, microenterprise or small business undergoing judicial recovery; and
- flexibility around rules involving the provision of guarantees, pledge and sale of assets.

Another possible negotiation alternative provided by the federal government is the Procedural Contract, ruled by the Ordinance PGFN No 742/2018.

Although the NJP does not provide any discounts, this settlement mechanism provides the possibility of discussing the payment methods with the PGFN.

6.2 Settlement of Tax Disputes by Means of ADR

According to the terms of the Ordinary Tax Transaction, the taxpayer must:

- provide information about its assets or income, whenever requested by the PGFN;
- act in good faith, not using the transaction to harm its competitors;
- definitively acknowledge the debts included under the Ordinary Tax Transaction; and
- settle the debt within the period agreed under the Ordinary Tax Transaction, which could reach 84 months (or 100 months in the event of an individual entrepreneur).

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Tax mediation or arbitration does not exist in Brazil.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

The presentation of a ruling request is feasible in Brazil, and it aims to clarify the interpretation of tax authorities regarding the tax legislation.

At the federal level, Decree 70.235/72 regulates the requirements that shall be met by the taxpayer, such as:

- the ruling request regarding the tax legislation shall be connected with a specific fact or circumstance;
- it should be presented through a written request; and
- the taxpayer cannot be under a tax audit connected with the requested fact.

Once the taxpayer receives the formal response from the tax authorities, this positioning would be effective and with binding effects for the tax authorities and that specific taxpayer.

If there are (i) new facts/circumstances regarding the ruling request, (ii) new tax legislation regulating the facts/circumstances in question, or (iii) new interpretations from the tax authorities, the previous formal response may be revoked by the tax authorities.

Nonetheless, this new positioning would only be applicable to future events (instead of retroactively), which provides security for the taxpayers in Brazil and avoids tax disputes regarding previous tax-triggering events.

6.5 Further Particulars Concerning Tax ADR Mechanisms

Federal Tax Transactions can be proposed by the PGFN to any taxpayer, that will subsequently decide whether to proceed – or not – with the adhesion, which means that requirements would be equal to all taxpayers; or through a singular proposition, in which the circumstances and possibilities of settlement involving that specific taxpayer would be deeply analysed.

It is worth stressing that the propositions presented to all taxpayers are limited to a BRL15 million threshold, while there is no threshold for singular propositions.

In addition to that, Federal Tax Transactions also grant taxpayers the possibility to reduce or settle the acknowledged debts with judicial pay orders (*precatórios judiciais*), which encourages taxpayers to use a credit that, although formally recognised by the courts, would only be compensated within a few years (which is the usual period until a judicial pay order is settled).

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

In Brazil, ADR mechanisms are not applicable to transfer pricing cases or cases of indirect determination of tax.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Reading the criminal aspects of a tax controversy, if the administrative discussion closes with an unfavourable final decision, such an administrative tax proceeding may lead to the filing of a criminal administrative proceeding to analyse the same facts which could also lead to an allegation of a crime against the tax system.

In this respect, the tax authorities are required to communicate to the Public Prosecutor's Office any administrative violation which, in theory, could also represent a crime.

However, some measures can be adopted in order to shelve or at least suspend this criminal administrative proceeding, such as payment of the tax debt or legal discussion of the duly guaranteed tax debt.

7.2 Relationship between Administrative and Criminal Processes

Upon receiving the communication from the tax authorities, the Public Prosecutor's Office may present judicial charges against the taxpayer, if it understands it has all the elements required for such a move; or request the filing of an administrative criminal proceeding in order to examine the facts.

Usually, the Public Prosecutor opts for the second possibility, in order to analyse all the facts.

7.3 Initiation of Administrative Processes and Criminal Cases

In Brazil, the administrative criminal proceeding can only be initiated after a final unfavourable decision is rendered in the administrative sphere.

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

7.4 Stages of Administrative Processes and Criminal Cases

Once the administrative criminal proceeding is initiated, the taxpayer may adopt some measures aimed at the shelving or at least the suspension of this proceeding, through either payment of the tax debt or legal discussion of the duly guaranteed tax debt.

If the taxpayer succeeds in shelving or suspending the administrative criminal proceeding, no judicial charge shall be filed.

On the other hand, if the taxpayer is not succeeded and the Public Prosecutor opts for presenting judicial charges against the taxpayer, the practice of the crime must be proven and shall be analysed and confirmed within a three level instance judicial litigation.

7.5 Possibility of Fine Reductions

A 150% aggravated penalty is imposed whenever the tax authorities believe that the taxpayer has practised acts that should qualify as wilful misconduct, fraud or simulation.

However, under Brazilian tax law, an aggravated penalty of 150% may only be imposed in cases in which the fraudulent/collusive intent is effectively evidenced. In cases where fraudulent/collusive intent is not proven, taxpayers may succeed in a tax litigation (administrative or judicial) aimed at the reduction of such fine to a 75% statutory penalty, which is applicable in cases where the taxpayer did not engage in any wilful misconduct, fraud or simulation.

7.6 Possibility of Agreements to Prevent Trial

In Brazil, it is not possible to enter into an agreement to prevent a criminal trial.

However, the full payment of the claimed tax (plus fines and interest) would eliminate the liability for crimes against the tax system.

7.7 Appeals against Criminal Tax Decisions

In Brazil, the criminal sphere may only be initiated once after a final unfavourable decision is rendered in the administrative sphere.

Subsequently, some measures may be adopted in order to shelve or at least suspend this criminal administrative proceeding, such as payment of the tax debt and/or legal discussion of the duly guaranteed tax debt.

Thus, if these steps are surpassed, the judicial charges against the taxpayer shall be analysed and confirmed within a three level instance judicial litigation.

In parallel, the judicial tax dispute may proceed independently. However, if the claimed tax (plus fines and interest) is settled, it would eliminate the liability for crimes against the tax system.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

A “substance over form” approach was introduced in Brazilian legislation by Supplementary Law No 104, of January 10, 2001 (“LC 104/01”), which introduced provisions intended to enable the tax authorities to disregard a taxpayer’s acts or businesses and, consequently, impose taxes based on a substance over form perspective.

However, the Brazilian Supreme Court has recently decided that such provision would only be applicable to transactions in which there is evidence of fraud or simulation.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Over the last decades, Brazil has entered into several Double Tax Treaties (DTTs) to avoid double taxation with other jurisdictions. However, Brazilian DTTs do not contain an Article similar to Article 9 (2) of the OECD Model Convention, which obliges contracting states to provide for corresponding adjustments.

However, in the context of the BEPS Project, Brazil has committed to seek a solution for double taxation cases caused by transfer pricing adjustments through a mutual agreement procedure (MAP).

Therefore, nowadays, MAPs are the available mechanism for eliminating double taxation arising from differences in the OECD methodologies and the application of Brazilian statutory rules.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Although Brazil has no GAAR/SAAR in force, tax authorities may disregard a taxpayer's acts or businesses and, consequently, impose taxes (plus a fine and interest) based on a "substance over form" rule prescribed in Article 116, sole paragraph of the Brazilian Tax Code.

8.3 Challenges to International Transfer Pricing Adjustments

Brazil is not a member of the OECD and Brazilian legislation is not aligned with the OECD Transfer Pricing Guidelines. Since Brazil has not adhered to a common international standard on transfer pricing reporting, multinational enterprises may deal with double taxation situations.

In an OECD scenario, where the tax authority of a contracting state increases the profits of an

enterprise due to the application of the transfer pricing rules ("primary adjustment"), the resulting double taxation is to be eliminated through a mechanism provided for in bilateral treaties, according to which the tax authority of the other contracting state should also provide for adjustments with a view to reducing the amount of profits taxable therein. Such mechanism is known as a "corresponding adjustment".

However, Brazilian DTTs do not contain an Article similar to Article 9 (2) of the OECD Model Convention, which obliges contracting states to provide for corresponding adjustments.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Advance pricing agreements are not available in Brazil.

8.5 Litigation Relating to Cross-Border Situations

In Brazil, there are several tax disputes involving cross-border situations, especially connected to the nature of the transaction, which could impact the tax burden involved.

For instance, remittances made abroad as a result of the import of a service or a licensing to use customised software would be subject to a withholding tax, while remittances abroad, in connection with the acquisition of perpetual licences for personal use, would not be subject to withholding tax.

Thus, it is important that agreements reflect the nature of the transaction, in order to avoid any additional tax assessment and consequent tax litigation.

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

Not applicable in Brazil.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

Not applicable in Brazil.

9.3 Challenges by Taxpayers

Not applicable in Brazil.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Not applicable in Brazil.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Not applicable in Brazil.

10.2 Types of Matters that Can Be Submitted to Arbitration

Not applicable in Brazil.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Not applicable in Brazil.

10.4 Implementation of the EU Directive on Arbitration

Not applicable in Brazil.

10.5 Existing Use of Recent International and EU Legal Instruments

Not applicable in Brazil.

10.6 New Procedures for New Developments under Pillar One and Two

Not applicable in Brazil.

10.7 Publication of Decisions

Not applicable in Brazil.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Not applicable in Brazil.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Not applicable in Brazil.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

In Brazil, administrative litigation is not subject to any costs or procedural fees.

11.2 Judicial Court Fees

In order to initiate a judicial claim, taxpayers shall pay court fees, which correspond to a small percentage of the amounts involved, such as 1% or 4%. This percentage may vary depending on the court in which such litigation is initiated.

However, each court establishes a cap for its court costs. For instance, São Paulo's State Court prescribes that its court costs shall be limited to approximately BRL95,000.

Tax authorities, however, are tax exempt from filing a tax foreclosure.

11.3 Indemnities

The Brazilian Code of Civil Procedure (CPC) establishes that the defeated party shall reimburse the prevailing party for all expenses

incurred during the judicial litigation, such as court costs and judicial expert fees.

11.4 Costs of ADR

In Brazil, ADR mechanisms are not subject to any specific costs or procedural fees.

12. STATISTICS

12.1 Pending Tax Court Cases

In 2022, the National Council of Justice (CNJ), which is the judicial body responsible for monitoring the Brazilian Judiciary, released a detailed report regarding the status of tax judicial litigation in Brazil. This report details, for example, that tax foreclosures represent 36% of all judicial procedures pending trials.

Moreover, according to the statistics made available by the Brazilian Supreme Court, tax cases currently represent approximately 10% of all pending cases at the Supreme Court.

12.2 Cases Relating to Different Taxes

In general, the tax disputes involving the highest amounts in Brazil relate to:

- social contributions over revenues (PIS/COFINS);
- corporate income tax (IRPJ) and the social contribution on net profits (CSL);
- tax on services (ISS);
- state value-added tax assessed over the sales of goods and some services (ICMS); and
- withholding income tax (IRRF).

12.3 Parties Succeeding in Litigation

According to the report made available by the CNJ, 51.4% of first level judicial decisions confirm the decisions rendered in the administrative sphere, while 48.6% of first level judicial

decisions modify the decisions rendered in the administrative sphere.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Initially, taxpayers should verify in which cases and situations a tax litigation should be initiated, since it is possible to obtain some tax results with no litigation.

For instance, on 24 April 2018, the STJ published a decision rendered in Special Appeal No 1.221.170/PR (Anhambí Case), which settled that the concept of input (which generates PIS/COFINS credits) should be assessed in accordance with the essentiality or relevance criteria, that is, considering the indispensability or importance of a certain item or expense for the development of the taxpayer's economic activity.

Based on that, it is necessary to identify the activity pursued by the taxpayer (based on a review of its business activities) and evaluate the indispensability or importance of this expense for the development of this economic activity.

Thus, if these requirements are accomplished, the taxpayer would be entitled to offset PIS and COFINS debts with credits originating from such expenses, with no need for previous tax litigation.

On the other hand, if tax litigation is necessary, the pros and cons of each type of judicial claim should also be analysed prior to the initiation of a tax litigation.

For example, a writ of mandamus grants a shorter period of litigation and exempts the defeated party from the payment of attorneys' fees in favour of the prevailing party. However, all evi-

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chiavassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

dence and documents needs to be presented at the time this claim is initiated, with no possibility of a court expert investigation regarding any evidence. This means that all documents should be clear and the facts undisputed.

Contributed by: Luiz Roberto Peroba Barbosa, Tércio Chivassa and Guilherme Villas Bôas, Pinheiro Neto Advogados

Pinheiro Neto Advogados is an independent, full-service Brazilian firm specialising in multi-disciplinary deals, and was the first Brazilian law firm to specialise in corporate clients. For 80 years, the firm has translated the Brazilian legal environment for the benefit of local and for-

eign clients. With clients in almost 80 countries, the firm has grown organically, and developed a distinctive, tight-knit culture, with a low associate-to-partner ratio. Its unique, democratic governance structure promotes transparency and consensus-building among the partners.

AUTHORS



Luiz Roberto Peroba Barbosa advises domestic and international clients from different industries both on tax counselling/planning and on litigation in administrative and

court disputes. Luiz Roberto actively participated in the setting up of the Pinheiro Neto Advogados office in Silicon Valley, and has acted as counsel for clients in the technology area on direct and indirect taxation of marketplaces and other activities involving software, apps, streaming, SaaS, and online advertising, among others, as well as on the structuring of international shipments and payment mechanisms to enable cross-border online B2B and B2C operations, etc.



Tércio Chivassa advises domestic and international clients from different industries both on tax counselling/planning and on litigation in administrative and court disputes and is

specialised in procedural law, with a focus on devising procedural strategies in tax, administrative or judicial disputes.



Guilherme Villas Bôas has been working at Pinheiro Neto since 2011, with a focus on tax litigation involving a variety of industries and on digital economy matters.

Pinheiro Neto Advogados

Rua Hungria, 1100
São Paulo – SP
01455-906
Brazil

Tel: +55 11 3247 8400
Email: institucional@pn.com.br
Web: www.pinheironeto.com.br

PINHEIRONETO
ADVOGADOS

Trends and Developments

Contributed by:

Machado Meyer Advogados see p.73

Introduction

Any overview of the 2022 tax litigation scenario in Brazil must begin with the confirmation of some trends from 2020 and 2021. Amid the need to maintain social distancing and the growing expectation of a gradual return to face-to-face activities, there has been an essential transition in work organisation models.

As elsewhere in society, the COVID-19 pandemic severely impacted the dynamics of tax disputes. Telecommuting at courts, companies, law firms, and public bodies, as well as the virtualisation of judicial and administrative procedures, are here to stay. It is an inescapable reality as legal practitioners and organisations focus on the benefits to productivity brought about by this digital era.

In 2020, the Brazilian Judiciary experienced the most significant reduction of pending cases ever reported, which was credited to the remote routines and digital tools. It was no different in 2021, and 2022 shall be hectic for litigation, especially in the tax field. The agenda already released by the Federal Supreme Court (STF) points to at least 16 tax matters to be ruled on by the STF's full bench in the first semester. Most of them are expected to be analysed in virtual sessions (by releasing the justices' written votes through an electronic system, without a public debate).

Despite the efficiency gains associated with those developments, there have been some downsides: the reduction of in-depth public debate at courts and the obstacles to the practical and qualified participation of lawyers and the community in several relevant tax disputes' resolutions.

The economic recession and the difficulties in managing public accounts have also compromised the purely legal analysis of tax controversies. A consequentialism guided by financial and political perspectives has been increasingly prevailing in the Superior Courts' decisions on tax disputes, sometimes to the detriment of the legal constitutional order's most technical interpretation.

Given this scenario, the tax litigation highlights for 2022 are the following.

A Paradigm Shift in the Criterion for Modulation of STF Decisions' Effects

As a rule, the declaration of the unconstitutionality of a law by the STF has retroactive effect, as if it had never been part of the legal system since its genesis. In tax practice, this means that taxpayers could claim the reimbursement of taxes unduly paid in the past, based on rules declared unconstitutional, but observing the statute of limitations.

Nevertheless, the Brazilian regulations exceptionally allow the Supreme Court to modulate these effects from a timing perspective, so that the binding decision only comes into effect from a specific point. In this sense, the mechanism should only be applied given the particularities of each case and in service of legal certainty.

Until 2020, the timeframe usually chosen for this modulation by the Supreme Court (under general repercussion or full control of constitutionality) was the judgment's publication date. However, taxpayers who previously filed a lawsuit claiming their rights were protected against this limitation.

However, as of 2021, the modulation mechanism has experienced unprecedented and more restrictive criteria in tax matters to protect public revenues, harming even those taxpayers who filed their legal measures much earlier than the STF's final rulings. That has happened in two significant cases with recognised general repercussions involving the following.

The STF ruled on the unconstitutionality of the institution of the tax on *causa mortis* transmission and donation of any property or right (ITCMD) by the states without prior national complementary law (Extraordinary Appeal 851.108), in which the effects were modulated as of the publication of the final decision, excluded from the limitation only those with lawsuits filed until then, but not assuring them the right to recover the tax unduly paid previously in every situation.

The STF ruled on the unconstitutionality of the increased rates of value-added sales tax (ICMS) charged by the states on the acquisition of electricity and telecommunication services, in light of the essential character of such items (Extraordinary Appeal 714.139). Accordingly, the decision on the merits favourable to taxpayers will take effect only in 2024, except for those actions filed up to the date of the beginning of the first STF session.

In both cases, the justices accepted a modulation criterion that harmed even those taxpayers who had filed lawsuits long before the end of the trial. This innovative approach is a notable tendency for 2022, and has led to considerable legal uncertainty. It extends the effects of tax rules declared unconstitutional over unpredictable timeframes – for the benefit of the tax administrations from case to case.

The Resolution of the “Tax Dispute of the Century” and Its Developments

In 2017, the STF ruled on the merits of Extraordinary Appeal 574.706. After almost 20 years, it was the beginning of the end for the most significant tax litigation ever seen in Brazil, known as “the tax dispute of the century”. The STF decided that ICMS must not be included in the taxable basis of PIS (contribution to the social integration plan) and COFINS (contribution for social security financing) contributions, since it does not represent a taxpayer's revenue. According to the *Instituição Fiscal Independente*, an agency under the authority of the Brazilian Senate, the withdrawal of ICMS from the PIS and COFINS basis could reduce the collection by BRL120 billion solely in 2021.

Four years later, in May 2021, the STF finished the analysis of a motion for clarification filed by the National Treasury, solving substantial uncertainties about the controversy's outcome. The Court modulated the effects of the decision as of 15 March 2017 (when the analysis of the merits was concluded) and determined the correct criteria to calculate the value of ICMS to be removed from the basis. Nonetheless, the modulation preserved the right of taxpayers pursuing the recovery of amounts unduly paid in the past, observing the statute of limitations, through lawsuits filed before March 2017.

Following the result, the majority of Brazilian companies immediately started the process of measuring the value of the tax credits, duly updated by the SELIC rate (Brazil's base interest rate set by the Central Bank), and analysing the best path to reimbursement.

At first, the Tax Authorities sought all means to prevent or at least delay the realisation of taxpayers' rights arbitrarily, in an attempt to minimise the damage to the public accounts. However, shortly after the final decision's publication, the

Attorney General's Office of the National Treasury finally resigned itself to the inevitable and issued an official legal opinion, mandating the Tax Authorities to comply fully with the STF's stand.

In this scenario, there will be an avalanche of requests for administrative refunds and offset of these tax credits throughout 2022, as well as a race to get the court-ordered debt payments by those who have filed a lawsuit.

Amid this, another important discussion arose regarding the moment of the taxation of the PIS/COFINS credits themselves. It is not disputed that these tax credit refunds have to be added to the basis of IRPJ (corporate income tax) and CSLL (social contribution on the net profit) as taxable income. However, the Tax Authorities have been defending questionable interpretations of the moment of the triggering event.

Courts are currently considering, among other lines of argument depending on the specifics of the case, if the moment of taxation occurs at

- the certification of res judicata if the respective judicial decision defines the specific amount of the tax credit;
- the effective measurement of the credits by taxpayers for accounting recognition as an asset (when there is no judicial claim);
- the filing of each administrative request for refund or offset before the Federal Revenue Service; or
- the effective acceptance of these requests by the Tax Authorities.

It is also worth mentioning that, although the long dispute involving the exclusion of ICMS from the PIS and COFINS basis is over, other tax controversies have entered the spotlight because of the rationale behind the STF's deci-

sion. Together, they could result in a cost of more than BRL90 billion to the public accounts.

These controversies are ramifications of the STF's understanding regarding the need to observe the strict concept of gross revenue set out in the Federal Constitution. The more significant ones are set out below.

Exclusion of ISS from the PIS and COFINS calculation basis

Taxpayers argue that ISS (tax on services, charged by the municipalities) cannot be considered as taxable revenue for PIS and COFINS contributions, since it merely passes through companies' cash flows to be later transferred to the public treasuries, exactly as happens with ICMS. In this sense, it is expected that the STF will apply the same concept of gross revenue to solve the case (Extraordinary Appeal 592.616) soon. The resumption of this trial is widely expected, and may take place in the second semester of 2022.

Exclusion of PIS and COFINS from their calculation bases

Following the same reasoning, taxpayers have asserted that the PIS and COFINS value itself cannot be included in the calculation basis of these contributions, since they are a transitory cash entry and not a company's taxable revenue. The STF estimates that there are more than 3,000 cases across the country waiting for the outcome of this judgment, which is not expected to be scheduled for the STF's agenda until the end of the year (Extraordinary Appeal 1.233.096).

According to the forecast provided by the Budget Guidelines Law, if defeated, the National Treasury would lose around BRL12 billion in a year and BRL60 billion over five years.

Exclusion of the presumed ICMS credit from the PIS and COFINS calculation basis

In this case, taxpayers claim that presumed ICMS credits do not constitute their revenue or billing, but a tax benefit granted by the states, that reduces the amount of ICMS collected by the companies. The STF has recognised the general repercussion of the question (Extraordinary Appeal 835.818).

Exclusion of the presumed ICMS credit from the IRPJ and CSLL calculation basis

Although this discussion is not under the general repercussion regime, the STJ has recently analysed it (Special Interlocutory Appeal 1.443.771). The Court gave an interpretation based on the ordinary legislation to decide that these values are non-taxable incomes for IRPJ and CSLL purposes since they are not equivalent to a taxpayer's revenue, but to tax benefits provided by the states' rules.

Interest from the Refund of Unduly Paid Taxes Are Non-taxable Income: a Major Taxpayers' Victory at the STF

At the end of 2021, the STF full bench ruled on a vital discussion on the taxable basis of corporate taxes (IRPJ and CSLL) under the general repercussion regime (Extraordinary Appeal 1.063.187).

The SELIC rate (the Brazilian economy's primary interest rate) is the only index of monetary correction and, at the same time, interest on late payment applicable to the assessment of tax debts by the Brazilian Federal Revenue. It is also applied in the event of reimbursement of taxes unduly paid by taxpayers.

The STF stated the unconstitutionality of IRPJ and CSLL collection on amounts related to the SELIC rate received as a result of tax refunds, as it would turn income taxation into property taxation, infringing the Federal Constitution. The

taxpayers' arguments were upheld: corporate taxes cannot be levied on default interest, given its indemnifying nature for emerging damages, nor on monetary correction, since this does not consist of a profit increase. These amounts do not represent an operating profit but a restoration of the property that already existed and diminished due to illegal tax collection.

This decision represents a substantial jurisprudential change because the Superior Court of Justice (STJ), the highest appellate court for non-constitutional issues, had addressed a previous binding stand allowing the taxation. As expected, the STF decided to modulate the effects of this decision.

There are likely to be further developments on this matter in 2022, mainly on the possibility of the application of the same understanding to the withdrawal of judicial deposits made by taxpayers, which are also indexed according to the SELIC rate.

The Tax Agenda at the High Courts for 2022

There was a flurry of lawsuits at the start of 2022 proposed by taxpayers to challenge the Complementary Law 190/2022, which introduced the collection of ICMS from the differential rate (DIFAL) by the states on interstate transactions of goods intended for non-taxpaying consumers.

There are arguments to discuss the beginning of the levy already in 2022, due to the tax rule that a law that imposes or increases taxes can only come into force as of the following annual exercise and must observe a 90-day holding period from its publication. According to the states, the delay in collecting ICMS DIFAL would correspond to losses of over BRL9 billion to the states' public accounts. The STF will analyse the question, but Brazilian companies are filing law-

suits to prevent the collection in their particular cases.

Besides that, other major tax disputes to be decided this year are set out below.

Concept of inputs for the appropriation of PIS and COFINS credits

In 2018, the STJ gave a legal interpretation, dismissing the restrictive interpretation argued by the Tax Authorities. It was decided that the concept of “inputs” should be defined in light of their essential character or relevance, that is, considering the indispensability or importance of a given item (good or service) for the economic activity performed by the taxpayer in each case. At this time, the estimated annual impact on the National Treasury’s revenues would reach BRL50 billion.

The question will now be ruled on by the STF (Extraordinary Appeal 841.979), from a constitutional standpoint, that is, given the non-cumulative taxation principle (Article 195, paragraph 12 of the Federal Constitution). In this case, the justices have to decide whether advertising and marketing expenses are inputs for a frozen foodstuffs manufacturer and, therefore, generate PIS and COFINS credits. The case will be solved under the general repercussion regime and the STF’s reasoning will impact other disputes involving the framing of different types of expenses as inputs of economic activities.

Unconstitutionality of the isolated fine imposed when the Federal Revenue Service rejects the taxpayer’s offset request

At the federal level, it is possible to pay tax debts with credits from undue or excessive payments made to the National Treasury. If this offset request is denied, the Tax Authorities apply an isolated fine of 50% over the amount of the tax debt. Taxpayers are challenging this penalty on the ground that it breaches the exercise of

the constitutional right to petition and to a full defence, the reasonableness and proportionality principles, and the prohibition of the use of taxes for confiscation purposes. The question will be decided by the STF (Extraordinary Appeal 796.939 and Direct Unconstitutionality Action 4.905).

The ending of the tie-breaking vote at CARF

Since the enactment of Law 13,988/2020, trials before the Administrative Tax Appeals Council (CARF), responsible for deciding federal tax disputes in the administrative sphere, have been held without the possibility of the tie-breaking vote (hence a double vote) by the chairperson of the panel (who is a representative of the tax administration). Therefore, in the case of a tie between the judges, the case should be settled on behalf of the taxpayer. This circumstance was crucial for a number of victories by taxpayers at CARF last year.

However, the constitutionality of this legal provision has been challenged before the Supreme Court (Direct Unconstitutionality Actions 6.415, 6.399, and 6.403) and is expected to be addressed in 2022.

Unconstitutionality of Contribution for Intervention in the Economic Domain (CIDE)

CIDE is a federal contribution created to promote Brazilian technological development. Hence, the 10% tax rate was originally levied on the remittances abroad made by Brazilian companies for the acquisition of technological knowledge and services with technology transfer provided by non-residents. However, the legislation was amended to extend the levy to other activities without any technology transfer, such as royalties and technical or administrative services. The STF will analyse whether this deviation from the CIDE’s purpose is constitutional or not (Extraordinary Appeal 928.943). The impact for the

National Treasury, in case of taxpayer success, could reach BRL19 billion.

Unconstitutionality of the reduction of the REINTEGRA regime percentage by the Executive Branch

REINTEGRA is a special tax regime established to ensure the refund of undue residual taxes verified in the chain of exported goods by Brazilian manufacturers due to the anomalies in the application of Brazilian tax rules. Taxpayers are questioning the possibility of discretionary reduction of the percentages for calculating the credits guaranteed by the regime in light of the Federal Constitution. The trial before the STF full bench (Direct Unconstitutionality Actions 6040 e 6055) shall be rescheduled at any time.

Limits of res judicata in tax matters

In May 2022, the STF will analyse whether a final and unappealable decision can lose its effectiveness when it has declared a specific taxpayer's right to not pay a tax and the STF decides on the contrary afterward, through a decision with binding effects. If the National Treasury wins the case, some taxpayers will have to deal with measures from the Tax Authorities aimed at taxation, despite having a personal judicial decision with a different conclusion.

The Postponement of the Due Date of Court-Ordered Debt Payments

According to the Brazilian constitutional rules, if the government (direct or indirect administrative entities of the Federal Union, states, federal districts, and municipalities) is convicted to pay any amounts due to legal entities or individuals in a lawsuit, these debts need to be paid through a payment request issued by the judiciary, to be properly included in a queue.

At the end of 2021, a Constitutional Amendment Proposal was approved to postpone the legal due date for payment of court-ordered debt pay-

ments (*precatórios*). Now, the government will have until 31 December 2029 to settle debts due on 25 May 2015, and also the ones due between those dates.

This measure derives from a disastrous fiscal crisis that started before the coronavirus pandemic, strongly marked by a great imbalance in the management of public accounts. Hence, taxpayers that successfully sued the Public Treasury aiming for the reimbursement of taxes unduly paid, based on levies declared unconstitutional or illegal by the judiciary, could be severely affected.

The Expectation for the Resumption of the Great Tax Disputes at the CARF

In 2021, given the requirements of social distance, the CARF held remote trial sessions via videoconference but restricted to cases involving amounts up to a maximum value (BRL1 million, altered to BRL8 million in August 2020 and BRL12 million in January 2021), or when the controversial point has already been solved by binding precedents from the CARF itself or the Judicial High Courts (STF and STJ).

As a result, tax administrative disputes involving nearly BRL1 trillion have been pending trial for almost two years, according to research by the *O Estado de S. Paulo* newspaper.

With the progress made in the vaccination campaign and the relaxation of social distancing measures, the activity at the CARF began 2022 at full speed. An impressively large group of cases was scheduled for in-person trial in January and February, without any restrictions related to the value involved or the matters under discussion. However, all this progress was compromised early in the first weeks of January because of a strike by federal public servants, and the rise in the number of COVID-19 cases in Brazil.

Contributed by: Machado Meyer Advogados

Nonetheless, because of the pressing urgency of reducing the stock of administrative proceedings, there are high expectation that CARF's activities will get back to a very quick pace as soon as possible, with the return of major tax disputes to the debate.

Machado Meyer Advogados has spent 50 years believing that it does not need to do what everyone else is doing. The firm is different: sure that thinking ahead, anticipating trends, and exercising foresight provides it with the necessary background to confidently explore increasingly innovative horizons for the future. It has grown following the fast pace of Brazil's expansion and continues to do so today. Attracted by challenges, the firm's attitude has always been to invest in people's growth, develop new practices,

and explore new sectors, with the purpose of providing legal intelligence to make its clients' strategies viable. Machado Meyer Advogados employs a team of creative people who are resolutely obstinate in their search for possible legal solutions. Together, they constantly learn and build their knowledge, with hard work, dedication, and commitment. In this new phase, the firm wants to amplify its actions with a focus on the future, following the demands of the world and in favour of society's development.

Machado Meyer Advogados

Ed. Seculum II - Rua José Gonçalves de Oliveira
No 116, 5º andar
Itaim Bibi
São Paulo, SP
Brazil, 01453-050

Tel: +55 11 3150 7000
Email: machadomeyer@machadomeyer.com.br
Web: www.machadomeyer.com.br



Law and Practice

Contributed by:

Luis Felipe Ocampo Moscoso

and Ignacio Iriarte Magadán

Recabarren & Asociados see p.93



CONTENTS

1. Tax Controversies	p.77	6. Alternative Dispute Resolution (ADR) Mechanisms	p.85
1.1 Tax Controversies in this Jurisdiction	p.77	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.85
1.2 Causes of Tax Controversies	p.77	6.2 Settlement of Tax Disputes by Means of ADR	p.85
1.3 Avoidance of Tax Controversies	p.77	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.85
1.4 Efforts to Combat Tax Avoidance	p.78	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.85
1.5 Additional Tax Assessments	p.78	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.86
2. Tax Audits	p.78	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.86
2.1 Main Rules Determining Tax Audits	p.78	7. Administrative and Criminal Tax Offences	p.86
2.2 Initiation and Duration of a Tax Audit	p.78	7.1 Interaction of Tax Assessments with Tax Infringements	p.86
2.3 Location and Procedure of Tax Audits	p.79	7.2 Relationship between Administrative and Criminal Processes	p.86
2.4 Areas of Special Attention in Tax Audits	p.79	7.3 Initiation of Administrative Processes and Criminal Cases	p.86
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.80	7.4 Stages of Administrative Processes and Criminal Cases	p.87
2.6 Strategic Points for Consideration during Tax Audits	p.80	7.5 Possibility of Fine Reductions	p.87
3. Administrative Litigation	p.81	7.6 Possibility of Agreements to Prevent Trial	p.87
3.1 Administrative Claim Phase	p.81	7.7 Appeals against Criminal Tax Decisions	p.88
3.2 Deadline for Administrative Claims	p.81	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.88
4. Judicial Litigation: First Instance	p.82	8. Cross-Border Tax Disputes	p.88
4.1 Initiation of Judicial Tax Litigation	p.82	8.1 Mechanisms to Deal with Double Taxation	p.88
4.2 Procedure of Judicial Tax Litigation	p.82	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.88
4.3 Relevance of Evidence in Judicial Tax Litigation	p.82	8.3 Challenges to International Transfer Pricing Adjustments	p.89
4.4 Burden of Proof in Judicial Tax Litigation	p.82		
4.5 Strategic Options in Judicial Tax Litigation	p.83		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.83		
5. Judicial Litigation: Appeals	p.83		
5.1 System for Appealing Judicial Tax Litigation	p.83		
5.2 Stages in the Tax Appeal Procedure	p.84		
5.3 Judges and Decisions in Tax Appeals	p.84		

8.4	Unilateral/Bilateral Advance Pricing Agreements	p.89	10.6	New Procedures for New Developments under Pillar One and Two	p.90
8.5	Litigation Relating to Cross-Border Situations	p.89	10.7	Publication of Decisions	p.90
9. State Aid Disputes		p.89	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.90
9.1	State Aid Disputes Involving Taxes	p.89	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.90
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.89	11. Costs/Fees		p.90
9.3	Challenges by Taxpayers	p.89	11.1	Costs/Fees Relating to Administrative Litigation	p.90
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.90	11.2	Judicial Court Fees	p.90
10. International Tax Arbitration Options and Procedures		p.90	11.3	Indemnities	p.90
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.90	11.4	Costs of ADR	p.91
10.2	Types of Matters that Can Be Submitted to Arbitration	p.90	12. Statistics		p.91
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.90	12.1	Pending Tax Court Cases	p.91
10.4	Implementation of the EU Directive on Arbitration	p.90	12.2	Cases Relating to Different Taxes	p.91
10.5	Existing Use of Recent International and EU Legal Instruments	p.90	12.3	Parties Succeeding in Litigation	p.91
			13. Strategies		p.91
			13.1	Strategic Guidelines in Tax Controversies	p.91

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Disputes with the tax administration are usually initiated through the application of audit plans regarding tax assessments presented by taxpayers. Audit plans are previously designed by the tax administration in order to verify the correct fulfilment of tax obligations by taxpayers.

Tax assessments have to reflect the economic facts correctly recorded by the taxpayer in their accounts, as well as the correct calculation of the applicable taxes.

These audit plans can be of two types.

- Massive plans, which are designed for a huge number of taxpayers, and which are generally carried out with the support of computerised systems.
- Selective processes, in which the tax administration divides taxpayers into groups and specifies the type of taxpayer, the tax to be audited, the tax administration's requirements, and tax risk issues. All of these are previously identified according to risk matrices.

On the other hand, it is possible to initiate an audit process by making a request for the application of tax benefits, such as tax refunds.

1.2 Causes of Tax Controversies

Traditionally, the main taxes that generate tax controversies are those related to corporate tax and personal taxes, as well as sales tax or value added tax.

However, the Tax Compliance Management Plan published by the Chilean Tax Administration in March 2022 emphasises preventative audits in order to verify multinationals and their opera-

tions abroad, high-net-worth individuals in Chile and VAT on digital platforms.

1.3 Avoidance of Tax Controversies

In order to avoid tax controversies, it is important for taxpayers to take certain precautionary measures related to the application and natural interpretation of the rules. It is also important to keep records of operations that have taken place during the fiscal year.

The recommendations are as follows.

- Interpretation and application of tax rules. It is necessary for taxpayers to update their knowledge based on official instructions issued by the Chilean Tax Administration (CTA), since the criteria contained in these instructions will be compulsorily applied by tax auditors in the audit processes. It is possible that the criteria of the administration may contradict the doctrine generated by the Courts of Justice, in which case, this could be resolved in favour of the private party at the judicial stage, although there may be a risk at the review stage, in the event of contingencies with the CTA.
- In many tax audits, the tax administration makes extensive background and information requests to the taxpayers in order to determine if their accounts and the taxes determined are in order. Therefore, it is necessary to keep the supporting documents, as well as provide them in an organised manner in the context of an audit process, explaining how such information can be used to confirm the tax declaration or the origin of the benefits or credits request by the taxpayer.
- Finally, and given the internationalisation of tax law, the increasing co-operation between the different tax administrations, the signing of multiple treaties to avoid double taxation, and the application of common criteria aimed at attacking the phenomenon of tax avoid-

ance and evasion, such as the OECD's Base Erosion and Profit Shifting (BEPS) project, it is the responsibility of taxpayers and their advisers to keep up to date with international criteria on relevant subjects.

1.4 Efforts to Combat Tax Avoidance

Through the 2014 tax reform, the Chilean legislature already decided to implement the anti-avoidance guidelines and standards established in the BEPS project of the OECD, of which Chile is a member. Specifically, in that year, a general anti-avoidance rule was incorporated, with the purpose of enabling the administration to start collecting the taxes charged on the acts or businesses effectively entered into by taxpayers, beyond situations of simulation or abuse of the law.

Although this new power of the tax authority has not been formally applied, and the authority has not had to use the judicial process that enables it to initiate a tax controversy with a specific person or company, charging the application of the general anti-avoidance rule, there is consensus that it has played a dissuasive role, implying that both taxpayers and their advisers avoid engaging in tax planning that may be classified as evasive, from that perspective reducing tax controversies.

1.5 Additional Tax Assessments

When the tax authority determines a tax difference, the taxpayer is not required to pay or guarantee the payment of taxes in order to file an administrative or judicial appeal. However, in the judicial appeal stage, the entity in charge of the collection of tax (General Treasury) can initiate a process to obtain the payment of the tax difference from the taxpayer. Nevertheless, it is possible to make a timely request that such a process be suspended until there is a final decision by the courts resolving the tax dispute.

It should be specified that in those cases where the tax assessment refers to certain taxes classified in Chile as withholding, surcharge or transfer (additional tax, workers' tax, etc) or sales tax, the charging document for the initiation of the collection procedure may be initiated immediately, without the need to present an administrative or judicial claim. The same situation applies for tax crimes and tax refunds or improper amounts.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

In the context of a modern tax administration that maximises tax collection, the CTA has prioritised its actions, directing them towards developing audit processes with respect to those taxpayers that have a High Net Worth and Key Risk classification on possible relevant non-compliance tax matters, which represent 89% of total collection, according to the information provided by the tax agency.

On the other hand, and in the context of the massive auditing processes, especially the annual business tax declaration and personals declarations, the administration initiates auditing processes in respect of taxpayers whose information is inconsistent or differs from the information that has been collected by the tax authority from third parties, such as banks, financial institutions, public record-keepers and investment companies.

2.2 Initiation and Duration of a Tax Audit

The tax administration may initiate an auditing process, recognising a general statute limitation period of three years, a lapse of time that starts from the date of tax payment that is the focus of the auditing process. However, this period may be extraordinarily extended to six years, when the taxpayer is obliged to present a tax declara-

tion but has not done so, or when, having presented it, the tax declaration has been found to be intentionally false.

On the other hand, the auditing processes initiated by the tax authority are also temporarily limited to a fixed-term period.

A general fixed-term period of nine months is established, with longer periods depending on the matter to be audited:

- twelve months for audits on transfer pricing, corporate reorganisation processes, and accounting of transactions between related companies, among others;
- eighteen months for audits on tax offences, application of the general anti-avoidance tax rule and requests for information from a foreign tax administration.

Once these periods have expired, without the administration having notified a request for information in accordance with the special attributions established in the tax regulations, or having determined any possible tax differences, the process must be certified as completed.

2.3 Location and Procedure of Tax Audits

Traditionally, tax audits are carried out at the tax authority's offices, with respect to the information and background information formally requested directly from taxpayers, complemented with data and background information on the taxpayer being audited, which can be compiled from tax statements submitted by third parties. Although this information is provided in paper form, it is also possible to provide it in electronic form.

There is the possibility for the taxpayer to offer that the auditors visit the domiciles of the companies to carry out their audits, as well as for the tax office to request such a mechanism, in those

cases where the volume of documentation or the nature of the activities to be reviewed makes it necessary.

Technological Tax Reforms

It should be noted that the numerous reforms of tax regulations in Chile have implemented electronic auditing processes, which means that the tax authority may request the taxpayer to give it telematics access to the technological systems in which they keep their accounting and backups.

Finally, the latest tax reforms also allow the creation of electronic files, in which the auditing processes are carried out and maintained, allowing this to be done remotely, from the beginning of the process by requesting background information, responding to it and communicating or notifying the decision adopted by the tax authority. This method has allowed the CTA to keep auditing taxpayers, regardless of the restrictions generated by the COVID-19 pandemic in the country.

2.4 Areas of Special Attention in Tax Audits

In the context of the years following the effects of the crisis generated by the COVID-19 pandemic, which will require states to inject additional resources to those traditionally budgeted, the Chilean Tax Administration focused on those areas that will have the greatest impact on the amounts to be collected, allowing it to ensure resources to support the State's operation.

Within this context, the Tax Compliance Management Plan for the year 2022 establishes the implementation of actions to ensure the tax compliance of different groups of taxpayers:

- high net worth individuals (HNWIs) and their families;
- multinational enterprises (MNEs), from the perspective of compliance with the param-

eters established in the BEPS project, and to ensure that the profits generated by such companies in the national territory are taxed in Chile, avoiding the transfer of profits and the erosion of the tax base; and

- business groups, in terms of their effective contribution to taxation, especially corporate taxation, verifying that their profits are not transferred to other tax jurisdictions with lower taxes.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The Chilean tax administration is an active member of the international tax community, being part of the Forum of Tax Administrations (FTA) of the OECD. In this context, Chile participates in the information transmission platform, Common Transmission System (CTS), as well as in the Convention on Mutual Administrative Assistance in Tax Matters (MAAT Convention).

This has allowed an increase in the exchange of information and experience between the different tax administrations and the CTA, with the clear objective of promoting general tax compliance, which implies fighting tax fraud and evasion. However, these exchanges of information do not involve the performance of joint formal auditing tasks in the national territory.

It should be noted that in 2015, the Chilean Tax Administration, like others around the world, received information collected in the so-called “Falciani List”, which involved HSBC bank account holders, including Chilean residents, who maintained accounts in that tax entity to avoid paying taxes. This information was duly processed by the CTA and led to audits of the taxpayers involved. A similar situation occurred in 2017 with the Chilean companies mentioned in the “Panama Papers” case. This task was car-

ried out in co-ordination with the 37 foreign tax administrations that are part of the Joint International Task Force on Intelligence Sharing and Collaboration (JITSIC).

2.6 Strategic Points for Consideration during Tax Audits

To avoid a legal dispute with the tax administration, which can determine tax differences or refuse the application of any benefit in favour of the taxpayer, it is advisable to consider the following recommendations.

- Before anything else, analyse in the correct way the requests for information or background information made by the tax authority, so as to be clear about the purpose of the audit, which will be useful to determine the substantive arguments to be presented in the administrative defence. In this regard, the 2020 tax reform incorporated as a taxpayer’s right that IRS actions must be founded, which implies that they must be clear and precise as to the reasons that motivate such actions.
- The taxpayer must keep the backup files of all the operations that support the economic facts that are recorded in its accounting, and determine the tax treatment given to such operations.
- The taxpayer must maintain direct contact with the administration, especially with the functionary in charge of the process, in order to answer any doubts or concerns that the functionary may have regarding the subject being audited. It is recommended that this contact is always made by the same person.
- If the taxpayer does not have an internal staff of experts in auditing and tax controversy resolution processes, it should be advised from the beginning of the audit by an outside expert.
- The taxpayer must make all the required background information available to the tax authority, providing it with an explanation as

to the incidence that each document has to support the taxpayer's position before the possible imputation of the tax authority. The answer must be clear, avoiding ambiguities or positions that could be understood as interpretative in favour of one of the parties.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

When the tax authority notifies a tax act or adjustment determining tax differences, or one that affects the payment of a tax or the elements that determine it, or charging taxes, the administrative appeal phase is optional. For this reason, the taxpayer may freely choose, in accordance with the legal deadlines, between initiating an administrative procedure before the tax authority itself, or taking legal action before the courts specialised in tax matters.

Administrative Tax Procedure

Tax declaration

The administrative tax procedure in Chile is the following. Once the taxpayer presents its tax declaration, the tax authority has, as a general rule, a period of three years to start any auditing procedures on such declarations. In the exercise of these faculties, the tax authority may request background information and answers from taxpayers in order to present a declaration or to correct, clarify, extend or confirm a previous one. Within the legal deadlines established for carrying out the review process, the tax authority may close the referred procedure by issuing the corresponding administrative act, being able, in such a case, to validate the taxpayer's return, or determine tax differences, or modify the elements used to determine the return.

Administrative appeal processes

Once the taxpayer has been notified of the referred tax act or assessment, they may file an administrative appeal called a "Voluntary Administrative Reposition" (VAR) within 30 days before the tax authority. The tax authority has 90 days to resolve the appeal. If the tax authority does not notify the resolution ruling on the administrative appeal within the 90-day period, the appeal will be considered to be rejected, and "negative silence" will operate, in other words, it is understood that all the taxpayer's arguments have been rejected.

Against the resolution that resolves the VAR, the taxpayer may exercise another administrative appeal called a "Hierarchical Recourse" (HR), which must be heard and resolved by the national director of the Chilean Tax Administration. The deadline to submit this appeal is five days, and the tax authority has a period of 30 days to resolve it. No appeal may be initiated against this latter decision. It is also worth mentioning that, with the presentation of the above-mentioned administrative appeals, the legal term to exercise legal actions before the courts specialised in tax matters is suspended.

3.2 Deadline for Administrative Claims

The CTA has fixed-term periods to resolve administrative claims presented by taxpayers. Where the administrative authority does not resolve a VAR appeal within 90 days, the latter is understood to be rejected, operating as negative silence or a tacit negative decision (see **3.1 Administrative Claim Phase**). Likewise, as indicated, the taxpayer may file a "Hierarchical Recourse" with the director of the tax authority in the event of obtaining an unfavourable resolution in its VAR appeal.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Tax litigation is initiated by presenting a claim (lawsuit) before the courts specialised in tax matters, called the Tax and Customs Court. These judicial actions can only be exercised if the taxpayer has been notified by the tax authority of a tax act or adjustment, determining tax differences, or collecting taxes, among other acts that are the object of a tax claim.

4.2 Procedure of Judicial Tax Litigation

Once the tax claim is filed at the specialised tax court, and the claim is accepted to be processed, the counterpart (the tax authority) must answer the claim in a term of 20 days. As of 2020, as an updating measure, and in view of the uncertainty generated by the mobilisation restrictions due to COVID-19, the filing of tax claims as well as filings through a web platform was initiated, in order to give continuity to the tax court service. Once the claim has been answered, the court will call the two parties to a conciliation audience. If the parties fail to reconcile or do not reach an agreement, the judge will issue a decision accepting the case for a probation period. The latter decision may be appealed by both parties. Once the probation period has begun, it will have a 20-day duration, in which the parties must present all the evidence (documentary and testimonial) to demonstrate their respective positions.

Once the period of probation has expired, within the following 10 days the parties may present in writing any observations regarding the evidence presented. At this stage, the court may, on its own motion or at the request of a party, once again call the parties to a conciliation audience. If the conciliation fails, whether or not there are any proceedings pending, the court shall call the parties to hear the judgment. Once the

sentence has been pronounced by the judge of first instance, both parties may file an appeal, which will be heard and resolved by the respective Court of Appeal (see **5. Judicial Litigation: Appeals**).

4.3 Relevance of Evidence in Judicial Tax Litigation

In a tax litigation, evidence is everything. Therefore, if the evidence is clear and properly presented before the court, there is a strong possibility that the court will invalidate the claimed act.

Likewise, in complex technical cases or where an abundance of evidence must be considered, expert reports play a fundamental role in supporting the jurisdictional work.

The documents may be provided together with the presentation of the claim, or during the evidential period.

Testimonial evidence, on the other hand, must be submitted during the evidential period.

Official documents, expert reports and other evidentiary procedures must be requested during the evidential period.

4.4 Burden of Proof in Judicial Tax Litigation

As a general rule, in Chilean law, it is the one who alleges the facts who must prove them. With the tax reform of February 2020, the law specified that, in civil tax litigation, each party must prove its respective claims in the process. Likewise, evidence in tax litigation is guaranteed in wide terms, admitting official letters, expert reports, evidentiary proceedings, and any other evidence capable of producing certainty.

On the other hand, in criminal tax litigation, the accuser is the one who must accredit or prove

the alleged facts, while the accused may submit evidence to dispute the alleged facts.

4.5 Strategic Options in Judicial Tax Litigation

The strategic options to be taken in a tax litigation will depend on the particular circumstances of each tax case, the legislation in force at the time of the declared tax, and previous court decisions in cases with similar characteristics, among others. It is highly important for the taxpayer to have the background information that demonstrates the situation that is disputed by the tax administration.

Also, the judicialisation of the case should be analysed from an economic perspective, since the implication is that the litigation will be in process for a long time, and in case of an unfavourable decision, the amount pending will increase due to the charging of interest readjustment and fines.

From another point of view, a strategy must consider the consequences that may impact on the tax result of the subsequent year, in order to defend the client's interests.

Another strategy that is considered is to pay the tax debt, even when it is in tax litigation. This is because, although the legislation allows the tax debt to be suspended during the judicial process of the litigation, the amount owed will increase due to the accrual of interest and readjustment of the debt for the time that the debt is suspended. In this way, in the event that the tax debt is considered to be paid, the amount owed will be limited to the actual payment, and, in the event that a favourable judicial result is obtained, the tax authorities will have to return the amount with the pertinent readjustments.

It should be noted that it is even possible to consider the payment of the taxes due before initiating the judicial phase, since the legislation

allows only a short term for the written presentation of the tax claim to the specialised courts. The referred payment will have the effect of extending this 90-day term, and this payment must always be made before the expiry of the original term. This last option is convenient in cases of high complexity.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

In Chilean law, judgments pronounced by the High Courts of Justice do not oblige other judges, since they have a relative effect. However, the jurisprudence of the specialised courts, as well as that emanating from the courts in tax matters, is very relevant and will be taken into consideration by the judges at the time of resolving tax litigation.

Similarly, international guidelines are also relevant in Chile, given that, depending on the matter under discussion, judges refer to international standards in order to support their decision regarding the tax controversy submitted to them.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The system for appealing tax disputes consists of two instances, a first instance that corresponds to the specialised and independent courts of the tax administration, and a second instance that corresponds to the respective Court of Appeal. The second instance has the power of reviewing the first-instance decision.

The Court of Appeal's case assignment system is related to the territorial location of the specialised court that resolved the controversy in the first instance.

Finally, the judicial decisions adopted by the Courts of Appeal may be subject to a recourse under strict law, called a “cassation appeal”, which will be heard and resolved by the Supreme Court, Chile’s highest national court. Under a cassation appeal, the Supreme Court will verify whether or not the judicial decisions adopted by the judges of the instance have infringed in any way the legal rules that were used to resolve the case.

5.2 Stages in the Tax Appeal Procedure Specialised Court

Once the appeal has been presented to the specialised court, they must decide whether it complies with the formal requirements of the law and whether it was presented within the corresponding time limit. If the appeal is not granted, an extraordinary appeal may be filed, which will be heard by the respective Court of Appeal. Once the appeal has been admitted, the specialised court must send the entire record of the case to the respective Court of Appeal.

Court of Appeal

Once the Court of Appeal has received the appeal, it shall issue a certificate stating that the appeal has been received, and an entry number shall be assigned to it. After that, the Court of Appeal must examine the appeal presented in the same terms as the specialised court. In case of declaring it inadmissible, a special appeal can be presented, which is resolved by the Court of Appeal itself.

In the second instance, the parties may submit additional evidence, which does not imply that there is an additional evidentiary term, but is an opportunity to incorporate more background information that was not included in the first-instance decision, due to the reviewing nature of the Court of Appeal.

Finally, the hearing is held, where the parties have a maximum of 30 minutes to present their arguments in the form of an oral presentation. Once the arguments of the parties have been heard by the judges of the Court of Appeal, they will issue the corresponding second-instance judgment, which may modify (revoke) the appealed judgment or confirm it.

Supreme Court

Regarding the procedure in the Supreme Court, the appeal is filed in the Court of Appeal that issued the second-instance judgment, which verifies that it has been filed within the deadline. Once it has been submitted to the Supreme Court, it is assigned an entry number and the formal elements of the appeal, as well as the substantive elements, are examined.

If the appeal is declared admissible, a hearing audience will be called, in which the parties’ arguments will be heard, and a replacement sentence will be dictated, either deciding that there was a violation of legal norms and that this infraction substantially influenced the resolution of the dispute, or confirming the decision of the Court of Appeal.

5.3 Judges and Decisions in Tax Appeals

The tax and customs courts are tribunals specialised in resolving tax and customs matters. They are special tribunals, independent of the judicial system, and their judges must be lawyers.

The judges of the tax and customs tribunals are appointed by the President of the Republic from a list of three persons proposed by the respective Court of Appeal.

The Courts of Appeal correspond to a court that is part of the judicial system and are distributed according to the regions into which Chile is ter-

ritorially divided (there are 17 Courts of Appeal, one for each region, with the exception of the Metropolitan Region which has two), and each of the Courts of Appeal is distributed into chambers, which are composed of three judges. Only the Santiago Court of Appeal has a specialised chamber for tax matters.

The judges are appointed by the President of the Republic at the proposal of the Supreme Court.

The Supreme Court is composed of 21 members, 16 of whom are judges who have served at different levels of the judicial system and five of whom are not members of the judicial system.

The judges are appointed by the President of the Republic with the agreement of the Senate, from a list of five persons with prestigious academic and professional backgrounds.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Through the 2020 Tax Reform, alternative dispute resolution mechanisms have acquired special relevance, as previously there was no effective method that could be used by the parties to a judicial tax dispute, even when there was agreement between them.

In this context, the 2020 Tax Reform established the following:

- total or partial out-of-court settlement, by which the taxpayer proposes directly to the CTA certain bases of agreement, in order to bring the pending litigation to an early end;

- either party can request a new conciliation hearing during a judicial process in the first instance.

6.2 Settlement of Tax Disputes by Means of ADR

Regarding out-of-court settlement, the taxpayer must submit a written presentation with the terms of the agreement to the CTA, for the national director of the CTA to approve or reject. If it is accepted, it must be presented to the specialised court for approval.

With respect to conciliation, either party may ask the specialised court to call for a new conciliation audience. The judge must propose the terms for a settlement.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Although there is no controversy mechanism aimed to reduce penalties, a condonation of penalties and interests generated (not including taxes or readjustment) has been defined as a state policy. However, it is necessary that the taxpayer complies with certain requirements, for example, that they are not on the exclusion list, which includes taxpayers who are under investigation for tax crimes.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Regarding dispute avoidance mechanisms, taxpayers that have an interest in transactions that may be considered as a tax avoidance from the perspective of the general anti-avoidance rule have the option to request a formal pronouncement from the CTA as to whether the operation corresponds to a tax avoidance activity or not. This CTA ruling is binding for the administration. Also, the CTA maintains a list of tax avoidance schemes.

6.5 Further Particulars Concerning Tax ADR Mechanisms

There are no other methods of dispute resolution besides those mentioned in **3.1 Administrative Claim Phase** and **4.1 Initiation of Judicial Tax Litigation**. In the case of dispute resolution by means of a tax claim, the forms of ADR mentioned under **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction** and **6.2 Settlement of Tax Disputes by Means of ADR** can also be used.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

Chilean regulations recognise the possibility for taxpayers that make transactions with related parties to propose to the CTA the signing of an advance pricing agreement (APA), which will refer to the determination of the normal market price, value or profitability of such transactions. Other tax administrations may also participate.

As long as the formally signed agreement is in force, the CTA may not determine transfer pricing tax differences in the transactions covered by it, provided that the prices, values or returns have been established or declared by the taxpayer in accordance with the terms of the agreement.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

In Chile, research proceedings for tax crimes can only be initiated by the presentation of a criminal action by the national director of the CTA. Even though this is a power that has been criticised, as the Public Prosecutor's Office and prosecutors are not free to investigate, this situation has been maintained to the present day.

In general, in order to decide the prosecution, the CTA gathers the background information, on the merits of which it adopts a well-founded position on the possible commission of an offence.

It should be noted that the collection of taxes evaded by the taxpayer will be charged by the tax authority, independently of whether or not an investigation is initiated for the crime.

The most common tax crimes in Chile correspond to those in which taxpayers use tax credits or benefits improperly, or when they declare tax returns omitting income, or obtain tax refunds that are not due to them.

In Chile, the application of the general anti-avoidance rule (GAAR) prevents the conduct from being classified as unlawful from a criminal perspective, corresponding to a case of exclusion from this rule that attacks avoidance and not evasion.

7.2 Relationship between Administrative and Criminal Processes

In the event of the commission of a tax crime, the tax administration may initiate civil proceedings, with the objective of collecting the taxes that have been fraudulently evaded by the taxpayer, and criminal proceedings, pursuing the application of the pecuniary and criminal sanction that the criminal tax type establishes.

These processes are different and independent. However, the determination of the evaded tax that will be collected in the civil process has transcendence over the criminal field, since it translates into the fiscal damage generated by the evader.

7.3 Initiation of Administrative Processes and Criminal Cases

While the main objective of the tax administration is to ensure the tax compliance of taxpay-

ers, determining differences if they exist, the CTA also proceeds with criminal prosecutions.

In order to determine on a well-founded basis which cases will be subject to criminal prosecution, the tax administration carries out a prior information compilation process.

The parameters considered in order to obtain a criminal sentence are mainly related to:

- the amount of tax damage generated by the taxpayer's conduct;
- the exemplary effect of the accusation or complaint;
- possible reoffending; and
- the quality of the evidence compiled.

It should be noted that the decision not to pursue a criminal proceeding and only recover the taxes may be cancelled at any time, and criminal proceedings may be initiated, as long as the statute of limitations for such action has not expired.

7.4 Stages of Administrative Processes and Criminal Cases

Once a denunciation or complaint is presented for a tax crime, the investigation is carried out by the Public Prosecutor's Office, as an autonomous institution, in charge of compiling the background information in order to conclude whether the acts may constitute a crime.

In the event that the investigation generates sufficient merit, the investigation will be formalised at the competent criminal court, at which stage, preventative measures can be requested, such as house arrest, prohibition to leave the country, or prison.

Finally, there is the possibility that the determination of the existence of the crime and the application of sanctions may be carried out in the same Guarantee Court, using simplified procedures, or

it may be referred to the Criminal Court, which will hear the background of the investigation in a complex and extensive criminal procedure.

In Chile, the prison penalties established in tax crimes are applied to managers, administrators or those who perform such work, but it must be demonstrated that they have participated directly and immediately in the acts that constitute the tax crime.

7.5 Possibility of Fine Reductions

In criminal matters, Chilean tax legislation establishes possibilities for the reduction of a penalty restricting freedom in the event of possible payments or credits with respect to the tax differences determined. This means that the payment of the tax due will be an attenuating circumstance of responsibility when there is a careful reparation of the infringement by the convicted taxpayer.

7.6 Possibility of Agreements to Prevent Trial

Chilean legislation establishes that the CTA shall be considered as a victim in criminal proceedings, and shall therefore act in such a capacity. This allows the tax administration to adopt alternative solutions with the taxpayer, such as, reparatory agreements. In this special case, the tax regulations establish the following requirements for its conclusion:

- payment of an amount not less than the pecuniary penalty; and
- payment of the tax due and the accrued adjustments and interest, without being eligible for remissions of any kind.

At the same time, and without the intervention of the tax administration, it is possible for the Public Prosecutor's Office and the taxpayer being prosecuted to apply for a conditional suspension of the proceedings, in which case, certain

requirements must be satisfied, including, in some cases, the approval of the regional prosecutor.

7.7 Appeals against Criminal Tax Decisions

Depending on the criminal procedure applied to resolve the tax crime complaint filed by the tax administration, there are two possible recourses to be presented by the affected party.

- Recourse for annulment, which is presented directly to the Oral Criminal Tribunal that issued the impugned sentence. This recourse is generally resolved by the competent Court of Appeal, although in some cases, depending on the reasons for the recourse, it will be heard by the Supreme Court (see **5. Judicial Litigation: Appeals**).
- Appeals against sentences issued by the Court of Guarantee in abbreviated proceedings. These appeals are resolved by the competent Court of Appeal (see **5. Judicial Litigation: Appeals**).

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

In Chile, the existence of a GAAR regulation has a relatively recent origin, specifically in 2014 with the tax reforms of that year. To this day, there have been no legal proceedings to enable the CTA to formally apply this regulation, so there have been no disputed transactions to inform. A similar situation has occurred with transfer pricing matters, which, even though they have generated tax litigation at the civil judicial level, have not referred to the existence of tax crimes.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Although in Chile, mutual agreement procedures (MAPs) are not common mechanisms for the resolution of cross-border tax disputes, given that there was no regulation of the procedure for their application, this was regularised in 2022, so more of these agreements are expected. According to information provided by the CTA, eight cases have been initiated in the areas of services, mining, and air passenger and cargo transport.

In turn, according to public information and within the agreement between Chile and Colombia to prevent tax evasion in relation to taxes on income and patrimony, the CTA took the decision to contact its Colombian counterpart. The purpose of this was to define answers to questions regarding the tax treatment of payments for services made by a company resident in Colombia to a company resident in Chile, under the application of the most favoured nation clause of the agreement in question, with the clear objective of avoiding a situation of double taxation.

However, considering the time taken for the judicial processes in which an international double taxation situation can be disputed, MAPs stand out for offering a more expeditious resolution of the contingency, so it is possible that these mechanisms will be used more frequently in future controversies involving taxpayers.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The general anti-avoidance rule (GAAR) in Chile has not been applied in cross-border tax disputes. However, the tax authority has impugned situations of application of international treaties to avoid double taxation, through specific anti-

abuse rules (SAAR), which has generated tax adjustments that have been claimed in court by taxpayers.

8.3 Challenges to International Transfer Pricing Adjustments

In Chile, there are no international adjustments under multilateral transfer pricing treaties that can be disputed in court. Transfer pricing adjustments are, however, made by the tax authority based on the faculties provided by Chilean law. In the first cases, the main objections held by the tax administration centred on the fact that there was an error in the use of the comparable values applied to make the adjustments, which were not credible, and the transfer pricing methods used did not correspond to any of those contained in the OECD guidelines for such purposes.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Advance pricing agreements (APAs) are recognised in Chilean legislation. In order to enter into such agreements, the interested taxpayer must present a request containing the following elements:

- descriptions of the operations carried out with related parties, their prices, values or normal market profits;
- the period to be covered by the agreement;
- the documentation or background information upon which it is supported; and
- a transfer pricing report or study in which the methods recognised by Chilean law have been applied.

The taxpayer's proposal must be accepted or rejected by the CTA within a maximum period of six months. If a favourable response is obtained, the taxpayer's proposal will be reduced to a memorandum of understanding, which will be signed by the CTA representative and the taxpayer.

The agreement will have a duration of three years, and may be renewed or extended by agreement of the parties, with the possibility for both the CTA and the taxpayer to revoke the agreement in advance, for example, when the essential information or circumstances that were taken into account at the time of its signing, extension or renewal have changed substantially.

Finally, the CTA will be restricted from determining transfer pricing tax differences on the transactions covered by the agreement, as long as the prices, values or returns have been established or declared by the taxpayer in accordance with the terms of the agreement.

According to information provided by the CTA, five APA procedures have been implemented in the retail, food, chemical and pharmaceutical, and investment companies sectors.

8.5 Litigation Relating to Cross-Border Situations

In general, the main matters that generate tax disputes related to cross-border issues relate to transfer pricing, use of credits attributable to corporate tax based on taxes paid abroad, legal treatment of payments as royalties or corporate profits.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

This is not applicable.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

This is not applicable.

9.3 Challenges by Taxpayers

This is not applicable.

9.4 Refunds Invoking Extra-Contractual Civil Liability

This is not applicable.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

This is not applicable.

10.2 Types of Matters that Can Be Submitted to Arbitration

This is not applicable.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This is not applicable.

10.4 Implementation of the EU Directive on Arbitration

This is not applicable.

10.5 Existing Use of Recent International and EU Legal Instruments

This is not applicable.

10.6 New Procedures for New Developments under Pillar One and Two

Chile, as a member of the OECD, was one of the countries that signed this global tax agreement, so it will be applicable. In this sense, those Chilean companies that maintain subsidiaries abroad are preparing for the entry into force of this agreement by reorganising their corporate networks.

10.7 Publication of Decisions

This is not applicable.

10.8 Most Common Legal Instruments to Settle Tax Disputes

This is not applicable.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

This is not applicable.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

In Chile, it is not necessary to pay any fee or amount to litigate at the administrative phase; this phase is absolutely free of charge.

The only related cost would be for advisers or if it is considered necessary to have an expert present a legal or technical opinion on the matter.

11.2 Judicial Court Fees

There are no fees that must be paid in advance in order to respond to litigation in court; the right to defence is established in the Chilean Constitution as a right of every person.

It is possible that the losing litigant may be ordered to pay personal expenses, eg, the fees of lawyers and other persons involved in the case. In those cases where the court considers that the losing litigant did not have a plausible motive to litigate, each party will have to pay their own expenses.

11.3 Indemnities

Under Chilean law, there is no possibility of requesting compensation from the CTA, should the tax authority lose the case before the court. However, Chilean tax regulations establish that in the case of payments of taxes, adjustments, interest, readjustments and penalties, paid on

the basis of a tax valuation made by the tax administration and subsequently annulled, the amount paid will be refunded with interest of 0.5% per month.

11.4 Costs of ADR

As in the administrative and judicial stage, there are no fees or amounts to enable the use of alternative dispute resolution.

12. STATISTICS

12.1 Pending Tax Court Cases

According to the latest statistical report developed by the tax and customs courts, prepared with the information existing as of 31 December 2019, there are about 2,200 pending tax court cases in Chile. The statistics consider as “pending tax cases” not only those that are being processed in the first instance, but also those that have a first-instance sentence but are still being examined by the Courts of Appeal or the Supreme Court.

The value of the 2,200 pending tax cases is approximately USD6.3 billion.

During the years 2020 and 2022, according to the information provided by the administration of the Tax and Customs Courts, 1,787 cases were presented, 48% of which were filed in the Metropolitan Region.

12.2 Cases Relating to Different Taxes

To date, no study has been conducted in Chile using concrete statistics, specifically identifying cases initiated and terminated in relation to the different taxes that exist in Chile (corporate tax, global complementary tax, additional tax, and sales and services tax, among others).

However, according to the information provided by the Administrative Unit of the Tax and Custom

Tribunals, for the years 2015–19, of the total number of cases filed, 35% were related to tax adjustments. Likewise, 36.93% of the total number of cases completed in this period correspond to tax adjustments.

12.3 Parties Succeeding in Litigation

According to report No 12 by the Chilean Judicial Observatory, during the period 2013–17, tax judges only accepted 30% of the tax claims (or lawsuits) presented by taxpayers. Of these, 70% of the rulings issued by tax judges were in favour of the tax authority.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

In a tax dispute that has been judicially litigated, it is advisable to consider the following guidelines.

- Have expert advisers in tax litigation and defence. The proceedings are conducted in specialised courts and involve oral hearings. Therefore, it is very important to have the support of a team of professionals.
- Documentary evidence is essential for the case. In order for a judge to rule in favour of a taxpayer, the taxpayer needs accounting backups, so it is advisable to keep these in order, and to be able to explain their incidence or importance for the theory of the case to be presented in court.
- Maintain a complete knowledge of the sentences dictated by the independent courts, as well as the instructions and positions on the application of the tax rule that have been dictated by the CTA. There are cases where the tax position is contrary to judicial jurisprudence and even to the CTA's own formal technical opinions. If such a situation is pre-

sented, it will become an important defence against the claim of the tax authority.

- Similar to the current situation, Chilean courts had established that there must be invariability in the treatment granted to a taxpayer by the CTA, and that this can only change when there are important reasons for this, which must be sufficiently substantiated and justified.
- The taxpayer must be aware of the consequences that a tax lawsuit may have, especially considering its long duration. That is, there could be new audits on the same matter, which could lead to other disputes with the CTA, but for different tax periods.

Contributed by: Luis Felipe Ocampo Moscoso and Ignacio Iriarte Magadán, Recabarren & Asociados

Recabarren & Asociados specialises in the provision of high-quality tax consultancy services to clients seeking expert legal and tax advice. The firm advises companies and individuals at a national and international level, through highly specialised work teams that are able to respond to the individual needs of each client. The firm is made up of 30 experts in tax matters who counsel clients from widely different

areas, such as retail, mining, family offices, real estate, infrastructure, and technology companies, among others. Recabarren & Asociados focuses exclusively on tax matters, such as tax examination processes, tax defence and litigation, tax planning for companies and individuals, business restructuring, consultancy for large and medium-sized companies, and advice for family businesses and HNWI's.

AUTHORS



Luis Felipe Ocampo Moscoso is a lawyer and partner at Recabarren & Asociados. He has more than 20 years of experience in tax litigation and taxpayer defence. He served as

a tax judge for more than seven years, after which he worked as a public defender in the public criminal defence department. He was director of the tax litigation area of EY Chile, always practising in the same area, and has been a professor at several universities. Luis Felipe has extensive experience in representing taxpayers in audit proceedings, as well as representing them in the courts of the republic.



Ignacio Iriarte Magadán is a lawyer and partner at Recabarren & Asociados. He worked for ten years in the Chilean tax administration in the area of tax crimes and litigation

at the tax courts. His main focus is on tax audits and taxpayer defence, both in administrative and judicial proceedings. Ignacio is also a postgraduate professor on taxpayers' rights and obligations at the Universidad Católica de Chile.

Recabarren & Asociados

Isidora Goyenechea
#3162 5th floor
Las Condes
Santiago
Chile

Tel: +56 2 2594 0550
Email: contacto@recabarrenasociados.com
Web: www.recabarrenasociados.com

RECARBAREN & ASOCIADOS
CONSULTORÍA TRIBUTARIA

Trends and Developments

Contributed by:

Luis Felipe Ocampo Moscoso

and Ignacio Iriarte Magadán

Recabarren & Asociados see p.97

Chile – an Uncertain Future in Terms of Taxes

The pandemic has now lost strength in Chile – the number of daily infections no longer worries the population, the symptoms of the disease are usually mild in those who contract it, and there are generally no significant after-effects once recovered. This health reality contrasts with the difficult political, economic and public security situation of uncertainty that the country is currently experiencing.

The uncertainty is due to the social unrest generated since October 2019, which has led to a delicate process of constitutional change that is still underway. It is hoped that this will be resolved with the plebiscite to be held on September 4th, in which Chileans will decide whether to apply the constitution that has been proposed by a commission elected for that purpose, or to continue with the constitution that currently governs. As can be expected, this situation is not very favourable for business, as political, tax and social stability is essential for the certainty of foreign and domestic investment.

In addition, the election of a government of very strong leftist ideological inspiration has occurred – a government that has adopted the populist messages of recent years, and which have been converted into promises of social benefits at a very high cost for the State, putting it under strong pressure from the people. However, the country's economic position is fragile in terms of savings, as the voluminous direct transfers of funds to the population in order to reduce the effects of the pandemic make it necessary to look for new sources of money in order to fulfil promises, and not lose public support.

This scenario makes it mandatory to initiate a new tax reform process to increase the tax burden on companies and high-net-worth individuals. The process has been presented as more participatory, and seeks to agree on points that will make it possible to impose new taxes, increase the burden of current taxes or eliminate exemptions, while at the same time seeking to give greater powers to the already powerful tax administration.

These new changes to the tax system will be the sixth process in the last seven years, but they come at a very difficult time, as Chile is on the verge of a recession. Constitutional reform can totally change the political structure of the country and taxation principles are not yet clearly delineated – especially with a world economy affected by the Russian invasion of Ukraine, causing profound distortions which are affecting even the prices of basic foodstuffs.

Under these circumstances, the future of the Chilean economy looks dark, investment and savings are declining, capital has been relocated and the economy is contracting, and the state is trying to impose higher taxes in order to satisfy political campaign promises.

The political and legal uncertainty that reigns in the country today means that Chile's competitiveness among emerging countries is now just a memory, as the foundations on which it was built have been destroyed and it will take time to recover the levels of growth and stability seen in the last 20 years, if it can be achieved at all.

On the other hand, the increased tax burden that is being pursued, the reduced economic activity that will soon be evident, and the potentially reduced constitutional protection that could result if the proposed constitution is adopted, mean that the levels of conflict in the fiscal sector are increasing.

In addition to the above, the constitutional changes propose a major reform of the judicial system, eliminating existing institutions in order to create a new justice system, considerably departing from the principle of separation of powers.

In this sense, a major step backwards is being proposed in the area of tax justice, as the aim is for the tax courts specialised in tax matters to become part of the new contentious administrative justice system, which will not only deal with tax matters but also with judicial disputes of other kinds. Therefore, if the creation of this new court is decided, the little progress made in recent years to achieve a more independent and impartial tax justice system that guarantees taxpayers' rights, while at the same time complying with the guarantees of essential rights treaties such as the Pact of San José, Costa Rica, will be lost.

Under this reality, already in 2021, the tax administration has been implementing a tax compliance plan, for the two years 2021 and 2022. This instrument makes it possible to anticipate with some precision the intensity of its actions and the target sectors.

Consequently, the plan focuses on two essential segments of taxpayers:

- high net worth individuals (HNWIs) – close control will be deployed to verify that they are declaring all their income and family relationships;

- multinational enterprises (MNEs) – the focus will be on transfer pricing, qualification of services and benefits, verification of interest paid abroad, the nature of financing operations, levels of indebtedness, and the location of profits and operations in jurisdictions with special tax treatments, among other control actions.

Another guide to avoid conflicts in tax matters is related to the catalogue of tax schemes, which constitutes a guideline of the tax administration on activities that can be qualified as elusive. In this sense, five income tax cases have been incorporated: two related to inheritance, allocations and donations tax; two involving both income taxes and inheritance, allocations and donations tax; and finally one VAT case. This way of proceeding by the tax administration is in line with the international trend to establish the prior declaration of possibly elusive schemes, as a measure aimed at improving legal certainty in a climate of co-operative compliance between taxpayers and the tax administration. This catalogue complements the tax compliance plan that the administration implements every year.

In this way, both the political and social reality along with the constitutional modifications, the matters that the tax administration has proposed as audit objectives, and the list of tax avoidance schemes, make it possible to predict a high level of judicialisation of tax problems in Chile.

Consequently, even though the legal changes introduced after the 2020 tax reform have improved the definition and consistency of taxpayers' rights, the State's need to generate more resources to cover the enormous expenses of recent years is apparent. This will place greater and unavoidable demands on the tax administration to reach tax collection targets, especially considering the major social changes that were the subject of the presidential campaign, and

which represent a significant tax load at a time when national reserves are becoming scarce.

The demands have already started as, in order to increase tax revenue, Law No 21.420 has been promulgated with the aim of eliminating various tax exemptions, among which can be found the following.

- A single tax of 10% on capital gains on instruments with stock market presence, taxing the higher value obtained on the disposal of certain instruments with stock market presence, with a single tax rate of 10% on the gains obtained. This provision comes into force from 1 September 2022.
- Tax treatment of leasing contracts will be equal to the tax treatment granted to financial leasing, so that their financial treatment must also be taken into account in tax matters. This provision comes into force from January 2023.
- Affectation with VAT to the provision of services: all service activities were included in the collection of VAT; only those that the law itself declares as exempt will be excluded from the tax. In this way, the current situation in which only some of the services were subject to VAT is modified. This provision comes into force from January 2023.

Another tax that needs attention relates to the wealth tax that has been discussed in recent years. It refers to the imposition of a wealth tax which could affect the personal assets of the wealthiest individuals. Although the legal project has suffered various modifications during its processing, due to dissimilar political and technical opinions, it is a reform that has had the support of the current President, which means that once the constitutional process has been resolved, it will be one of the issues that will be given special emphasis in its processing and approval.

In this way, the government and the tax administration will rigorously apply the legal tools they have today, an issue that will directly affect taxpayers, since, undoubtedly, internal and external social instability directly affects all people.

Ultimately, the government will have to take measures to mitigate the inevitable consequences that these imbalances have created, and which could result in a complex relationship between the tax administration and taxpayers regarding the collection of taxes, resulting in legal disputes which will undoubtedly lead to many review processes of the operations of national and foreign taxpayers.

From what has been said, we conclude that the future in Chile will not be simple, and much depends on how the process of constitutional change that is currently underway will end.

Recabarren & Asociados specialises in the provision of high-quality tax consultancy services to clients seeking expert legal and tax advice. The firm advises companies and individuals at a national and international level, through highly specialised work teams that are able to respond to the individual needs of each client. The firm is made up of 30 experts in tax matters who counsel clients from widely different

areas, such as retail, mining, family offices, real estate, infrastructure, and technology companies, among others. Recabarren & Asociados focuses exclusively on tax matters, such as tax examination processes, tax defence and litigation, tax planning for companies and individuals, business restructuring, consultancy for large and medium-sized companies, and advice for family businesses and HNWIs.

AUTHORS



Luis Felipe Ocampo Moscoso is a lawyer and partner at Recabarren & Asociados. He has more than 20 years of experience in tax litigation and taxpayer defence. He served as

a tax judge for more than seven years, after which he worked as a public defender in the public criminal defence department. He was director of the tax litigation area of EY Chile, always practising in the same area, and has been a professor at several universities. Luis Felipe has extensive experience in representing taxpayers in audit proceedings, as well as representing them in the courts of the republic.



Ignacio Iriarte Magadán is a lawyer and partner at Recabarren & Asociados. He worked for ten years in the Chilean tax administration in the area of tax crimes and litigation

at the tax courts. His main focus is on tax audits and taxpayer defence, both in administrative and judicial proceedings. Ignacio is also a postgraduate professor on taxpayers' rights and obligations at the Universidad Catolica de Chile.

Recabarren & Asociados

Isidora Goyenechea
#3162 5th floor
Las Condes
Santiago
Chile

Tel: +56 2 2594 0550

Email: contacto@recabarrenasociados.com

Web: www.recabarrenasociados.com

RECABARREN & ASOCIADOS
CONSULTORÍA TRIBUTARIA

Law and Practice

Contributed by:

Tony Dong, Duan Tao (Daisy), Zhang Ci (Alice)
and Wang Yan

King & Wood Mallesons see p.119



CONTENTS

1. Tax Controversies	p.101	5.3 Judges and Decisions in Tax Appeals	p.110
1.1 Tax Controversies in this Jurisdiction	p.101	6. Alternative Dispute Resolution (ADR) Mechanisms	p.111
1.2 Causes of Tax Controversies	p.101	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.111
1.3 Avoidance of Tax Controversies	p.101	6.2 Settlement of Tax Disputes by Means of ADR	p.111
1.4 Efforts to Combat Tax Avoidance	p.102	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.111
1.5 Additional Tax Assessments	p.102	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.111
2. Tax Audits	p.102	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.111
2.1 Main Rules Determining Tax Audits	p.102	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.111
2.2 Initiation and Duration of a Tax Audit	p.103	7. Administrative and Criminal Tax Offences	p.111
2.3 Location and Procedure of Tax Audits	p.103	7.1 Interaction of Tax Assessments with Tax Infringements	p.111
2.4 Areas of Special Attention in Tax Audits	p.104	7.2 Relationship between Administrative and Criminal Processes	p.112
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.104	7.3 Initiation of Administrative Processes and Criminal Cases	p.112
2.6 Strategic Points for Consideration during Tax Audits	p.104	7.4 Stages of Administrative Processes and Criminal Cases	p.112
3. Administrative Litigation	p.105	7.5 Possibility of Fine Reductions	p.113
3.1 Administrative Claim Phase	p.105	7.6 Possibility of Agreements to Prevent Trial	p.113
3.2 Deadline for Administrative Claims	p.106	7.7 Appeals against Criminal Tax Decisions	p.113
4. Judicial Litigation: First Instance	p.106	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.113
4.1 Initiation of Judicial Tax Litigation	p.106	8. Cross-Border Tax Disputes	p.114
4.2 Procedure of Judicial Tax Litigation	p.107	8.1 Mechanisms to Deal with Double Taxation	p.114
4.3 Relevance of Evidence in Judicial Tax Litigation	p.108	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.114
4.4 Burden of Proof in Judicial Tax Litigation	p.109		
4.5 Strategic Options in Judicial Tax Litigation	p.109		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.109		
5. Judicial Litigation: Appeals	p.110		
5.1 System for Appealing Judicial Tax Litigation	p.110		
5.2 Stages in the Tax Appeal Procedure	p.110		

8.3	Challenges to International Transfer Pricing Adjustments	p.114	10.5	Existing Use of Recent International and EU Legal Instruments	p.116
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.115	10.6	New Procedures for New Developments under Pillar One and Two	p.116
8.5	Litigation Relating to Cross-Border Situations	p.115	10.7	Publication of Decisions	p.116
9.	State Aid Disputes	p.116	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.116
9.1	State Aid Disputes Involving Taxes	p.116	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.116
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.116	11.	Costs/Fees	p.117
9.3	Challenges by Taxpayers	p.116	11.1	Costs/Fees Relating to Administrative Litigation	p.117
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.116	11.2	Judicial Court Fees	p.117
10.	International Tax Arbitration Options and Procedures	p.116	11.3	Indemnities	p.117
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.116	11.4	Costs of ADR	p.117
10.2	Types of Matters that Can Be Submitted to Arbitration	p.116	12.	Statistics	p.117
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.116	12.1	Pending Tax Court Cases	p.117
10.4	Implementation of the EU Directive on Arbitration	p.116	12.2	Cases Relating to Different Taxes	p.117
			12.3	Parties Succeeding in Litigation	p.118
			13.	Strategies	p.118
			13.1	Strategic Guidelines in Tax Controversies	p.118

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Tax controversies in China generally refer to tax disputes that arise between tax authorities and taxpayers or tax-withholding agents. Tax controversies may arise in various circumstances, such as in response to administrative decisions made by the tax authority under a tax audit, transfer-pricing investigations, general anti-tax avoidance investigations, etc. Sometimes, dissatisfaction with the routine tax administrative activities of the tax authority, such as denial of preferential tax treatment, denial of a tax refund, or failure to perform tax administrative duties (ie, so-called administrative omission) may also lead to tax controversies.

1.2 Causes of Tax Controversies

Value-added tax, enterprise income tax and individual income tax constitute the main sources of tax revenue in China, and these taxes usually give rise to most tax controversy cases in China.

Land value-added tax is also an area that may create tax controversies due to the complexity of the land value-added tax regime.

1.3 Avoidance of Tax Controversies

Before delving into how to mitigate tax controversy in China, it is first necessary to understand why tax controversies arise in China.

Based on our observations, the main reasons for tax controversies in China are as follows.

- The lack of explicit tax guidance rules, which leaves for ambiguity regarding different interpretations and positions held by the tax authorities and the taxpayer – as China is a civil-law country, tax laws and regulations should be followed by tax authorities and taxpayers and any precedent cases related

to tax controversies have no legally binding effects. However, tax legislation cannot cover all aspects of commercial activities. As a result, it is not uncommon that a taxpayer and the tax authority take different views on the application of tax rules to a specific case.

- Different understandings of the tax-related facts on which the tax assessment is made – there are quite often discrepancies between the tax authorities and taxpayers regarding the facts or the nature/characterisation of particular transactions. Different understandings of the facts may lead to different opinions on the tax treatment of the matter involved.
- The lack of a tax compliance system – corporate taxpayers failing to establish a sound internal tax compliance and risk-control system, meaning that they are not capable of detecting daily tax wrongdoing/misconduct or effecting preventative actions or rectifications in a timely manner.

To mitigate tax controversy risks, it is necessary for taxpayers to establish comprehensive, sound tax compliance management in their daily business operation, as detailed in the following.

- Before the implementation of a new transaction or project, taxpayers should not only carefully review the written tax rules, but also research the local practice of the tax authority, or enquire with the tax authority in advance, to ensure that the tax treatment for the new transaction or project is in line with the rules as well as local practice. If there is still any ambiguity after research, the taxpayer must make a more thorough assessment of the rules and the risk magnitude, and take any necessary proactive measures.
- To avoid any misunderstanding of the facts, it is always a good approach to document the key facts in a written form, such as in the relevant transactional agreement or in the

corporate internal memorandum, meeting minutes, etc.

- Taxpayers should establish an internal tax control system and regularly update/reassess its implementation.
- Last but not least, where a taxpayer is aware of any potential tax audit or challenge posed by the tax authority, timing is of the essence. A taxpayer should reach out to tax counsel for advice before making any concrete contact with the tax authority.

1.4 Efforts to Combat Tax Avoidance

As an active participant in the BEPS Action Plans, China takes the position that the BEPS achievements should be combined with the practical situation of the PRC. In line with the progress of BEPS, China issued administrative rules for general anti-tax avoidance in December 2014, updated rules governing the indirect transfer of Chinese taxable properties in February 2015 and introduced anti-tax avoidance rules into the individual income tax regime in August 2018. These measures set out a more comprehensive legal basis for tax authorities to combat anti-tax avoidance practice but, in the meantime, have caused an inevitable increase in the volume of tax controversies.

In addition, on the international side, China signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in June 2017, aiming to amend Chinese double tax treaties/arrangements in an effective manner and implement the BEPS actions in relation to tax treaties, eg, anti-treaty shopping rules and dispute-resolution mechanisms. This convention is expected to serve as guidance for mitigating cross-border tax risk and the better resolving of international tax disputes. The convention is not yet in effect, so its practical impact is subject to further observation in the future.

1.5 Additional Tax Assessments

If a taxpayer intends to contest an additional tax assessment imposed by its relevant tax authority, it must file an administrative review claim before initiating a judicial claim. To lodge an administrative review proceeding, it is necessary for the taxpayer to pay off the assessed tax and the interest surcharges or to provide an adequate guarantee within the prescribed time limit. Failure to do so will result in loss of the right to initiate the administrative review and the subsequent judicial claim proceeding.

If the taxpayer neither pays the assessed tax nor files an administrative review claim within the prescribed timeframe, the tax authority is empowered to initiate compulsory enforcement measures upon the approval of the competent tax bureau's chief. More specifically, the tax authority may notify the bank to deduct and remit the outstanding tax from the bank account of the taxpayer/tax-withholding agent, or detain, seal up and dispose of the goods or other properties of the taxpayer/tax-withholding agent by auction or sale at an amount equivalent to the tax, etc. In addition, the tax authority may impose an administrative fine ranging from 50% to 500% of the outstanding tax.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

China adopts a random selection system to select the targets of tax audits. Under this system, taxpayers are classified into:

- key tax-revenue source enterprises; and
- other taxpayers.

Around 20% of those classified as key tax-revenue source enterprises are selected for tax audit each year, which means that in principle a key

tax-revenue source enterprise is subject to tax audit every five years.

Among those classified as other taxpayers, no more than 3% of enterprise taxpayers and no more than 1% of non-corporate taxpayers are selected for tax audit each year.

Despite these general rules, if a taxpayer has any bad tax records, such as abnormal status of tax filings for a long period, low tax credibility rating, a history of violation of tax laws, etc, it will be exposed to higher likelihood of being selected for a tax audit.

In addition to the above general tax audit selection approaches, there are a few other situations which may cause a taxpayer to become the subject of a tax audit.

- If there is clear evidence showing that a taxpayer has conducted activities in violation of tax rules by reporting or by instruction from a higher-level tax authority or by information from other authorities (eg, a public security authority, the People's Procuratorate, etc), then a taxpayer will become a tax audit target.
- If a whistle-blower provides tipping information to the tax authority, the tax authority will make enquiries into or initiate a tax audit of the target.
- Under the current "Golden III" tax administration system, data selection, analysis and scrutiny have become more effective and efficient. The tax authorities set certain red-flagging thresholds in the system based on big data they have collected and accumulated during daily tax administration. Once a certain threshold is reached, a tax risk alert will pop up, according to which a taxpayer may be selected for tax assessment and further audit.

2.2 Initiation and Duration of a Tax Audit

Theoretically speaking, a tax audit should be completed within 60 days of its starting date. This period can be extended once by approval of the chief of the tax audit bureau. In practice, however, it is common that some audit cases may last longer (even for a few years) due to the complexities of the case concerned.

2.3 Location and Procedure of Tax Audits

A tax audit typically includes the following steps, including both on-site inspection and desktop review at the tax authority's office.

Investigation

The tax audit bureau issues a Notice of Tax Investigation to the tax audit target and initiates the tax audit process.

The investigation is conducted by various means, including on-site inspection, review and collection of the relevant accounting books and other materials, making inquiries with the relevant personnel, examination of relevant bank accounts, collecting information or seeking assistance from other tax bureaux or governmental authorities, etc.

Assessment

Upon completion of the initial investigation process, the investigation bureau shall submit its internal work report to the assessment division of the tax audit bureau for review. The assessment division, upon completion of the review, shall formulate a written opinion for review by the division head. If the tax audit case is complicated or has a significant impact, a collective trial shall be conducted to decide the case.

If the assessment division intends to impose a tax administrative punishment on the target, it shall deliver a Notice of Tax Administrative

Punishment and inform the target of its legal defence rights. If the target makes any statement or defence, this shall be properly documented and signed off by the target. In some cases, the target has the right to request a hearing.

Decision

Upon completion of the above assessment procedures, the tax audit bureau prepares the final notification letter(s). Depending on the results of the tax audit, the notification letter could be a Decision Letter on Tax Administrative Punishment, a Conclusion Notice of Tax Audit Case, etc.

Enforcement

The enforcement division of the tax audit bureau is responsible for delivering the final notification letter to the target. If the decision and notification letter require the target to pay additional tax, the target must pay off the outstanding tax, interest surcharges and/or the administrative fine within the stipulated time limit. Otherwise, the tax audit bureau may take compulsory enforcement measures upon approval by the head of the tax bureau, or apply to the People's Court for compulsory enforcement, unless the target lodges an administrative review process in due course.

2.4 Areas of Special Attention in Tax Audits

At the beginning of each year, the State Taxation Administration (STA) formulates the priorities of tax audit work nationwide for the year. This usually includes three aspects.

- Industries and transactions under special attention – normally, the STA selects three to six industries and transaction types as the key areas for tax audit. For instance, in recent years, export tax refunds, bulk commodities, the medical cosmetology industry, the entertainment and webcasting industry, and

high net worth individuals have been under the spotlight.

- Illegal acts attracting special attention – based on the major tax cases published by the STA in recent years, the typical illegal acts include false issuance of VAT invoices, concealing revenue or falsifying costs, malicious tax planning making use of “tax preferential regions” and related party transactions, and tax evasion through new business models, etc. These areas are among the focus areas of tax audits.
- Designated key taxpayers and cases – the STA selects key taxpayers and cases which are to be audited by the tax audit bureau of the STA directly or assigned to the tax audit bureaux at the provincial level for handling.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

With the enhancement of global collaboration in the exchange of information, and in order to combat cross-border tax avoidance, it is in no doubt that, going forward, more and more tax audit cases will arise from exchanged information, particularly in areas concerning Chinese tax residents' offshore assets/transactions, and the onshore assets/transactions of foreign nationals.

2.6 Strategic Points for Consideration during Tax Audits

When a taxpayer is faced with a tax audit, it is suggested to first and foremost contact competent tax counsel, which could help provide initial advice and tactics covering the aspects listed below. As the tax audit case progresses, the tax counsel could provide continuous legal support in all the following respects, and help achieve a relatively favourable audit result, to the extent possible.

- Understanding the tax audit procedures – the tax audit shall be conducted in line with the procedural requirements. A better understanding of some key procedures helps the taxpayer to protect its rights better. For example, when tax officials conduct on-site investigations, they must present certificates and notification letters; otherwise, the taxpayer has a right to deny the investigation.
- Formulating strategic and effective approaches to communicating with the tax officials – on the one hand, the taxpayer is legally obliged to accept inquiry from the tax authority; on the other, the inquiry gives the taxpayer a good opportunity to communicate with the tax authority to better understand the key tax issues being audited, and to present the taxpayer's position (including the relevant facts, the legal grounds and the supporting items). Effective communication is the rule of thumb in resolving tax audit cases.
- Prudently preparing the materials requested by the tax authority – during the tax audit, the tax authority will request that the taxpayer submit the relevant materials. The taxpayer should take this seriously, carefully reviewing all materials prior to submission. These materials may not only become the evidence used by the tax audit bureau to support its conclusion, but may also become the key evidence during the subsequent administrative review or judicial litigation proceeding.
- Analysing and identifying the effective legal grounds to support the taxpayer's position and preparing the relevant supporting materials – even though it is not mandatory for the taxpayer to submit its own statement letter defending the case during the tax audit process, it is strongly recommended that the taxpayer take proactive action to analyse the legal grounds in support of its position, lay out the relevant supporting facts and legal grounds in a written form such as a statement letter, and submit this to the tax authority,

together with other supporting evidence. As long as the tax authority receives such a position letter, it shall take it into consideration when making its tax administrative decision.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

A taxpayer may lodge an administrative appeal against the tax authorities in respect of a specific administrative act.

Where the specific administrative act relates to tax collection, an administrative appeal phase is compulsory before a judicial claim can be initiated. For other types of specific administrative acts conducted by tax authorities, eg, administrative punishment, compulsory enforcement measures, invoice administrative acts, failure to fulfil duties, etc, a taxpayer may elect to initiate a judicial claim directly without going through the administrative appeal phase.

As a general rule, a taxpayer must duly apply for an administrative appeal within 60 days of the date when it acknowledges the existence of the specific administrative act concerned. The taxpayer is required to pay off the assessed tax and the interest surcharges or provide an adequate guarantee within a specified time limit before filing an administrative review claim, which is usually 15 days in practice.

The administrative appeal application must be made to the competent tax administrative review authority, which in principle is the tax bureau at a higher level. There are some exceptions: for instance, an administrative claim against a specific administrative act conducted by a tax audit bureau must be made to the tax bureau to which the tax audit bureau is subordinate.

Upon receipt of the taxpayer's application, the appeal authority shall review the application within five days to decide whether to accept or reject the application, or request that the applicant supplement or correct the application materials.

The respondent tax authority is required to submit a written reply to provide the relevant evidence, legal basis and other relevant materials. The appeal authority will review the applicant's application and the respondent's response. The applicant also has access to the respondent's response materials, unless the materials involve any national secrets, commercial secrets or personal privacy. In addition, the respondent tax authority is not allowed to collect additional evidence from the taxpayer or other related parties during the review.

In principle, the administrative appeal shall be conducted on the basis of reviewing relevant written materials. However, if the taxpayer makes a request or the appeal authority considers it necessary, the appeal authority may hold a hearing in which the applicant and the respondent authority appear to present their positions.

3.2 Deadline for Administrative Claims

In principle, the appeal authority should make a decision within 60 days of its acceptance of a claim. However, if the case is complicated and the appeal authority is unable to make a decision within the prescribed time limit, the time limit may be extended to 90 days upon approval by the head of the appeal authority.

It is not uncommon in China that tax administrative appeal cases are eventually settled by the applicant and the respondent authority through mediation. During the mediation process the administrative appeal period is suspended.

If the appeal authority fails to make a decision within the prescribed time limit, the tax officials who are directly in charge (and other persons directly responsible for the violation) shall be issued with administrative sanctions, eg, disciplinary warning, recording of a demerit or of a serious demerit. In addition, technically speaking, the applicant may lodge a separate administrative review or judicial claim against the appeal authority for its failure to make the decision on time.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Tax disputes between taxpayers and tax authorities are classified into two categories: tax collection actions and other tax-related actions.

In tax collection actions, such as a decision to pursue taxes and late payment interests, administrative appeal to the upper-level tax authority is a prerequisite for filing a lawsuit to court. If a taxpayer refuses to accept an appeal decision (either sustained or changed by the upper-level authority), it can file to court. It should be noted that, currently, a taxpayer should settle tax payment and late payment interest or provide a tax guarantee that is confirmed by the initial tax authority before it can file an administrative appeal to the upper-level tax authority. The tax guarantee precondition mechanism is now under discussion and review for amendment by China's Tax Collection and Administration Law.

For other tax-related actions, such as administrative penalties or invoice administration measures, taxpayers are entitled either to claim an administrative appeal to the upper-level tax authority or to file to court straightaway.

4.2 Procedure of Judicial Tax Litigation

The current judicial system in China oversees three categories of litigation:

- civil litigation concerning disputes between equal parties (eg, a sales contract dispute);
- administrative litigation concerning disputes between a regulated party and the regulatory authority; and
- criminal litigation concerning crimes.

It should be made clear that China does not yet have a specialised tax court, nor does it have an exclusive judicial procedure for tax litigation, though in recent years China has been studying the feasibility of establishing specialised tax tribunals. Currently, litigation concerning tax disputes between taxpayers and tax authorities takes the form of administrative litigation, whereas litigation concerning tax crimes initiated by public prosecutors against taxpayers is considered as criminal litigation. Since criminal tax cases (ie, concerning serious illegal behaviour relating to taxes) are much less common than administrative tax cases, what follows will focus on administrative tax litigation. References to criminal tax offences are made in **7. Administrative and Criminal Tax Offences**.

The administrative tax litigation procedure is as follows.

Stage One – Initiation of Litigation and Acceptance of a Case

In tax collection cases, if a taxpayer refuses to accept the appeal decision, the taxpayer can, within 15 days of the date of receipt of the appeal decision, initiate litigation in the court which has jurisdiction. For other tax-related actions where the taxpayer decides to file directly to court, the court filing shall be made within six months of the date the taxpayer knew or ought to have been aware of the decision of the tax authority.

Before acceptance of a case, the court will review and consider whether the court filing satisfies statutory requirements, ie, the following.

- The plaintiff is the taxpayer, or any other party who has interests in the tax decision.
- There is a specific defendant (the initial tax authority being the defendant, if no appeal; the appeal tax authority being the defendant, if it has changed the action of the initial tax authority; the appeal tax authority and the initial tax authority being joint defendants, if the appeal tax authority sustains the action of the initial tax authority).
- There are specific claims and a corresponding factual basis.
- Additionally, the litigation falls within the scope of cases acceptable to the court and the jurisdiction of the court.

With respect to jurisdiction, administrative tax litigations should be filed to the court where the tax authority that initially undertook the tax decision is located, or also the court where the appeal tax authority is located if the case has been administratively appealed. In general, the primary courts (at the county level) will try first-instance cases, unless the case is of significant social impact and complexity.

Stage Two – Pre-trial Proceedings

When a case is accepted, the first-instance trial will formally begin. It proceeds in the following way.

- Establishment of collegial panel – generally, an administrative tax litigation applies an ordinary procedure, under which a collegial panel with an odd number of panellists (usually three) is established, consisting either entirely of judges or of a combination of judges and jurors. Nevertheless, upon consensus of parties, a simplified procedure can be applied, where a sole judge will try the case.

- Service of litigation documents to parties – the court will serve the defendant the statement of complaint, and serve the plaintiff the statement of response submitted by the defendant.
- Review of litigation documents and collection of evidence – if the court finds that the documents/evidence are insufficient, the court has the authority to notify the parties to supplement them, and the court has the authority to collect evidence from the administrative authority or other entity or individual, but the court shall not, for the purpose of proving the legitimacy of a specific administrative act, collect evidence which the defendant failed to collect at the time of the administrative act.
- Submission and exchange of evidence – the parties should submit evidence to court within a specified time limit or granted extension period. In complex cases, the court may initiate a pre-trial exchange of evidence.
- Closing statements of the parties – both parties summarise their claims and concluding opinions.
- Mediation procedure – in principle, mediation does not apply to tax litigations. However, for those cases concerning discretion of tax authorities (eg, administrative penalties, determination of deemed profit rate, etc), mediation can apply at the will of the parties.
- Collegial panel discussion – after adjournment of the hearing, the presiding judge will host the panel's internal discussion of the case, which is carried out secretly and follows the principle of majority rule.

Stage Four – Court Decision

In general, the court decision will be pronounced in public within six months of the date of a case's acceptance for a tax litigation applying the ordinary procedure, or 45 days for a litigation applying the simplified procedure.

Stage Three – Trial and Hearing

- Notice of commencement of trial – the court shall notify parties and other participants of the trial date three days in advance.
- Preparation of trial – the presiding judge checks identities of the parties and declares names of the panellists. If no party objects to the appearance of any other party or applies for recusal of any panellist, the substantive trial hearing begins.
- Court investigation – the plaintiff states its claims, facts and reasons; then the defendant states its responses. The parties, in order, present their own evidence, cross-examine the counterparty with regards to authenticity, legality and relevance of evidence, and cross-examine witnesses.
- Court debate – the presiding judge elicits the parties' arguments concerning the disputed issues, and the parties debate with each other with several rounds of rebuttal.

Where the court concludes that the tax authority's decision is inadequate in its essential evidence, erroneous in its application of laws and regulations, non-compliant in its legal procedures, ultra vires, constitutes a power abuse or is obviously unfair, the court will revoke or partially revoke the tax authority's action and rule that the tax authority must make a new tax decision. Otherwise, the court will reject the claims of the plaintiff.

4.3 Relevance of Evidence in Judicial Tax Litigation

Evidence and/or witnesses must be cross-examined during the court investigation session, at the trial and hearing stage.

The relevance of evidence depends on the individual facts of each case. Pursuant to the pertinent laws, the court shall scrutinise each piece of evidence with respect to authenticity, legality and relevance. The court shall then conduct

a comprehensive review of all evidence, and objectively and neutrally determine its degree of relevance to the case by following professional ethics (conscience) and using logical reasoning and life experience, excluding evidence that is not relevant, so as to determine accurately the facts of the case.

4.4 Burden of Proof in Judicial Tax Litigation

In principle, the defendant (ie, a tax authority) shall bear the burden of proof, and if it fails to provide evidence within the specified time limit, it will be deemed as having no evidence regarding the disputed tax decision. In individual cases, the plaintiff may also provide evidence proving the illegality of the tax decision, but the failure of the plaintiff to do so does not exempt the defendant's burden of proof.

In addition, administrative tax litigation strictly follows the rule that evidence obtained after making a tax decision cannot be used as evidence to justify the tax decision.

4.5 Strategic Options in Judicial Tax Litigation

Strategic options may include the following.

- Preparing litigation materials as early as possible – as time for a taxpayer's litigation against the tax authority for a tax collection decision is limited (15 days upon service of an appeal decision), the taxpayer should prepare solid evidence/arguments, if any, from the moment it decides to refuse a tax decision. For evidence that is difficult to obtain, the taxpayer can apply for extension of evidence submission, and such evidence can be presented during the court investigation session at the latest, upon the court's approval.
- Seeking the chance of settlement proactively – courts hear administrative cases on the legality of tax decisions made by a tax

authority, so courts will not assess on discretionary issues if the decision is in line with tax laws. Accordingly, in disputes relating to discretion (eg, deemed profit rate within a given range) or a reasonableness assessment (eg, transfer-pricing adjustment), the taxpayer should try its best to negotiate with the tax authority to reach a settlement or mediation mutually acceptable to the parties.

- Presenting expert opinions where necessary – an expert report is not a statutory type of evidence, but in practice, for cases concerning a special technical issue, the plaintiff can apply for submission of expert opinion to facilitate the court in better understanding a technical issue.

Overall, administrative tax litigation demands highly technical and rich experience in both tax and litigation, and taxpayers should seek assistance from professional tax lawyers.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Chinese courts adjudicate cases based on applicable rules derived from existing statutory rules. Pursuant to administrative litigation laws, the court's trial of an administrative litigation should be on the basis of laws (legislated by the National People's Congress or its Standing Committee), administrative regulations (legislated by the State Council) and local regulations (legislated by the Provincial People's Congresses or their Standing Committees).

Accordingly, when trying administrative tax cases, the courts will not rely on jurisprudence from international courts, doctrines or international guidelines; however, reference may be made to this jurisprudence where applicable under the framework of China's tax laws and regulations.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

China adopts a nationwide system of “four-tier courts and the second-instance judgment being the final judgment”. The four-tier court system includes the primary court at the county level, the intermediate court at the municipality level, the high court at the province level, and the Supreme People’s Court.

If either party to a case refuses to accept the first-instance judgment, then irrespective of the nature of the controversy or the value, it can file an appeal to the upper-level court for a second-instance trial. The appeal should be filed within 15 days of the date of service of the first-instance judgment (or 30 days for foreign parties).

A first-instance judgment which has not been appealed, or a second-instance appellate judgment, will effectively be a final judgment and should be executed. However, if either party believes the executed judgment is wrong (with respect to evidence, legal application, legal procedures, omission of claims, etc), it can initiate the procedure for trial supervision to the upper-level court within six months of the effective date.

5.2 Stages in the Tax Appeal Procedure

In second-instance trials, the court shall form a collegial panel of judges (usually three) to try the case through a court session, following the trial and hearing procedures as in a first-instance case. Nonetheless, if after review of the case file, investigation and questioning of the parties, the collegial panel finds that no new fact, evidence or reason is raised, it may decide not to hold a court session. The appellate court will generally make a judgment within three months.

In a trial supervisory procedure, a separate collegial panel should be established to hear a supervisory case. The supervisory case relating to a first-instance judgment follows the procedures of a first-instance trial, and the supervisory case relating to a second-instance judgment follows the procedures of a second-instance trial.

5.3 Judges and Decisions in Tax Appeals

At first instance, the ordinary procedure will generally be applied, under which a collegial panel with an odd number of panellists (usually three) should be established, consisting either entirely of judges or of a combination of judges and jurors. The presiding judge of a collegial panel is appointed by the president of the court or the chief judge of the administrative division within the court. When the president of the court or the chief judge of the administrative division participates in a trial, he or she shall be the presiding judge. The collegial panel will discuss the case internally and make a judgment following the principle of majority rule. Nevertheless, a simplified procedure can be applied upon consensus of the parties, in which a sole judge appointed by the president of the court will try the case and make a judgment.

At second instance, a collegial panel of judges (usually three) will be formed. The collegial panel of second instance cannot be a sole judge or a panel consisting of judges and jurors. The presiding judge of a collegial panel is appointed by the president of the appellate court or the chief judge of the administrative division within the appellate court.

Where the procedure for trial supervision is initiated, its establishment of judges follows the rule of first instance if it supervises a first-instance judgment, or second instance if it supervises a second-instance judgment.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

China has no alternative dispute resolution (ADR) mechanism available for resolving tax controversy cases. However, it is possible for a taxpayer and a tax bureau to resolve their tax disputes through settlement or mediation, which can be initiated during an administrative appeal or a judicial litigation.

6.2 Settlement of Tax Disputes by Means of ADR

Before the appeal authority makes a decision in an administrative appeal proceeding, the taxpayer and the respondent tax authority may reach a settlement, or the review authority may hold mediation based upon the mutual willingness of the parties, provided that the specific administrative act in dispute is a matter concerning the rationality, rather than the legitimacy, of the administrative act.

With respect to a judicial litigation regarding tax dispute claims, mediation is not allowed in principle, with certain exceptions. For example, a tax dispute case involving administrative compensation may be settled by mediation provided that both parties reach the agreement, and no national interest, public interest or other party's legitimate rights are adversely affected.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

In a settlement or mediation agreement, the parties may only agree to reduce the assessed tax amount if the tax assessment in dispute was made by the tax authority in invoking its discretionary rights; for instance, where the tax was assessed based on a profit rate deemed by the tax authority with certain discretion. Similarly, the

amount of an administrative fine may be reduced through settlement or mediation, as the extent of administrative fines is generally determined at the discretion of the tax authority.

Notably, however, no settlement or mediation can be reached to reduce the amount of interest surcharges, as the interest surcharges are automatically calculated based on the overdue days and the outstanding tax amount. The tax authority has no discretion in determining the amount of interest surcharges.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

China does not currently have a formal advance ruling mechanism in its tax laws. In the last two years, however, some local tax authorities, such as Shenzhen, Guangzhou, Shanghai, and Jiangsu province, have started exploring advance ruling practice for certain significant and complex transactions.

6.5 Further Particulars Concerning Tax ADR Mechanisms

This is not applicable in China, as China does not have an ADR mechanism with respect to tax controversies.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

This is not applicable in China. There are no ADR mechanisms for transfer-pricing cases or cases where taxes are determined by indirect methods.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

If a tax authority makes a tax assessment requesting payment of overdue tax (or late payment

interests or penalties), such a tax assessment does not in itself confer an administrative tax offence on the taxpayer, irrespective of whether it is based on a tax audit or special tax adjustment by applying general anti-avoidance rules (GAAR), specific anti-avoidance rules (SAAR), etc. This is because such an assessment is not final, given that the taxpayer is entitled to file an administrative appeal to the upper-level tax authority or to file administrative tax litigation to court, if the taxpayer believes the tax assessment is wrongful in its fact-finding, application of laws or due process, etc.

With respect to criminal tax offences, whether or not a tax crime has been committed should be exclusively determined by a court upon trial and hearing of a criminal litigation, which is initiated by a public prosecutor against a suspected taxpayer, rather than an assessment made by tax authorities, though the clues indicating tax crimes are generally provided by tax authorities.

7.2 Relationship between Administrative and Criminal Processes

There is no direct relationship between the administrative process and the criminal process.

The administrative process governs disputes between the taxpayer and the tax authority concerning whether or not taxes should be paid (or late payment interests or penalties) or whether the taxpayer has issued false invoices, etc, and follows the theory of judicial supervision of administrative power and protection of taxpayer rights.

The criminal process, meanwhile, deals with serious behaviour jeopardising tax collection and administration of the state, such as tax evasion, false issuance of invoices, or defrauding of export tax refunds, etc, which in principle are unlawful acts concerning large amounts of tax.

7.3 Initiation of Administrative Processes and Criminal Cases

The administrative process is initiated once a tax authority makes an additional tax assessment. If the taxpayer refuses to accept the assessment, it can file an administrative appeal to the upper-level tax authority, or then file administrative tax litigation to court.

A criminal tax offence under a criminal hearing and trial generally results from tax assessment. This is because tax crimes refer to serious illegal tax behaviour, while in practice it is the tax authority that has first access to illegal tax acts information during its assessment. Pursuant to the relevant laws, tax authorities are obliged to transfer suspected criminal tax offences to public security bureaux for investigation, if the tax authority takes the view that a suspected tax crime has been committed during/after its assessment. If the public security bureau then identifies a suspected tax crime after investigation, it should file the case to the public prosecutor for criminal proceedings.

7.4 Stages of Administrative Processes and Criminal Cases

As mentioned above, there is not currently a specialised tax court in China, and accordingly, administrative tax litigation is tried by following the general administrative case process, whereas criminal tax offences are tried by following the general criminal case process, and there is no direct relationship between the two.

For the stages of administrative tax litigation, please refer to **4.2 Procedure of Judicial Tax Litigation**.

The stages of criminal tax litigation mainly include:

- case filing by the public security bureau;
- investigation by the public security bureau;

- institution of public prosecution by the procuratorate (the Prosecutor General's Office);
- trial and hearing in court (a first-instance judgment is subject to a second-instance trial or further supervisory procedure, upon application of either the accused or the public prosecutor); and
- final binding judgment and execution.

Compared to administrative litigation, criminal litigation follows stricter requirements for procedural rights of the suspect and adopts a higher standard of proof (beyond reasonable doubt).

Each level of court under the four-tier court system contains a civil division, an administrative division and a criminal division, and the three divisions respectively hear civil cases, administrative cases or criminal cases. As such, administrative tax litigation and criminal tax litigation may be heard by separate divisions of the same court.

7.5 Possibility of Fine Reductions

Legally speaking, there is no statutory rule stating that upfront payment of an additional tax assessment can reduce corresponding fines. However, since the statutes usually stipulate fines in terms of a range and grant the tax authority discretion on the specific number of fines, the tax authority may, at its own discretion, apply a lower limit to the fine range if the taxpayer makes payment proactively.

7.6 Possibility of Agreements to Prevent Trial

The law does not allow entry into an agreement with a tax authority or the public prosecutor to prevent or stop a criminal tax trial.

Nevertheless, it should be noted that criminal law provides for exemption from criminal liabilities for tax evasion crime if certain requirements are met. Specifically, if the taxpayer who com-

mitted the tax evasion act has made up the taxes payable and late payment interests upon the request of the tax authority, and has been administratively punished, the taxpayer shall not be subject to criminal liability, except if the taxpayer has already been criminally punished for tax evasion within the preceding five years or has been administratively punished by tax authorities for tax evasion twice or more within the preceding five years.

7.7 Appeals against Criminal Tax Decisions

Any party (the accused or the public prosecutor) refusing to accept the first-instance judgment on a criminal tax offence can appeal to the upper-level court for a second-instance trial within ten days of service of the first-instance judgment. The accused's appeal can be made in writing or orally.

A supervisory procedure can be initiated for an effective judgment (ie, a first-instance judgment which has not been appealed, or a second-instance appellate judgment), upon application of either the accused or the public prosecutor, if they believe the executed judgment is wrong with respect to evidence, application of law, legal procedures, etc.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Tax authorities are empowered to make special tax adjustments on tax-avoidance transactions/operations, by applying GAAR or SAAR (eg, transfer pricing, thin capitalisation, controlled foreign corporations, etc). The tax authority will comprehensively assess the reasonable commercial purposes and economic substance of a transaction/operation, based on detailed analysis of the facts and particulars of each individual case.

Technically speaking, a taxpayer can appeal to the upper-level tax authority or file a lawsuit to court with respect to such a tax adjustment decision. In practice, however, there have only been a limited number of appeals or litigations in this regard. Two concerns may contribute to the situation: firstly, in common practice, a GAAR investigation or a transfer-pricing investigation will conduct substantial communication with taxpayers, and the decision may be internally reported to upper-level tax authorities for review or confirmation, given its complexity and the large amount of taxes concerned. After such an investigation process, the taxpayer will generally accept the tax-adjustment decision and the appellate tax authority would always sustain such a decision. Secondly, the tax adjustment on tax avoidance is more of a matter of reasonableness assessment than a legality issue, but the current administrative litigation allows a court to check the legality of a tax decision, unless it is obviously unfair. However, the court is not in a tax-professional position to determine the degree of unfairness of a special tax adjustment, such that the court will not easily overturn a special tax-adjustment decision.

Separately, tax avoidance cases, being different from tax evasion cases which involve intentionally evading taxes, generally do not give rise to criminal liabilities.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In cases where a double taxation situation occurs due to a tax assessment or tax adjustment in a cross-border situation, it is rare for the taxpayer to resort to domestic litigation. Double taxation generally originates from two tax jurisdictions' different treatments of a tax matter, but

the court will only check the legality of the Chinese tax authority's decision. Hence, if the decision fully complies with domestic tax laws, it will be sustained by the court. Any double taxation resulting from the tax decision is supposed to be managed through communication between competent authorities of the two jurisdictions.

Taxpayers may make use of a mutual agreement procedure (MAP), which is stipulated in double tax treaties entered into by China, and domestic tax laws also provide guidance on initiation of MAPs by the taxpayer or a competent tax authority in other jurisdictions. The MLI is not yet in effect in China.

On a separate note, China does not currently accept any international tax arbitration mechanism.

8.2 Application of GAAR/SAAR to Cross-Border Situations

GAAR or SAAR applies in cross-border situations covered by bilateral tax treaties. For example, the tax authority can perform transfer-pricing adjustment on transactions between a Chinese entity and its related party in a contracting state, and the tax authority can apply GAAR to deny entitlement of treaty benefits under a treaty-shopping arrangement, etc.

China has introduced the PPT test in some tax treaties, but it remains to be seen how it will be interpreted in practice.

8.3 Challenges to International Transfer Pricing Adjustments

Transfer-pricing adjustment cases are rarely presented to a domestic court. One of the important reasons for this is that a transfer-pricing adjustment focuses on the reasonableness of profit allocation between related parties, while the administrative litigation is currently restricted to legality censorship; hence, the chance of a tax-

payer obtaining court support against a transfer-pricing adjustment is not high.

Most tax treaties entered into by China contain a mutual agreement procedure (MAP) clause, which allows the tax authorities of the contracting states to settle cross-border tax disputes, including transfer pricing, by agreement. According to China's MAP statistics, 19 cases (including 15 transfer-pricing cases) were closed in 2019 and 15 cases (including five transfer-pricing cases) were closed in 2020. Most cases were agreed by bilateral tax authorities to eliminate completely or partially the impact of double taxation, and there were also cases withdrawn by the taxpayers or resolved via domestic remedy.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Since 2005, China has negotiated and entered into advance pricing agreements (APAs) with multinational enterprises. From 2005 to 2020, Chinese tax authorities signed a total of 116 unilateral APAs and 90 bilateral APAs. China has been steadily promoting APA negotiation work aiming at improving tax certainties, reducing tax administration costs, as well as avoidance of double taxation.

Enterprises whose related transaction volume exceeds CNY40 million per annum for the past three years are eligible to apply for APA negotiation with a tax authority. APA negotiation contains six main stages, as follows.

- Preparatory meetings in which the applicant briefly introduces elements of the proposed APA.
- A letter of intention in which the applicant submits its intention with a draft APA proposal.
- Analysis and assessment, in which the tax authority analyses the draft APA proposal and

assesses whether or not it conforms to the arm's-length principle.

- Formal application, at which point the applicant submits a formal APA proposal upon consent of the tax authority.
- Negotiation and signatures, when the tax authority reviews a formal APA proposal, and the parties reach a formal APA document for representatives of parties' signatures.
- Supervision of implementation, when the tax authority monitors the implementation of the APA on an annual basis within the applicable APA period. Upon expiry of this period, the APA will automatically be terminated, or can be renewed upon application of the enterprise in advance.

In 2021, China announced a simplified procedure for unilateral APA negotiation with qualified taxpayers, involving three stages: application and evaluation, negotiation and signing, and implementation and monitoring.

8.5 Litigation Relating to Cross-Border Situations

Overall, the number of litigations against tax decisions in cross-border situations is quite small, given the reasonableness assessment nature of such tax adjustment and the shackle of legality censorship under the current judicial regime. The WHT concerning indirect transfer of Chinese taxable equities and assets generates more litigation.

In 2015, there was an attention-attracting administrative litigation filed by a foreign entity against tax authorities' withholding of tax collection on an offshore share transfer, where the tax authority, by applying GAAR, deemed the transaction to be an indirect transfer of a Chinese entity without reasonable commercial purpose. The case went through first instance, second instance and the trial supervision procedure, and the courts determined that the plaintiff lacked sufficient

evidence to prove that the tax decision was illegal, and thus upheld the tax authority's GAAR adjustment.

To mitigate tax litigation, taxpayers should improve tax compliance in transactions/operations and duly keep relevant materials to substantiate a tax-compliance status; and the tax authority should strictly follow the laws and regulations in tax administration and conclude tax decisions accepted by taxpayers based on solid technical and sufficient evidence.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

This does not apply to this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

This does not apply to this jurisdiction.

9.3 Challenges by Taxpayers

This does not apply to this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

This does not apply to this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

This topic is not applicable to this jurisdiction since the MLI is not yet in effect in China. Currently there is only some academic discussion on the application of international tax arbitration.

10.2 Types of Matters that Can Be Submitted to Arbitration

This does not apply to this jurisdiction.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This does not apply to this jurisdiction.

10.4 Implementation of the EU Directive on Arbitration

This does not apply to this jurisdiction.

10.5 Existing Use of Recent International and EU Legal Instruments

This does not apply to this jurisdiction.

10.6 New Procedures for New Developments under Pillar One and Two

It is expected that the envisaged instruments to mitigate controversies and the tax certainty procedures will help prevent and resolve tax disputes. At the current stage, it is hard to foresee whether Pillars One and Two will take effect in China, but China has upheld the spirit of multilateralism and an open and co-operative attitude to actively participate in relevant work, and to promote the implementation of the "two-pillar" plan.

10.7 Publication of Decisions

This does not apply to this jurisdiction.

10.8 Most Common Legal Instruments to Settle Tax Disputes

A MAP under old DTTs is most commonly used to settle tax disputes, while the MLI is not yet in effect in China.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

This does not apply to this jurisdiction.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

No official charges are levied by the authorities in a tax administrative appeal proceeding.

11.2 Judicial Court Fees

The court charges a case acceptance fee at a fixed amount of RMB50 (USD8) for each instance of tax administrative litigation. The fee shall be prepaid by the taxpayer within seven days of receipt of the Notice for Litigation Fee Payment from the court before the beginning of the proceedings, and borne by the losing party at the end of the litigation, unless the winning party agrees to bear the fee voluntarily.

11.3 Indemnities

The applicant (eg, a taxpayer) may request an indemnity (ie, administrative compensation) in an administrative appeal claim. Where the applicant wins the administrative appeal case, the review authority will grant the taxpayer's compensation claim, where the taxpayer will be compensated in accordance with the standards prescribed under China's National Compensation Law.

Similarly, the taxpayer may claim for the indemnity (ie, administrative compensation) in a judicial litigation proceeding. If it is judged that the specific administrative act which caused damage to the taxpayer is illegal or invalid, the court may mediate on the compensation matter. If the mediation fails, the court may proceed to issue the judgment on the compensation matter; or, as an alternative, the court may inform the taxpayer to initiate a separate litigation on the compensation matter.

Where the taxpayer does not claim for an indemnity during the administrative review claim or judicial litigation proceeding, it may lodge a

separate litigation with respect to the compensation claim.

11.4 Costs of ADR

As mentioned in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**, there is no ADR mechanism in China, and there are no fees charged under a settlement or mediation process.

12. STATISTICS

12.1 Pending Tax Court Cases

Since China does not have a specialised tax court, litigation cases concerning tax disputes between taxpayers and tax authorities are uniformly heard by the administrative divisions of courts, who also hear administrative cases involving other government authorities. There is not currently a specific platform to disclose progress of pending tax cases.

12.2 Cases Relating to Different Taxes

According to statistics provided by the Supreme People's Court from 2018 to 2020, there were 641 first-instance administrative tax cases in 2018, 659 in 2019, and 688 in 2020. The annual average of tax cases was 662, accounting for 0.25% of the annual average of all administrative cases (265,483).

There is no official public data on types of taxes or value involved in these tax cases. Unofficial statistics on case information provided by a third-party database show that, of administrative tax cases in the past decade, VAT (including business tax) cases accounted for about 30%, individual income tax cases accounted for about 15%, enterprise income tax cases accounted for about 15%, and cases relating to other taxes (social security fee, stamp duty, deed tax, land VAT, real estate tax, etc) aggregately account for about 40%. Also, according to database statis-

tics, the average disputed value of tax cases is around RMB5 million, varying from RMB100 to RMB100 million.

12.3 Parties Succeeding in Litigation

Unofficial statistics on case information provided by a third-party database show that tax authorities succeed in almost 90% of administrative tax cases, while taxpayers succeed in around 10% of administrative tax cases. However, the number of taxpayers succeeding has been increasing in recent years, and this momentum is expected to continue, given the continuously improving tax judicial environment in China.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Key strategic guidelines to consider in a tax controversy are summarised as follows.

- To engage in effective communication with tax authorities – tax controversies often arise from taxpayers' and tax authorities' different viewpoints of the nature of a transaction/operation, or different interpretation of tax laws and regulations. In fact, such disagreement would be effectively mitigated or resolved by the elimination of information asymmetry. As such, taxpayers should engage in dialogue with tax authorities in a positive and constructive manner or even seek the possibility of mediation/reconciliation in order to achieve win-win settlements of disputes in a cost-efficient way.
- To devise tailor-made strategies for individual cases – tax controversies contain various types of tax issues and different cases demand different tactics. For those concerning tax in a complicated or uncommon transaction, the taxpayer should focus on a good explanation of the business facts, by means

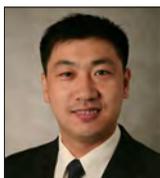
of providing legal and accounting documents or inviting tax authorities to field visit, etc. For those concerning different interpretations of laws and regulations, the taxpayer should place emphasis on the rationale and legal interpretation, common practice of a rule, legislative background and intention of a rule, etc. For those concerning tax authorities' discretion on reasonableness, the taxpayer may consider which form of reconciliation is in its best interest.

- To present evidence in a logical way to substantiate a tax position – to assist the tax authority in clearly understanding a disputed issue, the taxpayer should duly sort evidence in a way that is logically established, instead of a massive amount of redundant materials. For evidence closely related to a case but omitted in the inspection/audit phase, the taxpayer can make presentations to the upper-level tax authority to prove the legality and reasonability of the taxpayer's position.
- To make wise use of procedural rights – in addition to efforts on substantive aspects, taxpayers should also consider a wise use of procedural rights provided by the law. In a tax audit, the taxpayer may claim the right to a hearing during a tax penalty investigation; in a tax appeal, the taxpayer may consider how to provide a guaranty in an efficient way to mitigate cash flow concerns; in administrative tax litigation, the taxpayer may apply for suspension of execution of penalties, etc.

King & Wood Mallesons is known for the diversity and breadth of its experience in all aspects of Chinese and international taxes. To differentiate from international accounting firms or local tax firms, the team provides tax advice and dispute solutions in a combined context of tax, accounting and legal aspects, and is particularly well versed in representing clients in tax audit defence, transfer pricing negotiation support, tax appeal and litigation cases. The KWM

tax team currently has seven tax partners and more than 40 tax lawyers, located in its Beijing, Shanghai and Shenzhen offices in China; it also has tax teams in Australia, the US and Europe. Besides tax dispute resolution, their tax practice spectrum also covers tax advice for M&A transactions, tax risk management and business advice, etc, and has been well recognised as a market-leading tax practice in Mainland China.

AUTHORS



Tony Dong has more than 20 years of experience in advising clients on Chinese tax and legal matters, including tax planning, tax compliance and risk management, M&A and

business structuring, as well as tax controversy practice. He has successfully represented many MNC and domestic clients in tax audit defence, tax appeals, tax litigation, tax-related arbitration, etc. Tony has published a number of articles and publications on the taxation of cross-border transactions, transfer pricing and tax dispute issues. Tony was admitted to practise law in the PRC, and is a certified tax agent in China.



Duan Tao (Daisy) has over 17 years' experience in providing comprehensive tax services for domestic and international clients. In particular, Daisy has solid experience in assisting

clients in tax audit defence, transfer pricing investigation and tax appeal/litigation cases, and has successfully represented clients in accomplishing a number of highly challenging dispute cases. Daisy has published several articles on tax audit defence, transfer pricing, and so on. Daisy is a certified tax agent and is licensed to practise law in the PRC.

Contributed by: Tony Dong, Duan Tao (Daisy), Zhang Ci (Alice) and Wang Yan, King & Wood Mallesons



Zhang Ci (Alice) has more than 14 years' professional experience in providing tax and related legal services, rendering a one-stop "tax and legal and commercial" problem-solving

service to clients. Ms Zhang's practice focuses on tax planning and dispute resolution, where she has solid experience in representing clients in tax audit defence, administrative appeals, tax anti-avoidance and transfer pricing audits, as well as tax-related arbitration cases, and has achieved successful outcomes for clients, gaining their trust and admiration. Ms Zhang is a licensed PRC and US (New York State) lawyer.



Wang Yan is an associate with experience in advising clients on PRC tax and international tax issues, including tax compliance consultancy, tax planning for foreign investment in China and

outbound investments, transfer pricing analysis, and anti-avoidance disputes. She is licensed to practise law in the PRC.

King & Wood Mallesons

18th Floor, East Tower, World Financial Center
1 Dongsanhuan Zhonglu Chaoyang District,
Beijing 100020
P. R. China

Tel: +86 10 5878 5588
Fax: +86 10 5878 5599
Email: tony.dong@cn.kwm.com
Web: www.kwm.com

金杜律师事务所
KING & WOOD
MALLESONS

Trends and Developments

Contributed by:

Juan Camilo de Bedout

Posse Herrera Ruiz see p.128



Trends and Developments of Tax Controversies in Colombia

In a schematic, clear and practical way, this document presents the main trends and the most relevant current developments of tax controversies in Colombia.

Tax controversies in Colombia have evolved and shown an exponential development in two main ways: first, the introduction of virtuality in the administration of justice for all actions that are carried out by the parties, judges, courts, and tribunals, as well as by third parties involved in the controversies.

Second, an element that has impacted tax controversies, and that undoubtedly is and will be a constant integrating aspect of the development of future disputes, is the application of the decisions of jurisprudential unification issued by the Council of State. Such decisions constitute a valid jurisprudential precedent, in which general rules and sub-rules of law are incorporated and therefore can be demanded by taxpayers in similar situations either within an administrative or a judicial process, and likewise, in some instances they may serve as a support basis to be used by the Tax Authority through expedited mechanisms, guaranteeing an agile and equal application of tax justice in similar cases.

Regarding trends in tax controversies, considering the matter in dispute, there are four focal points in the audit and control processes undertaken by the Tax Authority, which tend to increase the litigious acts against the legal posi-

tions considered by taxpayers when fulfilling substantial and formal tax obligations.

The first relates to the economic and commercial substantiality of the transactions carried out by taxpayers, providing that their conclusion and execution produce tax effects.

This trend has been monitored under a thorough investigation and audit conducted by the Tax Authorities, focusing on the business purpose derived from the actions developed by taxpayers, emphasising substantiality over formality, and therefore, contesting transactions that present a correct and formal appearance but lack business purposes.

The second relevant aspect in terms of trends in tax controversies is closely linked to the first, in regard to the growth in the demand for solid and complete defence files by taxpayers in relation to all the elements that are subtracted or detracted to determine the applicable tax, such as: liabilities, costs, expenses, discounts, discountable taxes, withholdings and tax benefits.

Thus, in addition to the substantiality of the transactions, the origin of the private tax determination will only proceed upon the existence of comprehensive evidentiary defence files, in which both the fulfilment of formal and substantial requirements, within the framework of evidentiary tax law, is incorporated.

The third integral element is related to the thorough, substantial and detailed audit of transfer pricing documentation.

In this regard, the Tax Authority has evolved from its previous position in which the investigations were focused on the application and appropriateness of comparability adjustments in transactions subject to the transfer pricing regime, to the current investigations, which are based on elements of the substance of the analysis of transactions between related parties, such as: the correct selection of the transfer pricing method; the economic indicators applied; the selection of comparable third parties; the acceptance and rejection of documentation; the functional analysis related to assets, functions and risks; the periodicity of the information used for the analysis; and the fulfilment of formal obligations.

Lastly, the fourth aspect related to the trends in current tax controversies, which although may seem contradictory to the above, is limited to a robust audit on the formal compliance with the obligation to submit tax information.

Under the existing tax obligations in Colombia, there is an obligation to submit information, which can originate both by regulatory requirement and by a direct and timely request from the Tax Authority.

This being the case, the failure to submit information, errors in the data transmitted, and late submission constitute a punishable fact.

This particular trend in tax controversies has been centralised in the punishable fact regarding the sending of information with errors from a formal and non-substantial point of view, such as, for example, matters related to the tax identification number of the parties of an operation, or whether those involved in an operation as

Colombian or non-residents, aspects that, being merely formal, have led to an increase in the penalties to be discussed before the Tax Authority.

Thus, both the trends and the developments in tax controversies in Colombia can be divided into two main areas: (i) the development of tax litigation and the jurisprudential basis related to tax controversies, and (ii) the principal matters of tax controversies.

Looking in detail at the integral aspects of these two main areas, we find the following.

The development of tax litigation and the jurisprudential basis in the context of tax controversies

As a result of the COVID-19 pandemic, justice in general, and especially that related to tax matters, swiftly moved towards a transition in the management of controversies starting with a justice system based on written actions and “in person” hearings to virtual formats.

Also, in recent years the number of unification judgments issued by the Council of State has increased significantly, in which multiple rules and sub-rules of law of general application have been defined, which integrate the tax system and allow taxpayers to focus and rely on them in cases in which a similar matter is disputed.

The impact that the virtual process on tax justice, like the judgments of jurisprudential unification, has generated in the development of tax controversies, is critical, so it must be addressed independently, given that a new system was established to access and interact within the context of the administration of justice, while on the other hand, a binding force was granted to the jurisprudential precedent against analogous or assimilable cases.

Given the different and independent relevance of these aspects, it is important to consider the impact of both developments related to tax controversies.

Tax controversies as a result of virtual procedures

Although the administrative procedural regulations, in which tax controversies are aired, had already ruled on various elements for the digitalisation of files of matters in dispute, aiming to implement the virtuality in controversies, however with the situation derived from the COVID-19 pandemic, these processes were advanced to the point where, since June 2020, virtual processes were used for all the actions of the parties, third parties and judicial bodies in the context of an administrative tax dispute.

Thus, the submission of lawsuits related to tax matters, the response to those by the Tax Authority, the intervention of third parties with a legitimate interest in the process, and the orders and judgments are presented and incorporated into the process by digital means.

In the same way, all the hearings are held virtually, and their content is incorporated into the file for the process through the virtual tools accessed by the electronic links where the proceedings and the supporting documentation are saved.

This new implementation of virtual processes and communication technologies for tax controversies has been a significant advance, especially in relation to the timelines and agility of judicial decisions.

However, these favourable advances have generated in some cases, divergent positions regarding a legal aspect, which must be utterly evident in the context of a judicial discussion, the understanding of deadline dates and procedural opportunities.

In this regard, some provisions have indicated that the terms and dates must be considered from the day following the sending of the decision by emails, and others have suggested that the terms granted must be calculated from the day following the proof of receipt of the decision sent by email; the latter position was considered as the most accurate and guarantor of the rights of defence of the parties by the Constitutional Court.

As previously mentioned, virtual technology an excellent advance in tax controversies, however the understanding of the date on which the terms start, in this new way of litigation, must be unified in order to ensure legal certainty and due process; in the meantime, the most conservative position must be applied to avoid discussions regarding the timeframes of the proceedings.

In conclusion, the rise of tax controversies as a result of virtual processes is a significant and highly favourable advance for the interested parties, however, being a novel procedure, special care must be taken in all the hitherto grey areas of legislation under development.

The Jurisprudential Basis in the Context of Tax Controversies

Although an essential sector of the doctrine and of the tax litigants in Colombia focused on the mandatory nature of the jurisprudential precedents, with the introduction of the judgments of jurisprudential unification in administrative controversies multiple legal provisions were incorporated that support and sustain the binding nature of these decisions against subsequent analogous cases.

Judgments of jurisprudential unification are those issued by the Council of State, as the highest authority of administrative justice in Colombia, for reasons of legal importance or economic or social significance, or with the pur-

pose of establishing or unifying jurisprudence, or specifying its scope.

In matters related to tax controversies, most judgments of jurisprudential unification have been delivered in which jurisprudence is established or unified.

Establishing jurisprudence refers to the determination of a position on the application of a legal provision that had not previously been carried out, while unifying jurisprudence corresponds to the definition of a determination on the existence of various previous jurisprudential positions.

Thus, unification judgments create rules or sub-rules of law applicable to subsequent cases in which the same assumptions of fact and law defined in said decisions are discussed.

In this sense, the rules and sub-rules incorporated and defined in these judgments represent a legal basis enforceable by taxpayers, both in the context of a discussion directly with the Tax Authority, and before the administrative judges.

Additionally, given the importance and enforceability of this type of judgment, in the administrative procedural regulations applicable to tax law, an expedited mechanism was defined to demand the fulfilment of these decisions directly from the Administrative Authority; this is known as the mechanism of extension of jurisprudence.

This mechanism of extension of jurisprudence requires that taxpayers be in the same factual and legal conditions as those determined in the unification judgment; this ruling recognises a right, and that the opportunity to file a lawsuit against the administrative acts on which the application of the unification judgment is requested has not expired.

The prominent cases that have been the subject of a unification judgment in national tax controversies are the following:

- requirements for the deductibility of expenses in income tax;
- rates of compensation for tax losses in merger processes by absorption;
- penalties for failing to comply with the obligation to send information;
- due process in the imposition of penalties;
- assessment of the penalties for improper tax refunds or compensation;
- intervention of joint and several debtors in a tax dispute; and
- statute of limitations of the income tax returns for taxpayers obliged to apply the transfer pricing regime.

In this vein, jurisprudential unification judgments are an essential development of tax controversies, as they are an ideal mechanism to support a tax treatment or position, require the application of a rule or sub-rule of law and anticipate the results in a discussion that has been the subject to such a judgment.

In conclusion, the performance of tax litigation in Colombia will have to be carried out in compliance with jurisprudence in general, and especially in relation to judgments of jurisprudential unification.

Hence, it is important to note the critical development that tax controversies have had in Colombia, both in terms of their set up, mechanisms and procedures to access justice, as well as in relation to the jurisprudential support in the context of a tax discussion directly with the tax authority or before the administrative judges.

The Main Matters of Tax Controversies

Although taxpayers in Colombia can initiate a tax dispute, through a refund request or an official

request, the Tax Authority usually undertakes controversies as part of investigation, audit and monitoring exercise within the statute of limitations.

In the exercise of this fundamental assignment of the Tax Authority, this entity determines research programmes or trends by which controversies with taxpayers will develop, without prejudice to deploying every type of investigation that it considers applicable.

As previously mentioned, the leading audit trends are divided into four aspects:

- the substantiality of the transactions carried out by taxpayers;
- the strength of the defence files;
- the determination of transfer pricing; and
- the penalties derived from formal errors in the information submitted.

The main elements to highlight these four trends towards which tax controversies are currently directed are as follows.

The substantiality of the transactions carried out by taxpayers

The current investigation, audit and tax control programmes focus on a comprehensive analysis of the transactions carried out by taxpayers. As part of these programmes, the appearance of an operation is no longer the element that will generate the tax effects. In addition, the definite purpose of a transaction that caused a tax impact must be demonstrated.

Before the current trend, the origin of the deductibility of expenses generated in a transaction, for example, was supported by the signing of a contract, by the invoices issued relating to the transaction and by the accounting records.

The substantiality to which the tax system evolved, and the controversies derived therefrom, created a trend requiring support or motivation to incur in the returns. The substance of a transaction cannot rely on a mere tax effect, but the taxpayer should consider an economic or business intent.

In the proposed example, it would be necessary to evaluate the necessity and impact of the conclusion of the contract and the result derived from the execution of the agreement, among others.

This audit trend should not be confused with a limitation on taxpayers' transactions. This trend aims to determine the tax impact of transactions and not the conclusion or execution of agreements.

Thus, the tax effects of a transaction must be triggered under a substantial approximation, as part of a necessity and causality for the business development of the producing activity of a taxpayer. Therefore, tax effects derived from a transaction only supported from a formal position are not considered appropriate.

The strength of defence files

In line with the enforceable substantiality of the transactions carried out by taxpayers, evidentiary material that supports the determination has undergone a sophistication process. As a result, the origin of a tax determination is tied, restricted, and conditioned to the operation's integral evidentiary support, not simply to the formal aspects.

This tendency of control is based on the principle of evidentiary law. The party who is interested in demonstrating the legal effect derived from a fact is obliged to demonstrate the fact.

In this sense, as the taxpayer is the main interested party in demonstrating that the tax return is correct, the probative responsibility of all the elements that establish the proper tax determination are upon the taxpayer.

Therefore, considering a defence file based on merely formal aspects, without proving the completeness of the facts, the Tax Authority will proceed with a controversy against the taxpayer. In the end, the taxpayer will be the one who bears the burden of proof, and if they do not comply, they will surely not obtain a favourable result in the decision on the controversy.

The determination of transfer pricing

Tax controversies regarding the application of transfer pricing regime have been a trend in Colombia since the introduction of this regime at the beginning of the new millennium. However, the current trend is not about the general object of the dispute but about the specific elements discussed.

The Tax Authority has improved the sophistication of its approach to the regime by questioning the integrality of the support of these transactions.

The paradigm shift in transfer pricing controversies has been evident. Previously, the main element under discussion was the application of comparability adjustments by taxpayers. Although it is still a subject of dispute, the Tax Authority now studies, discusses and contests all aspects related to the regime.

The primary trend in these controversies focuses on the use of transfer pricing methods, which have been developed by the Tax Authority, by repeatedly questioning the use of traditional operational methods in preference to results methods.

Likewise, the Tax Authority has been restricting the choice of comparable companies, the acceptance and rejection studies determined by taxpayers, and the functional analyses carried out.

Despite the depth of current transfer pricing controversies, discussions related to the fulfilment of the formal duties of the transfer pricing regime remain a critical control programme developed by the Tax Authority.

In this sense, controversies related to the transfer pricing regime have been affected by a focused trend, as have the two previous points on substantiality and burden of proof attributed to taxpayers.

Penalties resulting from formal errors in the information submitted

Despite the substantial trends in tax controversies, the Tax Authority has been simultaneously developing discussions based on simply formal aspects.

As previously explained, the Colombian tax penalty regime penalises non-compliance with all substantial and formal tax obligations.

Regarding non-compliance with formal obligations, an audit trend has developed. As a result, the Tax Authority has imposed penalties on taxpayers who send information with errors even though these are merely formal.

The formal errors, repeatedly penalised by the Tax Authority, relate to taxpayers that included incorrect tax identification numbers, the absence of a tax identification number of a third party located abroad, or the type of taxpayer, ie, if it is national or foreign.

This trend in controversies related to penalties is formalistic and far from the substantiality previously developed. Nevertheless, it has meant that, in the application of the constitutional principle of the priority of substance over form, legal provisions that regulated this penalty have been controverted, provided that the Tax Authority only imposes penalties upon the occurrence of an error that did not cause any damage.

In conclusion, although the audit trends are evolving based on the regulatory modifications and the transactions carried out by the taxpayers – and, in general, with the execution of different legal businesses – nowadays, economic substance and evidentiary material, without neglecting formal obligations, remain.

Contributed by: Juan Camilo de Bedout, Posse Herrera Ruiz

Posse Herrera Ruiz is a Colombian law firm that uses a multidisciplinary, systematic approach to finding creative, prudent and value-generating business solutions. The firm has extensive experience of advising national and international transactions in the most relevant and complex transactions in Colombia in recent years. Posse Herrera Ruiz provides legal coun-

sel tailored to each client and its needs, whether a single practice area or a combination of practice areas are needed. The firm's team of highly competent, experienced and multidisciplinary professionals continually strives to achieve the best results for its clients, providing a full service which optimises the clients' return on investment, while minimising risks.

AUTHOR



Juan Camilo de Bedout is a partner at Posse Herrera Ruiz, where he leads the area of tax, customs and transfer pricing litigation and controversy. His professional practice focuses on

tax planning, taxes, transfer pricing, controversy, and tax and customs litigation. Juan Camilo has extensive experience in matters related to administrative and judicial

discussions with national and territorial tax authorities, and in advising on international issues. He is the director of the Tax Jurisprudence Observatory of the Colombian Institute of Tax Law (ICDT), and is regularly invited as a lecturer to different national and international academic settings. As well as co-authoring books on tax procedure, he has acted as an advisor to the Ministry of Justice on Colombia's Ten-Year Justice Plan.

Posse Herrera Ruiz

Carrera 7 No 71- 52
Torre A, Piso 5
Bogotá
Colombia

Tel: +571 325 7300
Fax: +571 325 7313
Email: phr@phrlegal.com
Web: www.phrlegal.com

**POSSE
HERRERA
RUIZ** 

Law and Practice

Contributed by:

Fabio Salas and Priscilla Zamora

Deloitte Tax & Legal Costa Rica see p.144



CONTENTS

1. Tax Controversies	p.131	5.3 Judges and Decisions in Tax Appeals	p.138
1.1 Tax Controversies in this Jurisdiction	p.131	6. Alternative Dispute Resolution (ADR) Mechanisms	p.138
1.2 Causes of Tax Controversies	p.131	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.138
1.3 Avoidance of Tax Controversies	p.131	6.2 Settlement of Tax Disputes by Means of ADR	p.138
1.4 Efforts to Combat Tax Avoidance	p.132	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.138
1.5 Additional Tax Assessments	p.132	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.138
2. Tax Audits	p.133	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.138
2.1 Main Rules Determining Tax Audits	p.133	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.138
2.2 Initiation and Duration of a Tax Audit	p.133	7. Administrative and Criminal Tax Offences	p.138
2.3 Location and Procedure of Tax Audits	p.133	7.1 Interaction of Tax Assessments with Tax Infringements	p.138
2.4 Areas of Special Attention in Tax Audits	p.134	7.2 Relationship between Administrative and Criminal Processes	p.139
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.134	7.3 Initiation of Administrative Processes and Criminal Cases	p.139
2.6 Strategic Points for Consideration during Tax Audits	p.134	7.4 Stages of Administrative Processes and Criminal Cases	p.139
3. Administrative Litigation	p.135	7.5 Possibility of Fine Reductions	p.140
3.1 Administrative Claim Phase	p.135	7.6 Possibility of Agreements to Prevent Trial	p.140
3.2 Deadline for Administrative Claims	p.135	7.7 Appeals against Criminal Tax Decisions	p.140
4. Judicial Litigation: First Instance	p.135	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.140
4.1 Initiation of Judicial Tax Litigation	p.135	8. Cross-Border Tax Disputes	p.141
4.2 Procedure of Judicial Tax Litigation	p.136	8.1 Mechanisms to Deal with Double Taxation	p.141
4.3 Relevance of Evidence in Judicial Tax Litigation	p.136	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.141
4.4 Burden of Proof in Judicial Tax Litigation	p.137		
4.5 Strategic Options in Judicial Tax Litigation	p.137		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.137		
5. Judicial Litigation: Appeals	p.137		
5.1 System for Appealing Judicial Tax Litigation	p.137		
5.2 Stages in the Tax Appeal Procedure	p.138		

8.3	Challenges to International Transfer Pricing Adjustments	p.141	10.5	Existing Use of Recent International and EU Legal Instruments	p.142
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.141	10.6	New Procedures for New Developments under Pillar One and Two	p.142
8.5	Litigation Relating to Cross-Border Situations	p.141	10.7	Publication of Decisions	p.142
9	State Aid Disputes	p.141	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.142
9.1	State Aid Disputes Involving Taxes	p.141	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.142
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.141	11	Costs/Fees	p.143
9.3	Challenges by Taxpayers	p.141	11.1	Costs/Fees Relating to Administrative Litigation	p.143
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.141	11.2	Judicial Court Fees	p.143
10	International Tax Arbitration Options and Procedures	p.142	11.3	Indemnities	p.143
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.142	11.4	Costs of ADR	p.143
10.2	Types of Matters that Can Be Submitted to Arbitration	p.142	12	Statistics	p.143
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.142	12.1	Pending Tax Court Cases	p.143
10.4	Implementation of the EU Directive on Arbitration	p.142	12.2	Cases Relating to Different Taxes	p.143
			12.3	Parties Succeeding in Litigation	p.143
			13	Strategies	p.143
			13.1	Strategic Guidelines in Tax Controversies	p.143

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In Costa Rica, tax self-assessment is the most common mechanism for taxpayers to comply with the main taxes, which are income tax and value-added tax.

Consequently, the Tax Administration is always carrying out tax control programmes to verify if taxpayers have fully complied with their tax duties and if they have correctly followed the applicable tax provisions when self-assessing the corresponding tax.

Although some of these tax control programmes focus on formal duties (ie, being registered as a taxpayer with the Tax Administration or filing tax returns on a timely manner), tax controversies usually arise following a tax audit or assessment. A tax audit can be focused on a specific point or entail a broad analysis of the taxpayer's substantive tax duties.

In some cases, especially when it identifies inconsistent information, the Tax Administration may request an explanation from the taxpayer. If the taxpayer provides a satisfactory explanation or corrects its errors, the matter will be closed. Otherwise, the Tax Administration will likely open a tax audit.

The Tax Administration may also open a tax audit after a taxpayer files a self-reassessment return that decreases the tax paid or requires a tax refund derived from unreliable transactions.

1.2 Causes of Tax Controversies

Most tax controversies in Costa Rica refer to corporate income tax and individual income tax (ie, *impuesto sobre las utilidades*) matters. These tax audits generally focus on verifying if the deductible expenses incurred by the taxpayers are effectively required and related to its taxable

economic activity, as well as on exempt income or income not subject to taxation in Costa Rica due to the application of the territoriality principle.

The number of tax audits regarding the former general sales tax (ie, *impuesto general sobre las ventas*) decreased in the last decade. However, this situation may change in the near future since the Tax Administration may want to assess taxpayers' compliance with the recently implemented value-added tax (ie, *impuesto sobre el valor agregado*), which entered into force on 1 July 2019.

Other tax controversies arise when the Tax Administration verifies certain taxpayers' compliance with their obligation to withhold taxes on passive income and salaries and pensions. A similar situation happens with the non-resident income tax (ie, *impuesto sobre remesas al exterior*), which must be withheld by the taxpayer who pays the agreed amount to the non-resident person or entity.

1.3 Avoidance of Tax Controversies

Taxpayers can mitigate the risk of tax controversy by being fully compliant with their formal and substantive tax duties. Taxpayers should also confirm that the operations included in the respective tax return are in line with the Tax Administration's positions and interpretations of the law, which are available for online public consultation.

If the situation has not been addressed before, or if more certainty is required before self-assessing the corresponding tax, taxpayers can request a private letter ruling to obtain the Tax Administration's position regarding a particular transaction. The criteria delivered in such ruling is binding for the Tax Administration, but not for the taxpayer.

In addition, taxpayers should pay close attention to their invoices and confirm that these are consistent with the information in the hands of the Tax Administration through the mandatory use of electronic invoicing, as well as with the information provided by third parties.

Once the Tax Administration has communicated the start of a tax audit, taxpayers should carefully review information requirements and ensure that all the explanations are consistent with the documents that support each transaction or decision. Not providing the required information in a timely manner may result in an additional tax assessment and will be subject to a pecuniary penalty.

1.4 Efforts to Combat Tax Avoidance

The Costa Rican Tax Administration mainly relies on the economic reality principle to tackle tax avoidance. The Tax Administration has extensively used this principle – included in Article 8 of the General Tax Code – to support several of its tax audit findings and assessments. In practice, the so-called economic reality principle acts as a general anti-abuse rule (GAAR) that allows the Tax Administration to determine the reality behind a transaction and its tax implications.

In December 2018, Costa Rica significantly reformed its Income Tax Law. For individual and corporate income tax purposes, the new legislation incorporated some specific anti-abuse rules following BEPS recommendations, including provisions to deny or limit deductions in the case of anti-hybrid mismatch arrangements and an interest expense.

These new BEPS-inspired rules were first applicable to FY20, which ended on 31 December 2020. Therefore, their impact on tax controversies is yet to be determined, although an increase is foreseeable while both the Tax Administration and taxpayers come to understand the scope

and effect of the new provisions on the corresponding income tax duty.

In April 2022, the Tax Administration issued general guidelines for the application of double tax treaties (MH-DGT-PRO05-GUI-002). In this guidance, the Tax Administration recognises that each taxpayer is responsible for analysing its particular situation and deciding whether the corresponding treaty is applicable; while also stating that the Tax Administration may consider such instrument not to be applicable when there is double non-taxation, or an abusive application of the treaty benefits.

1.5 Additional Tax Assessments

The Tax Administration's decision regarding an additional tax assessment is communicated through a Notice of Deficiency (ie, *Resolución Determinativa*), which the taxpayer can appeal firstly before the same office and then before the Administrative Tax Court. The taxpayer is not supposed to pay the additional tax assessment to challenge the Notice of Deficiency.

If the taxpayer decides not to contest the Tax Administration's position or if the Administrative Tax Court confirms the additional tax assessment, they have 30 days to pay voluntarily the tax due with interest.

If there is no voluntary payment, the Tax Administration will send a tax bill granting the taxpayer 15 business days to pay the tax owed, plus interest and a late payment fine. During this term, the taxpayer can pay the full amount or request an authorisation from the tax authorities to pay the amount owed in a maximum of 24 instalments. In Costa Rica, it is not possible for taxpayers to render a guarantee or request an extension.

Once the 15-day term is due, the Tax Administration can execute further collection actions, including account and asset seizure measures.

These actions will not be suspended unless the Administrative Court (ie, *Tribunal Contencioso Administrativo*) grants interim measures in favour of the taxpayer.

Payment of the additional tax assessment is not required for the taxpayer to file a lawsuit against the State to continue discussing the matter, but lodging a claim does not suspend the Tax Administration's collection actions.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The main rules that may determine a tax audit are outlined in a decree (ie, *Reglamento sobre Criterios Objetivos de Selección de Contribuyentes para Fiscalización*) issued by the Tax Administration to establish the objective criteria that must be followed when selecting tax audit cases.

Pursuant to this decree, the following aspects are relevant to determine which taxpayers will be subject to a tax assessment:

- being classified as a large taxpayer;
- existence of inconsistent information;
- having a tax benefit or exemption;
- non-compliance with substantive tax duties;
- filing a self-reassessment return that decreases the tax liability;
- having related-party transactions or being related to an entity or person undergoing a tax audit; and
- belonging to any of the following economic sectors: agriculture, manufacturing, energy, construction, wholesale and retail, transportation, accommodation and food services, financial services, real estate, independent personal services, education, and human health.

2.2 Initiation and Duration of a Tax Audit

In Costa Rica, the Tax Administration can initiate a tax audit within the statute of limitations period. Pursuant to Article 51 of the General Tax Code, the Tax Administration has four years to assess the corresponding tax obligation and determine if the taxpayers' self-assessment is in accordance with the applicable tax provisions.

The Tax Administration's notice concerning the start of a tax audit interrupts the statute of limitations period. Therefore, once the Tax Administration communicates with the taxpayer about the opening of a tax audit, it will have four years to analyse the relevant information, communicate the tax audit findings and issue the Notice of Deficiency.

Although there are no statutory time limits regarding a tax audit's duration, on average, it can be expected to last approximately 24 months from its start and until the Tax Administration issues the Notice of Deficiency. In most cases, the Tax Administration delivers the tax audit findings within six to 12 months after the audit started. In the event the taxpayer does not agree with the proposed additional tax assessment, the Tax Administration will issue the Notice of Deficiency in the following six to 12 months.

2.3 Location and Procedure of Tax Audits

Tax audits generally take place in the tax authority's headquarters. During the initial phase of such procedure, the tax auditor will request information from the taxpayer and from third parties, if considered necessary. The auditor then reviews and analyses this information in the Tax Administration's offices, except for specific matters that require the tax auditor to visit the taxpayer's offices or business premises. If such a visit is required, the tax auditor will inform the taxpayer in advance.

Depending on the case, tax audits can be based both on printed documents and on digital records made available by the taxpayer. However, in the past few years, digital data stored in electronic format has become more relevant for purposes of assessing the taxpayers' compliance with the applicable tax provisions.

Further, since November 2018, electronic invoicing became mandatory in Costa Rica. Consequently, a higher reliance on digital data is expected in future tax audits.

2.4 Areas of Special Attention in Tax Audits

The areas of special attention in tax audits vary depending on the tax that is being audited by the Tax Administration.

Regarding income tax audits, regardless of whether the taxpayer is a corporate entity or an individual, tax auditors tend to focus on deductible expenses, as well as on income that is exempt or not subject to taxation in Costa Rica. In some other cases, the Tax Administration concentrates on intercompany transactions, which may lead to transfer pricing or similar adjustments.

Regarding the former general sales tax (GST), the tax authorities used to focus on verifying if the input tax reclaimed by the taxpayer in its tax returns was effectively related to those transactions subject to GST. The Tax Administration also paid attention to discounts and similar operations that could decrease the tax base of the GST.

Taxpayers should pay special attention to:

- invoices and any similar documents required for proving the veracity of deductible expenses, which must be issued in accordance with the applicable regulations;

- information in the hands of the Tax Administration, which should be consistent with tax self-assessments and with data periodically provided by third parties; and
- contracts and transfer pricing studies performed when there are related-party transactions.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

While Costa Rica has reformed and included multiple provisions in its General Tax Code to ensure its compliance with the international tax transparency standards, the adoption of rules concerning cross-border exchange of information and mutual assistance between tax authorities has not yet had a significant impact on tax audits.

In some very particular cases, the Tax Administration has considered that foreseeably relevant information from other jurisdictions is required for tax audit purposes. In these cases, the Tax Administration is allowed to request information from another jurisdiction with which it has a Tax Information Exchange Agreement or that is a signatory of the Convention on Mutual Administrative Assistance in Tax Matters.

2.6 Strategic Points for Consideration during Tax Audits

From a strategic point of view, the most important aspect during a tax audit is to provide the tax auditor with clear and concise answers that are consistent with the information and documentation that is being requested and provided throughout the procedure.

Another key point is that taxpayers should ensure that the information in their records and the data provided to the tax authorities is consistent with their accounting and fiscal records, as well as

with the information provided to other public entities, as would be the case, for instance, of the Social Security Administration.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

When the Tax Administration gives notice of the additional tax assessment (ie, Notice of Deficiency), the taxpayer can directly file a lawsuit before the Administrative Court (ie, *Tribunal Contencioso Administrativo*) or follow the administrative claim phase. The optional administrative claim phase comprises two appeals:

- an administrative appeal before the same office that issued the Notice of Deficiency; and
- an appeal before the Administrative Tax Court (ie, *Tribunal Fiscal Administrativo*).

Taxpayers can also skip the administrative appeal to go directly before the Administrative Tax Court.

If the taxpayer chooses to follow the full administrative claim phase, it will have 30 business days to file the administrative appeal against the Notice of Deficiency. The Tax Administration will take between six and 24 months to issue a decision regarding such appeal.

If the Tax Administration's decision is to maintain the additional tax assessment, the taxpayer has 30 business days to file the appeal before the Administrative Tax Court. Once the Tax Administration admits this appeal, it will grant another 30 business days for the taxpayer to restate its arguments and present further evidence. The Administrative Tax Court will take between six and 36 months to issue a final decision regarding this appeal.

There is no further administrative claim that can be filed by the taxpayer against this decision, but the dispute may still be taken to a judicial court.

3.2 Deadline for Administrative Claims

In Costa Rica, there are no explicit deadlines for the tax authorities to decide an administrative claim lodged by the taxpayer. Hence, the period for obtaining a decision from the Tax Administration may vary significantly from one case to another.

Although the General Tax Code establishes some terms for the tax authorities to decide administrative claims, these have been understood as referred to the calculation of interest. Therefore, during the first 30 business days after the administrative appeal is filed, interest will be computed, while no interest will be added afterwards, regardless of how much time the Tax Administration takes to communicate its decision. Similarly, when the taxpayer files an appeal before the Administrative Tax Court, interest will be computed during the first six months after the claim was lodged, but not afterwards.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

In Costa Rica, judicial tax litigation is initiated by filing a lawsuit against the State before the Administrative Court (ie, *Tribunal Contencioso Administrativo*), which is the one in charge of deciding cases involving tax matters since there are no judicial tax courts in Costa Rica.

The lawsuit is the formal document in which the plaintiff sets out its case theory. This claim must contain all the facts and circumstances of the tax audit followed by the Tax Administration, as well as the plaintiff's reasoning and analysis of the applicable legislation and regulations. Further-

more, this is the main opportunity for the plaintiff to provide all the evidence that supports its position. The lawsuit must contain a clear petition, which unmistakably outlines the plaintiff's expectations.

In general, the plaintiff will be the taxpayer who was audited by the Tax Administration. However, in cases where the Administrative Tax Court agrees with the taxpayer, the tax authorities may consider that this decision is against public interest and request the State to file a lawsuit against the taxpayer.

4.2 Procedure of Judicial Tax Litigation

Initial Phase

Once the lawsuit has been filed, the court will admit it and provide the State 30 business days to file a response and a certified copy of the administrative file regarding the tax controversy held with the Tax Administration.

After the State files its response and the certified copy of the administrative file, the judge in charge of the case will provide the plaintiff three business days to present a brief replying to the State's response and provide any additional evidence.

At the same time, the court will schedule a preliminary hearing.

Oral Phase

After all of these documents are filed and the initial written phase has concluded, the court will hold the preliminary hearing, in which both the plaintiff and the defendant will have the opportunity to:

- amend any errors incurred in the previous phase;
- restate or adjust their petition; and
- identify the relevant documentary evidence and justify the need for witnesses or experts.

During the preliminary hearing, the judge will admit the evidence deemed necessary for the tribunal to decide the case.

In cases where all the evidence is documentary, both parties will deliver their oral concluding arguments during the preliminary hearing. The case will then be sent to the tribunal that will be in charge of issuing a written decision.

Meanwhile, if the judge admits the testimony of witnesses or experts, the court will schedule a public trial in which cross-examining will take place.

Final Phase

Once the trial has ended, the tribunal in charge of the case has 15 business days to issue its decision.

Upon communication of the decision, both parties have 15 business days to analyse this first instance decision and decide whether or not to file an extraordinary appeal before the First Chamber of the Supreme Court.

4.3 Relevance of Evidence in Judicial Tax Litigation

In a civil tax litigation process, the most important documentary evidence is the administrative file related to the tax audit performed by the Tax Administration. The documents must be in chronological order and the file must be duly certified by the tax authorities to be presented in court.

Although both documentary and witness evidence are relevant in a tax litigation process, the latter is important when the tax aspects under dispute are highly technical or require previous knowledge in a particular field, as would be the case, for instance, of a transfer pricing adjustment. See **4.2 Procedure of Judicial Tax Litigation**.

4.4 Burden of Proof in Judicial Tax Litigation

As a rule, in civil tax litigation proceedings, the burden of the proof rests on the plaintiff, which depending on the case may be the taxpayer or the State. Consequently, the plaintiff is responsible for demonstrating that his case theory is correct and consistent with the applicable law.

Similarly, in criminal tax litigation cases, the burden of proof lies with the Prosecutor's Office, which would be the one in charge of proving that the taxpayer committed tax fraud in a Criminal Court.

4.5 Strategic Options in Judicial Tax Litigation

Since there are no specialised tax courts in Costa Rica, the main strategic option when litigating a tax case before the Administrative Court is to point out the administrative errors incurred by the Tax Administration during the tax audit, which eventually could represent the annulment of the whole administrative procedure, thus voiding the additional tax assessment under dispute.

Another highly suggested strategy in the judicial case is to identify and select the evidence that directly demonstrates the reliability of the taxpayer's position throughout the tax audit. Such evidence should also be associated with each fact and with the concluding arguments.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

In Costa Rica, the only binding jurisprudence is the one issued by the Constitutional Chamber of the Supreme Court. Jurisprudence from lower courts and from the First Chamber of the Supreme Court is not binding for the parties or the Administrative Court. Nevertheless, precedents are relevant for argumentative purposes and to underline the outcome obtained in cases with similar issues or facts.

Although less common, in some cases doctrine is also used as a source to explain to the judges how a particular concept should be understood and applied in practice.

International guidelines are a form of soft law that is also taken into consideration by Costa Rican courts. In this regard, the Constitutional Chamber of the Supreme Court expressly authorised the Tax Administration to apply the OECD Transfer Pricing Guidelines in cases dealing with related-party transactions.

While no tax cases regarding the application of double tax treaties have been taken to court so far, a similar reasoning is expected in these cases, for which the OECD Commentary on the Model Tax Convention and the OECD BEPS reports may be relevant to decide the case.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

In a judicial tax litigation, once the Administrative Court has issued its decision, the only resource to challenge this first instance decision is to file an extraordinary appeal before the First Chamber of the Supreme Court.

This extraordinary appeal (ie, *recurso de casación*) can only be submitted once and the term to do so is within 15 business days after the first instance decision was communicated.

This type of appeal is meant to be lodged when the losing party considers that there are significant errors in the Administrative Court's decision, which may derive from an incorrect analysis of the evidence or from a lack of reasoning, as well as from an improper interpretation of the applicable law.

5.2 Stages in the Tax Appeal Procedure Admission Phase

Once the tribunal has issued the first instance decision, the losing party has 15 business days to file an extraordinary appeal requesting the First Chamber of the Supreme Court to evaluate if the tribunal's decision is in accordance with the applicable legislation.

Given its extraordinary character, the First Chamber will first verify if the appeal correctly identifies the alleged errors in the lower court's decision.

If so, the First Chamber will admit the extraordinary appeal and inform the other party, granting it 15 business days to present its arguments.

Decision Phase

Once the extraordinary appeal has been admitted and the other party has presented its arguments against it, the First Chamber will assign the matter to one of its justices to decide the case.

The First Chamber's final decision closes any further discussion of the case and cannot be appealed.

5.3 Judges and Decisions in Tax Appeals

As mentioned in **5.2 Stages in the Tax Appeal Procedure**, if admitted, the extraordinary appeal will be decided by the First Chamber of the Supreme Court, based on the detailed analysis performed by the justice in charge of the case. Each extraordinary appeal is randomly assigned to one of the justices.

The First Chamber of the Supreme Court is integrated by five justices who are appointed by the Costa Rican Congress for a renewable eight-year term.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

This is not applicable in Costa Rica.

6.2 Settlement of Tax Disputes by Means of ADR

This is not applicable in Costa Rica.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

This is not applicable in Costa Rica.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

This is not applicable in Costa Rica.

6.5 Further Particulars Concerning Tax ADR Mechanisms

This is not applicable in Costa Rica.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

This is not applicable in Costa Rica.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Pursuant to Article 81 of the General Tax Code, when a tax audit concludes with an additional tax assessment, the Tax Administration can impose a pecuniary penalty. This tax infringement is an administrative tax offence, punished with a pecuniary penalty of 50%, 100% or 150% of the additional tax assessment.

For purposes of imposing this sanction, the tax authorities should evaluate if the taxpayer's actions that lead to an inexact payment of the corresponding tax are sanctionable. However, in practice, when the Tax Administration considers that the exact taxes were not paid, it will communicate such conclusion to the taxpayer through a tax audit findings report. Given this result, in almost all cases, the Tax Administration considers that the taxpayer is automatically subject to the administrative tax offence established under Article 81 of the General Tax Code.

Therefore, the process to impose the sanction is initiated at the same time the tax audit findings report is communicated to the taxpayer. The first act corresponds to a notice informing the taxpayer under audit of the proposed sanction. The taxpayer will have ten business days to file its arguments against this proposal and then the procedure will be suspended until the additional tax assessment is final.

7.2 Relationship between Administrative and Criminal Processes

The administrative tax infringement file is closely related to the tax audit file, which means that the events and development of the latter have a direct impact on the sanctioning procedure.

As mentioned before, the Tax Administration opens the administrative tax infringement procedure by the time it communicates the tax audit findings to the taxpayer, but said procedure will then be suspended until the decision regarding the additional tax assessment is final and can no longer be challenged by the taxpayer before the administrative authorities. Afterwards, the administrative infringement file will be resumed regardless of whether the taxpayer decided to continue discussing the tax assessment through judicial litigation.

7.3 Initiation of Administrative Processes and Criminal Cases

The Tax Administration generally initiates the administrative infringement procedure by the time it reaches a conclusion in the tax audit procedure. The tax authorities' intention of imposing a pecuniary penalty is usually communicated to the taxpayer together with the tax audit findings report.

In Costa Rica, an administrative infringement procedure cannot evolve into a criminal tax case. The Tax Administration is the only authority entitled to impose the pecuniary penalty contained in Article 81 of the General Tax Code when the exact taxes were not paid.

7.4 Stages of Administrative Processes and Criminal Cases

The tax administrative infringement process starts with a notice through which the Tax Administration informs the taxpayer about the proposed sanction for its non-compliance with the applicable law. The tax authorities expressly indicate that the administrative infringement derives from the additional tax assessment and grant the taxpayer ten business days to challenge the proposed penalty.

Upon receiving the taxpayer's arguments against the proposed sanction notice, the administrative infringement process is suspended until the Tax Administration's decision regarding the additional tax assessment is final.

When the procedure is reopened, the Tax Administration will issue a Sanctioning Decision to impose the corresponding pecuniary penalty, which will be 50%, 100%, or 150% of the additional tax assessment, depending on the severity of the taxpayer's non-compliance with the applicable rules when self-assessing the tax.

The taxpayer can challenge the Sanctioning Decision through an administrative appeal before the same office, which has to be filed within 30 business days after the decision was communicated.

The taxpayer will also have 30 business days to file an appeal before the Administrative Tax Court against the Sanctioning Decision and the Tax Administration's decision regarding the administrative appeal. Alternatively, the taxpayer can present the appeal before the Administrative Tax Court without filing the administrative appeal before the Tax Administration.

7.5 Possibility of Fine Reductions

The taxpayer can benefit from reductions of potential fines if an upfront payment of both the additional tax assessment and the proposed penalty is made.

If the additional tax assessment is paid before the Tax Administration issues the Notice of Deficiency, the penalty will be reduced by 50%. If the taxpayer opts to pay the fine at the same time, it will be reduced by 55%.

If the additional tax assessment is paid after the Tax Administration issues the Notice of Deficiency but before the term to file an appeal is due, the penalty will be reduced by 25%. If the taxpayer opts to pay the fine at the same time, it will be reduced by 30%.

In such cases, the taxpayer is required to inform the Tax Administration and provide evidence of the payments made.

7.6 Possibility of Agreements to Prevent Trial

In Costa Rica, a criminal tax trial will only take place if the taxpayer is accused of committing tax fraud. If the Tax Administration considers that a taxpayer committed such crime, it will suspend

the tax audit and the administrative infringement procedures and file a criminal complaint before the Prosecutor's Office.

Depending on the case, it may be possible for the taxpayer to enter an agreement with the Attorney General's Office, which will likely represent full payment of the tax assessed, plus interest and penalties. Such agreement has to be approved by the Prosecutor's Office.

Costa Rican experience with criminal tax cases is limited and there are no guidelines regarding the type of cases that could be resolved through this kind of agreement.

7.7 Appeals against Criminal Tax Decisions

After a criminal tax trial, the Court of First Instance will issue and communicate its decision, which can be appealed before the Appeals Court when either party considers there is an incorrect understanding of the facts or evidence, as well as when there are errors in the interpretation of the applicable law or in the taxpayer's punishment.

In some cases, the decision issued by the Court of Second Instance can be challenged through an extraordinary appeal before the Third Chamber of the Supreme Court. To be admitted, such appeal has to be based on:

- the existence of a contradiction between the decision issued by the Appeals Court and other precedents from the same court or from the Third Chamber; or
- the incorrect application of substantive legal provisions.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a rule, transactions and operations that have been challenged under the GAAR or transfer

pricing rules generally give rise to administrative tax cases that will likely become civil tax litigation cases.

In the administrative tax controversy procedure, the tax authorities have extensively supported their position on the economic reality principle. The Tax Court and the First Chamber of the Supreme Court have also allowed the Tax Administration to apply this GAAR where considered appropriate.

In transfer pricing cases, the Tax Administration has decided to apply the OECD Transfer Pricing Guidelines, which has been supported by the Administrative Tax Court and confirmed by the Constitutional Chamber of the Supreme Court.

In judicial tax litigation cases, the opportunity for the Administrative Court to address substantive transfer pricing matters has been fairly limited, since most of the cases have had significant errors that represent the annulment of the whole administrative procedure.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Although Costa Rica has four double tax treaties in force, there is no experience regarding additional tax assessments derived from a double taxation situation.

8.2 Application of GAAR/SAAR to Cross-Border Situations

There is no jurisprudence concerning the application of the domestic GAAR or SAARs to cross-border situations covered by bilateral double tax treaties.

8.3 Challenges to International Transfer Pricing Adjustments

There is no experience with international transfer pricing arrangements in Costa Rica.

8.4 Unilateral/Bilateral Advance Pricing Agreements

While it is possible to sign an advance pricing arrangement with the Tax Administration, no agreement of this type has been finalised yet.

8.5 Litigation Relating to Cross-Border Situations

Cross-border situations have not been subject to litigation in Costa Rica.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

There is no applicable information in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

There is no applicable information in this jurisdiction.

9.3 Challenges by Taxpayers

There is no applicable information in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

There is no applicable information in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Costa Rica did not opt for mandatory arbitration to CTAs under Part VI of the MLI and none of its double tax treaties include an arbitration clause. The probable reasons for this decision refer to constitutional and legal constraints. In particular, Article 50 of the General Tax Code provides that a substantive tax duty can only be modified or forgiven by law. Therefore, no agreement regarding the amount of the tax obligation could be reached in an arbitration procedure.

10.2 Types of Matters that Can Be Submitted to Arbitration

This is not applicable in Costa Rica.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This is not applicable in Costa Rica.

10.4 Implementation of the EU Directive on Arbitration

This is not applicable in Costa Rica.

10.5 Existing Use of Recent International and EU Legal Instruments

This is not applicable in Costa Rica.

10.6 New Procedures for New Developments under Pillar One and Two

As a member of the OECD and of the Inclusive Framework on BEPS, Costa Rica will likely promote changes to its legislation following Pillars One and Two. Although the country's position regarding each pillar and the suggested rules is yet to be determined, amendments to the existent income tax legislation or new bills can be

expected. Given the significance and complexity of the proposed reforms, the new rules may not be enacted or implemented by the agreed timeframes.

Concerning the envisaged instruments to ensure tax certainty, such as the use of standardised returns and centralised filing, these are important and necessary both for businesses and tax administrations implementing the new rules to address the tax challenges arising from digitalisation and globalisation of the economy. The enactment of harmonised rules by countries that have committed to the adoption of the new international tax framework is key, specially considering the challenges associated to Pillars One and Two proposals.

Particularly regarding the proposed measures to mitigate controversies and avoid double taxation deriving from Pillar One's approach, these will not be initially binding and mandatory for Costa Rica. Instead, given its low level of MAP disputes and as a country that has not been subject to the BEPS Action 14 (effective dispute resolution) peer review, Costa Rica will be able to elect whether to apply the binding dispute resolution mechanism to issues related to the reallocated income (ie, Amount A).

10.7 Publication of Decisions

This is not applicable in Costa Rica.

10.8 Most Common Legal Instruments to Settle Tax Disputes

This is not applicable in Costa Rica.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

This is not applicable in Costa Rica.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

In an administrative litigation, taxpayers are not required to hire a lawyer or tax adviser to participate in the different stages of the procedure. Furthermore, the tax authorities do not charge a fee regarding this kind of administrative procedure, neither at the tax audit phase nor at the administrative claim phases.

However, in cases where the taxpayer hires a professional tax adviser or lawyer, the costs to litigate at the administrative level may be represented by the fees they charge for their services.

11.2 Judicial Court Fees

The fees to litigate before the Administrative Court are based on the Attorney Fees Decree (ie, *Arancel honorarios por servicios profesionales de abogacía y notariado*) in force at the time the lawsuit is filed. As stated in Article 16 of Decree No 41457-JP, the professional fees are calculated as follows:

- up to CRC16.5 million, 20%;
- on the excess over CRC16.5 million and up to CRC82.5 million, 15%; and
- over CRC82.5 million, 10%.

Upon issuing its final decision, the court decides which party is responsible for paying the fees. This aspect may also be modified or confirmed by the First Chamber of the Supreme Court.

After the case's decision is final and if the losing party is responsible for covering all of the tax litigation fees, the winning party will request the Administrative Court to set the amount to be paid by the losing party. In some cases, the judge in charge of this matter may consider that the above-mentioned decree is not applicable and set a different amount based on its criteria.

11.3 Indemnities

Although the taxpayer can request an indemnity if the court decides that the additional tax assessment is absolutely null and void, this is not a common practice in Costa Rica.

11.4 Costs of ADR

There are no alternative dispute resolution mechanisms available for the taxpayer to settle the case.

12. STATISTICS

12.1 Pending Tax Court Cases

The Administrative Court does not publish statistics regarding pending tax cases and their value.

12.2 Cases Relating to Different Taxes

Neither the Tax Administration nor the Administrative Court publish the number of cases initiated and terminated every year relating to the different taxes being audited and their value.

12.3 Parties Succeeding in Litigation

There are no statistics regarding the party that succeeds the most in tax litigation cases.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The most important guideline to consider in a tax controversy is to develop a case theory that is consistent with the facts and circumstances, as well as with the evidence to be provided to the authorities.

In addition, it is important to present clear and concise arguments that can be understood both by the taxpayer and the authorities, regardless of whether the case is being discussed in the administrative or judicial phase.

Deloitte Tax & Legal Costa Rica is a multidisciplinary firm of the global organisation Deloitte Touche Tohmatsu Limited, which provides consulting, tax and legal advice to local and multinational entities to help foster their operations in the country. Among its business lines, Deloitte Tax & Legal has solid experience providing tax controversy and litigation advisory services, ranging from assistance throughout the tax audit procedure and preparation of administrative

appeals, to lodging a lawsuit and guiding the client through the phases that must be followed to obtain a final decision from the judicial authorities. Five professionals form Deloitte's tax controversy team. Having devoted their careers to the tax litigation field, all the team members have significant expertise in this practice area, not only in the private sector, but also in the public sector.

AUTHORS



Fabio Salas is a partner and has led the Deloitte Tax & Legal tax controversy practice since 2019, where he started as a director in 2017. His vast experience in tax litigation includes working at the

Comptroller's Office as part of the team handling cases concerning public finance matters, and as an attorney in a boutique law firm. He obtained his law degree and Master's in public law from the Universidad Escuela Libre de Derecho, where he is also a PhD candidate. Fabio is a columnist in tax matters for local media and a member of the Costa Rican Bar Association.



Priscilla Zamora is the manager in charge of Deloitte Tax & Legal's tax controversy practice. She formerly worked at the Costa Rican Tax Administration, where she served as general

director after years of working as a legal adviser on international tax, tax policy and tax controversy matters. Priscilla also worked at the Attorney General's Office, where she handled judicial tax cases. She obtained her law degree from the University of Costa Rica and received a Master of Laws in taxation from Georgetown University. Priscilla is a member of the Costa Rican Bar Association and of the board of directors of the Costa Rican Institute of Fiscal Studies.

Deloitte Tax & Legal Costa Rica

Centro Corporativo El Cafetal
Edificio B, piso 2
La Ribera, Belén
Heredia
Costa Rica

Tel: +506 2246 5000
Email: fsalas@deloitte.com
Web: www2.deloitte.com/cr/es

Law and Practice

Contributed by:

*Eric Meier, Regis Torlet, Ariane Calloud
and Mathieu Valetteau*

Baker McKenzie AARPI see p.166



CONTENTS

1. Tax Controversies	p.147	5.3 Judges and Decisions in Tax Appeals	p.155
1.1 Tax Controversies in this Jurisdiction	p.147	6. Alternative Dispute Resolution (ADR) Mechanisms	p.155
1.2 Causes of Tax Controversies	p.147	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.155
1.3 Avoidance of Tax Controversies	p.148	6.2 Settlement of Tax Disputes by Means of ADR	p.156
1.4 Efforts to Combat Tax Avoidance	p.148	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.156
1.5 Additional Tax Assessments	p.149	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.156
2. Tax Audits	p.150	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.156
2.1 Main Rules Determining Tax Audits	p.150	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.157
2.2 Initiation and Duration of a Tax Audit	p.150	7. Administrative and Criminal Tax Offences	p.157
2.3 Location and Procedure of Tax Audits	p.151	7.1 Interaction of Tax Assessments with Tax Infringements	p.157
2.4 Areas of Special Attention in Tax Audits	p.151	7.2 Relationship between Administrative and Criminal Processes	p.157
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.152	7.3 Initiation of Administrative Processes and Criminal Cases	p.158
2.6 Strategic Points for Consideration during Tax Audits	p.152	7.4 Stages of Administrative Processes and Criminal Cases	p.158
3. Administrative Litigation	p.152	7.5 Possibility of Fine Reductions	p.159
3.1 Administrative Claim Phase	p.152	7.6 Possibility of Agreements to Prevent Trial	p.159
3.2 Deadline for Administrative Claims	p.153	7.7 Appeals against Criminal Tax Decisions	p.159
4. Judicial Litigation: First Instance	p.154	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.159
4.1 Initiation of Judicial Tax Litigation	p.154	8. Cross-Border Tax Disputes	p.160
4.2 Procedure of Judicial Tax Litigation	p.154	8.1 Mechanisms to Deal with Double Taxation	p.160
4.3 Relevance of Evidence in Judicial Tax Litigation	p.154	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.160
4.4 Burden of Proof in Judicial Tax Litigation	p.154		
4.5 Strategic Options in Judicial Tax Litigation	p.154		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.154		
5. Judicial Litigation: Appeals	p.154		
5.1 System for Appealing Judicial Tax Litigation	p.154		
5.2 Stages in the Tax Appeal Procedure	p.155		

8.3	Challenges to International Transfer Pricing Adjustments	p.160	10.5	Existing Use of Recent International and EU Legal Instruments	p.163
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.160	10.6	New Procedures for New Developments under Pillar One and Two	p.163
8.5	Litigation Relating to Cross-Border Situations	p.161	10.7	Publication of Decisions	p.163
9. State Aid Disputes		p.161	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.164
9.1	State Aid Disputes Involving Taxes	p.161	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.164
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.162	11. Costs/Fees		p.164
9.3	Challenges by Taxpayers	p.162	11.1	Costs/Fees Relating to Administrative Litigation	p.164
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.162	11.2	Judicial Court Fees	p.164
10. International Tax Arbitration Options and Procedures		p.162	11.3	Indemnities	p.165
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.162	11.4	Costs of ADR	p.165
10.2	Types of Matters that Can Be Submitted to Arbitration	p.162	12. Statistics		p.165
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.163	12.1	Pending Tax Court Cases	p.165
10.4	Implementation of the EU Directive on Arbitration	p.163	12.2	Cases Relating to Different Taxes	p.165
			12.3	Parties Succeeding in Litigation	p.165
			13. Strategies		p.165
			13.1	Strategic Guidelines in Tax Controversies	p.165

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

The French tax authorities (FTA) audit the tax returns, the documents used for the establishment of taxes, and supporting documents filed by taxpayers.

An audit may take different forms.

Off-Site Audits (Contrôle Sur Pièces)

Off-site audits consist in carrying out a critical examination of the returns filed by the taxpayer, and aim at:

- checking that all taxpayers have filed their returns;
- correcting errors, deficiencies, inaccuracies, omissions or concealments in the tax basis; and
- with respect to income tax, ensuring that the overall income declared is consistent with the taxpayer's situation.

Tax Audit

Where the taxpayer is:

- an individual, a contradictory examination of the personal tax situation (*examen contradictoire de la situation fiscale personnelle*) is initiated, consisting in checking the consistency between the declared income and the assets, cash flow situation and the lifestyle elements of the members of the tax household (Article L. 12 of the French Book of Tax Procedures (*Livre des procédures fiscales*), the FBTP); and
- a company, an accounting audit (*vérification de comptabilité*) is initiated involving, beyond a simple examination of the accounts, a comparison of the extra-accounting information with the accounting data on which the declarations are based (Articles L. 13 and R. 13-1 of the FBTP).

Remote Simplified Tax Audit Procedure

When the FTA consider that an accounting audit is not necessary, and provided the taxpayer uses a computerised accounting system to book its accounts, the audit can also take the form of a remote simplified tax audit procedure (*examen de comptabilité à distance*).

Pursuant to sections L. 13 G and L. 47 AA of the FBTP, the taxpayer is required to provide to the FTA a copy of its “dematerialised accounting files” (*fichier des écritures comptables*, FEC). The FTA may conduct any sorting operations, and are allowed to request additional information, justifications or clarifications to characterise anomalies detected.

The FTA may follow two different routes to reassess a taxpayer's taxable basis, either through an adversarial adjustment procedural or, under certain circumstances, through a unilateral adjustment procedure (see **3.1 Administrative Claim Phase**).

1.2 Causes of Tax Controversies

According to the 2020 Annual Report (*Rapport d'activité 2020 – Direction Générale des Finances Publiques*) of the General Directorate of Public Finance (DGFIP), the taxes that give rise to the most tax controversies and the values (net values in 2020) involved are:

- corporate income tax – EUR1,997 billion;
- income tax – EUR1,094 billion;
- VAT and refunds of VAT credits – EUR2,662 billion;
- stamp tax – EUR1,427 billion;
- wealth tax/wealth tax on real estate (ISF/IFI) – EUR352 million;
- local taxes – EUR348 million; and
- miscellaneous taxes – EUR997 million.

1.3 Avoidance of Tax Controversies

Tax controversy can be mitigated by being prepared in advance (ie, by having reviewed the documentation that needs to be made available to the FTA or that could be requested by the tax auditor at any time, for example, transfer pricing documentation, FEC files and documentation supporting transactions, including archives).

1.4 Efforts to Combat Tax Avoidance

EU Measures

Several of the EU's recent measures were transposed into domestic law to combat tax avoidance.

The Finance Act for 2019 transposed the Anti-Tax Avoidance Directive (ATAD) 2016/1164/EU dated 12 July 2016 on interest limitation rules. It creates a new general mechanism for limiting net financial expenses and provides for specific rules depending on whether or not the company or tax group is thinly capitalised.

The Finance Act for 2020 transposed the Anti-Tax Avoidance (ATAD 2) 2017/952 dated 29 May 2017 in order to prevent French-based entities from deducting expenses related to hybrid arrangements or from taxing – in France – an expense related to a hybrid arrangement that has been deducted abroad (Articles 205 B, 205 C and 205 D of the French Tax Code (FTC) applicable to fiscal years beginning from 1 January 2020).

Moreover, the general anti-abuse clause provided for by the ATAD Directive is transposed into Article 205 A of the FTC, which provides that “in the assessment of corporation tax, no arrangement or series of arrangements shall be taken into account which, having been put in place to obtain, as a main objective or as one of the main objectives, a tax advantage contrary to the object or purpose of the applicable tax law,

is/are not authentic in the light of all the relevant facts and circumstances.”

Finally, a specific anti-abuse rule (SAAR) with regard to the exemption of withholding tax on dividends distributed to a European parent is provided for under Article 119 ter of the FTC (resulting from the transposition of the Council Directive 2015/121 of 27 January 2015, which supplemented the Parent-Subsidiary Directive 2011/96 of 30 November 2011).

Therefore, dividends distributed as part of an arrangement which, having been set up to obtain – as a main objective or as part of one of the main objectives – a tax advantage that defeats the object or purpose of the tax regime, are excluded from the exemption from withholding tax, which is granted under certain conditions.

BEPS Recommendations

France implemented the country-by-country reporting rules, following the release of the OECD/G20 BEPS Action 13 report.

Article 223 quinquies C of the FTC is similar to the provisions of the Directive 2016/881/EU as regards mandatory automatic exchange of information in the field of taxation.

Further to Action 5 of the BEPS project, the French taxation of revenues derived from intellectual property (IP) assets or a “patent box” regime was considered harmful since it was not in line with the so-called “Nexus” approach. Therefore, the 2019 French Finance Act reformed this patent box regime, introducing substantial changes to the scope and conditions of its application (Article 238 of the FTC).

Furthermore, the definition of a permanent establishment (PE) is currently evolving, following the final report of the OECD/G20 BEPS Action 7 on Preventing the Artificial Avoidance of

PE Status and depending on the willingness of states to implement this evolution into their double tax treaties (DTTs). On 7 June 2017, France signed the OECD Multilateral Instrument (MLI) and notably opted to include Article 12 of the MLI, which enshrines a new broader PE notion. The application of this broader notion in DTTs, however, depends on the choices made by other signatories (eg, the tax treaty concluded between France and Luxembourg on 20 March 2018 (in force since 1 January 2020) includes such a broader PE notion).

1.5 Additional Tax Assessments

In principle, once tax collection notices have been issued (see **3.1 Administrative Claim Phase**), the taxpayer has to pay the tax due before lodging a claim before the FTA (administrative phase). Then, a refund may be granted to the taxpayer if a court invalidates the reassessments.

After having challenged the proposed tax reassessments and during the pre-litigation phase of the procedure, the taxpayer may claim the benefit of the deferral of payment of the tax due until a decision is granted by the court, provided sufficient financial guarantees are given (Article L. 277 of the FBTP).

The FTA, therefore, send the taxpayer a request to enter into or provide guarantees supporting the deferral of payment that was claimed. The provision of guarantees is required for any payment deferral. In the absence of an answer by the taxpayer, the payment deferral could be rejected and the taxpayer would have to pay immediately. The FTA are obliged to examine all the offered guarantees.

Should they consider the proposed guarantees insufficient, the authorities can reject them in a decision that is supported by adequate grounds sent to the taxpayer. This decision can be chal-

lenged, however, before a tax judge within a period of 15 days as of the receipt of the letter from the Treasury Accountant (*Comptable du Trésor Public*), informing the taxpayer of the refusal of the proposed guarantees. The tax judge will only take a position on the guarantees proposed by the taxpayer and will not hand down a decision on the merits of the reassessments.

If the taxpayer obtains the payment deferral, and if the lower tax court rejects its claim, the taxpayer will have to pay the reassessed tax, late payment fees and penalties, and additional late payment interest. Conversely, the taxpayer will be entitled to a refund of the guarantee fees. If the taxpayer decides to pay immediately after the receipt of the tax collection notice, and if the lower tax court upholds the right to its claims, it will be entitled to a refund of the sums paid, plus late payment interest.

Tax Penalties and Fines

Tax penalties apply if the taxpayer fails to declare and/or pay the tax in due time. The sanctions for failing to file declarations correctly, pay taxes or fulfil other tax obligations can be divided into two broad categories:

- late payment interest and tax fines applied by the FTA which are subject to appeal before the administrative courts; and
- criminal penalties imposed by criminal courts.

Fines

In principle, late payment interest of 0.2% per month is due on all late payment of taxes (Article 1727 of the FTC) caused by the late filing of tax returns and other assessment documents, under-payments (errors or omissions) and simple late payments. This late payment interest is not capped and its starting point depends on the taxes adjusted.

The late payment interest may be reduced in certain circumstances, notably depending on the behaviour of the taxpayer.

The FTC also provides for a specific penalty for the failure to file declarations and documents or the failure to file these on time (10% when the late declaration is filed by the taxpayer prior to any notice of the French tax authorities or within 30 days after an initial official notice (*mise en demeure*); 40% if the declaration or information document is not sent to the FTA within 30 days after the official notice; or 80% in the event of concealed activity).

Other tax penalties are applicable – eg, in the case of a deliberate breach (amounting to 40%), abuse of law (amounting either to 40 or 80%), fraudulent behaviour (amounting to 80%) or refusal to co-operate during a tax audit (amounting to 100%).

Criminal penalties

The general offence of tax fraud is broadly defined by Article 1741 of the FTC and is punishable, regardless of the applicable tax penalties, by five years' imprisonment and a fine of EUR500,000, which may be increased to an amount equal to twice the proceeds of the offence (note that the level of penalties can be increased up to five times the above-mentioned amount for legal entities, which could represent EUR2.5 million or ten times the proceeds of the offence).

The penalties are increased where the acts were committed by an organised group or under specified circumstances.

The level of these maximum penalties may be lowered by a judge.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

In France, enterprises are audited on a discretionary basis and, consequently, some entities are more likely than others to be subject to tax audits (eg, large companies are audited about once every three years). The FTA may use databases to identify and follow companies that need to be audited regularly or apply a method using different ratios, taking into account the turnover declared, inventories, purchases, labour costs, purchase of assets, debts, income and booked reserves, and depreciation allowances.

Furthermore, the local tax authorities (*Service des Impôts*) monitor the consistency of tax returns and look for errors in order to propose tax audits. Specific tax departments, such as the *Direction Nationale des Enquêtes Fiscales*, process information (press, derogatory procedures, etc) per activity and sector.

The General Directorate of Public Finance has a tax policy that is dependent on strategic sectors and also looks for specific frauds (eg, intra-community VAT, new business and R&D tax credit).

2.2 Initiation and Duration of a Tax Audit

There is no specific time limit within which the tax audit must be initiated, even though in practice, tax authorities are limited by the statute of limitations.

For small and medium-sized businesses, the tax inspector is not authorised to stay for more than three months on the premises of audited companies (Article L. 52 of the FBTP).

For individuals, the audit may not exceed one year as of the notice of audit, extended to two years if an undeclared activity is discovered (Article L. 12 of the FBTP).

In all other cases, the FTA do not have any time limit within which the tax audit must be completed.

The FTA can only exercise their authority to audit and reassess within three calendar years following the year during which the taxable event occurred (Article L. 169 of the FBTP).

There are several exceptions to this general rule (eg, the statute of limitations is extended to ten years in the event of a concealed activity or when French-controlled foreign companies rules are involved).

Moreover, the FTA may audit the origin of tax losses generated during a statute-barred year, which are carried over to a year that is still open to tax audit, and reassess them.

The statute of limitations is interrupted by:

- either a reassessment notice or by any other declarations or notifications of minutes;
- any act involving recognition of the parties liable for payment (payment of a deposit, request for an additional time limit, request for a penalties discount, precise accounting records, etc); or
- any other commonplace law-interrupting acts (legal proceedings, enforcement actions).

2.3 Location and Procedure of Tax Audits

Where the taxpayer is an individual, the tax audit takes place, in principle, within the FTA's premises.

Where the taxpayer is an entity, the tax audit generally takes the form of an on-site tax audit (*verification de comptabilité*), in principle, within the premises of the company or, under certain circumstances takes the form of a remote sim-

plified tax audit procedure (*examen de comptabilité à distance*).

To obtain more information than is provided by the taxpayer, the FTA also have, notably:

- a right of communication (Article L. 81 of the FBTP) allowing them to ask a third party, or the taxpayer itself, for information in its possession, or to examine certain documents; and
- a right to visit and seize (Article L. 16 B of the FBTP) in order to investigate offences relating to direct taxes and turnover taxes, subject to an authorisation given by a judge when there is a presumption of tax fraud.

2.4 Areas of Special Attention in Tax Audits

Key areas and matters for tax auditors' special attention are transfer pricing and questions of PE.

Transfer pricing issues are sensitive issues and need specific attention with increased challenges to the functional profile of French entities and the application of the profit split method.

There have been numerous permanent establishment assessments made by the FTA over the last few years. In the *Conversant* case, dated 11 December 2020, the French Supreme Administrative Court set out principles that broadly interpret treaty provisions of permanent establishment and take an innovative approach to European Union law regarding the characterisation of fixed establishment for VAT purposes. These cases are highly dependent on a case-by-case factual analysis.

The FTA also pay special attention to matters such as business restructurings, VAT, withholding tax, employee benefits and R&D tax credits.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

As part of the BEPS project, Article 223 quinquies C of the FTC introduced country-by-country declaration of economic, accounting and tax results that must be remotely declared by certain companies in order to combat tax optimisation and tax evasion.

Moreover, Article L. 114 of the FBTP allows the FTA to communicate any information concerning direct or indirect taxes upon the request of another EU member state, as long as the FTA have reciprocal treatment in that state.

Besides, in DTT provisions, the contracting states generally agree to exchange information within the scope of the tax treaty. The OECD Model Tax Convention notably allows the FTA to ask for information on a group of taxpayers, without naming them individually, as long as the request is not a “fishing expedition”.

Furthermore, Article L. 45 of the FBTP provides that the FTA can agree with another member state to initiate simultaneous audits. Information gathered during the course of these audits will be exchanged between the different tax authorities.

Article L. 45 of the FBTP also provides for the possibility of initiating joint tax audits even if this still remains rare in France.

2.6 Strategic Points for Consideration during Tax Audits

It is advisable to engage in continual discussions with the tax auditor to be able to understand their potential concerns since the procedure must be adversarial.

During the closing meeting of the audit, it is important to clearly understand the intent of the tax auditor and the items they intend to reassess. This is the last step before the receipt of a tax reassessment notice (*proposition de rectification*).

Following the receipt of the tax reassessment notice, it is generally recommended to develop all the arguments that may be relevant in the taxpayer’s response.

During the entire procedure, the main issue is to determine whether the taxpayer should try to enter into a settlement agreement with the FTA or move forward with litigation. This will mainly depend on the arguments of the FTA and the nature of the reassessment, but it is recommended to challenge all the reassessments and determine the chance of success of the taxpayer’s positions.

In the event of disagreement, the taxpayer has the right to appeal to the Departmental Interlocutor (*Interlocuteur Départemental*), who is one of the heads of the FTA’s service in charge of tax audits.

In certain circumstances, the dispute may be submitted for an opinion to the Departmental Committee on direct taxes and turnover taxes at the request of one or other of the parties.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

The administrative claim phase begins with the implementation of either the adversarial adjustment procedure or the unilateral reassessment procedure. At the end of these procedures, a tax collection notice is sent to the taxpayer,

which allows it to file a tax claim before the FTA to request the withdrawal of the reassessments.

If the FTA determine, after an audit, that the taxpayer's tax return contains a deficiency, omission or concealment, or is inaccurate upon comparison with the latter's taxable income or transactions, they may initiate a contradictory reassessment procedure (*procédure de rectification contradictoire*) by sending a tax reassessment notice to the taxpayer (Article L. 55 of the FBTP). A tax reassessment notice, notably, must set forth the amount of the proposed reassessment, the reasons justifying it, and the tax consequences of such a reassessment (Articles L. 57 and L. 48 of the FBTP).

Within 30 days from the date of receipt of the tax reassessment notice (which can be extended to 60 days at the taxpayer's request), the taxpayer must either accept the proposed reassessment or submit a response challenging the reassessment (*observations du contribuable*) (Article R. 57-1 of the FBTP).

If the taxpayer accepts this reassessment, or fails to respond, it is not barred from challenging the reassessment but the burden of proof will shift from the FTA to the taxpayer. If the taxpayer refuses the reassessment and files a response, the FTA may thereupon either drop, confirm or modify the proposed reassessment (Article L. 57 of the FBTP) by way of an answer to the taxpayer's comments (*réponse aux observations du contribuable*).

In this respect, the FTA have an obligation to respond to the observations of the taxpayer within 60 days (concerning industrial and commercial companies whose turnover does not exceed EUR1.526 million, and companies with a non-commercial activity whose turnover does not exceed EUR460,000) (Article L. 57 A of the FBTP). Otherwise, the FTA will be deemed to

have accepted the observations of the taxpayer. After this notice has been sent by the FTA, the taxpayer may resort to administrative appeals.

Both the FTA and the taxpayer have the right, under certain conditions, to submit the matter to the Commission for direct taxes and turnover taxes (*Commission des impôts directs et des taxes sur le chiffre d'affaires*) or the Departmental Conciliation Committee (*Commission Départementale de conciliation*) within 30 days (Article L. 59 of the FBTP). These bodies will issue a non-binding opinion on questions of fact, not of law.

After the final letter of the FTA, and in the absence of recourse to the Commission, the FTA are entitled to issue a tax collection notice requiring the taxpayer to pay the tax due (*avis de mise en recouvrement*).

In certain instances, the FTA can reassess the taxpayer's income (Article L. 65 of the FBTP) unilaterally (eg, where the taxpayer failed to file a tax return in due time, and fails to do so within 30 days of its receipt of a notice sent to that effect by the FTA (Articles L. 67 and L. 68 of the FBTP)).

3.2 Deadline for Administrative Claims

The time period within which the taxpayer can file a claim would generally expire on December 31st of the second year following the year of the receipt of the tax collection notice or the payment of the tax.

The FTA will review the claim and have the right to change the stated legal basis for the reassessment, as well as reduce or cancel the reassessment.

It is only upon a response by the FTA to such a claim that the case can be brought to court. A lack of response from the FTA after a six-month period allows the action to be initiated with the court.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is initiated by the means of an introductory brief (*requête introductive d'instance*) before the administrative court or a subpoena to initiate proceedings (assignment) before the civil court.

The competent jurisdiction depends on the nature of the tax in dispute and will depend geographically on the jurisdiction in which the branch of the FTA in charge of the collection of the tax is located.

4.2 Procedure of Judicial Tax Litigation

Appeals against administrative tax decisions will be heard either before the lower civil courts (for stamp duties, indirect contributions, taxes on real estate and wealth tax) or before the lower administrative courts (for direct taxes and turnover taxes).

4.3 Relevance of Evidence in Judicial Tax Litigation

Before lower courts, the parties' claims and arguments are set out in written conclusions. Pleadings must only refer to those claims already raised in written conclusions.

4.4 Burden of Proof in Judicial Tax Litigation

Before the tax court, the question of burden of proof depends on the reassessment procedure.

In principle, the FTA bear the burden of proof when they intend to reassess the tax base of a taxpayer; for some procedures, such as the ex officio procedure, the burden may be passed to the taxpayer.

Before the criminal courts, the burden of proof lies in all cases with the Public Prosecutor's

Office, to which the tax authorities may be added as a civil party.

4.5 Strategic Options in Judicial Tax Litigation

The strategic options to consider during tax litigation depend on the factual and legal background of the case and should be assessed on a case-by-case basis.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

In addition to domestic case law, French courts take into consideration case law from the European Court of Justice and the European Court of Human Rights.

The FTA's doctrines (official published guidelines and individual decisions) are also enforceable in cases of tax reassessment. Article L. 80 A of the FBTP prohibits tax authorities from raising taxes that would be in contradiction with the administrative doctrine in force at the time they were applied, either by the FTA or by the taxpayer.

Finally, in the recent *Conversant* case dated 11 December 2020, the Supreme Administrative Court expressly referred to interpretative commentaries issued after the entry into force of the treaty concluded between France and Ireland.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Judgments of lower courts may be appealed to the Court of Appeal (*Cour d'appel*) within whose jurisdiction the lower court is located.

The deadline to file such an appeal depends on the appealing party (the taxpayer or FTA) and

whether the first instance decision was rendered by an administrative or a civil lower court.

Judgments of appellate courts can be appealed before the supreme courts – the Supreme Administrative Court (*Conseil d'Etat*) or the Supreme Civil Court (*Cour de Cassation*).

Supreme courts are, technically, not a third level of jurisdiction (as they do not rule on the merits of a case but decide if the law has been correctly applied).

5.2 Stages in the Tax Appeal Procedure

The parties' claims and arguments are set out in written conclusions.

Depending on the competent jurisdiction, deadlines to file written conclusions may be binding.

5.3 Judges and Decisions in Tax Appeals

The composition of the court depends on the nature of the litigation and the complexity of the case.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Alternative dispute resolution (ADR) mechanisms such as mutual agreement procedures (MAPs) may be used to resolve situations of double taxation that are caused by transfer pricing or permanent establishment reassessments.

France has concluded more than 120 bilateral tax treaties containing a MAP article. For transfer pricing matters resulting in double taxation, a MAP can also be initiated under the European

arbitration convention. The opening of both procedures can be requested in parallel.

French Tax Treaties

The French competent authorities may refuse to open a MAP under certain circumstances. Depending on the applicable bilateral tax treaty, the deadline to request the opening of a MAP ranges from three months to three years from the measure that leads to double taxation. In some bilateral tax treaties, no deadline is specified. In practice, it is generally recommended that the opening of a MAP be requested soon after the administrative appeals have been exhausted, it being specified that it does not suspend the issuance of tax collection notices and that the competent authorities are not obliged to reach an agreement.

In addition, a few tax treaties concluded by France include an arbitration clause, consistent with Article 25 (5) of the OECD Model Tax Convention. The MLI has included provisions for arbitration which were generally adopted by France (with some reservations) when submitting its instrument of ratification on 27 September 2018 (applicable since 1 January 2019).

European Arbitration Convention

At the European level, the European arbitration convention allows the reaching of an agreement on transfer pricing matters resulting in double taxation within – in theory – a two-year deadline. Otherwise, an arbitration phase should be opened, subject to the taxpayer's agreement. In practice, very few cases have reached this phase despite the fact that a significant number of MAP cases have not been resolved within the two-year timeframe.

Furthermore, the EU Directive 2017/1852 on tax dispute resolution mechanisms in the EU has introduced a more co-ordinated EU approach to ensure that disputes related to the interpretation

of tax treaties or double taxation problems can be resolved more swiftly and effectively (transposed at Article L. 251 B and subsequent of the FBTP).

6.2 Settlement of Tax Disputes by Means of ADR

As regards MAPs and arbitration procedures, please refer to **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

According to Article L. 247 of the FBTP, tax settlements are only possible in regard to tax penalties.

However, another procedure – a global settlement (*règlement d'ensemble*) – may also be made as part of a tax audit of a company, enabling the company to reach an agreement with the tax authorities on the amount of taxes and penalties due.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Please refer to **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction** and **6.2 Settlement of Tax Disputes by Means of ADR**.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

There are different kinds of rulings under French law:

- “special rulings”, exhaustively listed in Article L. 80 B, No 2 et seq of the FBTP, including for instance, a “no permanent establishment (no-PE) ruling” under which a taxpayer asks the FTA whether it has a permanent establishment in France; and
- “general rulings” (Article L. 80 B, No 1 of the FBTP) under which a taxpayer asks the FTA to draw the legal consequences of a given factual situation.

In both cases, the ruling shall clearly outline the technical analysis of the applicant and a precise, complete and sincere presentation of the factual situation (ie, complete disclosure of the facts).

It should be noted that:

- regarding no-PE rulings, the FTA has three months as from the receipt of the application to provide its position – the reply or absence of a reply is binding vis-à-vis the FTA;
- regarding general rulings, the FTA has also three months as from the receipt of the application to provide its position – in the case of a reply, this position is binding vis-à-vis the FTA but unlike in the case of a special ruling, the absence of a reply to a general ruling within this deadline has no consequences vis-à-vis the FTA; and
- it is possible to file a ruling on a “no-name basis” but the response of the FTA (if any) would not be binding.

The information disclosed through a ruling application should remain confidential.

6.5 Further Particulars Concerning Tax ADR Mechanisms

Tax settlements cover all kinds of situations (ie, all taxes and penalties, except where a settlement would be based on Article L. 247 of the FBTP, which only covers the amount of penalties) and can be reached at any time of the procedure (including where a litigation is ongoing) with no specific deadline applicable, even though they are generally reached before the issuance of the tax collection notice. In France, tax settlements are generally definitive and not subject to appeal or any other recourse.

MAPs cover economic or legal double taxation and specific deadlines are applicable (see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**).

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

ADR mechanisms can be used to settle disputes over transfer pricing cases, since they could lead to double taxation (in this respect, see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**). Transfer pricing cases or cases where taxes are determined by indirect methods may also be settled by a global settlement.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

When characterised presumptions of tax fraud exist, the Public Prosecutor is only allowed to prosecute the offence of tax fraud in cases where the FTA lodge a criminal complaint.

In addition to the possibility of the FTA filing complaints for tax fraud (only after getting a favourable binding opinion of the committee on tax offences in cases of non-aggravated tax fraud), Law No 2018-898 on the fight against fraud, dated 23 October 2018, provides that the FTA are compelled to report facts to the Public Prosecutor where these facts lead to the following.

A tax reassessment exceeding an amount of EUR100,000; and

The application (in a tax collection notice) of:

- (a) the 100% penalty (ex officio procedure);
- (b) the 80% penalties (eg, for concealed activity or fraudulent behaviour); or
- (c) the 40% penalties (late submission of a tax return or deliberate breach), where the taxpayer has been subject:
 - (i) to the penalties listed at a), b) or c) in the context of a previous tax audit during the last six calendar years; or

- (ii) to a complaint of the French tax authorities further to a previous tax audit.

Once the facts have been reported, the Public Prosecutor is entitled to prosecute for the offence of tax fraud.

If the FTA has filed a criminal complaint for tax fraud regarding a taxpayer, the Public Prosecutor can extend criminal charges to other taxes and other years without the need for a further criminal complaint or reporting for those years from the FTA.

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

The offence of money laundering of tax fraud can be prosecuted by the Public Prosecutor on their own initiative.

7.2 Relationship between Administrative and Criminal Processes

Administrative courts are not bound by the decisions of judicial courts in criminal matters, and vice versa, by virtue of the principle of independence of tax and criminal proceedings. Judicial courts are thus not required to stay the proceedings and await the decision of administrative courts, nor are they bound by the latter's decisions, which means that they can find taxpayers guilty of tax fraud even if the Supreme Administrative Court has recognised that the reassessments which justified the criminal proceedings for tax fraud were not grounded, as long as the criminal judge characterises the same facts in a different manner.

However, there are limits to this principle of procedural independence.

Firstly, the administrative judge is bound by the material findings of facts by the criminal judge, and by their legal characterisation for criminal law purposes, upon two conditions.

First, that these findings of facts are made in a final judgment on the merits (ie, a judgment that has the force of *res judicata*). Conversely, the administrative judge is not bound by a decision to dismiss proceedings (*ordonnance de non-lieu*) or by a referral order (*ordonnance de renvoi*) by the investigating judge (*juge d'instruction*).

Second, that these findings of facts constitute the necessary grounds of the decision of the criminal judge. Conversely, the administrative judge is not bound by the findings of facts that do not motivate the decision of the criminal judge (Supreme Administrative Court 14 Dec 1984, No 37200). Therefore, where a decision of acquittal is rendered by a criminal court, the administrative court is required, before making its own assessment regarding the materiality and characterisation of the facts for tax law purposes, to determine whether this acquittal was based on findings of fact which are binding on it.

If these conditions are met, the facts found by the criminal judge are deemed materially established, and the taxpayer is not entitled to challenge their accuracy before the administrative judge.

Finally, and conversely, the criminal judge may, without disregarding their jurisdiction or breaching the above-mentioned principle of procedural independency, justify their decision to acquit in view, among other things, of the decisions handed down by administrative courts to discharge the taxpayer.

In several decisions, the Constitutional Court has ruled that the cumulative application of tax and criminal penalties was in compliance with

Article 8 of the Declaration of the Rights of Man and of the Citizen, but has expressed interpretative reservations according to which it is applicable if certain conditions are met.

7.3 Initiation of Administrative Processes and Criminal Cases

The general offence of tax fraud is broadly defined by Article 1741 of the FTC.

Theoretically, all tax adjustments may lead to criminal prosecution.

Except for the rules under which the tax authorities are compelled to report facts to the Public Prosecutor, the prosecution of the offence of tax fraud is at the sole discretion of the FTA.

7.4 Stages of Administrative Processes and Criminal Cases

Once a complaint has been filed by the FTA (or facts have been reported to the Public Prosecutor by the FTA), judicial investigations are generally launched by the police.

Several investigative acts (dawn raids, production orders, witness interviews, free interviews, placement under police custody, geo-tracking, telephone-tapping, surveillance and undercover operations) may be performed by police officers or directly by the Public Prosecutor in preliminary investigations.

As regards the duration of preliminary investigations, there is no legal timeframe within which investigations shall be concluded.

Under French criminal law, the Public Prosecutor is granted significant leeway when deciding whether to prosecute a criminal offence or not. If they consider that the preliminary investigation is sufficient, they may decide to seize the criminal court of that offence (the tax court being not competent to hear tax criminal cases).

Judicial Investigations

If the Public Prosecutor considers that the preliminary investigation did not result in the revelation of all the circumstances surrounding the commission of a criminal offence, thus preventing its immediate criminal prosecution, they may decide to appoint an investigating judge tasked with further investigating that criminal offence during a so-called judicial investigation. At the end of the judicial investigation, the investigating judge may consider either that there are insufficient charges to seize the court, and shall hence issue a dismissal order, or that there are sufficient grounds for a person to stand trial, in which case it shall issue a specific committal order laying out charges with a view to seizing the criminal court having jurisdiction to try the offence.

7.5 Possibility of Fine Reductions

There is no rule under which a taxpayer can benefit from reductions of fines applicable to the corresponding tax offence where upfront payment of the additional tax assessment is made.

The criminal judge may, however, take this element into account to reduce the amount of the fine provided by the criminal law.

7.6 Possibility of Agreements to Prevent Trial

Paying the tax assessed, plus interest and penalties, cannot prevent or stop a criminal tax trial.

However, two criminal settlement proceedings could potentially be envisaged under French law (both applicable for the offences of tax fraud and the money laundering of tax fraud).

The CRPC

A settlement close to plea bargaining agreements is referred to as *comparution sur reconnaissance préalable de culpabilité* (CRPC). The CRPC requires that the defendant pleads guilty

to the charges and applies to both individuals and companies but only for certain offences. Once the Public Prosecutor and the defendant reach an agreement, the defendant is brought before the president of the first instance tribunal.

The CJIP

A settlement close to a deferred prosecution agreement (*Convention Judiciaire d'intérêt Public*, CJIP) allows entities (ie, not individuals) to avoid a criminal conviction by:

- paying a fine proportionate to the gains derived from the company's wrongdoing, which total cannot exceed 30% of the company's annual turnover; and
- implementing a compliance monitorship for a period up to three years.

Unlike with the CRPC, the defendant is not required to plead guilty to the charges. The CJIP must be approved by a judge, and if so, the prosecution office issues a press release and the approval order issued by the judge is published on the new National Anti-Corruption Agency's website.

7.7 Appeals against Criminal Tax Decisions

It is possible to appeal before the competent appellate court against a decision adopted by a court of first instance that decided on the criminal tax offence in question. The court of appeal has the ability to re-examine the entire case. The appeal has a suspensive effect.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Rules challenging transactions and operations, notably under general anti-abuse rules (GAAR) or under transfer pricing rules, could give rise to criminal tax cases, even though until now the vast majority of criminal tax cases have been related to VAT fraud.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In the event that a double taxation situation occurs due to a tax adjustment performed by the FTA, it is common to use both domestic litigation to challenge the position of the FTA and the available mechanism under the double tax treaty (eg, the MAP or an arbitration), it being noted that domestic litigation is often a prerequisite to challenge instances of double taxation. The impact of the MLI and the EU Tax Disputes Directive 2017/1852 remains limited from a tax dispute perspective given their recent adoptions.

8.2 Application of GAAR/SAAR to Cross-Border Situations

In France, general anti-abuse rules (GAAR) and specific anti-abuse rules (SAAR) apply to cross-border situations covered by bilateral tax treaties.

GAAR

Article L. 64 of the FBTP, which is comparable to the principal purpose test (PPT) introduced by the MLI, provides for an abuse of law (*abus de droit*) procedure that allows the FTA to dismiss, as not enforceable against it, the acts constituting an abuse of law. In the Verdannet case, dated 26 October 2017, the Supreme Administrative Court ruled that the FTA may apply Article L. 64 of the FBTP to prevent the application of a tax treaty even if the latter does not contain a specific clause regarding abuse of law. The Supreme Administrative Court further added, in line with DTT preambles as amended by the MLI, that situations arising from artificial arrangements devoid of any economic substance are necessarily contrary to the purpose of DTTs.

In addition, acts committed or carried out, from 1 January 2020, may henceforth be excluded by

tax authorities in the case of an abuse of law, on the grounds that their main purpose is tax avoidance (L. 64 A of the FBTP).

In terms of corporate income tax, a general anti-abuse clause allows the FTA to ignore an arrangement or a series of arrangements, which – having been put into place for the central purpose of (or if one of the central purposes is) obtaining a tax advantage that defeats the object or purpose of the applicable tax law – are not genuine, having regard to all relevant facts and circumstances (Article 205 A of the FTC).

SAAR

Various specific anti-abuse rules are also provided for under French legislation and specifically cover abuses of law allowed by cross-border situations.

8.3 Challenges to International Transfer Pricing Adjustments

The transfer pricing method used by a company could be challenged by the FTA based on both domestic provisions and double tax treaty provisions.

Article 57 of the FTC allows the FTA to adjust the profits of a French enterprise in the event that the latter has indirectly transferred profits to a foreign-associated enterprise by an increase or decrease in purchase or sale prices, or by any other means. The arm's-length principle is also set out in Article 9 of the OECD Model Tax Convention.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Multinational enterprises can request unilateral or bilateral advance pricing agreements (APAs) from the FTA to reach an agreement on the determination of a transfer pricing method over a given period of time for future related-party

transactions, and so avoid future litigation over transfer pricing matters.

The FTA has expressed a preference for bilateral APAs.

Unilateral APAs are especially available in the following cases:

- where there is no available APA programme in the other state;
- where the relevant business transactions involve a large number of countries (for instance, a French company with a large number of foreign distributors), unless it is possible to request bilateral APAs with the countries where the largest transactions take place;
- if the transactions relate to a specific problem, which is not complex but gives rise to recurrent disputes, such as invoicing general expenses within a group; or
- when the applicant is a small or a medium-sized enterprise.

No unilateral APA is granted for transactions with enterprises situated in countries that do not have a treaty with France and have a privileged tax regime (as defined in Article 238 A of the FTC).

In an APA, the FTA agrees on the method, not on the price itself. An APA can be requested for all the transactions between a French enterprise and its associated foreign enterprise, or dealings between a permanent establishment and the rest of the enterprise to which it belongs. Alternatively, an APA can be requested – subject to the FTA agreeing that such a restricted scope is acceptable – for a segment of the enterprise's activities only, a type of transaction, a function or a product.

A simplified APA procedure exists for research and development centres.

8.5 Litigation Relating to Cross-Border Situations

The key areas and matters for tax auditors' special attention are transfer pricing, withholding tax and permanent establishment questions. These questions therefore generate the most litigation on cross-border situations.

Considering the recent *Conversant* case on PE as well as recent cases on the application of the profit split method, specific attention should be paid to the functions, assets and risks of each group company involved in the value chain.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

France has been involved in two types of state aid dispute involving taxes: disputes relating to tax measures constituting unlawful or incompatible state aid and disputes relating to taxes financing a state aid measure.

Disputes Relating to Tax Measures Constituting Unlawful or Incompatible State Aid

The French aid scheme for depreciation granted to economic interest groups has been qualified by the European Commission as unlawful and incompatible aid (European Commission, decision No 2007/256/EC dated 20 December 2006).

It is also possible to mention the dispute involving the French company *Electricité de France*, which, according to the European Commission, benefited from an unlawful and incompatible aid in the form of an exemption from corporate income tax (European Commission, decision No 2005/145/EC dated 16 December 2003; European Commission, decision No (EU) 2016/154 dated 22 July 2015).

Disputes Relating to Taxes Financing a State Aid Measure

If a state aid regime does not comply with EU law and if the taxes financing that regime are qualified as an integral part of the regime, taxpayers are entitled to claim for a refund of the taxes paid.

The trend in recent years has been rather unfavourable to taxpayers insofar as it is frequently judged that the criterion of hypothecation between the tax and the aid scheme is not met (eg, Supreme Administrative Court, 12 April 2019, No 376193).

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

French national law does not provide for any specific procedure for the recovery of incompatible or unlawful state aid. The Supreme Administrative Court has consistently ruled that the regime for the recovery of state aid is entirely governed by the provisions of Council Regulation No (EU) 2015/1589 dated 13 July 2015.

9.3 Challenges by Taxpayers

Instances of taxpayers challenging requests or additional tax assessments to recover unlawful/incompatible fiscal state aid are very limited.

For example, in the case concerning *Électricité de France* (see **9.1 State Aid Disputes Involving Taxes**), the latter challenged the request for recovery of illegal and incompatible aid that it had received.

9.4 Refunds Invoking Extra-Contractual Civil Liability

In a case dated 7 June 2017 (No 386627), the Supreme Administrative Court ruled that a taxpayer cannot obtain compensation on the ground that the France would be liable for the unlawful fiscal state aid it granted.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

In accordance with Article 18 of the MLI, France has elected to apply Part VI.

10.2 Types of Matters that Can Be Submitted to Arbitration

France did not make reservations on the principle of applying the arbitration mechanism provided for by the BEPS measures implemented through the MLI. Arbitration clauses, although not often used by France in the past, should be applied more widely in the future, subject to the reservations made by the other signatory states of the MLI.

France has made, however, some reservations regarding the type of case that it may exclude from arbitration. These include:

- cases where elements of income or wealth are not taxed by a contracting jurisdiction;
- cases where a taxpayer is subject to an administrative or criminal sanction for tax fraud, deliberate omission, or serious breach of a filing obligation;
- cases that can be submitted to an arbitration procedure provided for by EU laws or regulations;
- cases in which the average taxable amount per fiscal year or per calendar year is less than EUR150,000; and
- cases for which a common agreement with the competent authority of the other state has been reached.

EU Arbitration

At the EU level, the possibility to use arbitration is based on the EU Convention (90/436/CEE),

which is, however, limited to transfer pricing issues between related companies. Access to the EU Convention may be denied in case of application of severe penalties.

As of 1 July 2019, the EU Directive 2017/1852 on tax dispute resolution mechanisms (transposed in articles L. 251 B and seq of the FBTP) applies to disputes between the FTA and the authorities of other EU member states arising from the interpretation and application of DTTs concluded between France and one or more EU member states, and resulting in taxation not in accordance with the applicable treaties.

However, such a procedure cannot be applied in the case of a definitive application of a 40% penalty for deliberate breach or an 80% penalty for abuse of law, or if a definitive court decision has confirmed the taxation. Articulation with litigation could raise practical issues. For further details regarding arbitration procedure, please refer to **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Further to the implementation of the MLI in tax treaties concluded by France, the baseball arbitration method should now prevail over the independent opinion arbitration method, subject to the agreement of both parties.

In the context of the EU Directive 2017/1852, baseball arbitration shall be considered as an alternative dispute resolution mechanism at the disposal of the French competent authority. French law grants the competent authority the right to constitute an alternative dispute resolution commission with the other competent authority(ies) concerned so as to apply another decision-making process. This could lead to the application of baseball arbitration.

10.4 Implementation of the EU Directive on Arbitration

See **10.2 Types of Matters that Can Be Submitted to Arbitration**.

10.5 Existing Use of Recent International and EU Legal Instruments

Recent international and EU legal instruments are often used in France. With the MLI and the EU Directive 2017/1852, more cases have become eligible for arbitration proceeding and such proceedings should therefore increase in the coming years.

10.6 New Procedures for New Developments under Pillar One and Two

At the beginning of 2022, Bruno Le Maire, French Minister of the Economy and Finance, and also President of ECOFIN (the EU's Economic and Financial Affairs Council), indicated that France intended to maintain the objective of a rapid implementation of the OECD agreement on Pillar One and Pillar Two by early 2023 at the latest. However, in view of the recent discussions at both OECD/G20 and EU levels, it may be difficult to meet this challenging timeline.

Pillar One provides for mandatory and binding dispute prevention and resolution mechanisms to deal with any risk of double taxation. With regard to Pillar Two, the OECD is currently working on draft legislation on a stage-by-stage basis (several consultation papers are released building block by building block). The building block related to the prevention of dispute resolution has not yet been released (May 2022). As a general matter, these mechanisms may not be sufficient due to the complexity of the envisaged instruments.

10.7 Publication of Decisions

In principle, information given and received during arbitration is treated as confidential. A breach of confidentiality may end the procedure. The

EU Directive 2017/1852 provides for the possibility to publish final decisions under certain conditions subject to the consent of each of the persons concerned.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Taxpayers may choose the most suitable tool depending on the matter at stake (eg, transfer pricing or other cases). A large range of tools may be used in France:

- DTTs that include an arbitration clause (eg, the DTT with the USA);
- DTTs impacted by the MLI;
- the EU Dispute Resolution Directive and the domestic rules that implemented it; or
- the EU Arbitration Convention.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Each member of the arbitration commission shall be independent from people directly involved in the case and is designated by the competent authorities.

In principle, taxpayers are allowed to hire independent professionals to represent them during the arbitration proceeding.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

No costs are required to litigate at the administrative level.

11.2 Judicial Court Fees

For the lower court, the taxpayer is not obliged to appoint an attorney before an administrative court and can act on their own behalf. Con-

versely, since the decree No 2019-1333, dated 11 December 2019, the taxpayer is required to appoint an attorney before a civil court and cannot act on their own behalf.

Before the Court of Appeal, the principle is of the application of the procedure with mandatory representation by an attorney for proceedings in tax matters.

The declaration of appeal before the Supreme Court must be performed by a special attorney at the Supreme Court.

Trial costs can be divided into two categories, ordinary expenses and “irrecoverable” costs (*frais irrépétibles*).

Regarding ordinary expenses: when the claimant is successful, in whole or in part, the costs of service are refunded to them.

With regard to irrecoverable costs, in all proceedings, the judge shall order the party liable to pay the above-mentioned expenses or, failing that, the losing party to pay the other party the amount they determine, for the costs incurred and not included in the ordinary expenses (eg, lawyers’ fees).

In tax matters, taxpayers who obtain a favourable judgment from a lower court may be reimbursed for the costs of guarantees provided in order to benefit from the payment deferral or may obtain late payment interest in cases where they paid the tax adjustments instead of requesting the benefit of the payment deferral.

However, taxpayers who obtain a payment deferral further to the filing of a tax claim must pay late interest to the state if the court issues an unfavourable decision against them or if they withdraw from the dispute.

11.3 Indemnities

No indemnities are provided for within French legislation if the court decides that the initial additional tax assessment is absolutely void and null.

However, it is possible in certain circumstances to bring an action for damages against the FTA in order to obtain indemnities.

11.4 Costs of ADR

There are no court fees applicable if a taxpayer opts to use any of the ADR mechanisms.

12. STATISTICS

12.1 Pending Tax Court Cases

According to the 2020 Annual Report (*Rapport d'activité 2020 – Direction Générale des Finances Publiques*) of the General Directorate of Public Finance, the number of pending tax court cases in 2020 are as follows.

Administrative Courts

- Before the Lower Administrative Court: 11,887.
- Before the Administrative Court of Appeal: 3,184.
- Before the Supreme Administrative Court: 387.

Civil Courts

- Before the Lower Civil Court: 590.
- Before the Civil Court of Appeal: 361.
- Before the Supreme Court: 49.

12.2 Cases Relating to Different Taxes

For the value of net taxes recovered by the FTA relating to different taxes, please see **1.2 Causes of Tax Controversies**.

According to the 2020 Annual Report (*Rapport d'activité 2020 – Direction Générale des Finances Publiques*) of the General Directorate of Public Finance, statistics with regard to the number of terminated tax claims relating to different taxes are as listed below:

- income tax – 779,552;
- corporate tax and other direct taxes – 43,253;
- taxes on turnover – 40,385;
- stamp duties – 11,794;
- real estate taxes – 316,465; and
- property tax – 852,156.

12.3 Parties Succeeding in Litigation

Statistics regarding the party (tax authorities or taxpayers) that succeeds in litigation are not published in France.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

As previously mentioned in **2.6 Strategic Points for Consideration during Tax Audits** and **4.5 Strategic Options in Judicial Tax Litigation**, the legal and factual analysis of the circumstances of the case are crucial to determine the strategy to be followed in a tax controversy and thus depend on a case-by-case analysis.

Baker McKenzie AARPI works as an integrated global team, covering all multi-jurisdictional aspects and effects of an audit or dispute. The firm has more than 250 tax dispute resolution lawyers worldwide (in over 70 offices), offering broad international experience and deep local know-how in concluding disputes through the

full range of administrative and legal dispute resolution techniques. The team of tax litigators at Baker McKenzie Paris acts at each stage of a tax controversy, including assistance with tax audit procedures, negotiations with the French tax administration and litigation before domestic and EU jurisdictions.

AUTHORS



Eric Meier has worked at Baker McKenzie since 2006 and is currently a partner in the tax group. Previously, he worked with Arthur Andersen International (1994–2002), where

he participated in developing tax audits and litigation, and TAJ (2002–06). His key practice areas are search and seizure procedures, tax audit follow-up (particularly concerning the difficulties of applying international tax treaties, permanent establishment, anti-abuse rules, and withholding tax), negotiations with the tax authorities, disputes before the administrative and civil courts, handling tax fraud cases before the tax offences committee and criminal courts, procedures before the EU Institutions, and interventions before the French Constitutional Council.



Regis Torlet joined Baker McKenzie in 2006 and became a senior counsel in 2017. His practice is focused on various aspects of tax audits and litigation (assistance with tax

audit procedures, negotiations with tax authorities and litigation). Prior to joining Baker McKenzie, Regis worked with Arthur Andersen International (1999–2002) and TAJ (2002–06). He received a postgraduate diploma in business law and taxation from Aix-en-Provence University.

Contributed by: Eric Meier, Regis Torlet, Ariane Calloud and Mathieu Vaiteau, Baker McKenzie AARPI



Ariane Calloud joined Baker McKenzie in 2007 and became a partner in 2014. Her practice focuses on international tax dispute resolution. In particular, she assists clients in the context

of search and seizure procedures, tax audits in an international context, negotiations with the tax authorities and tax litigation. Prior to joining Baker McKenzie, she worked with PwC (2004–07), where she practised corporate tax and international tax law. Ariane has earned postgraduate degrees in business law at Paris I Sorbonne and in corporate tax law at Paris Dauphine. She was an IFA French Branch Reporter in 2018.



Mathieu Vaiteau joined Baker McKenzie in 2014 and became a partner in 2021. He mainly focuses on tax audits and litigation. Mathieu also advises companies and individuals in

connection with investigations, prosecutions and criminal settlement procedures in the areas of tax fraud and money laundering of tax fraud. Mathieu is a lecturer at the EDHEC Business School and the University of Poitiers. Mathieu holds an LLM in Law and Tax Management from the EDHEC Business School and a Master's degree in Business and Tax Law (DJCE) from the University of Poitiers.

Baker McKenzie AARPI

1 rue Paul Baudry
75008 Paris
France

Tel: +33 1 44 17 53 00
Fax: +33 1 44 17 45 75
Email: eric.meier@bakermckenzie.com
Web: www.bakermckenzie.com

The Baker McKenzie logo, featuring the word "Baker" in a bold, red, sans-serif font above the word "McKenzie." in a larger, bold, red, sans-serif font. The period at the end of "McKenzie." is also red.

Law and Practice

Contributed by:

Alex Karopoulos, Dimitris Gialouris, Eva Yotakou
and George Vlachakis

Zepos & Yannopoulos see p.188



CONTENTS

1. Tax Controversies	p.171	5.3 Judges and Decisions in Tax Appeals	p.180
1.1 Tax Controversies in this Jurisdiction	p.171	6. Alternative Dispute Resolution (ADR) Mechanisms	p.180
1.2 Causes of Tax Controversies	p.171	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.180
1.3 Avoidance of Tax Controversies	p.171	6.2 Settlement of Tax Disputes by Means of ADR	p.180
1.4 Efforts to Combat Tax Avoidance	p.172	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.180
1.5 Additional Tax Assessments	p.172	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.180
2. Tax Audits	p.173	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.180
2.1 Main Rules Determining Tax Audits	p.173	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.180
2.2 Initiation and Duration of a Tax Audit	p.173	7. Administrative and Criminal Tax Offences	p.181
2.3 Location and Procedure of Tax Audits	p.174	7.1 Interaction of Tax Assessments with Tax Infringements	p.181
2.4 Areas of Special Attention in Tax Audits	p.174	7.2 Relationship between Administrative and Criminal Processes	p.181
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.175	7.3 Initiation of Administrative Processes and Criminal Cases	p.181
2.6 Strategic Points for Consideration during Tax Audits	p.175	7.4 Stages of Administrative Processes and Criminal Cases	p.181
3. Administrative Litigation	p.175	7.5 Possibility of Fine Reductions	p.182
3.1 Administrative Claim Phase	p.175	7.6 Possibility of Agreements to Prevent Trial	p.182
3.2 Deadline for Administrative Claims	p.175	7.7 Appeals against Criminal Tax Decisions	p.182
4. Judicial Litigation: First Instance	p.176	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.182
4.1 Initiation of Judicial Tax Litigation	p.176	8. Cross-Border Tax Disputes	p.183
4.2 Procedure of Judicial Tax Litigation	p.176	8.1 Mechanisms to Deal with Double Taxation	p.183
4.3 Relevance of Evidence in Judicial Tax Litigation	p.176	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.183
4.4 Burden of Proof in Judicial Tax Litigation	p.177		
4.5 Strategic Options in Judicial Tax Litigation	p.177		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.178		
5. Judicial Litigation: Appeals	p.178		
5.1 System for Appealing Judicial Tax Litigation	p.178		
5.2 Stages in the Tax Appeal Procedure	p.179		

8.3	Challenges to International Transfer Pricing Adjustments	p.183	10.5	Existing Use of Recent International and EU Legal Instruments	p.185
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.183	10.6	New Procedures for New Developments under Pillar One and Two	p.185
8.5	Litigation Relating to Cross-Border Situations	p.184	10.7	Publication of Decisions	p.185
9. State Aid Disputes		p.184	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.186
9.1	State Aid Disputes Involving Taxes	p.184	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.186
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.184	11. Costs/Fees		p.186
9.3	Challenges by Taxpayers	p.184	11.1	Costs/Fees Relating to Administrative Litigation	p.186
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.184	11.2	Judicial Court Fees	p.186
10. International Tax Arbitration Options and Procedures		p.185	11.3	Indemnities	p.186
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.185	11.4	Costs of ADR	p.186
10.2	Types of Matters that Can Be Submitted to Arbitration	p.185	12. Statistics		p.186
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.185	12.1	Pending Tax Court Cases	p.186
10.4	Implementation of the EU Directive on Arbitration	p.185	12.2	Cases Relating to Different Taxes	p.187
			12.3	Parties Succeeding in Litigation	p.187
			13. Strategies		p.187
			13.1	Strategic Guidelines in Tax Controversies	p.187

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

The majority of tax controversies in Greece arise following a tax audit initiated by the tax authorities. The taxpayers to be audited are selected on the basis of a risk analysis made centrally by the tax administration, using criteria not officially published. Once the taxpayer is selected for audit, an audit order is issued and notified to the taxpayer, thus initiating the tax audit. Furthermore, unannounced tax audits may be performed on the spot to check the compliance of taxpayers. Depending on the findings, tax audits may result in the assessment of taxes, penalties and interest against the taxpayer, which the latter has the right to dispute.

A tax controversy may also be initiated in cases where:

- the taxpayer files tax refund claims, when in a tax credit position; or
- the taxpayer files tax returns with reservation or revokes tax returns already filed and asks for the refund of a tax they consider to have been unduly paid.

In both the above-mentioned cases, the tax authorities may:

- perform an audit in order to review the refund claim of the taxpayer, which can result in its rejection; or
- let the relevant deadline for reviewing the refund claim pass, thus tacitly rejecting the refund claim.

1.2 Causes of Tax Controversies

There is no official statistical data as regards the taxes that more often give rise to tax controversies, either in terms of nature or values involved. In practice, however, it appears that the most

common areas of tax controversy for legal entities concern corporate income tax (including transfer pricing), VAT and stamp duty. For individuals, tax controversies arise mostly in relation to personal income tax and property taxes.

1.3 Avoidance of Tax Controversies

Tax legislation in Greece is often complex, and at times outdated, not adjusting to the changing economic reality and new types of transactions carried out. As a result, there are many issues whose tax treatment is currently not regulated by Greek tax law. At the same time, tax legislation is widely fragmented, with many decisions and circulars being issued for the interpretation of the applicable legal framework and the provision of guidelines for its implementation. Furthermore, especially since the financial crisis, tax legislation has been subject to constant amendments, which are sometimes not easy to keep up with.

In view of the above, it can be difficult for taxpayers to achieve full compliance with their tax obligations and therefore mitigate the possibility of a tax controversy. They are protected, however, when they have followed the interpretation and guidelines contained in the circulars and decisions issued by the tax administration, which are binding for the tax authorities. As long as this is the case, the taxpayers cannot be assessed with taxes and penalties.

However, Greek tax legislation does not provide for the issuance of binding tax rulings, so it is not possible to receive, in advance, the binding position of the tax administration on the tax treatment of certain transactions, and thus reduce uncertainty. Written queries may be filed with the tax administration, although their prevailing policy is no longer to issue individual replies, but, when they receive multiple queries on the same issue, to issue (where possible) general guidelines through circulars. However, even when they issue individual replies, the tax auditors are not

bound by them and can adopt a different position.

There is an exception for transfer pricing, where advance pricing agreements (APAs) can be concluded with the tax authorities.

1.4 Efforts to Combat Tax Avoidance

The OECD's base erosion and profit shifting (BEPS) recommendations and the EU's recent measures to combat tax avoidance have not yet had an impact on tax controversies in Greece. The reason for this is that they are relatively new and not many audits have yet been performed for the fiscal years in which these rules have been in effect. It should be noted that the statute of limitations for the right of the tax authorities to perform audits is, in principle, five years starting from the end of the tax year in which the relevant tax return should be filed and usually the tax authorities perform audits towards the end of this period.

There have been isolated cases where the general anti-abuse rule (GAAR), contained in the Tax Procedures Code has been invoked by the tax authorities; however, the Administrative Courts have not yet examined and commented on this rule.

1.5 Additional Tax Assessments

Upon issuance of the final tax assessment note following an audit, the taxpayer is obliged to pay the total amount assessed within 30 days. Making this payment is not a pre-condition for disputing the assessment further. However, when an administrative appeal is filed and 50% of the assessed amount is paid, payment of the remaining 50% can be suspended by law. If the administrative appeal is rejected and the taxpayer proceeds with a judicial appeal at first instance, the suspension remains (although in the event that the appeal is dismissed, payment of the suspended amount will be burdened with

8.76% interest per year, from the date it had originally become due).

However, if the judicial appeal is dismissed at first instance, payment of 20% of the main tax upheld by the first instance court that is due (excluding penalties and interest) is a condition for the admissibility of the second instance appeal.

If the assessed amounts are not paid when they become due, without being lawfully suspended, they become overdue, and the tax administration has the right to take enforcement measures.

Safeguard Measures

Nevertheless, even before the tax debt becomes due and payable, the tax administration may impose so-called safeguard measures in order to avoid the imminent risk of not collecting taxes. Such measures include the seizure of movable and immovable assets or claims of the debtor.

In a case where, in the context of a tax audit, the tax authorities consider that the taxpayer has not paid VAT; insurance premium tax; or taxes, duties and contributions which are either withheld or passed on to the counterparty, the amount of which exceeds EUR150,000, they have the right to proceed with the following safeguard measures against the taxpayer:

- freezing 50% of the bank deposits and the contents of safety-deposit boxes;
- freezing the entirety of the non-monetary assets of safety-deposit boxes; and
- not issuing documents required for the transfer of assets (eg, tax clearance certificate).

Where the taxpayer who is found not to have paid the above amount of taxes is a legal entity, the aforementioned safeguard measures are also imposed against any individual involved in the management, administration and representation of the legal entity.

The safeguard measures are lifted if 70% of the total assessed amount is paid, or the taxpayer submits a guarantee letter of an equal amount in favour of the Greek State.

Penalties and Criminal Proceedings

When an additional tax assessment is made, apart from the main tax due, penalties and interest are also assessed. These penalties include the administrative penalties that are applicable to the tax infringements identified and therefore administrative offences are not subject to a procedure separate from the additional tax assessment.

Should, however, the tax infringements result in tax evasion that triggers criminal liability, criminal proceedings may be initiated against the taxpayer (or their representatives, when the taxpayer is a legal entity).

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

As mentioned in **1.1 Tax Controversies in this Jurisdiction**, the taxpayers to be audited are selected on the basis of a risk analysis made centrally by the tax administration, using criteria not published. Therefore, the tax administration identifies those taxpayers for whom there is an auditing priority; however, the way in which this qualification is made is not disclosed. In this respect, tax audits may also be triggered by information the tax authorities receive from other countries (when the taxpayer is involved in cross-border transactions) or from audits performed on other taxpayers, for example when a supplier is found to have been issuing fictitious invoices. Furthermore, unannounced tax audits may be performed on the spot to check the compliance of taxpayers, usually those engaged in the retail sector where the risk of tax evasion is high (eg, unannounced visits to restaurants

to check the issuance of retail receipts to the customers).

2.2 Initiation and Duration of a Tax Audit

A tax audit can be initiated at any time within the statute of limitations; ie, as long as the right of the tax authorities to proceed with an assessment has not expired under the statute of limitations rules. According to these rules, the tax authorities have the right to assess taxes within five years, starting from the end of the tax year in which the relevant tax return should be filed.

The aforementioned statute of limitations is extended as follows.

- For one year if the taxpayer submits an initial or an amending tax return within the fifth year of the statute of limitations or if new evidence is made known to the tax authorities within the fifth year of the statute of limitations; in the latter case, the extension applies only for the matter which the new evidence relates to.
- In a case where a request for information is submitted to foreign tax authorities, the statute of limitations is extended for as long as it takes for the transmission of the requested information, plus one year from the receipt thereof by Greek tax authorities.
- In a case where an administrative or a judicial appeal is filed, the statute of limitations is extended for one year following the issuance of the decision; the extension concerns only the subject matter under dispute.
- In a case where a mutual administrative procedure (MAP) is initiated, the statute of limitations is extended for as long as the MAP lasts and only for the subject matter under dispute; if a decision is issued in the context of the MAP, the statute of limitations is extended for one year following the issuance of the decision.

- In a case where an application for the annulment or amendment of a tax assessment is made because a numerical mistake has been made or it is obvious that no tax liability exists, or the annulment/amendment is made by the tax authorities without an application having been made, the statute of limitations is extended for one year after the annulment/amendment and only for the matter the assessment concerns.
- In a case of non-filing of a tax return within five years from the end of the year in which the tax return should be filed or new evidence is made known to the tax authorities after the completion of the aforementioned five-year period, the statute of limitations is extended to ten years.

As long as the statute of limitations has not lapsed, there is no time limit for the completion of the audit, although the tax audit order issued for the particular audit provides an indicative duration of the audit.

The issuance of a tax audit order, or the tax audit itself, does not suspend or interrupt the statute of limitations. Any such suspension occurs only upon the issuance of the final tax assessment note to the taxpayer.

2.3 Location and Procedure of Tax Audits

Usually, the main part of the audit is performed from the tax authorities' offices. Upon initiation of the tax audit, the tax authorities serve a written request to the taxpayer, requesting them to provide certain data from their books and records. The taxpayer provides them electronically and then the audit is performed remotely. However, during the audit, the tax auditors may regularly visit the taxpayer's premises to discuss certain issues they need to clarify with them, or to check additional documentation.

2.4 Areas of Special Attention in Tax Audits

As regards corporate income tax, the deductibility of expenses is still the main focus of tax auditors. In this respect, the tax auditors may challenge this deductibility on two grounds:

- because they consider that the productivity condition has not been met (ie, that the expense has not contributed to the expansion of the business and the increase of its income); or
- because the supporting documentation available is not sufficient to establish the deductibility (eg, no detailed descriptions on the invoices).

In relation to VAT, the application of exemptions and reduced VAT rates is scrutinised, both with regard to the substantive conditions for their application, as well as the formal conditions (eg, the existence of supporting documentation evidencing the nature of the VAT-exempt activity or the goods that are subject to the reduced rates).

Stamp duty has been another area of focus for tax auditors, especially cross-border inter-company loans and whether their execution is deemed to have taken place in Greece, as per the territoriality rule. In this respect, auditors will review the flow of payments made in the context of such loans.

Lately, the focus of audits has also shifted to transfer pricing, with the tax auditors scrutinising the benchmarking studies. Cross-border cost-plus structures are also reviewed for permanent/ fixed establishment purposes.

Overall, the tax authorities still focus equally on substantive issues as well as formal ones (as regards the existence and proper issuance of fiscal documentation); in the coming years,

however, it is expected that more focus will be placed on the substantive issues.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Cross-border exchanges of information and mutual assistance have increased, especially with regard to VAT audits, where cross-border exchanges of information and assistance are more common. The audits usually focus on discrepancies detected in the transactions declared in EC Sales Lists, whereas audits on possible carousel frauds are also performed. Lately, multi-country audits have started being conducted, again with regard to VAT. Additionally, this exchange of information has recently started to be extended to the income of individuals generated in other countries.

2.6 Strategic Points for Consideration during Tax Audits

From a strategic point of view, during a tax audit it is important for the taxpayer to respond in a timely manner to any requests raised by tax authorities. This means that the taxpayer should provide all documentation and data requested, and be prepared to provide explanations and clarifications on issues not clear to the tax auditor. Orderly bookkeeping, prompt retrieval of any supporting documentation requested and solid explanations may have a positive impact, since otherwise the tax auditors may be negatively predisposed and therefore become more aggressive.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Upon completion of the tax audit, the competent tax authorities that performed it shall serve

the taxpayer with a preliminary audit findings report, together with a provisional assessment note on the amount of taxes and penalties to be assessed.

The taxpayer shall have a 20-day deadline to submit an explanatory memorandum raising arguments against the audit findings together with any supporting documentation.

Following the review of the aforementioned memorandum, the tax authorities may accept the arguments raised by the taxpayer either fully or partially, or may reject them entirely. Accordingly, and within a month from receiving the memorandum, they shall issue the final audit report and the final tax assessment notes assessing the taxes and penalties.

Upon being served the final assessment notes, the taxpayer shall have a 30-day deadline (60 days if the taxpayer is not established in Greece) to submit an administrative appeal before the Dispute Resolution Unit, a special directorate of the Independent Authority for Public Revenue, which is exclusively competent to review administrative appeals.

The submission of such an administrative appeal is a condition of admissibility for any subsequent judicial appeal before the competent court.

3.2 Deadline for Administrative Claims

The Dispute Resolution Unit shall have a 120-day deadline to issue a decision on the administrative appeal (the deadline is suspended from August 1st to 31st). Upon the lapse of the aforementioned deadline, and in so far as no decision has been issued, the administrative appeal shall be considered as tacitly rejected.

In such a case the tacit rejection can be challenged by filing a judicial appeal with the competent administrative court, the explicit rejection

of an administrative appeal is challenged in the same way.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is only initiated following the explicit or tacit rejection by the Dispute Resolution Unit of the administrative appeal filed by the taxpayer. Direct recourse to the courts without prior filing of an administrative appeal is not permitted. The judicial appeal is filed within 30 days (or 90 days for taxpayers not established in Greece) from the service of the negative decision by the Dispute Resolution Unit or the tacit rejection of the administrative appeal.

4.2 Procedure of Judicial Tax Litigation

As long as the amount of the main tax or tax penalty under dispute is lower than EUR150,000, the case is lodged before the Administrative Court of First Instance. If the amount exceeds the aforementioned threshold, the case is directly lodged at first instance before the Administrative Court of Appeals.

Initially, the taxpayer must submit an appeal before the competent court, as defined in **4.1 Initiation of Judicial Tax Litigation**. The competent court is also determined by reference to the place of establishment of the taxpayer filing the appeal. The appeal should include the legal and factual arguments against the negative decision of the Dispute Resolution Unit or the tacit rejection of the administrative appeal. Subsequently, and in any case no later than 15 days before the hearing date, the taxpayer has the right to submit additional grounds for the appeal. The document containing these additional grounds should be officially served by the taxpayer to the litigant tax authorities through a court bailiff.

The competent court shall set a hearing date and notify the parties accordingly. The taxpayer has the right to ask for an adjournment of the hearing, explaining the reasons they are asking for it. Usually, the first time an adjournment is requested, the court agrees to it. However, requests for adjournment in subsequent hearings are less likely to be accepted.

The tax administration must submit before the court the case file, together with a report which sets out its position on the case, at the latest 30 days before the hearing date (although in practice this deadline is usually not observed). The taxpayer must furnish any supporting documentation and evidence to the court up to one day prior to the hearing date.

Following the hearing, the parties shall have three working days to submit a memorandum to elaborate further on any arguments already raised. Upon the lapse of this deadline, each party shall have three more working days to rebut the arguments offered by the other party in its memorandum.

The procedure is then completed, the court examines all documents submitted and issues its decision.

4.3 Relevance of Evidence in Judicial Tax Litigation

As mentioned in **4.2 Procedure of Judicial Tax Litigation**, any supporting documentation and evidence should be submitted to the court up to one day prior to the hearing date. The supporting documentation submitted by the taxpayer is very important for the substantiation of their arguments and it is taken into account by the court. It is often the case that the court will dismiss appeals on the ground that the supporting documentation submitted by the taxpayer was not sufficient to prove their arguments.

Witness testimony is possible both in the form of an affidavit and through direct examination in court.

An affidavit may be furnished to the court, together with the other supporting documentation. In order for such an affidavit to be admissible, at least ten days prior to the testimony date, the taxpayer should notify the State (with an invitation served to the litigant tax authorities through a court bailiff), on the date, time and place (ie, the notary public's office) where the testimony will take place. This is to allow the tax authorities to have the opportunity to attend the testimony and ask questions if they so wish, but in practice they never attend.

The court may, of its own motion or following the request of a litigant party, order the examination of a witness before the court or before the Judge-Rapporteur, even if the witness has already testified via an affidavit. The request of a party for such an examination must be either included in the appeal or in a special application submitted to the court five days prior to the hearing date. This option, however, is not usually followed in practice.

It is often the case that witness testimonies are not taken into account equally by the court with the rest of the supporting documentation (eg, agreements, invoices, extracts from the accounting books).

4.4 Burden of Proof in Judicial Tax Litigation

In the tax litigation proceedings before the administrative courts, each party has the burden to prove any facts it has invoked and support the argumentation it has raised, unless otherwise provided by law. The other party shall have the right to submit evidence in rebuttal.

As regards criminal proceedings, the competent criminal authorities should provide all the necessary evidence to substantiate the accusation, while the taxpayer needs to prove their own arguments.

4.5 Strategic Options in Judicial Tax Litigation

Timing

The procedure before the court is standard: all legal arguments should be included in the judicial appeal at the time of its filing with the court, or with an additional document that can be filed up to 15 days prior to the hearing. Therefore, the Greek State will have the time and opportunity to review these arguments and rebut them with its own memoranda. Thus, there is no room for a strategy as regards the timing of the raising of arguments. The same applies for supporting documentation and evidence. They should be submitted to the court up to one day before the hearing date. Usually, the tax authorities do not comment on the documentation and evidence submitted, but they focus on rebutting the legal argumentation raised by the taxpayer.

It used to be debated whether all arguments should already be raised, and the supporting documentation and evidence submitted, at the level of the administrative appeal, or whether it was possible for them to be raised and submitted for the first time at the level of the judicial appeal. The Supreme Administrative Court, however, has now ruled that arguments relating to the facts of the case cannot be raised for the first time at the level of the judicial appeal if they had not already been raised with the administrative appeal. On the other hand, legal arguments related to the validity and interpretation of the applicable legislation or legal principles may be raised for the first time with the judicial appeal. In this respect, it is advisable for the taxpayer to raise all their arguments and submit all evidence at the level of the administrative appeal.

Settlements

In principle, and with certain limited exceptions, Greek law does not provide for a settlement procedure during the judicial phase, which, if entered into by the taxpayer, could result in the reduction of the payable amounts.

Payment in Advance

The payment of the amounts assessed is not considered as acceptance of the assessment by the courts. As mentioned above, in **1.5 Additional Tax Assessments**, upon filing of the administrative appeal and payment of 50% of the assessed amount, payment of the remaining 50% is suspended. The suspension continues even if the administrative appeal is rejected and a judicial appeal is filed. If the court issues a negative decision for the taxpayer, the taxpayer needs to pay the remaining 50%; however, this will be burdened with interest of 8.76% annually (from the date this amount had originally become due). Therefore, when it is ambiguous whether the case will be won at court, taxpayers opt to pay the total amount assessed at the beginning, in order to avoid paying interest if they lose.

Expert Reports

Expert reports can be submitted as additional evidence. This could be opportune, especially as regards issues that present a certain degree of complexity for judges; eg, transfer pricing issues or issues requiring clarification on the accounting treatment of transactions.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The jurisprudence of international courts is usually taken into account by Greek courts and it is often the case that the courts base their rulings on such jurisprudence. This occurs especially when they examine VAT cases, where they almost always invoke relevant ECJ jurisprudence.

Doctrine may be referenced by Greek courts, in order to substantiate a position they have taken, but not that often. The same applies for the jurisprudence of foreign courts, with the Supreme Administrative Court being more likely to reference it, rather than the lower courts.

As regards international guidelines, BEPS reports have not yet started being invoked, whereas the OECD Commentary on the Model Convention on Income and on Capital, and the OECD Transfer Pricing Guidelines are invoked when relevant issues are examined by the courts.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

If the amount of the main tax or tax penalty under dispute exceeds EUR150,000, the case is lodged directly before the Administrative Court of Appeals. In such a case, this court rules at first and last instance and its decision is not subject to an appeal (at second instance) but only to a writ of cassation before the Supreme Administrative Court.

Recourse to the Supreme Court is allowed only for matters relating to the interpretation of law. The writ of cassation is admissible in so far as the disputed amount exceeds EUR40,000. This amount refers to the main tax (not including penalties or interest). An additional condition of admissibility is that, for the legal matter in question, there is no prior jurisprudence of the Supreme Administration Court, or the contested decision of the Administrative Court of Appeals is contrary to existing jurisprudence of the Supreme Administrative Court or other supreme courts (including the ECJ or the ECHR), or to an irrevocable decision of an Administrative Court.

If the amount of the main tax or tax penalty under dispute does not exceed EUR150,000, the case is lodged before the Administrative Court of First Instance. In such a case, its decision is subject to an appeal (at second instance) before the Administrative Court of Appeals, provided that the amount under dispute exceeds EUR5,000. The appeal may be based on both legal and factual grounds. The decision of the Administrative Court of Appeals is again subject to a writ of cassation, under the conditions mentioned above.

5.2 Stages in the Tax Appeal Procedure

Administrative Court of Appeals

The second instance appeal before the Administrative Court of Appeals is filed within 60 days from the date on which the decision of the Administrative Court of First Instance is served. The deadline is extended to 120 days for taxpayers not established in Greece. Additional grounds other than those included in the initial appeal can be put forward; however, the relevant document should be submitted to the Administrative Court of Appeals, at the latest, 15 days before the hearing date. The document with the additional grounds should be officially served to the litigant tax authorities through a court bailiff.

The court will set a hearing date and notify the litigant parties accordingly. The taxpayer has the right to ask for an adjournment of the hearing, explaining the reasons for which they are asking for that adjournment. Usually, the first time an adjournment is requested, the court agrees to it. However, requests for adjournment in subsequent hearings are less likely to be accepted.

The taxpayer should submit all supporting documentation and evidence, at the latest, by the day before the hearing. The tax administration must also submit before the court the file of the case, together with a report which sets out its position on the case, 30 days before the hearing date

(although this deadline is usually not observed in practice).

Following the hearing, the parties shall have three working days in which to submit a memorandum to elaborate further on any arguments already raised. Upon the lapse of that deadline, each party shall have three more working days to rebut the arguments elaborated by the other party in its memorandum.

The procedure is then completed, the court examines all the documents submitted and issues its decision.

Supreme Administrative Court

As regards the writ of cassation before the Supreme Administrative Court, it is filed 60 days after the contested decision of the Administrative Court of Appeals is served to the taxpayer. If the taxpayer is not established in Greece, the deadline for the filing is extended to 90 days.

The Supreme Court shall set a hearing date and notify the applicant taxpayer accordingly. The latter should further serve the writ to the litigant tax authorities 20 days prior to the hearing date. Given the nature of the writ of cassation, no supporting documentation and evidence is submitted. The parties may submit a memorandum, to elaborate further on their arguments, six full days prior to the hearing. At the hearing, they may also make a request to the court president to submit an additional memorandum, within a fixed deadline to be determined by the president.

At the hearing, both representative lawyers of the taxpayer and the Greek State have the right to elaborate fully on their arguments and they may receive questions from the judges.

It is often the case that the hearings before the Supreme Administrative Court are adjourned ex officio, due to the heavy workload of the judges.

5.3 Judges and Decisions in Tax Appeals

Cases where the amount in dispute is less than EUR60,000 (this amount refers to the main tax, not including penalties and interest) are heard by the single-judge Administrative Court of First Instance. If the amount exceeds EUR60,000 and up to EUR150,000, the case is heard by the Administrative Court of First Instance sitting with three judges.

If the amount exceeds the amount of EUR150,000, the case is heard at first and last instance by the Administrative Court of Appeals sitting with three judges.

The appeal against the decision of the single-judge Administrative Court of First Instance is heard by the single-judge Administrative Court of Appeals, while the appeal against the decision of the Administrative Court of First Instance sitting with three judges is heard by the Administrative Court of Appeals sitting with three judges.

Both the Administrative Court of First Instance and the Administrative Court of Appeals have many chambers comprised of different judges. The allocation of the cases to each chamber is made internally.

The writ of cassation before the Supreme Administrative Court is heard by the competent chamber of the Court sitting with five judges, who differ for each case, depending on the internal allocation of the cases that has been made. Important cases may be referred to the chamber sitting with seven judges or the Plenary of the Supreme Administrative Court.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

In principle, there is no alternative dispute resolution (ADR) mechanism applicable for taxes in Greece.

6.2 Settlement of Tax Disputes by Means of ADR

Please see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Please see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Greek tax law does not provide for the issuance of binding rulings. Written queries can be filed with the tax authorities and the latter can provide written answers; however, these answers are not binding and the tax auditors can adopt a different position in the context of a tax audit. There is an exception, however, as regards transfer pricing, where APAs are available.

6.5 Further Particulars Concerning Tax ADR Mechanisms

Please see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

Please see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

When an additional tax assessment is made, apart from the main tax due, penalties and interest are also assessed. These penalties include the administrative penalties that are applicable to the tax infringements identified, and therefore the administrative offences are not subject to a separate procedure from the additional tax assessment. When the taxpayer assessed is a legal entity, the individuals managing and representing the legal entity are also jointly liable for payment of the assessed amounts (taxes and penalties). Namely, if the legal entity does not pay its tax debt and it becomes overdue, the tax authorities have the right to approach the aforementioned individuals and request payment of the debt. At the same time, as mentioned in **1.5 Additional Tax Assessments**, the tax authorities have the right to impose safeguarding measures against the taxpayer (or their representing individuals) in order to ensure collection of the tax debts.

If the taxpayer commits tax evasion, they will also have criminal liability. Tax evasion is an offence triggering criminal liability, when the taxpayer intentionally avoids the payment of taxes, evidenced by omitting to file a tax return or filing an inaccurate tax return, or recording fictitious expenses in their accounting books.

Tax evasion also requires that certain thresholds of tax not paid be exceeded on an annual basis; ie, EUR50,000 for VAT or EUR100,000 for any other tax, this threshold being applicable separately to each type of tax.

When the taxpayer is a legal person and tax evasion is committed, the burden of criminal liability is borne by the individuals who manage and represent the legal entity.

In practice, following the issuance of the final tax assessment notes, and as long as the aforementioned thresholds for committing tax evasion are met, the tax officers – without examining or assessing whether the element of “intention”, as required by law for the offence of tax evasion, actually exists – will submit a criminal complaint to the competent Public Prosecutor against the persons bearing criminal liability.

The tax administration has clarified through relevant guidelines that ordinary income tax adjustments (ie, disallowed expenses), as well as TP adjustments and stamp duty, should not be considered as falling under the scope of tax evasion.

Furthermore, a separate criminal offence is provided by Greek law, when the tax debts of a taxpayer exceeding EUR100,000 have become overdue and the taxpayer does not pay them within four months from when they became overdue.

7.2 Relationship between Administrative and Criminal Processes

Criminal proceedings are suspended, until the deadline for the taxpayer to challenge the assessment expires, or if the taxpayer has challenged the assessment, until an irrevocable decision by the administrative courts is issued.

7.3 Initiation of Administrative Processes and Criminal Cases

Please see **7.1 Interaction of Tax Assessments with Tax Infringements** and **7.2 Relationship between Administrative and Criminal Processes**.

7.4 Stages of Administrative Processes and Criminal Cases

As mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**, the tax administrative infringement process is not separate from the additional tax assessment.

As regards the tax criminal procedure, following the submission of the criminal complaint by the tax authorities against the persons bearing criminal liability for the offence of tax evasion (and unless the relevant proceedings have not been suspended), the Public Prosecutor, on the basis of the evidence available, can decide either to initiate a pre-interrogation or interrogation procedure, to send the case directly to the competent criminal court, or to close the file. At the pre-interrogation or interrogation stage, the accused individual has the right to submit a defence statement along with all available supporting documentation. At this point, the Public Prosecutor may decide not to continue the criminal procedure or to send the case to the criminal court. In the latter case and at the hearing, the accused individual should present all substantiating documentation, in order to support their case. Following the hearing and the examination of the facts and evidence, the court shall issue its decision.

Criminal tax cases are heard exclusively by criminal courts, which are totally separate from administrative courts, which only decide on the tax assessments, on the basis of tax law.

7.5 Possibility of Fine Reductions

Reduction of the applicable penalties for tax offences is only possible during the course of the audit and until the issuance of the preliminary audit findings report. After the audit has started, the taxpayer can voluntarily file corrective tax returns and pay any tax due, prior to that tax being assessed. In such a case, the applicable penalties are reduced. However, the reduction applies under the condition that the taxpayer will waive their right to challenge the payment of the taxes and penalties further.

Furthermore, once the tax assessment is finalised, no reduction is provided in the event that the taxpayer pays the total amount assessed,

which becomes due anyway within 30 days from the assessment.

7.6 Possibility of Agreements to Prevent Trial

No such agreement is possible, whereas if the total amount assessed is paid, although the criminal tax trial will still take place, in practice it should be expected that the individual will be acquitted.

7.7 Appeals against Criminal Tax Decisions

In criminal proceedings, the decision of the first instance court is subject to an appeal at second instance before the competent criminal court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Pursuant to guidelines issued by the Greek tax administration, transfer pricing adjustments should not be considered as falling under the scope of tax evasion. Therefore, in the event of such findings, criminal proceedings are not initiated.

However, as regards tax assessments arising from the application of the general anti-abuse rule (GAAR) or the specific anti-abuse rule (SAAR), tax authorities should be expected to submit a criminal complaint, where the relevant thresholds for committing tax evasion have been exceeded. Nevertheless, such rules are still not commonly invoked by tax authorities and therefore they do not result in tax disputes. There have been isolated cases where the GAAR has been invoked, especially in stamp duty cases; given, however, that the non-payment of stamp duty does not fall within the definition of tax evasion, no criminal proceedings have been initiated in this respect.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Until now, limited use of MAPs has been made in cases of tax assessments concerning cross-border elements, due mainly to the lack of response by the Greek tax authorities. Therefore, it has been more common for recourse to be made solely to domestic litigation.

In 2017, however, a renewed legislative framework was introduced for the processing of applications through MAPs, which provides for a structured review and response to such applications. Therefore, it may be possible for MAPs to start being used more by taxpayers. Nevertheless, it should be noted that if recourse has also been made for the same matter to a domestic court and the latter issues a decision, then the MAP can no longer proceed.

In 2020 Greece also implemented Directive 2017/1852 on tax dispute resolution mechanisms in the European Union. In 2021 the Multilateral Instrument (MLI) was also ratified, but neither of the two has yet had an impact on resolving double taxation issues, as they are very recent.

8.2 Application of GAAR/SAAR to Cross-Border Situations

As mentioned in **7.8 Rules Challenging Transactions and Operations in this Jurisdiction**, the GAAR or SAAR are still not commonly used and therefore no tax disputes have arisen due to their application. The same also applies with respect to the principal purpose test (PPT) introduced by the MLI and the amendments made in the DTTs, as the ratification of the MLI is very recent. It should be expected, however, that it could potentially create more disputes with the tax authorities. The taxpayers would normally

bring such disputes before the courts, the position of which cannot be predicted in advance, given the lack of precedent.

8.3 Challenges to International Transfer Pricing Adjustments

Transfer pricing adjustments have mostly been challenged under domestic litigation. There have been fewer cases where the MAP has been used, on the basis of both the EU Directive and the applicable double tax treaty.

8.4 Unilateral/Bilateral Advance Pricing Agreements

APAs are provided for in Greek tax legislation and are increasingly used as a mechanism to mitigate litigation in transfer pricing matters. Roll-back APAs have been introduced into Greek tax legislation as well.

APA applications are filed with the Directorate of Tax Audits of the tax administration and comprise the following stages.

- Preliminary consultations – any taxpayer interested in an APA may request entry into an informal preliminary consultation with the aforementioned competent Directorate, in order to explore the possibilities of the APA application being approved.
- Submission of the official APA application together with the minimum documentation provided by the applicable legal framework; if a preliminary consultation has taken place, the APA application should be filed within 30 days.
- Evaluation of the APA application – the competent Directorate evaluates the APA application and issues a document setting out its position; within ten days from the issuance of the aforementioned document, a final meeting is set with the interested taxpayer, who must be invited at least 20 days prior to the meeting date.

- If during the meeting an agreement is reached, relevant minutes are drafted.
- Within 20 days from the meeting, and on the basis of the minutes thereof, the decision on the APA is issued, which is served together with the minutes to the applicant.

The decision on the APA should be issued within 120 days from filing the relevant application. However, in cases where arrangements with foreign tax authorities need to be made, the above deadline is not applicable. The duration of the decision on the APA cannot exceed four years.

8.5 Litigation Relating to Cross-Border Situations

Until now, it was more common for litigation to be generated from cases concerning withholding taxes, and more specifically the definition of royalties (which are subject to withholding tax) versus business income (which is not subject to withholding tax). In such a case, litigation could be mitigated if the agreements in place gave a detailed description of the services actually provided (in order for their nature to be more easily defined) and, accordingly, the invoices contained sufficient descriptions or made reference to the agreements in place.

However, transfer pricing litigation is increasing, with APAs being suitable to mitigate litigation. Furthermore, there has been some litigation involving permanent/fixed establishment assessments concerning cost-plus structures, with the tax authorities adopting aggressive interpretations of the respective provisions of double taxation treaties and VAT legislation, which, however, have so far been upheld by the courts as well.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

There have been state aid disputes in the past involving taxes. One such dispute concerned tax-free reserves that certain companies had been allowed by law to form from their undistributed profits, under the condition that the respective amounts would be used in the next three years for certain investments.

However, the European Commission decided that the above incentive constituted state aid incompatible with the single internal market.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

The practice followed for such recovery is that the competent tax authority issues an assessment note requesting the taxpayer to pay the tax that was not paid due to the application of the measure that has been qualified as unlawful/incompatible state aid.

9.3 Challenges by Taxpayers

There have been cases where taxpayers have challenged the assessment notes issued by the tax authorities by filing administrative appeals before the Dispute Resolution Union and judicial appeals before the competent administrative courts. However the courts tend to confirm the assessments made by the tax authorities.

9.4 Refunds Invoking Extra-Contractual Civil Liability

In practice taxpayers have not recovered the taxes they have paid on the basis of measures that have subsequently been qualified as unlawful/incompatible state aid, invoking extra-contractual civil liability of the state.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Greece has chosen to apply Part VI on arbitration to all 57 DTTs it has concluded, which therefore qualify as Covered Tax Agreements. Only three of these DTTs (with Switzerland, Canada and Mexico) already include an arbitration clause, but even for those Part VI is applicable.

10.2 Types of Matters that Can Be Submitted to Arbitration

As regards the existing DTTs that already include an arbitration clause, the DTT with Switzerland excludes from the scope of arbitration, matters for which a decision has already been rendered by a Greek or Swiss court or administrative tribunal. The DTT with Mexico allows arbitration only to the extent the taxpayer agrees in writing to be bound by the decision of the arbitration board.

Under the MLI, Greece has reserved the right to exclude from the right to submit to arbitration, cases:

- for which a decision on the issue has already been rendered by a court or administrative tribunal of either contracting jurisdiction;
- in respect to which application has been filed under the Convention on the Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises (90/436/EEC), as amended, or any subsequent regulation;
- involving the application of domestic anti-abuse rules;
- concerning items of income or capital that are not taxed by a contracting jurisdiction, because they are not included in the taxable base in that contracting jurisdiction or

because they are subject to an exemption or zero tax rate provided under the domestic tax law of that contracting jurisdiction; and

- involving conduct for which the taxpayer or a person acting on behalf of the taxpayer has been found guilty by a court for tax fraud or another criminal offence.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Greece has selected to apply the Independent Opinion Procedure.

10.4 Implementation of the EU Directive on Arbitration

In 2020, Greece implemented Directive 2017/1852 on tax dispute resolution mechanisms in the European Union. Given that its implementation is recent there is no precedent yet as regards its application.

10.5 Existing Use of Recent International and EU Legal Instruments

The recent international and EU legal instruments to settle tax disputes were not already used in Greece.

10.6 New Procedures for New Developments under Pillar One and Two

Both Pillars will take effect in Greece. It remains to be seen how they will be implemented, in order to evaluate whether they could mitigate tax controversies.

10.7 Publication of Decisions

Decisions adopted in the context of the mutual agreement procedure are published on the website of the Independent Authority for Public Revenue, without mentioning the details of the taxpayer concerned. If the taxpayer disagrees with the publication of the whole decision, a summary is published, which includes the description of

the matter, the second country involved, the tax year and the legal basis for the decision.

10.8 Most Common Legal Instruments to Settle Tax Disputes

The legal instruments available so far have been the DTTs (prior to the MLI) and the EU Arbitration Convention. Furthermore, the EU Dispute Resolution Directive has been implemented, as well as the amendments in the DTTs after the MLI. Given that the last two have been recently implemented, so far, the most common legal instrument used to settle tax disputes has been the old DTTs (prior to the MLI), although their use has not been very extensive.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

It is very common for lawyers to be hired by taxpayers in order to initiate and carry out the available procedures for the settlement of tax disputes.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

No fees apply at the administrative stage.

11.2 Judicial Court Fees

For lodging an appeal at first and at second instance, the taxpayer shall pay a court duty equal to 1% of the amount under dispute and up to the amount of EUR15,000.

If the aforementioned court duty exceeds the amount of EUR3,000, only this amount has to be paid; any remaining amount up to the amount of EUR15,000 will be assessed by the court decision, if negative for the taxpayer.

Upon submission of the appeal at first or second instance the taxpayer shall pay one third of the court duty, whereas the remaining amount should be paid prior to the hearing date.

If the appeal is rejected, the court duty shall be forfeited in favour of the Greek State. However, if the appeal is accepted, the court duty is refunded to the taxpayer (any such refund does not bear any interest).

11.3 Indemnities

With the appeal, the taxpayer can ask for the assessed amount of taxes and penalties they have already paid to be refunded with interest. Indeed, when they issue positive decisions for the taxpayers and order the refund of taxes and penalties, the courts usually award interest as well.

11.4 Costs of ADR

Please see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

12. STATISTICS

12.1 Pending Tax Court Cases

The Greek Ministry of Justice issues, on a quarterly basis, certain statistics regarding the number of court cases per instance.

As regards the administrative courts, based on the latest report available for 2020, the pending tax cases (including customs cases) on 31 December 2020 were as follows.

In the Administrative Court of First Instance – 15,830 total pending tax cases, comprising:

- 6,018 tax cases for which no hearing date had been set;

- 5,206 tax cases for which a hearing date had been set but which had not yet been heard; and
- 4,606 tax cases which have been heard but for which no decision has yet been issued.

In the Administrative Court of Appeals – 6,339 total pending tax cases, comprising:

- 1,837 tax cases for which no hearing date had been set;
- 2,927 tax cases for which a hearing date had been set but which had not yet been heard; and
- 1,575 tax cases which had been heard but for which no decision had yet been issued.

As regards the Supreme Administrative Court, based on the latest report available for 2020, the total pending tax cases on 31 December 2020 were 3,622 analysed per amount under dispute as follows:

- 120 lower than EUR10,000;
- 235 between EUR10,001 and 50,000;
- 356 between EUR50,001 and 100,000;
- 1,193 between EUR100,001 and 500,000; and
- 1,128 over EUR500,000.

12.2 Cases Relating to Different Taxes

No statistical data is available as regards the number of cases per tax type and their value.

12.3 Parties Succeeding in Litigation

No statistical data is available regarding which parties have succeeded in litigation.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Given the multiple stages of a tax controversy, it is important that the taxpayer sets the defensive line from the very early stage of the audit in order to be in a position to present a solid case before the tax administration and the competent courts. In this context, depending on the issues involved, the best efforts should be put forward in order to present the tax administration and courts with detailed and conclusive evidence on the factual background of the case as well as any administrative guidelines and jurisprudence on the interpretation of the applicable provisions. It should go without saying that the whole tax controversy procedure requires close monitoring at each stage in order to meet the deadlines and safeguard the best outcome.

Zepos & Yannopoulos is one of the longest-established law firms in Greece, having been founded in 1893. Throughout its history it has consistently been one of the most prominent law firms in the country. Zepos & Yannopoulos offers comprehensive legal and tax services, with a focus on multinational companies and high net worth individuals. The firm's tax and accounting practice, acknowledged as the largest and most specialised in any law firm in Greece,

offers the full range of tax services on both a transactional and ongoing basis to clients doing business in the country, in collaboration with its affiliated company Zeya Accounting. The tax and accounting practice covers the areas of corporate tax and accounting compliance, international tax and M&A, tax controversy and litigation, real estate taxation, transfer pricing, VAT, indirect tax and customs, banking and finance taxation.

AUTHORS



Alex Karopoulos is a partner at Zepos & Yannopoulos who heads the tax controversy practice. He has extensive experience in advising multinational companies on all stages of tax controversies and representing them before the tax authorities and all court instances, including the Supreme Administrative Court. He has litigated some of the biggest tax assessments ever made in Greece and has won tax disputes concerning income tax, VAT and stamp duty, as well as the incompatibility of local taxes with EU legislation. Alex regularly advises on the indirect tax aspects of corporate reorganisations and M&A. His clients include those in the financial and insurance services, real estate, public procurement, energy, IT, aviation, pharma, travel and retail sectors.



Dimitris Gialouris is a partner in the tax controversy practice of Zepos & Yannopoulos. Dimitris' practice focuses on tax litigation involving both direct and indirect taxation, as well as matters of interpretation of both domestic and EU law. He has extensive experience in dispute resolution and has successfully pleaded before courts of all instances, including the Supreme Administrative Court. Dimitris, who has a PhD in tax law from the University of Heidelberg, has also provided advice to domestic and multinational companies on direct and indirect tax matters, as well as on administrative and court procedures. He has also published extensively in Greek and international tax law journals.

Contributed by: Alex Karopoulos, Dimitris Gialouris, Eva Yotakou and George Vlachakis, Zepos & Yannopoulos



Eva Yotakou is a senior associate in the tax controversy practice of Zepos & Yannopoulos. Eva focuses on tax litigation in matters of direct and indirect taxation and

regularly advises clients on indirect taxation and customs issues.



George Vlachakis is an associate in the tax controversy practice of Zepos & Yannopoulos. George focuses on tax litigation in the areas of direct and indirect taxation. He

has experience in advising and assisting clients in the course of tax audits and court proceedings. He also advises clients on direct and indirect tax matters. Before joining the firm, he held a position in a foreign multinational consulting firm, where he practised international and European tax law.

Zepos & Yannopoulos

280 Kifissias Av
152 32 Halandri
Athens
Greece

Tel: +30 210 6967 000
Fax: +30 210 6994 640
Email: info@zeyya.com
Web: www.zeyya.com

Z E P O S & Y A N N O P O U L O S

Trends and Developments

Contributed by:

*Alex Karopoulos and Diana Tsourapa
Zepos & Yannopoulos see p.193*

The Role of the Dispute Resolution Unit

In the case of tax assessments, the taxpayer is not allowed to have direct recourse to the court. It is mandatory to first file an administrative appeal with a special directorate within the tax administration: the Dispute Resolution Unit (DRU). Such a procedure gives the tax administration the opportunity to re-examine the issues that gave rise to the tax assessment and, if possible, resolve the dispute in a very short period of time, without it being necessary for the dispute to be brought before the administrative courts. The DRU is obliged to issue a decision within 120 days from the filing of the administrative appeal and, if it issues a decision in favour of the taxpayer, the dispute is resolved irrevocably, since the tax authorities do not have the right to challenge the decision before the court.

In addition, the decisions of the DRU usually serve as a binding precedent for the tax auditors. If the DRU has resolved a certain issue in favour of the taxpayer, the tax auditors normally refrain from challenging that same issue in the audits they subsequently perform, since they know that the assessment will be overturned by the DRU if the taxpayer files an administrative appeal.

This procedure for resolving tax disputes at an administrative level, in the form that it currently stands, was introduced in 2014. Although the role of the DRU is to operate as an independent body, in the beginning of its operation, the DRU was clearly inclined to issue decisions in favour of the tax authorities. The fact that the personnel of the DRU were officers who had previously worked for the tax administration contributed to this favourable treatment of the tax authorities' assessments.

As the years have passed, however, it appears that the DRU is transforming into a truly independent body, issuing decisions that find in favour of taxpayers' long standing tax issues. Indicative examples of such ground-breaking decisions are discussed in this article.

Imposition of Stamp Duty on Loans

Under Greek stamp duty legislation, loans (both the capital and the interest) are subject to 2.4% stamp duty. At the same time, however, the territoriality rule applies, according to which no stamp duty applies as long as the loan agreements are signed abroad and they do not concern movable or immovable property located in Greece, or obligations executable therein.

As regards the latter condition and in line with older guidelines of the Greek Ministry of Finance, all Greek companies that wanted to borrow funds from affiliated companies abroad were using foreign bank accounts where relevant deposits were made. On that basis it was argued, and the tax authorities accepted, that the relevant obligations from the loans were executed abroad through the deposits in the foreign bank accounts.

However, the position of the tax auditors changed at some point, and they started assessing huge amounts of stamp duty and penalties on inter-company loans received by Greek companies from abroad, arguing that the use of foreign bank accounts by the Greek companies did not render the loans executed abroad, as long as the loan capital was subsequently remitted to and used in Greece.

At the same time, Greek VAT law provides that transactions within the scope of VAT (even when exempt therefrom) are not allowed to be subject to stamp duty. There were strong arguments, however, that the granting of interest-bearing loans, not only by financial institutions but also by companies, was a transaction (supply of service) within the scope of VAT qualifying as a “granting of credit”.

Following assessments of hundreds of millions of euros, the Supreme Court eventually decided that the practice of the tax authorities of imposing stamp duty on interest-bearing loans was indeed a transaction within the scope of VAT and accordingly declared the imposition of stamp duty on such loans illegal from the date VAT was introduced in Greece (ie, 1987).

Although however, the above rulings of the Supreme Court were issued more than one and a half years ago, the Greek tax administration has not officially endorsed them yet. Therefore no guidelines have been provided to the tax authorities to stop imposing stamp duty on interest-bearing loans. As a result, relevant assessments continued to be made which were challenged by taxpayers before the DRU.

Following a review of the respective administrative appeals, the DRU has issued decisions, annulling the stamp duty assessments on the basis of the Supreme Court case law, despite the lack of official guideline from the Greek tax administration. The DRU has even gone one step further, applying the Supreme Court case law not only to interest-bearing loans, but to other forms of credit, such as cash pooling and zero balancing.

Recovery of VAT in the Case of Bad Debts

Greek VAT law, as it currently stands, does not provide for the recovery of VAT in the case of bad debts; ie, when a supplier has issued an invoice

and has paid the corresponding VAT to the tax authorities, while the client has not – for any reason – paid the amount of the invoice (including the VAT) to the supplier. In situations like this, the VAT becomes a financial burden for the supplier, contrary to the neutrality principle, since the supplier is obliged to pay to the tax authorities VAT that has not been collected from the client.

The issue was brought to the Supreme Court, which ruled that, in accordance with EU VAT law and the case law of the Court of Justice of the European Union, taxpayers are entitled to recover the VAT in cases of bad debts. It limited this right, however, to cases where the clients that were in default of payment had been declared bankrupt, had been placed under special administration or had entered into rehabilitation agreements.

The case in which the Supreme Court issued the above decision concerned a specific retailer that had entered into a rehabilitation agreement which provided for the write off of part of the creditors’ claims. The Greek tax administration issued guidelines for the endorsement of the Supreme Court decision, limiting their application, however, to the creditors of the specific retailer for which the above decision was issued. Therefore, any other suppliers who had paid VAT that had not been collected were still not entitled to recover this VAT.

Following the Supreme Court decisions, taxpayers started claiming the VAT paid in other cases of bad debts by filing administrative appeals. The DRU has issued decisions, allowing the recovery of VAT in cases where the client has been declared bankrupt or has entered into a rehabilitation agreement, despite the lack of general guidelines from Greek tax authorities, thus relieving taxpayers from the VAT burden.

Income Tax Deductibility of Participation Costs

Greek tax legislation (Article 48 paragraph 4 of the Income Tax Code) provides for the non-deductibility of business costs related to participation in an entity that generates tax-exempt dividend income in accordance with the EU Parent/Subsidiary Directive 2011/96/EU (“participation exemption”). The Greek tax administration’s interpretation of this rule adopts the position that the non-deductibility is not dependent on the actual payment of tax-exempt dividends but shall apply irrespectively, as long as business costs are incurred for participating in another entity.

In a case where a taxpayer had issued a bond loan to finance the acquisition of the majority of shares in another entity, which the taxpayer subsequently absorbed, the DRU accepted that the above limitation does not apply to business costs comprising of the interest payable under the bond loan. The rationale behind this position was that it would never be possible for the taxpayer to receive tax-exempt dividends from the other entity, since that entity had been absorbed.

Zepos & Yannopoulos is one of the longest-established law firms in Greece, having been founded in 1893. Throughout its history it has consistently been one of the most prominent law firms in the country. Zepos & Yannopoulos offers comprehensive legal and tax services with a focus on multinational companies and high net worth individuals. The firm's tax and accounting practice, acknowledged as the largest and most specialised of any law firm in Greece,

offers the full range of tax services on both a transactional and ongoing basis to clients doing business in the country, in collaboration with its affiliated company Zeya Accounting. The tax and accounting practice covers the areas of corporate tax and accounting compliance, international tax and M&A, tax controversy and litigation, real estate taxation, transfer pricing, VAT, indirect tax and customs, and banking and finance taxation.

AUTHORS



Alex Karopoulos is a partner at Zepos & Yannopoulos who heads the tax controversy practice. He has extensive experience in advising multinational companies on all

stages of tax controversy and representing them before the tax authorities and all court instances, including the Supreme Administrative Court. He has litigated some of the biggest tax assessments ever made in Greece and has won tax disputes concerning income tax and VAT. Alex regularly advises on the indirect tax aspects of corporate reorganisations and M&A. His clients include those in the financial and insurance services, real estate, public procurement, energy, IT, aviation, pharma, travel and retail sectors.



Diana Tsourapa is a senior associate in the tax controversy practice of Zepos & Yannopoulos, and she has extensive experience in handling tax audits of multinational

companies, including tax matters such as income tax and transfer pricing, VAT, stamp duty and real estate taxes. She works closely with clients in order to determine the appropriate line of defence and represents them before tax authorities and courts of all instances, including the Supreme Administrative Court. In addition, Diana has extensive experience in advising multinational companies across most industries on the full scope of corporate tax issues arising in Greece. She also advises clients on matters of international tax regarding cross-border transactions, corporate restructurings, mergers and acquisitions.

Zepos & Yannopoulos

280 Kifissias Av
152 32 Halandri
Athens
Greece

Tel: +30 210 6967 000
Fax: +30 210 6994 640
Email: info@zeya.com
Web: www.zeya.com

Z E P O S & Y A N N O P O U L O S

Law and Practice

Contributed by:

*Mukesh Butani and Shankey Agrawal
BMR Legal Advocates see p.212*



CONTENTS

1. Tax Controversies	p.197	5.3 Judges and Decisions in Tax Appeals	p.204
1.1 Tax Controversies in this Jurisdiction	p.197	6. Alternative Dispute Resolution (ADR) Mechanisms	p.204
1.2 Causes of Tax Controversies	p.197	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.204
1.3 Avoidance of Tax Controversies	p.197	6.2 Settlement of Tax Disputes by Means of ADR	p.205
1.4 Efforts to Combat Tax Avoidance	p.197	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.205
1.5 Additional Tax Assessments	p.198	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.205
2. Tax Audits	p.198	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.205
2.1 Main Rules Determining Tax Audits	p.198	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.206
2.2 Initiation and Duration of a Tax Audit	p.199	7. Administrative and Criminal Tax Offences	p.206
2.3 Location and Procedure of Tax Audits	p.199	7.1 Interaction of Tax Assessments with Tax Infringements	p.206
2.4 Areas of Special Attention in Tax Audits	p.199	7.2 Relationship between Administrative and Criminal Processes	p.206
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.199	7.3 Initiation of Administrative Processes and Criminal Cases	p.206
2.6 Strategic Points for Consideration during Tax Audits	p.200	7.4 Stages of Administrative Processes and Criminal Cases	p.207
3. Administrative Litigation	p.200	7.5 Possibility of Fine Reductions	p.207
3.1 Administrative Claim Phase	p.200	7.6 Possibility of Agreements to Prevent Trial	p.207
3.2 Deadline for Administrative Claims	p.201	7.7 Appeals against Criminal Tax Decisions	p.207
4. Judicial Litigation: First Instance	p.201	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.208
4.1 Initiation of Judicial Tax Litigation	p.201	8. Cross-Border Tax Disputes	p.208
4.2 Procedure of Judicial Tax Litigation	p.202	8.1 Mechanisms to Deal with Double Taxation	p.208
4.3 Relevance of Evidence in Judicial Tax Litigation	p.202	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.208
4.4 Burden of Proof in Judicial Tax Litigation	p.202		
4.5 Strategic Options in Judicial Tax Litigation	p.203		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.203		
5. Judicial Litigation: Appeals	p.203		
5.1 System for Appealing Judicial Tax Litigation	p.203		
5.2 Stages in the Tax Appeal Procedure	p.204		

8.3	Challenges to International Transfer Pricing Adjustments	p.208	10.5	Existing Use of Recent International and EU Legal Instruments	p.210
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.208	10.6	New Procedures for New Developments under Pillar One and Two	p.210
8.5	Litigation Relating to Cross-Border Situations	p.209	10.7	Publication of Decisions	p.210
9. State Aid Disputes		p.209	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.210
9.1	State Aid Disputes Involving Taxes	p.209	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.210
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.209	11. Costs/Fees		p.210
9.3	Challenges by Taxpayers	p.209	11.1	Costs/Fees Relating to Administrative Litigation	p.210
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.209	11.2	Judicial Court Fees	p.210
10. International Tax Arbitration Options and Procedures		p.209	11.3	Indemnities	p.210
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.209	11.4	Costs of ADR	p.210
10.2	Types of Matters that Can Be Submitted to Arbitration	p.209	12. Statistics		p.210
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.209	12.1	Pending Tax Court Cases	p.210
10.4	Implementation of the EU Directive on Arbitration	p.210	12.2	Cases Relating to Different Taxes	p.211
			12.3	Parties Succeeding in Litigation	p.211
			13. Strategies		p.211
			13.1	Strategic Guidelines in Tax Controversies	p.211

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

India follows a regime of self-assessment, where the taxpayer makes a self-assessment of their tax liability by filing their returns. The genesis of tax controversy in India usually involves the relevant department's scrutiny or audits of the taxpayer's returns. The Indian tax authorities are also empowered to reopen a concluded assessment if any additional facts come to light to suggest escapement of taxable income, which often leads to tax controversies. Further, Indian tax authorities' refusal to grant a lower or NIL withholding tax certificate may also lead to a tax controversy between the authority and taxpayers.

1.2 Causes of Tax Controversies

There are frequent disputes relating to computation of income and denial of exemptions by tax authorities as far as corporate income tax is concerned. In the international tax arena, transfer pricing claims arising out of arm's-length pricing adjustments and selection of comparables are a subject matter of regular litigation.

Tax controversies pertaining to consumption taxes are common. Highly litigated aspects of consumption taxes include undervaluation of transactions; classification of goods and services for ascertaining the appropriate rate of tax; refund of taxes, etc. While rare, similar disputes may also arise in relation to transactional taxes such as stamp duty and excise taxes on alcohol tax, etc.

There could be various reasons for tax controversies in India, including:

- aggressive interpretation of the tax law provisions by either the taxpayer or the tax authority;

- lack of clarity or scope for interpretation of legal provisions or procedures established under the law;
- conflicting judgments/orders pronounced by the appellate forums;
- efforts by the tax authorities to emphasise source-based taxation for cross-border transactions.

1.3 Avoidance of Tax Controversies

Tax controversy mitigation strategies involve a mix of compliance with the law and co-operation with the tax authorities. To this end, taxpayers should ensure:

- proper vetting of legal documents by competent tax professionals to support disclosures in tax returns;
- opting for non-aggressive tax positions;
- full disclosure and complete co-operation with the tax authority at the time of audits; and
- timely compliance and rectification of the tax returns upon discovery of any mistake.

Apart from this, taxpayers may also opt for the advance ruling mechanism to clarify tax positions on critical transactions. Similarly, in transfer pricing cases, taxpayers can mitigate controversies by seeking an advance pricing agreement (APA) whereby the transfer price is decided in advance to avoid any future litigation, and gain certainty.

Adopting the above measures to avoid tax controversy can further help the taxpayer prevent penalties and fines.

1.4 Efforts to Combat Tax Avoidance

India is fully aligned with and actively follows the BEPS movement and has enacted amendments to its domestic law and tax treaties to align with BEPS standards. These include introducing Indian digital tax, ie, an equalisation levy and provi-

sions relating to Significant Economic Presence (SEP) to combat tax challenges arising from the digital economy. While the impact of BEPS recommendations on tax controversies has yet to be practically noticed, it is the author's assessment that such implementations will go a long way in curbing tax avoidance strategies.

Further, India has also introduced general anti-avoidance rule (GAAR) requirements into its domestic law. As a result, tax authorities are empowered to reject tax benefits in case the primary purpose of an arrangement is to obtain a tax benefit.

1.5 Additional Tax Assessments

In its tax return, the taxpayer must disclose the amount of income tax payable. However, upon assessment by a tax officer, an additional tax liability may be imposed upon the taxpayer.

Even if the taxpayer decides to contest the assessment order, the taxpayer must deposit the amount of tax determined by the tax officer before approaching the First Appellate Authority. However, the First Appellate Authority may, on the taxpayer's request, exempt the taxpayer from paying taxes before submitting the appeal. This benefit is awarded if the taxpayer can demonstrate a reasonable and adequate basis for not paying the tax before submitting the appeal.

Similarly, the taxpayer can also request a full/partial stay against tax demands at the time of the second appeal before the Income Tax Appellate Tribunal (ITAT).

Under indirect tax law, ie, Goods and Services Tax (GST), a taxpayer at the time of filing an appeal must pre-deposit an amount equivalent to 10% of the tax demand. Similarly, in the case of a second appeal before the GST Appellate Tribunal, an additional amount equivalent to 20% of the tax demand must be deposited before

filing the appeal. The balance tax and penalty demand remain suspended until the disposal of respective appeals.

If the taxpayer loses the appeal, they would be required to deposit the balance tax amount as determined by the tax authority along with any appropriate interest and penalty. However, if the taxpayer succeeds in their appeal, then the amount deposited by the taxpayer is refunded.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Under income tax laws, a taxpayer who is a business enterprise must get the books of accounts audited by a certified professional if the sales, turnover, or gross receipts of the business exceed the prescribed threshold limit. Further, a tax officer at any stage of the proceedings before him may direct the taxpayer to get the accounts audited by a chartered accountant. A tax officer may mandate an audit when there are doubts about the correctness of the reports, the multiplicity of transactions in the funds or the specialised nature of the business activity.

Apart from the above, certain returns are selected for further scrutiny by the tax department on a random basis, wherein the transactions and deductions claimed are scrutinised in detail.

Similarly, under GST, every registered taxable person whose turnover during a financial year exceeds the prescribed limit is subject to audit, and such taxpayers must get their books of accounts audited by a qualified professional. Further, the tax authority is empowered to conduct tax audits upon issuing appropriate notice. The tax officer can also direct a special audit, wherein the tax officer shall appoint a qualified professional. However, it is advisable to conduct

an internal audit to avoid the discovery of any discrepancies during the departmental audit.

2.2 Initiation and Duration of a Tax Audit

Under income tax law, the taxpayer liable to produce an audit report must file it by September 30th of the immediately succeeding financial year. Where the tax department directs an audit, then this must be completed within 180 days from the date of such a direction.

Under GST, the taxpayer liable to get his accounts audited must file his audit report along with his GST annual returns. In the case of special audits directed by the tax officer, the audit must be completed within three months from the date of commencement of the audit. This period of three months can be further extended to six months by recording the appropriate reasons in writing.

A special audit may also be initiated by the assistant commissioner if he is of the opinion that value has not been correctly declared, or incorrect credit has been availed during any stage of scrutiny/inquiry/investigation. A special audit may be conducted by the tax department even if the accounts have been already audited under any other provision.

2.3 Location and Procedure of Tax Audits

Under income tax provisions, where the tax officer directs the audit, the audit is typically conducted at the office or the place of work of the business. In such a case, the taxpayer must submit all the necessary documents to the qualified professional appointed to conduct the audit. Upon filing the prescribed forms, the audit is completed by a qualified professional.

Under GST, the tax audit shall be conducted by an authorised officer at the place of business

and in the office of the registered taxpayer. The taxpayer shall be issued a notice at least 15 days before conducting such an audit. At the time of the tax audit, the taxpayer must provide the necessary facility to verify the books of accounts or other documents, and give information and assistance for the timely completion of the audit. Once the audit is complete, the officer must inform the taxpayer within 30 days of its completion about its findings, his reasons, and the rights and obligations of the taxpayer.

2.4 Areas of Special Attention in Tax Audits

While conducting a tax audit, tax officers mostly concern themselves with cases where the taxpayer has either evaded tax or avoided paying tax – for instance, whether there is any undisclosed income of the taxpayer, or where an exemption/deduction is claimed by the taxpayer. Specifically, this includes a mismatch between accounting treatment in books of accounts vis-à-vis intercompany agreements; scrutiny of large or questionable items in the returns; misreporting of capital gains; mismatch of tax deducted at source reported by the deductor and of that claimed in the return of income; non-disclosure of income or investments made; and so on. Under international tax law, most tax audits concern transfer pricing adjustments and selection of comparables.

Under GST, the tax authorities during an audit put special emphasis on classification adopted by the taxpayer for the purpose of tax rate, valuation of supplies, tax exemptions and input tax credits claimed by the taxpayer.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

There has been an increasing focus on sharing of information between Indian tax authorities

with their foreign counterparts. As a part of G20 and OECD countries, India is working towards developing a Common Reporting Standard (CRS) on Automatic Exchange of Information (AEOI), which requires financial institutions to collect and report information to the relevant tax authorities about account holders “resident” in other countries. Such information is automatically transmitted to the tax authorities in other jurisdictions.

The exchange of information is primarily meant to determine if there is a case of tax evasion or tax avoidance by the taxpayer. The tax department also obtains the required information from foreign tax authorities to conduct an effective assessment. Such an exchange of information can be upon specific request by the other country under the tax treaty. These initiatives by the tax authorities make it important for the taxpayer to provide correct information while filing a tax return and align this with their global responses.

2.6 Strategic Points for Consideration during Tax Audits

There are many points that a taxpayer must keep in mind before or during a tax audit.

Firstly, prior to the filing of a tax return, the taxpayer should ensure adequate documentation in support of its tax positions. Such documentation should include intercompany agreements, internal and external email correspondence, etc.

Specific to international transactions, a taxpayer must ensure arm’s-length price when the transaction is between related entities. If any offshore transaction may result in a change in ownership of an Indian entity, this becomes taxable in India, and hence must be reported correctly.

Secondly, once the taxpayer has been served notice for the commencement of the tax audit, they must reassess the tax liability and tax return

before challenging the contentions put forward by the tax officer. The materiality of the exposure to the tax implications shall also be determined by the taxpayer such that the taxpayer does not suffer any injustice at the hands of the tax officer.

Thirdly, the taxpayer must have a clear picture of the factual background and legal submissions, to respond to the tax officer’s assessment and to be able to support the tax positions adopted by the taxpayer. There must not be a position where the taxpayer is learning facts at the instigation of the tax officer. The taxpayer must have all the requisite documents and must undertake filing as per the laws laid down under the respective legislations.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Upon scrutiny of tax returns, the assessing officer may reject the self-assessment and confirm a tax demand on the taxpayer. In this case, the assessing officer will issue an assessment order. Such an assessment order can be appealed before the First Appellate Authority, which is essentially an administrative authority having powers concomitant to the powers of the tax officers.

Recently, a Faceless Assessment and Appeal Scheme was introduced whereby all assessments and appeal proceedings up to the First Appellate Authority shall be conducted through a designated online portal without any physical interface. However, appeals relating to serious fraud, major tax evasion and international tax matters have been kept out of this scheme, for now.

In matters involving transfer pricing adjustments, a slightly different procedure is available. In

such matters, the assessing officer is required to make a reference to another administrative officer specialising in transfer pricing for determining the proper arm's-length price. After recommendations from the transfer pricing officer, the assessing officer is required to pass a draft assessment order. Objections against the draft assessment order can be filed by the taxpayer to the Dispute Resolution Panel (a panel consisting of three commissioner-level officers). The assessing officer is required to pass the final assessment order giving effect to the directions of the Dispute Resolution Panel. In such cases, an appeal can be filed directly to the appellate tribunal bypassing the first appeal before the First Appellate Authority.

Under GST, the authorities issue a show cause-cum-demand notice to the taxpayer as an outcome of the scrutiny of returns or audit proceedings. The taxpayer is required to file a response to the notice and a personal hearing is granted to the taxpayer before an order is passed. Upon receipt of the order, the taxpayer/tax department may refer an appeal before the First Appellate Tribunal.

3.2 Deadline for Administrative Claims

Under Indian income tax, an order of assessment must be made within 21 months from the relevant assessment year. However, the tax officer may pass a reassessment order after that period in case any income has escaped assessment. The time limit for filing an appeal before the First Appellate Authority is 30 days from the date of receipt of the assessment/reassessment order.

Under GST laws, the tax officer is not required to pass any assessment order. However, where the tax officer is of the view that tax has been short-paid or an erroneous refund has been granted, a demand order may be passed within three years from the due date of filing the GST annual return.

The order can be passed by the tax officer only after issuing a show cause notice and giving an opportunity for a personal hearing. An appeal against the order may be filed before the First Appellate Authority within three months from the date of the communication of the order of assessment.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Under direct tax laws, an appeal from the order of the First Appellate Authority lies before the Income Tax Appellate Tribunal (ITAT). Thus, where either the taxpayer or the revenue authorities are not satisfied with the order of the First Appellate Authority, they may file an appeal before the ITAT. The ITAT is a quasi-judicial body comprising a judicial member and an accounting member. Similarly, appeals under GST are filed before the GST Appellate Tribunal (GSTAT). The appeal before the ITAT/ GSTAT marks the beginning of the judicial tax litigation process in India.

Alternatively, the taxpayer may directly approach the High Court under its writ jurisdiction challenging the notice or order of assessment. However, the High Court's writ jurisdiction can be invoked on very limited grounds challenging the decision-making process. For instance, where the authority has failed to give a hearing or acted in gross error of law or exercised power where none exists, then the High Court may interfere under the writ jurisdiction. The High Court would exercise its jurisdiction wherein it is demonstrated that no alternative remedy is available to the taxpayer. Pertinently, the factual basis behind the decision cannot be challenged as it is a subject matter of appeal.

4.2 Procedure of Judicial Tax Litigation

Against the order by the First Appellate Authority, an appeal before the jurisdictional ITAT must be filed within a period of 60 days from the date of communication of the order. This appeal is filed electronically on the online portal in the prescribed form and upon payment of the prescribed fees. The form is a detailed document that requires a taxpayer to provide basic information, income details, disputed tax amount, statement of facts, grounds of appeals, etc. Also, once an electronic copy has been filed by the taxpayer, the same must be deposited with the tribunal in physical form.

After filing of the appeal, the Tribunal lists the matter for hearing, where both the taxpayer and the tax department are represented by their legal representatives. After hearing both sides, the Tribunal may issue an order either confirming, modifying, or annulling the decision or order appealed against – or it may refer the case back to the Appellate Authority or the revisional authority, or the original adjudicating authority, with such directions as it deems appropriate, for a fresh adjudication or decision, as the case may be, after taking additional evidence if necessary.

Under GST, a similar procedure has been envisaged. An aggrieved taxpayer or the revenue authority may file an appeal against the order of the First Appellate Authority before the GSTAT within three months from the date of the order. It is important to note that GSTAT has a two-tier structure. Where the dispute relates to determination of place of supply, the appeal is to be filed before the National Bench of the GSTAT. In other cases, the appeal must be filed before the State Bench of the GSTAT. In both cases, the appeal must be accompanied by payment of 20% of the amount of tax in dispute. Given that GST law is relatively nascent, due to certain legal and administrative issues, the GSTAT is in the process of being constituted.

4.3 Relevance of Evidence in Judicial Tax Litigation

Taxpayers must submit all documents, evidence, certificates, etc, in support of their case before the First Appellate Authority as well as the ITAT. All relevant documents and evidence must be on record before the judicial authority decides the issue. Any witnesses including expert witnesses are examined very rarely, and only before the assessing officer or before the First Appellate Authority. The ITAT is the final fact-finding authority that considers all arguments and materials placed on record before it. Based on the adjudication of all facts and documentary evidence, the ITAT renders its findings on facts.

As a rule, any evidence not placed before the First Appellate Authority cannot be placed before the ITAT. However, in limited cases where admission of evidence is necessary for deciding a dispute, the ITAT may allow admission of additional evidence.

4.4 Burden of Proof in Judicial Tax Litigation

The Indian courts have laid down the foundational principles on the burden to prove valid taxation. Essentially, the onus of establishing that the conditions for taxability are fulfilled is always on the tax authorities. Similarly, the onus to prove that the taxpayer has evaded tax is also on the tax authorities. The burden of proof may be discharged by demonstrating facts and circumstances through which it can be reasonably inferred that the taxpayer has, in fact, attempted to evade tax lawfully payable by it. Once the burden of proof is discharged by the tax authorities, the burden then shifts onto the taxpayer to disprove the case of the tax department.

However, in cases where a taxpayer is claiming an exemption from tax, the burden of proof would be on the taxpayer to show that it qualifies within the parameters of the exemption.

4.5 Strategic Options in Judicial Tax Litigation

The manner of managing litigation varies depending on the specific facts of the case. While a general standard procedure may not be followed, experience helps in selecting the best path to follow.

Strategic issues occur at various phases of tax litigation. Strategic issues arise, for example, when deciding whether to appeal to the tribunal after the jurisdictional commissioner's order; what grounds of appeal to present; how much detail to include when doing so; and what relevant case laws to show. Separately, it is of strategic importance to identify whether the matter can be challenged under the High Court's writ jurisdiction or whether it is a subject matter of appeal. Depending upon the relief sought, the taxpayer may choose to go to appeal or under the High Court's writ jurisdiction.

Therefore, the taxpayer must look at all the probable options available to him before proceeding with a tax litigation such that an effective result can be obtained. The taxpayer may also opt for alternative dispute resolution mechanisms in order to solve the tax dispute (see **6. Alternative Dispute Resolution (ADR) Mechanisms**).

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The Indian legal system follows a hierarchical system of binding precedent where decisions of higher courts bind the authorities below. Supreme Court decisions are a declaration of the law and are binding upon all lower courts in India. Similarly, the decisions of High Courts are binding upon the authorities within its territorial jurisdiction. Further down, the decisions of a tribunal are binding on the First Appellate Authority, ie, the jurisdictional commissioner.

In the Indian legal system, foreign court decisions, while not binding, do have persuasive precedence. As such, where no contrary decisions have been rendered by Indian courts, tribunals may give effect to foreign court decisions in cases where the provisions are similar or identical to those of the foreign jurisdiction.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Upon issuance of the ITAT order, aggrieved parties may appeal against the order before the High Court within 120 days of its receipt. The appeal before the High Court is filed in a prescribed memorandum of appeal, setting out the questions of law involved. The appeal before the High Court is not a statutory right, and the appeal is entertained only where the High Court is satisfied that the matter involves a "substantial question of law".

The High Court may admit the appeal and proceed to formulate the substantial question of law. After hearing the case, the High Court will decide the question of law so formulated and deliver its judgment, giving reasons. In addition, the High Court may determine any issue which has not been determined by the ITAT, or an issue which has been wrongly decided.

An appeal against the decision of the High Court can be filed before the Supreme Court. The appeal to the Supreme Court would lie by way of a special leave petition to appeal, or where the High Court certifies that it is a fit case for appeal. The High Court can grant a certificate of appeal on its own or upon application by the taxpayer. In case, the High Court refuses to grant the certificate, the taxpayer may file a special leave petition against this before the Supreme Court.

In GST, an appeal against the judgment of the State Bench of the GSTAT is filed before the High Court of the relevant state, and an appeal against the judgment of the National Bench of the GSTAT is filed before the Supreme Court. The appeal is admitted only where there is a substantial question of law involved.

5.2 Stages in the Tax Appeal Procedure

The different stages in tax appeal procedures have been listed below.

- An appeal against the adjudicating authority's order must be filed before the jurisdictional commissioner, which is the First Appellate Authority. The First Appellate Authority shall take into consideration the evidence and pass an appeal order.
- Upon issuance of the order by the First Appellate Authority, an appeal can be filed before the tribunal.
- Upon issuance of the tribunal's order, the aggrieved person can approach the High Court. The appeal shall only be heard by the court if a substantial question of law is involved.
- Once an order is passed by the High Court, an appeal against the order lies with the Supreme Court.
- The Supreme Court may grant special leave to appeal in a fit case and decide the matter where it deems fit.

5.3 Judges and Decisions in Tax Appeals

Appeals, in the first instance, are decided by the First Appellate Authority, who is an officer of the tax department. Thereafter, in the second instance, the appeals go to the ITAT, which comprises two members, ie, a judicial member and an accountant member. While the accountant member is an officer of the tax department or an experienced chartered accountant, the judicial member is an experienced professional (ie,

a lawyer or district court judge) or a retired judge of the High Court/Supreme Court. All members of the ITAT are full-time members.

Appeals before the High Court and Supreme Court are decided by sitting judges (two or three). In India, judges of the High Court and Supreme Court must have law degrees. These judges are appointed from the lower judiciary or practising advocates with sufficient years of experience.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

There are multiple options for ADR in tax disputes. Under direct tax laws, taxpayers may avail themselves of any of the following options.

- Dispute Resolution Committee (DRC): the DRC was recently introduced to provide tax certainty to small taxpayers. The DRC has the power to reduce, waive any penalty or give immunity from any offence punishable under the Income Tax Act.
- Dispute Resolution Panel (DRP): taxpayers have the option to approach the DRP for filing objections against transfer pricing adjustments made by the assessing officer. The DRP is a collegium of three officers of the tax department and must issue its directions within nine months. Until the conclusion of the matter before the DRP, the tax demand cannot be recovered from the taxpayer.
- Board for Advance Ruling (BAR): taxpayers also have the option to file an advance ruling seeking clarifications on the taxability of a prospective/proposed transaction. The advance ruling mechanism thereby ensures certainty for taxpayers. The BAR comprises

two officers of the revenue department and its rulings are binding on both the taxpayer and the tax authorities.

- Mutual agreement procedure (MAP): a MAP request may be made by a taxpayer when it considers that the actions of the tax authorities of the treaty partners will result in taxation not in accordance with the DTAs. The competent authorities of both jurisdictions have to endeavour to reach an appropriate solution if the claim appears to be justified. India allows suspension of tax collection under a memorandum of understanding signed with a treaty partner. The suspension of collection is based on furnishing a bank guarantee of the amount of the disputed demand, including interest charges imposed.
- Advance pricing agreements (APAs): For transfer pricing matters, taxpayers and tax authorities can voluntarily and mutually agree on transfer pricing issues in advance under the APA programme. The Indian APA programme has been considered largely successful and has led to a significant reduction in transfer pricing litigation.

Similar to the BAR for income tax cases, the GST Authority of Advance Ruling (AAR) and GST Appellate Authority of Advance Ruling (AAAR) has been constituted for taxpayers to obtain advance rulings on GST issues.

6.2 Settlement of Tax Disputes by Means of ADR

India has also witnessed increasing reliance on ADR mechanisms such as APA, MAP, etc for the settlement of tax disputes. Further, the Indian government has also taken a similar stance that aims to promote ADR/non-litigation modes for settlement of tax disputes. The government has taken robust measures to introduce time-effective ways of resolving tax disputes viz a faceless assessment scheme, the E-Advance Rulings Scheme, etc.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

There is no mechanism under Indian law where the tax, interest or penalty may be reduced through an arbitration or mediation process. However, the government of India routinely adopts several measures to settle disputes and reduce tax litigation in India. Various schemes of the government under direct tax and indirect tax laws have been introduced to reduce litigation by waiving a substantial part of the tax, interest or penalty for the settlement of disputes.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Advance rulings can be used by a non-resident to determine the income tax aspects of a proposed or current transaction. Advance rulings can also be used by an Indian resident entering a transaction with a non-resident to determine tax liability. The obvious advantages are advance clarity and tax certainty on the covered transactions as well as enhancing the ease of doing business.

The advance rulings are binding on the applicants as well as the jurisdictional tax officers. However, the applicant does have the option to challenge the advance ruling before the High Court, in case the applicant is not satisfied with the advance ruling pronounced by the relevant authority. Under GST law, taxpayers regularly apply for advance rulings to obtain clarifications on interpretational aspects.

6.5 Further Particulars Concerning Tax ADR Mechanisms

As noted earlier, the ADR mechanism has limited applicability and the provisions do not allow tax arbitration or mediation for the settlement of tax disputes in India.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

In contrast to other jurisdictions, in India there is no formal Alternative Dispute Resolution (ADR) mechanism for the settlement of transfer pricing disputes with the tax authorities. Taxpayers may, however, opt for the mutual agreement procedure (MAP) under the treaty, and post-adjustment by the tax authorities. For mitigating tax disputes, safe-harbour provisions and unilateral and bilateral APA mechanisms may be adopted by taxpayers.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Tax infringements may come to light pursuant to assessments carried out by the revenue authorities. Indian income tax law views tax infringements very seriously and any wilful misconduct may constitute either an administrative or criminal tax offence.

In the course of tax assessments, if it is apparent that a person has wilfully failed to pay taxes, failed to furnish returns, suppressed income, failed to furnish correct books of accounts, etc, then criminal proceedings may be initiated by the tax authorities. On the other hand, if the taxpayer defaults on procedural issues, such as a delay in furnishing returns, payment of self-assessed tax, or failure to file statements, then prescribed penalties are levied.

Any disputes which arise due to a favourable interpretation of law adopted by the taxpayer do not invite criminal prosecution. The element of mens rea, ie, a wilful intention to suppress facts and evade tax, is the determinative element for initiation of criminal prosecutions.

7.2 Relationship between Administrative and Criminal Processes

Apart from the penalty for defaults, the Income Tax Act also empowers tax authorities to initiate criminal proceedings against taxpayers for various offences. While administrative offences are visited by a monetary penalty, criminal offences would attract far more rigorous punishments, including fines and imprisonment.

The Income Tax Act considers tax evasion as a serious offence and prescribes rigorous punishment for tax evaders including by way of fines and imprisonment. Tax authorities in India are responsible for the initiation of criminal proceedings. The punishment for any offence is imprisonment with or without fines. The duration of imprisonment will depend on the crime committed and discretion exercised by the criminal judge.

7.3 Initiation of Administrative Processes and Criminal Cases

For initiating administrative processes, Indian tax authorities can initiate scrutiny proceedings against a taxpayer, by issuing a show cause notice. The taxpayer is then given an opportunity to demonstrate why a proceeding should not be instituted against him. If he is unable to do so, then he can either accept the charges and the accompanying punishment, or file an appeal in the order in which forums are discussed in **7.1 Interaction of Tax Assessments with Tax Infringements**.

Criminal proceedings can only be commenced by high-ranking officials of the Department of Revenue, namely the Principal Commissioner of Income Tax or Commissioner of Income Tax, by issuing instructions to initiate such proceedings. Once the instructions are received from such officials, the criminal proceedings are instituted against the evaders by filing a criminal complaint. The offences are then tried in a criminal

court under the Code of Criminal Procedure. A court not inferior to a Presidency Magistrate or a Magistrate of the First Class can try any offence under the Income Tax Act.

7.4 Stages of Administrative Processes and Criminal Cases

Indian income tax law provides for a four-tiered appellate mechanism against an administrative process initiated against a taxpayer for tax infringement. The procedure is similar to tax assessment and appellate mechanisms.

At the first level, an aggrieved taxpayer can file an appeal before the First Appellate Authority, whereafter the appeal may be filed before the ITAT. Thereafter, on a substantial question of law, appeals may be filed before the jurisdictional High Court. Finally, the taxpayer may approach the Supreme Court of India appealing the decision of the High Court.

Under GST, the tax authorities follow a similar approach, in which they issue a show cause notice to the taxpayer, giving them an opportunity to state their case, followed by the assessing authority issuing a speaking order. The assessing authority's order may be appealed to the GSTAT. Following the appellate tribunal's order, an appeal may be filed with the High Court, which has authority for the case's question of law. The Supreme Court is the last and final resort in the event of an unsatisfactory judgment by a High Court.

Proceedings pertaining to criminal tax cases follow the Code of Criminal Procedure, 1973. The Code does not prescribe any special procedure/treatment for tax evasion cases but follows the general procedure applicable in respect of criminal offences. The judges must hear both sides of the case and pass a reasoned order. The orders passed by the criminal courts are the subject

matter of appellate jurisdiction of the Court of Sessions, High Court, and Supreme Court.

7.5 Possibility of Fine Reductions

Under the Income Tax Act, the penalty proceedings can be contested by the taxpayer before the First Appellate Authority and thereafter before the ITAT. Penalties imposed by the taxpayer can be set aside by the Appellate Authority where the condition precedents for imposition of a penalty are not met. A similar procedure is followed under GST law as well, where the penalty proceedings can be contested before appellate authorities.

7.6 Possibility of Agreements to Prevent Trial

Under Indian income tax laws, a person may apply to the Principal Commissioner or Commissioner for settlement under Indian tax law. A settlement order provides for immunity from criminal prosecution. Under the settlement proceedings, a compounding fee is imposed by the Principal Commissioner or Commissioner for the settlement of cases.

The quantum of the compounding fee depends on various factors such as gravity of the offence, taxpayers' conduct, evaded tax amount, etc. Upon payment of the compounding fee, the criminal proceedings are not initiated against the offender. However, it is noteworthy that the application for immunity shall not be made after the institution of criminal prosecution proceedings.

7.7 Appeals against Criminal Tax Decisions

An appeal against the order of the court of first instance is available before the Court of Sessions. An appeal against the order of the Court of Sessions would lie before the High Court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Challenges to transactions under GAAR have not been initiated to date by the Indian tax authorities. However, specific anti-avoidance provisions under the law and transfer pricing normally give rise to administrative tax cases. Criminal procedure is not invoked unless the authorities suspect fraud or blatant misrepresentation. For these challenges, the same set of procedures and regulations apply as for assessments and appeals set out in **4. Judicial Litigation: First Instance** and **5. Judicial Litigation: Appeals**.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Any administrative claims or actions of tax authorities towards denial of benefit under the double taxation avoidance agreement are countered by taking recourse to domestic litigation. Such recourse may be obtained either through appeals before the tax authorities or directly to the High Court under writ jurisdiction. Alternatively, taxpayers may occasionally choose to adopt MAPs.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Chapter X-A of the Income Tax Act includes GAAR provisions, which have an overriding effect on the other provisions of the Act. GAAR will apply to transactions, notwithstanding any other provisions of the Act. GAAR applies to any arrangement that is considered an Impermissible Avoidance Arrangement.

Furthermore, under its provisions, certain transactions are deemed to lack commercial substance. GAAR is not merely restricted to cross-border transactions but also applies to domestic

arrangements. Once the revenue authorities decide to treat an arrangement as an Impermissible Avoidance Arrangement, the onus to prove otherwise is on taxpayers. Consequently, they are required to substantiate the commercial reasons for such arrangements and that availing of tax benefit was not the main purpose for these transactions. The government of India has recently notified the first GAAR Panel.

8.3 Challenges to International Transfer Pricing Adjustments

Indian TP regulations are based on the arm's-length principle. Indian TP regulations provide that any income arising from an international transaction between associated enterprises shall be computed with regard to the arm's-length price (ALP).

A major challenge in international transfer pricing adjustments pertains to the comparability analysis conducted by the authorities. Owing to increased complexity in international transactions, comparability analysis in the determination of arm's-length price is a major source of litigation between the taxpayer and the tax revenue authorities. From a tax policy standpoint, there has been an increasing challenge to assimilate "market analysis" within the traditional FAR analysis for profit attribution.

8.4 Unilateral/Bilateral Advance Pricing Agreements

The purpose of an advance pricing agreement (APA) is to provide a means by which taxpayers and tax administrations can voluntarily and mutually agree on transfer pricing (TP) issues in advance. This process may be bilateral in nature, involving tax administrations in other countries in which the taxpayer has transactions with associated enterprises. Alternatively, it could be unilateral where a tax administration of the resident country enters into an agreement with the taxpayer on the relevant TP issues. Under

Indian law, both unilateral and bilateral APAs are recognised.

The Indian APA programme has received more than 1,500 applications. In the financial year 2021–22, India entered into 62 APAs. This includes 13 bilateral APAs and 49 unilateral APAs. As of March 2022, a total of 421 APAs have been signed by India.

8.5 Litigation Relating to Cross-Border Situations

Most cross-border litigation in India arises out of international tax issues pertaining to tax planning, permanent establishment, the applicability of beneficial DTAA provisions, transfer pricing adjustments, etc.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

No information on this topic is available for this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

No information on this topic is available for this jurisdiction.

9.3 Challenges by Taxpayers

No information on this topic is available for this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

No information on this topic is available for this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

India has not opted to apply Part VI to its covered tax agreements, which require mandatory binding arbitration. India does not accept a mandatory binding arbitration mechanism specifically for tax disputes on grounds of sovereignty. Despite India's reservations on mandatory binding arbitrations for tax disputes, some non-resident taxpayers like Vodafone and Cairn have invoked India's bilateral investment treaties (BITs) resulting in long-running tax disputes over India's retrospective taxation regime. Hence, in the revised model BIT, taxation matters have been excluded.

The government of India has taken a policy stance that taxation is an integral function of the state's sovereignty. Hence, India has not agreed to the position that such matters may be escalated under the treaty dispute settlement mechanism.

10.2 Types of Matters that Can Be Submitted to Arbitration

Since India has not opted for mandatory arbitration, the disputes relating to any treaty benefits cannot be submitted to arbitration.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Since India has not opted for mandatory arbitration, the baseball arbitration and independent opinion procedure is not applicable for any treaty disputes.

10.4 Implementation of the EU Directive on Arbitration

Not applicable to this jurisdiction.

10.5 Existing Use of Recent International and EU Legal Instruments

Since India has not opted for mandatory arbitration, the disputes relating to any treaty benefits cannot be submitted to arbitration.

10.6 New Procedures for New Developments under Pillar One and Two

Not applicable to this jurisdiction.

10.7 Publication of Decisions

This is not applicable since India has not opted for mandatory arbitration.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Tax disputes under the Indian legal system are settled through litigation before the appellate authorities and thereafter before the High Court and Supreme Court. In certain cases, ADR mechanisms may be employed, as have been detailed in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

This is not applicable since India has not opted for mandatory arbitration.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

Litigation costs to tax disputes before administrative forums vary for each authority. At the first level of litigation, ie, the assessment stage, no fee is generally payable by the taxpayer. Also,

the fee payable for filing an appeal before First Appellate Authority is also a very nominal fee. However, such disputes may also involve professional fees for representation before the authorities and other incidental expenses and costs.

11.2 Judicial Court Fees

Every judicial forum mandates payment of court fees for filing any appeals, including tax appeals. Besides these fixed court fees, taxpayers often need to deposit a certain percentage of the tax demand before approaching any forum against the aggrieved order for filing an appeal.

Any fee charged by the administrative authority and judicial courts is not refunded to the taxpayer irrespective of the result of the proceedings. Awarding costs of litigation in tax disputes is rare and each party must bear its own costs and expenses.

11.3 Indemnities

The Indian tax departments are not required to indemnify taxpayers even if the latter succeed in their contentions before any forum. There may be an exception where costs of litigation are awarded by the judges. Only in situations where the relief pertains to a refund of taxes already recovered/paid by the taxpayer is the tax department bound to refund the tax amount, along with applicable interest.

11.4 Costs of ADR

Not applicable to this jurisdiction.

12. STATISTICS

12.1 Pending Tax Court Cases

As matters stand, there are between 120,000 and 140,000 cases pending before the ITAT and other tax tribunals. Before the High Court, there are approximately 40,000 to 50,000 cases pending, while before the Supreme Court there are

approximately 6,000 tax cases pending, as of the last financial year.

12.2 Cases Relating to Different Taxes

No figures are available to indicate how many cases are initiated and decided each year for different taxes.

12.3 Parties Succeeding in Litigation

There are no official statistics available regarding the success of litigation by taxpayers and tax departments. However, it has been observed that in the majority of cases, the taxpayer succeeds in litigation. This is primarily due to the aggressive approach of the Indian tax department, which often files appeals even in cases where there are slim chances of success.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

It is essential that tax audits and lower-level litigations are handled proactively since these procedures become the basis for future litigation or alternative dispute resolution processes. In order to minimise the risks of prolonged litigation, it is advisable for taxpayers to involve tax experts at the initial stages and maintain robust documentation as much as possible.

It is also strategically important to decide whether the litigants want to continue pursuing appeals before judicial forums, or consider alternative dispute resolution options.

Depending on their complexity, tax disputes in India can meander within the judicial system for years. It is important for all parties to approach disputes in India from an efficient resolution standpoint. In other words, the aim should be to pursue the best possible strategy for the litigating parties. There is no “one size fits all” while handling tax controversies, and it all depends on the complexity of the issues involved. Strategised communication, discussions, and efficient strategies all play an equally critical role.

BMR Legal Advocates is a boutique law firm specialising in the areas of corporate international tax, transfer pricing, GST, customs and trade, with expertise in policy, disputes and transaction advice. The firm advises and supports clients on tax litigation, tax investigations and alternative dispute resolution, and acts as an expert witness on treaty and transfer pricing law. The firm specialises in providing strategic insights and legal advice on complex tax issues, including pre-litigation and litigation

support and representation. Founded in 2010 and based in New Delhi, the firm has won the confidence of numerous companies. Most professionals are dual-qualified with legal and tax advisory expertise and a deep understanding of specified industries. The firm has successfully represented several Indian and multinational clients, in several high-profile tax disputes before tribunals, High Courts and the Supreme Court on complex domestic tax, treaty and transfer pricing matters.

AUTHORS



Mukesh Butani is founder and managing partner of BMR Legal Advocates. With specialisation in domestic corporate international tax and transfer pricing, he has over three

decades of experience in advising multinationals and Indian conglomerates. He is an acknowledged expert with several landmark judgments to his credit. Mukesh is a qualified chartered accountant and holds a bachelor's degree in Commerce and Law, and practises before various tribunals, High Courts and the Supreme Court of India. He has authored various research papers, books and treatises, including *General Anti-Avoidance Rules: The Final Tax Frontier?* and *Transfer Pricing: An Indian Perspective*.



Shankey Agrawal is a partner at BMR Legal Advocates, with over 13 years of robust experience in both direct and indirect tax litigation. He is an Advocate-on-Record before the

Supreme Court of India and also a qualified company secretary. Shankey is a member of the Bar Council of Delhi (BCD), the Supreme Court Bar Association (SCBA), and the Supreme Court Advocates on Records Association (SCOARA). He has multiple reputed publications to his credit, including a recent book, *Goods & Services Tax: Decoding important issues and emerging litigation trends* for Taxmann Publications, and a report for ASSOCHAM on the Equalisation Levy.

BMR Legal Advocates

13 A-B, Hansalaya Building
15 Barakhamba Road
New Delhi – 110 001
India

Tel: +91 11 6678 3010
Email: Mukesh.butani@bmrlegal.in
Web: bmrlegal.in

BMR Legal
A D V O C A T E S

Trends and Developments

Contributed by:

*Mukesh Butani and Shankey Agrawal
BMR Legal Advocates see p.218*

Introduction

Indian tax policy developments have in general been dynamic. From the introduction of the landmark Goods and Services Tax Law in 2017, to debates on the new tax code to replace the Income Tax Act, 1961, India has often been in the news regarding tax disputes and controversies. There are multiple factors to this, such as frequent legislative changes, aggressive enforcement by revenue authorities and favourable interpretation given by courts to the taxpayer. Recent policy developments suggest significant legislative changes to reduce litigation, promote investor confidence and ease taxpayer uncertainty, including codification of the Taxpayers' Charter. There has also been an increased focus on digital taxation and the implementation of the OECD lead BEPS recommendations. The major trends and developments in the Indian tax sphere have been clubbed under separate heads and discussed in the paragraphs that follow.

Focus on Taxpayer Facilitation and Reducing Litigation

In recent years, a major policy stance of the government has been to provide taxpayer certainty by curtailing litigation. The Taxpayers' Charter of 2020 is a major step in this direction, which aims to develop taxpayers' trust in the tax system. The Charter contains many obligations, such as the presumption of honest taxpayers, respecting taxpayers' privacy, maintaining confidentiality, and publishing service standards and reports periodically.

Another major move has been to stem tax dispute litigation with the rollout of amnesty schemes for settlement of past tax disputes. As part of the amnesty schemes, India has fore-

gone a substantial part of the duty liability along with interests and penalties. For instance, in direct tax cases, the Vivad Se Vishwas settlement saw over 133,000 applications leading to a recovery of over INR540 billion in disputed tax liability. Similarly, under indirect taxes, the Sabka Vishwas Dispute Resolution Scheme for legacy cases saw a total of 189,000 declarations involving settlement of tax dues amounting to INR900 billion.

Other policy actions have involved addressing retrospective tax legislation by way of ordinances in 2021, and deferral of the Indian general anti-avoidance rule (GAAR) law of April 1 2017 by two years, signalling that India is willing to hear investors' voices and engage in consultation with stakeholders.

Other measures for curtailing litigation include increasing monetary threshold limits for filing appeals by the Tax Department. The law has been amended to prevent the Tax Department from filing repetitive appeals, where an identical matter is pending determination by higher courts. In 2021, a law was passed to set up the Dispute Resolution Committee (DRC) for small taxpayers with an income of INR5 million. Additionally, the legislation witnessed wide-ranging changes including the introduction of a new procedure for reassessment, faceless assessment, and abolition of the Dividend Distribution Tax (DDT). Also worth mentioning is the replacement of the quasi-judicial forum of Authority for Advance Ruling with the Board of Advance Ruling, comprising commissioners to speed up the issuing of rulings.

Certainly, some measures have backfired. For instance, upon the introduction of a new procedure for reassessment, the Department of Revenue issued notices for previous years without following the new procedure, resulting in considerable litigation before multiple High Courts by taxpayers – a matter which is currently pending before the Supreme Court, which recently issued its judgment to settle the law.

Similarly, abolition of the DDT has led to disputes on the application of tax on dividends due to the availability of the MFN clause under India's double tax conventions with countries in the OECD. As a result, the changes to domestic tax legislation have been met with consistent challenges by taxpayers. As a result, the judiciary has had to repeatedly step in to clarify interpretation and clear ambiguities in the law.

Reducing the Interface with the Tax Department

As another measure for facilitating taxpayers and bringing transparency to tax administration, a law was introduced for a faceless assessment and appeals scheme. This scheme has eliminated any physical interface between taxpayers and the Department of Revenue as far as assessments and appeals are concerned. Pursuant to High Court directives, the scheme has been amended to address taxpayer demands for physical hearings in specified cases.

Under the faceless assessment and appeals scheme, all the assessments and appeals are adjudicated in a faceless environment and monitored by a central agency. The scheme is applicable for all assessments and appeals except cases relating to evasion of tax, serious frauds, black money, international tax, etc.

Withdrawal of Retrospective Amendment

The Indian parliament introduced a retrospective amendment in 2012 for offshore taxation of indi-

rect transfer of capital assets. This much-criticised move has become a constant source of litigation under domestic and treaty law, including claims under bilateral investment promotion agreements (BIPAs). In 2021, the government took a major policy stance by withdrawing the retrospective effect for cases before various courts, including cases where the Hague Tribunal had issued awards under a BIPA.

The effect of this withdrawal means that all proceedings pertaining to taxation of offshore transfer of assets (with underlying assets in India) and pending before the authorities have been deemed to have never been made. As a precondition for availing of this benefit, taxpayers must withdraw any pending appeals, writ petitions or challenges before domestic courts as well as before the International Arbitral Tribunal. It has been clarified that amounts collected under the 2012 provisions shall be refunded to the taxpayers without payment of interest.

Withdrawal of retrospectivity and refunds to taxpayers will not only conclusively rest the controversy, but shall also boost investors' confidence.

Taxation of Digital Economy

A key trend to watch out for will be India's position on taxing supplies within the digital economy. The Base Erosion and Profit Shifting (BEPS) Action Plan 1 proposal is aimed at addressing the tax problems associated with economic digitalisation. As a response to BEPS Action Plan 1, India was amongst the first countries to incorporate measures for digital taxation in its domestic law. To this end, India enacted a digital tax by way of an "equalisation levy" at 6% on online advertising. This unilateral move by India to tax digital transactions was intended only as a temporary measure until the emergence of global consensus on digital tax.

In 2020, India broadened the scope of the levy to taxing all non-resident e-commerce operators for goods and services through an e-commerce portal. Tax has been introduced at 2% of payments for e-commerce supplies offered or facilitated by non-resident e-commerce operators. The rushed wide-sweeping changes lead to US trade representatives initiating actions under the US Trade Act. Such actions are now pending due to an understanding between the two nations.

With effect from April 1 2021, amendments pertaining to Significant Economic Presence (SEP) will take effect. Prior to the SEP condition, any income accrued or derived from a business/commercial link in India was taxed under the global formulary approach. Such a relationship typically entailed non-residents conducting operations in India through the actual presence of a fixed establishment, employees, or agents. In the case of treaties, the permanent establishment rules would apply.

After the SEP legislation, non-treaty countries will be impacted, and a business connection will be established even without an office location or people. A non-resident from a non-treaty nation will be considered to have an SEP in India if it transacts in any commodities, services, or property with an Indian resident in excess of INR20 million (about USD270,000) or the non-resident solicits business or interacts with a minimum of 300,000 users in India.

Another major tax policy move has been the taxation of digital assets, especially cryptocurrencies and non-fungible tokens (NFTs). Until recently, the law did not contain clear provisions for taxation of such digital assets. The Indian parliament, vide the Finance Act, 2022, has legislated provisions for taxation of “virtual digital assets” (VDAs), including various forms of crypto-assets, NFTs and any other tokens or assets created by cryptographic means.

Emerging Tax Treaty Interpretation Disputes and Jurisprudence

There is an emerging trend of tax treaty interpretation disputes. In 2021, the Supreme Court of India delivered a landmark judgment, which finally resolved the decade-long dispute on the taxability of cross-border supply of software. The Supreme Court held that amounts paid in consideration for software to non-residents will not amount to royalty under both domestic law and DTAAAs. In doing so, the Supreme Court has re-endorsed the primacy of international treaties over domestic legislation and held that treaty benefits cannot be denied in situations of retrospective amendment to domestic laws.

The Court upheld the position that OECD commentaries are a useful aid in interpreting tax treaties, and following the commentary held that India’s reservations are not legislative changes that would alter the treaties. The Court has conclusively held that until the treaty is amended by way of bilateral/multilateral renegotiation, the treaty provisions will continue to be followed and overrule domestic law provisions.

An area of treaty interpretation which has recently witnessed judicial discourse is the applicability of the Most Favoured Nation (MFN) clause. In 2020, India abolished the dividend distribution tax (DDT). This gave rise to disputes over the applicability of the MFN clause with certain treaty partners, who are members of OECD. Several investors from countries like France, Switzerland, Netherlands, Spain, etc, paid tax at the rate of 10–15% on dividends under tax treaties with India. However, residents of these jurisdictions began to apply a lower tax on dividends by triggering MFN clauses where India fixed a lower tax rate of 5% in tax treaties with Slovenia, Lithuania and Columbia, who became OECD members.

The dispute was decided in favour of the taxpayers by the Delhi High Court. However, the tax administration subsequently issued a directive to tax officials that stated lower tax applicable to Slovenia, Lithuania and Columbia cannot be extended to other OECD countries, as they were not OECD members when India signed the respective treaties. Further, it was specified that a separate notification shall be issued by India for importing benefits from one treaty into another, and that such practice cannot be automatic. This debate remains unsettled and is pending consideration before the Supreme Court of India.

Emerging Trend of Alternative Dispute Resolution in Tax Disputes

An increasing trend for adoption of Alternative Dispute Resolution (ADR) by taxpayers is also visible. To facilitate this, India has also taken significant steps to reform the existing ADR mechanism.

Constitution of the Board of Advance Ruling (BAR)

The erstwhile Authority for Advance Ruling (AAR) was disbanded and restructured in the form of a new authority, the Board of Advance Ruling (BAR), in the Union Budget 2021. As opposed to the AAR, which was a quasi-judicial body, the BAR is a ministerial body empowered to issue an advance ruling, ie, a written opinion that determines the tax consequences of a transaction or of a future transaction.

Numerous changes have been made to the existing AAR mechanism, some of which are detailed here:

- each region's board shall consist of two senior revenue officers;
- the board's ruling is not binding on the revenue or the applicant;

- unlike with the AAR, the BAR mechanism allows both the tax department and the petitioner to challenge the advance ruling before Indian High Courts.

Another enhancement to the BAR is the notion of an e-advance ruling, which was recently adopted in January 2022. As per this scheme, the proceedings before the BAR shall not be open to public.

Mutually Agreed Procedures (MAPs) and Advance Pricing Agreements (APAs)

Given the growing number of international tax disputes (particularly those involving intercompany cross-border transactions), the importance of accessible and effective dispute resolution mechanisms under MAPs has merely grown.

India has had a fairly established MAP mechanism for resolving international tax disputes resulting in taxation inconsistent with the tax convention. For this purpose, the MAP process has enabled a constructive dialogue with competent authorities of treaty partners, authorised by contracting states' governments to communicate with the goal of resolving an international tax dispute.

Action Plan 14 of the G20 and OECD countries' BEPS project on "Making Dispute Resolution More Effective" made a host of recommendations to improve the MAP process, including a mechanism for peer review. India has accordingly amended the pertinent rules, and in 2020 issued administrative guidance to incorporate the peer review observations.

Similarly, the introduction of the concept of advance pricing agreements (APAs) was to further the reduction transfer pricing disputes and usher in an environment of certainty on cross-border transaction pricing. The competent authority has legal authority to enter into

advance pricing agreements (APAs) with taxpayers for a maximum period of five years and a roll-back of four years in respect of international transactions between associated enterprises (AEs) to determine the arm's-length price (ALP). There is an increasing trend in the adoption of APAs, which should aid the reduction of transfer pricing controversies.

Increasing Disputes under Goods and Services Tax (GST)

The Indian Goods and Services Tax (GST) was introduced in 2017, which replaced and consolidated most indirect tax levies. GST law is in a nascent stage and its implementation and enforcement has given rise to litigation involving taxpayers.

There are many facets to GST law, including classification of goods and services, valuation of supplies, and eligibility to avail of input-tax credits (ITCs), which have given rise to litigation. Issues often arise on the scrutiny of annual tax returns filed by taxpayers. The Department of Revenue has been proactive in issuing circulars and notifications to eliminate many such issues, as well as issuing advance rulings. The formation of the National Appellate Tribunal for GST is, however, still awaited.

GAAR Panel

India's GAAR law came into effect from April 1 2017. The law classifies certain transactions which avail of tax benefits as tax avoidance if they fail the test of commercial expediency or arm's-length nature, or are carried out for bona fide purposes or in abuse of the tax code. A GAAR Panel vets proposals of the Department of Revenue to initiate the proceedings. The GAAR panel was recently set up comprising a retired judge, commissioner and an independent academician.

As part of the BEPS inclusive framework, India has been a signatory to the Multilateral Instrument. In pursuance thereto, it has a wide network of treaty partners with whom it has Covered Tax Agreements. The minimum standard under BEPS which mandates the principal purpose test in the preamble to the treaties has been incorporated into domestic law.

BMR Legal Advocates is a boutique law firm specialising in the areas of corporate international tax, transfer pricing, GST, customs and trade, with expertise in policy, disputes and transaction advice. The firm advises and supports clients on tax litigation, tax investigations, alternative dispute resolution and acts as an expert witness on treaty and transfer pricing law. The firm specialises in providing strategic insights and legal advice on complex tax issues, including pre-litigation and litigation

support and representation. Founded in 2010 and based in New Delhi, the firm has won the confidence of numerous companies. Most professionals are dual-qualified with legal and tax advisory expertise and a deep understanding of specified industries. The firm has successfully represented several Indian and multinational clients, in several high-profile tax disputes before tribunals, High Courts and the Supreme Court on complex domestic tax, treaty and transfer pricing matters.

AUTHORS



Mukesh Butani is founder and managing partner of BMR Legal Advocates. With specialisation in domestic corporate international tax and transfer pricing, he has over three

decades of experience in advising multinationals and Indian conglomerates. He is an acknowledged expert with several landmark judgments to his credit. Mukesh is a qualified chartered accountant and holds a bachelor's degree in Commerce and Law, and practises before various tribunals, High Courts and the Supreme Court of India. He has authored various research papers, books and treatises, including *General Anti-Avoidance Rules: The Final Tax Frontier?* and *Transfer Pricing: An Indian Perspective*.



Shankey Agrawal is a partner at BMR Legal Advocates, with over 13 years of robust experience in both direct and indirect tax litigation. He is an Advocate-on-Record before the

Supreme Court of India and also a qualified company secretary. Shankey is a member of the Bar Council of Delhi (BCD), the Supreme Court Bar Association (SCBA), and the Supreme Court Advocates on Records Association (SCOARA). He has multiple reputed publications to his credit, including a recent book, *Goods & Services Tax: Decoding important issues and emerging litigation trends* for Taxmann Publications, and a report for ASSOCHAM on the Equalisation Levy.

BMR Legal Advocates

13 A-B, Hansalaya Building
15 Barakhamba Road
New Delhi – 110 001
India

Tel: +91 11 6678 3010
Email: Mukesh.butani@bmrlegal.in
Web: bmrlegal.in

BMR Legal
A D V O C A T E S

Law and Practice

Contributed by:

Meir Linzen, Yuval Navot and Ofer Granot
Herzog Fox & Neeman see p.237



CONTENTS

1. Tax Controversies	p.221	5.3 Judges and Decisions in Tax Appeals	p.228
1.1 Tax Controversies in this Jurisdiction	p.221	6. Alternative Dispute Resolution (ADR) Mechanisms	p.228
1.2 Causes of Tax Controversies	p.221	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.228
1.3 Avoidance of Tax Controversies	p.221	6.2 Settlement of Tax Disputes by Means of ADR	p.228
1.4 Efforts to Combat Tax Avoidance	p.221	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.228
1.5 Additional Tax Assessments	p.221	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.228
2. Tax Audits	p.222	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.228
2.1 Main Rules Determining Tax Audits	p.222	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.228
2.2 Initiation and Duration of a Tax Audit	p.223	7. Administrative and Criminal Tax Offences	p.229
2.3 Location and Procedure of Tax Audits	p.223	7.1 Interaction of Tax Assessments with Tax Infringements	p.229
2.4 Areas of Special Attention in Tax Audits	p.223	7.2 Relationship between Administrative and Criminal Processes	p.229
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.223	7.3 Initiation of Administrative Processes and Criminal Cases	p.230
2.6 Strategic Points for Consideration during Tax Audits	p.224	7.4 Stages of Administrative Processes and Criminal Cases	p.230
3. Administrative Litigation	p.225	7.5 Possibility of Fine Reductions	p.230
3.1 Administrative Claim Phase	p.225	7.6 Possibility of Agreements to Prevent Trial	p.230
3.2 Deadline for Administrative Claims	p.225	7.7 Appeals against Criminal Tax Decisions	p.231
4. Judicial Litigation: First Instance	p.225	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.232
4.1 Initiation of Judicial Tax Litigation	p.225	8. Cross-Border Tax Disputes	p.232
4.2 Procedure of Judicial Tax Litigation	p.226	8.1 Mechanisms to Deal with Double Taxation	p.232
4.3 Relevance of Evidence in Judicial Tax Litigation	p.226	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.232
4.4 Burden of Proof in Judicial Tax Litigation	p.226		
4.5 Strategic Options in Judicial Tax Litigation	p.226		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.227		
5. Judicial Litigation: Appeals	p.227		
5.1 System for Appealing Judicial Tax Litigation	p.227		
5.2 Stages in the Tax Appeal Procedure	p.227		

8.3	Challenges to International Transfer Pricing Adjustments	p.233	10.5	Existing Use of Recent International and EU Legal Instruments	p.234
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.233	10.6	New Procedures for New Developments under Pillar One and Two	p.234
8.5	Litigation Relating to Cross-Border Situations	p.233	10.7	Publication of Decisions	p.235
9. State Aid Disputes		p.233	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.235
9.1	State Aid Disputes Involving Taxes	p.233	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.235
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.233	11. Costs/Fees		p.235
9.3	Challenges by Taxpayers	p.233	11.1	Costs/Fees Relating to Administrative Litigation	p.235
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.233	11.2	Judicial Court Fees	p.235
10. International Tax Arbitration Options and Procedures		p.234	11.3	Indemnities	p.235
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.234	11.4	Costs of ADR	p.235
10.2	Types of Matters that Can Be Submitted to Arbitration	p.234	12. Statistics		p.235
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.234	12.1	Pending Tax Court Cases	p.235
10.4	Implementation of the EU Directive on Arbitration	p.234	12.2	Cases Relating to Different Taxes	p.235
			12.3	Parties Succeeding in Litigation	p.235
			13. Strategies		p.236
			13.1	Strategic Guidelines in Tax Controversies	p.236

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Many tax controversies are initiated as a consequence of examination by the Israeli Tax Authority (ITA) of tax returns – for example, self-assessments and value added tax (VAT) returns – or tax withholdings filings. Other causes of tax controversies include tax audits, requests to amend tax returns, requests for exemption from or reduction of withholding tax, requests for tax refunds, ruling requests and notices to the ITA (such as notices of transactions). A tax controversy regarding a certain tax issue may also trigger controversies in other kinds of taxes. For example, an income tax audit may trigger a VAT or real estate tax audit or social security audit. Similarly, a civil tax audit may trigger a criminal investigation and vice versa.

1.2 Causes of Tax Controversies

There are no formal statistics as to which taxes or tax matters give rise to the most controversies. In general, the more significant the matter (or legal or tax principle concerned), the greater is the chance that it will trigger an audit or give rise to controversy. Low tax amounts in dispute (less than a few hundred thousand Israeli new shekels (ILS)) are not usually the subject of litigation, except in rare cases where the matter has implications on other matters regarding the taxpayer or if the matter in dispute is considered as constituting one of principle, either to the ITA or to the taxpayer. Where the amount of tax involved is large, there are tax controversies involving billions of shekels in cases of individuals and corporations.

1.3 Avoidance of Tax Controversies

A tax controversy may be avoided through a ruling procedure, under which the ITA's position can be confirmed in advance. Tax opinions can

mitigate the risk of criminal liability but not the risk of a civil tax controversy.

1.4 Efforts to Combat Tax Avoidance

The Base Erosion and Profit Shifting (BEPS) recommendations of the OECD contribute to an increasing number of tax controversies in Israel. Prior to the final BEPS recommendations, the ITA had already adopted in various matters, by way of administrative circulars or practices, a stricter and more tax-maximising approach than those eventually adopted in the BEPS recommendations. This includes issues regarding the digital economy, transfer pricing, permanent establishment and VAT. At the same time, the ITA views the final BEPS recommendations as a source for legitimacy and policy justification for the ITA's positions in related matters. The ITA also views the indecisiveness and lack of a coherent global policy in certain matters (such as those affecting the digital economy) as an opportunity to take an independent approach and thereby to affect the implementation of the BEPS recommendations.

1.5 Additional Tax Assessments

Once the ITA issues an assessment, the taxpayer is required to pay the additional tax liability unless the taxpayer files an administrative appeal (an Objection) against the assessment. In this case, the taxpayer is obliged to pay only the tax that is not in dispute. If the ITA does not accept the Objection and issues an order (a second-stage assessment) then the taxpayer must pay the tax in dispute unless the taxpayer files an appeal to the District Court. However, the tax liability, as decided in the ruling of the District Court, must be paid by the taxpayer even if the taxpayer files an appeal to the Supreme Court against the ruling of the District Court (unless the Supreme Court decides differently, which is extremely rare). In any event, the tax that is in dispute bears interest and linkage differentials (Consumer Price Index) during the time in which the taxpayer is not required to pay it. As long as

the tax in dispute is not paid, the income tax and VAT authorities have the authority not to make certain refunds to the taxpayer.

In circumstances in which the ITA is concerned that the taxpayer will not be able (or willing) to pay the tax it owes (for example, the tax in dispute is substantial or the taxpayer does not have sufficient financial resources in Israel), the ITA may ask the taxpayer to provide guarantees. If the taxpayer does not provide guarantees that are acceptable to the ITA, the ITA may approach the court to place a lien on the assets of the taxpayer or to prohibit the taxpayer (or officers or shareholders of the taxpayer) from travelling outside Israel. Failure to provide the requested guarantees may prevent the taxpayer from appealing against the tax assessment.

A civil tax proceeding may lead to the initiation of criminal proceedings and vice versa. In general, there is no automatic suspension of civil proceedings due to the existence of criminal proceedings and vice versa.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

General Policy

In general, all tax returns are examined on a random basis, with different selection rates depending on the type of taxpayer (individuals, corporations, relevant field of activity). Those individuals and corporations considered as being “significant” are usually audited on a yearly basis. In addition, the ITA has internal guidelines (not all of which are made public), which are updated from time to time, that set out the main considerations for initiating tax audits. The guidelines include criteria regarding:

- the magnitude of the self-assessments;
- the turnover or the balances reported;

- certain business sectors;
- profitability rates;
- certain types of incomes (capital gains, exempt income, non-Israeli income);
- a taxpayer who has reported (as required under the law) a special tax position, issued an opinion or entered into a transaction;
- a taxpayer who has requested a ruling or a tax refund;
- the situation where the taxpayer’s auditor’s opinion concerning the financial statements or tax returns was not without reservations;
- a taxpayer whose books were previously disqualified by the ITA;
- a taxpayer who has been investigated by the ITA; and
- the incoherency of a taxpayer’s various tax filings.

The guidelines also include special topics of interest such as transfer pricing in multinational group entities, M&A and intercompany financing, and tax incentives.

Individual Field Tax Office Practice

At the same time, the field tax office entrusted with a specific case has discretion with respect to the initiation of tax audits. In this regard, the question of whether an audit is initiated can be influenced, for example, by an office’s staff availability, the expertise and qualifications of a tax office, and the familiarity of a tax office with various issues. In certain particularly important issues for the ITA, or in across-the-board issues, all the tax audits on such issues (including the decision of whether to initiate a tax audit) can be supervised by a special professional steering team consisting of the management of the ITA. In recent years, the ITA has recruited a significant number of inspectors (auditors) and university graduates conversant in English, and allocated them among the various field offices to mitigate the differences between the field tax offices. These steps, together with an increasing

use of digital databases by tax inspectors, have resulted in an increasing number of tax audits each year.

2.2 Initiation and Duration of a Tax Audit

The ITA may issue a tax assessment until the end of the fourth tax year from the end of the tax year in which the tax return (self-assessment) was filed. VAT assessments can, in general, be issued within five years from the submission of the relevant VAT return. If a taxpayer has been indicted by a court for certain tax offences or paid a “ransom”, the ITA may issue a civil tax assessment one year following such indictment or payment, even if the applicable civil statute of limitations period has already elapsed. See **7.6 Possibility of Agreements to Prevent Trial** for further discussion of ransoms.

The duration of the tax audits varies from case to case and can be influenced, for example, by the complexity of the case, the co-operation of the taxpayer, the involvement of other taxpayers or other departments of the ITA that are involved in the case, collection-of-information efforts, negotiations, and the existence of other similar or related tax audits, or similar cases pending before courts. In many cases, the ITA exhausts the entire audit period and issues the assessment near the end of the statute of limitations period. In this regard, a tax audit does not suspend the statute of limitations period. Accordingly, the audit must be completed before the statute of limitations period elapses.

2.3 Location and Procedure of Tax Audits

In general, audits take place at the offices of the relevant tax office. Tax inspectors may, at their own discretion, visit the taxpayer’s premises, which is common during the audit process, particularly in the case of corporations. Audits are based on both printed documents and data

made available electronically. The ITA often requests that the taxpayer submit an electronic file called a Unified Format File that contains significant information regarding the taxpayer. The ITA usually requests that the taxpayer provide data in both printed and soft copy (computer files) form.

2.4 Areas of Special Attention in Tax Audits

Auditors usually begin by examining general aspects such as the dates of legally required tax returns and notices, the existence of proper documentation (eg, expenses, tax withholding certificates, foreign tax credit) and any foreign tax payments or confirmations of donations, the group structure, and related parties.

Substantive issues that currently appear to attract the attention of tax auditors include:

- taxation of the digital economy;
- permanent establishment;
- transfer pricing;
- intercompany financing and balances;
- business restructuring and the transfer of functions, assets and risks (FAR);
- proper tax withholding;
- tax incentives; and
- opinions received by the taxpayer.

With regard to VAT audits, the main substantive issues include the “recapturing” of input VAT, occasional transactions, real estate transactions, activities in the capital markets, as well as the activity of non-Israeli companies in Israel.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

This firm is not aware of a significant increase in the number of audits due to the cross-border exchange of information. However, the new rules

have influenced the ITA's mindset and its willingness to settle in certain audits. For example, the ITA has taken a relatively strict position in audits resulting from voluntary disclosure procedures based on the assumption that even if the taxpayer does not disclose the information, the ITA would eventually be able to obtain the relevant information from the relevant foreign tax authorities.

2.6 Strategic Points for Consideration during Tax Audits

Have Legal Representation from the Early Stages of the Audit

Audits are legal proceedings and have legal implications. Tax inspectors are consulted by the ITA's legal department at the time of the audit. Mistakenly waiving rights or arguments that should have been argued at the first possible opportunity possible, not providing all the factual and legal reasoning to the merits, or failing to meet certain ITA requirements on time (if there is no justification to object) may have a significantly adverse effect on the taxpayer's case at the next stages of the controversy. Accordingly, lawyers are now involved in tax audits from the initial stage of the proceedings and not only when the case gets to court.

The Distinction between Civil and Criminal Proceedings

In certain cases (such as VAT audits), it is not always clear whether the proceedings are civil or criminal. However, different rules and rights apply in civil and criminal proceedings, and it is important to obtain a clear view as to the nature of the proceedings taken against the taxpayer.

Be Represented

A representative of the taxpayer can attend any meetings and communication with the ITA (except for certain criminal proceedings).

The Procedure Is Strategic

There are no "off the record" discussions with the ITA. Any informal talks with the ITA (if not defined as "negotiations") could be used by the ITA as evidence against the taxpayer.

Written records of any communication with the ITA should be maintained (eg, delivery of information, arguments or complaints raised before the ITA, extensions granted by the ITA, requests made by the taxpayer, the ITA's arguments and responses). Mere oral communication is not sufficient, and it is difficult to use it in evidence or prove it at later stages.

Protocols of audit meetings should be asked for, the ITA must provide them.

Any right or procedural argument must be raised at the first possible opportunity (eg, regarding the statute of limitations or legal privilege). Otherwise, such a right or argument may be considered as having been waived and will not be heard later.

Although the power of the ITA to collect or request information is very broad, it is still restricted, for example, by reasons of legal privilege, rules of international law (eg, the documents of foreign companies) and statutory restrictions on the collection of certain information (eg, access to computer and digital information requires the obtaining of a court order; moreover, there is a prohibition on interviewing employees and former employees of the taxpayer).

Taxpayers should prevent "fishing exercises" for information; they must insist on clear arguments and questions by the ITA.

Negotiations Have to Be Timed Properly

In general, the more advanced the process, the more people are involved and the greater the alleged tax liability is, making it more difficult to

reach an agreement. However, compromising with the ITA at a premature stage may result in a settlement that can be excessive in amount or considered by non-Israeli tax authorities as a voluntary tax payment that cannot be deducted.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

The administrative claim phase is generally mandatory before the judicial phase. A taxpayer is required to file its Objection (administrative appeal) against the assessment issued by the ITA within 30 days from the date on which the taxpayer received the tax assessment, unless the taxpayer has received a written extension from the ITA. The same timeframe applies to a VAT administrative appeal. An administrative appeal against a tax withholding assessment must be filed within two weeks from the issuance of that assessment. The Objection has to be filed to the same tax office that issued the assessment.

The Objection has to include all the factual and legal arguments, and the main supporting documents. The taxpayer may not be able to bring or raise such facts and legal arguments at later stages if they have not already been raised and presented in the Objection document and during the stage of the administrative appeal.

The administrative appeal (at the Objection stage) is similar to the initial tax audit. The case is examined from the outset by a different team from the same tax office. At the same time, at the administrative appeal stage, the professional department of the ITA's headquarters (in addition to the tax office) and higher-level ITA officers are usually involved. The taxpayer has the right to receive from the ITA all the materials and documents relating to the assessment.

In making a decision in the administrative appeal, the ITA is not bound by the first-stage assessment. The decision in the administrative appeal can be based on different factual or legal arguments (even if these contradict the first assessment) and the decision in the appeal could decrease as well as increase the tax liability argued by the ITA.

3.2 Deadline for Administrative Claims

The deadline for the ITA to decide an administrative appeal (to settle the matter or to issue a second-stage assessment, which is called an Order) is the later of one year from the date of the submission of the appeal or four years from the end of the tax year in which the tax return was filed. In VAT matters, the deadline for the ITA is one year from the date of the submission of the administrative appeal. If the ITA does not issue another assessment by the end of this period, then the administrative appeal is considered to have been accepted by the ITA and no further steps need to be taken by the taxpayer.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

A tax order (a second-stage tax assessment) issued by the ITA or dismissal of the VAT administrative appeal can be appealed to a District Court. The jurisdiction of the relevant District Court is determined on the basis of various parameters, including which tax office audited the taxpayer and the address of the taxpayer. A tax appeal is heard before a single judge who examines and decides on the facts and the legal arguments.

In order to initiate a tax appeal, an appeal notice must be filed to the court. In income tax cases, the appeal notice has to be filed within 30 days from the date on which the ITA's order was

served to the taxpayer. The income tax appeal notice is a short document that mainly provides the income and tax amounts in dispute. In VAT matters, the notice has to be filed within 60 days from the date on which the ITA's dismissal of the administrative appeal was served to the taxpayer. The VAT appeal notice is a thorough document and it has to include all the factual and legal arguments in detail.

4.2 Procedure of Judicial Tax Litigation

After the initiation of the income tax appeal through the submission of an appeal notice, the ITA has 30 days to file its arguments against the assessment and the taxpayer will then have 30 days to file its arguments for the appeal (following the submission by the ITA). Usually, both parties request extensions. The arguments for the appeal have to include all the factual and legal arguments, and the main supporting documents (contradicting factual arguments are generally not allowed, while contradicting legal arguments are generally considered as being legitimate). Otherwise, the taxpayer may not be allowed to raise these arguments before the court. In VAT appeals, the appeal is initiated with a detailed appeal notice of the taxpayer and the VAT Authority has 60 days to submit its detailed response.

Until the first court hearing, the taxpayer can file procedural and preliminary requests (for example, document disclosure requests and questionnaires). After the arguments for the appeal are filed, the court usually holds a court hearing to discuss the procedural and preliminary requests, and to set the procedures for the evidentiary stage.

After the evidentiary stage, summations are filed in court, both by the taxpayer and the ITA. Thereafter, the taxpayer's summations-in-response are filed. The court will then render its judgment in writing.

4.3 Relevance of Evidence in Judicial Tax Litigation

In most cases, testimonies-in-chief (the equivalent of the US "direct examination") are given in writing while cross-examination of witnesses is oral, at a court hearing. Documents need to be served as evidence to court through the witnesses (either directly or at the stage of cross-examination). Only those documents that were disclosed and exchanged between the parties at the earlier stages (for example, during the audit, the submissions to court and the disclosure stage) can be served as evidence to the court.

4.4 Burden of Proof in Judicial Tax Litigation

The general rule in a civil tax appeal is that the burden of proof rests on the taxpayer. However, if the argument of the ITA in the appeal concerns the bookkeeping of the taxpayer, which was not disqualified by the ITA, or if the main argument of the ITA is that the relevant transactions are artificial, then the burden of proof would rest on the ITA (however, this occurs relatively rarely). In addition, if the ITA argues for a transfer pricing adjustment in a case where a transfer pricing study has been submitted by the taxpayer then the burden of proof will also rest on the ITA. In criminal cases the burden rests on the ITA.

4.5 Strategic Options in Judicial Tax Litigation

Tax Litigation Is Tax and Litigation

Tax litigation before a court of law involves not only tax but also substantive litigation issues. Tax appeals are sometimes unjustly regarded less as litigation and more as tax procedures. This firm considers that approach to be inherently flawed. Both tax expertise and expertise in litigation are crucial to the actual court case. An in-depth understanding and knowledge of litigation and its procedures – including with respect to the applicable pleadings; the application of the limitation periods; the burden of proof, tes-

timonies and cross-examinations; the use of experts; document disclosure (discovery and questionnaires); and written summations – can make a considerable difference and improve the position of the taxpayer in court.

Mutual Agreement Procedure (MAP)

Initiation of a MAP is a strategic measure in cross-border cases. In order to make sure that the judicial appeal proceedings will be stayed until the exhaustion of the MAP and to preserve certain procedural advantages, the initiation of the MAP needs to be carefully considered and planned in advance, preferably before the initiation of the judicial appeal.

Payment of the Tax in Dispute

There is no obligation to pay the tax in dispute until the District Court publishes its ruling in the case. In fact, by not paying the tax in dispute, a taxpayer provides a greater incentive to the ITA to settle in order to expedite collection. At the same time, the taxpayer needs to bear in mind that the tax in dispute bears 4% interest and linkage differentials until actual payment.

Negotiations

Negotiations can also take place during the tax litigation stage in court. If a settlement is not reached before the court proceedings, then negotiations will usually become relevant again further to the comments or recommendations of the judge during the court hearings, the evaluation of the State Attorney of the ITA's chances of success in the case and the potential implications of a court ruling, or initiation of a MAP.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Israeli courts use non-Israeli resources – in particular from the USA, the UK and other OECD countries – as a source for the interpretation of the law. Such resources include:

- the model tax treaties of the OECD, the USA and the UN, and their commentaries;
- OECD reports and guidelines;
- circulars and guidelines issued by non-Israeli tax authorities (mainly the IRS);
- non-Israeli case law; and
- academic articles.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The ITA and the taxpayer can file an appeal to the Supreme Court on the ruling rendered by the District Court. The Supreme Court examines only the legal questions and does not examine the facts. After the Supreme Court renders its rulings in the appeal, no further appeal is possible. However, it is possible to request an “additional review” by the Supreme Court, in a case where the Supreme Court’s decision is novel or contradicts former binding precedents and will have significant implications on many taxpayers, and not only on the matter concerning the specific taxpayer. However, such a request is accepted only in rare cases.

5.2 Stages in the Tax Appeal Procedure

The appellant files a notice of appeal to the Supreme Court which include his or her arguments and the documents upon which the appellant relies. The appellant must deposit a guarantee for the expenses of the other party. The Supreme Court may reject the appeal without the response of the other party, ask for a response, or order the parties to submit a brief that summarises their main arguments in the appeal and a court hearing may then be scheduled. Summations may be heard orally or submitted in writing, or the court may decide without the need for summations.

5.3 Judges and Decisions in Tax Appeals

Appeals before the Supreme Court are heard by three justices, who are allocated to cases by the secretariat of the Court or by the Chief Justice of the Supreme Court.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

There are no tax-related alternative dispute resolution (ADR) mechanisms in Israel. In the case of a tax controversy between the ITA and a government entity, the controversy must be brought before the Attorney General of Israel and the Director of the Government Companies Authority (where government companies are involved) prior to initiating court proceedings.

6.2 Settlement of Tax Disputes by Means of ADR

The procedure before the Attorney General for controversies related to government entities is not strictly defined. The rules imply that the procedure is in the nature of a mediation or negotiations with the assistance of the Attorney General. However, the ITA usually requires that the procedure take place as an arbitration and that the parties be subject to the decision of the arbitrator. In any case, if the parties do not agree with regard to the procedure or if the parties do not accept the decision made under that procedure, then the controversy can be litigated in court.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

The ITA may issue advance tax rulings, which are issued by the professional department within the headquarters of the ITA. In certain cases, the

taxpayer is obliged to obtain a ruling to take a certain tax position or to execute certain transactions (for example, in the case of tax-free mergers). A tax ruling that is issued by way of an agreement between the ITA and the taxpayer is binding. If the ITA issues a ruling that is not with the agreement of the taxpayer (such that the ITA refuses the tax treatment requested by the taxpayer) then the taxpayer can file an appeal against the ruling. The ruling usually states that it is based on the facts presented by the taxpayer, which have not been reviewed by the ITA. It is also possible to reach an advanced pricing agreement (APA), which can be unilateral, bilateral or multilateral. The field tax office may examine the facts during tax audits. If the facts were incorrect or not complete, then the ruling could be void or cancelled. An APA cannot be issued by the field tax offices. However, it is possible to reach an agreement to settle an ongoing matter.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**, **6.2 Settlement of Tax Disputes by Means of ADR** and **6.3 Agreements to Reduce Tax Assessments, Interest or Penalties** for relevant information.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**, **6.2 Settlement of Tax Disputes by Means of ADR** and **6.3 Agreements to Reduce Tax Assessments, Interest or Penalties** for relevant information.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**, **6.2 Settlement of Tax Disputes by Means of ADR** and **6.3 Agreements**

to Reduce Tax Assessments, Interest or Penalties for relevant information.

- through a reference of the matter to the Investigations Tax Office by the civil tax office; and
- owing to information received by the Investigations Tax Office.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Israeli tax laws provide for the imposition of criminal liability for various actions, or failures to act, whether intentional or unintentional. Under the Israeli VAT Law, any failure to comply with the law constitutes, in principle, a criminal offence. The Israeli Administrative Offences Law sets out offences that could be subject to administrative fines instead of criminal charges.

The ITA does not implement the applicable criminal provisions on every matter that is covered under such offences, and not every case of underpayment of taxes triggers criminal (or administrative) proceedings. In general, the use of criminal or administrative proceedings is less frequent in income tax matters and more common in VAT cases. Cases of gross negligence, intentional misconduct or fraud are more likely to result in prosecution. Taxpayers who have based their position on a written opinion issued by a tax expert are unlikely to be prosecuted. As a general matter, the use of general anti-avoidance rules (GAAR) or specific anti-avoidance rules (SAAR) by the ITA would not result, in itself, in criminal charges against the taxpayer. However, in the case of a “fictitious transaction” (namely, a false transaction that never took place), criminal liability could ensue.

Criminal proceedings can be initiated in various ways, such as:

- at the initiative of the ITA’s Investigations Tax Office;

Within the context of a VAT matter, a criminal investigation can be initiated by any VAT inspector (not only by the Investigations Tax Office). Moreover, a VAT civil audit can instantly be transformed into a criminal investigation, at the discretion of the VAT inspector (namely, a civil audit meeting can be immediately transformed into a criminal investigation).

Administrative proceedings can be initiated by the civil tax office in which the taxpayer’s tax file is registered. For example, since administrative infringements are of a technical nature, the civil tax office can conduct a special search on the ITA’s data systems (SHAAM) to identify taxpayers who have allegedly committed such infringements. In addition, according to internal ITA procedures, any member of the ITA’s personnel who encounters a case that could result in an administrative fine should inform the relevant local office of such a case.

It should be noted that the ITA is authorised to impose “deficit fines” equal to 15–30% of the tax required by the ITA in excess of what was stated in the tax report under the self-assessment of the taxpayer. Such deficit fines constitute a civil sanction and not a criminal or administrative sanction.

7.2 Relationship between Administrative and Criminal Processes

As a general matter, cases that constitute an administrative offence will be treated as such and criminal proceedings will not be initiated, except in special circumstances (such as repeated offences, significant amounts or where special deterrence is needed). Once an administrative process is initiated, taxpayers will not be

prosecuted for the same offence, unless the taxpayers themselves request to be prosecuted and to face trial, instead of paying an administrative fine.

Criminal or administrative proceedings are separate to civil proceedings. Administrative or criminal proceedings can take place simultaneously with civil proceedings. The court will usually dismiss requests to stay civil court cases until after the criminal proceedings are concluded. Such requests may only be accepted in special circumstances, where the court is convinced that not staying the civil case will significantly and adversely affect the taxpayer's rights. Also, the internal guidelines of the ITA instruct the civil tax offices not to issue tax assessments where a criminal investigation is under way until the criminal investigation is completed (subject to statute of limitations constraints).

7.3 Initiation of Administrative Processes and Criminal Cases

See **7.1 Interaction of Tax Assessments with Tax Infringements**.

Once an administrative process has been initiated, the taxpayer will not be prosecuted for the same offence, unless the taxpayer asks to be prosecuted and to face a trial instead of paying an administrative fine.

7.4 Stages of Administrative Processes and Criminal Cases

Administrative Infringement Process

Once an infringement is identified by the ITA, it should carry out an internal process under which it will ensure that the required criteria for levying an administrative fine have been met. Once this preliminary stage is completed, the taxpayer should be summoned for a hearing in front of the relevant tax officer. If, prior to the hearing, the taxpayer rectifies the misconduct that was the reason for the hearing then the local office may

consider not imposing an administrative fine (but only a civil fine, if applicable). Subject to the findings of the hearing, the fine will be imposed by the local tax office.

The taxpayer can submit a request to cancel the administrative fine, which must be submitted within 30 days, to a specific officer (who has been nominated by the Attorney General). The officer may cancel the fine but only if the officer finds that there has been no infringement, or that the infringement was caused not by the taxpayer, or that there is no public interest in a fine being imposed under the circumstances. If the officer rejects the taxpayer's request to cancel the fine, then the taxpayer may request to be prosecuted and to face trial with respect to the infringement.

Criminal Cases

Criminal cases usually commence with an investigation. The findings of the investigation are provided to the relevant prosecution department within the Attorney General's office. The department will then examine the findings to decide whether to prosecute (in some cases, a decision to prosecute is subject to a hearing). In general, criminal tax cases are heard before a single judge of the Magistrate's Court whereas the civil court case will be heard before a District Court.

7.5 Possibility of Fine Reductions

Administrative fines may be reduced (at the discretion of the tax office) due to the payment of the civil tax liability, but only if the payment was made prior to the hearing (regarding the imposition of the administrative fine).

7.6 Possibility of Agreements to Prevent Trial

The ITA is entitled to withdraw criminal proceedings on the condition that the taxpayer makes what is referred to as a "ransom payment". The ransom amount is determined by the ITA and

can be as high as twice the applicable fine that applies under the Israeli Income Tax Ordinance for the income tax offence, or the applicable fine itself in the case of a VAT offence. The ransom is not in lieu of the payment of the applicable tax liability, including interest and linkage differentials. Moreover, the payment of a ransom can be used as evidence in a civil procedure, even though it is not regarded as a criminal conviction.

The main considerations published by the ITA, to be taken into account in deciding whether to convert the criminal proceedings into a ransom payment, are detailed below.

Considerations in Favour of Conversion

Considerations in favour of conversion include the following.

- The leniency of the offence – the financial scope of the offence is relatively small; the degree of the taxpayer's guilt; prior rulings of the courts in similar cases.
- The extent of the taxpayer's involvement and initiative in committing the offence (whether the taxpayer is an accomplice and not the principal offender or an accomplice).
- The personal situation of the offender – including old age, serious illness or disability and personal adverse circumstances.
- The situation of family members who depend on the offender.
- The public interest in bringing the offender to justice – whether the harm resulting from prosecuting will exceed the benefits; the burden on the judicial system; and if there is need for deterrence in the circumstances of the particular case.
- The rectifying of the criminal act by means of tax payment, amendments being made to the applicable tax reports, etc.
- In exceptional cases, the following considerations will also be taken into account:

- (a) the fact that the taxpayer was injured during his or her service in the Israeli army and has any other homeland security background – the contribution of the taxpayer to the public;
- (b) the degree of co-operation of the taxpayer during the investigation process; or
- (c) significant time delays – if such delays were not caused by the taxpayer.

Considerations against Conversion

Considerations against conversion include the following.

- The taxpayer was previously given warnings; whether they had previous convictions; the offence has previously occurred in the taxpayer's case; whether ransom payments were made by the taxpayer in former cases.
- The severity of the offence – whether the financial scope of the offence is relatively significant; the duration of the occurrence of the offence; the failure to remove the offending act or omission.
- An offence made by a representative of the taxpayer (lawyer, Certified Public Accountant, etc) within the framework of his or her position as representative.
- The existence of any deterrence factor in certain industries (sectors in which offences have become very common).
- An offence in a field that requires trust or loyalty.
- Where, in addition to the tax offence, the taxpayer has committed other criminal offences under the general law.
- An offer has been made in the past to the taxpayer to make a ransom payment and they refused to do so.

7.7 Appeals against Criminal Tax Decisions

The court's ruling in the first instance can be appealed to the higher instance by both sides

(the taxpayer or the ITA). Assuming the first instance was the Magistrate's Court, the appeal will be submitted to the District Court. The ruling of the District Court (as a second instance) can be appealed to the Supreme Court but only if the Court grants its consent. A ruling of the Supreme Court cannot be appealed. A request can be made for an "additional review" by the Supreme Court in cases involving novel and principle legal issues, but such a request will rarely be accepted.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a general matter, the use of general anti-avoidance rules (GAAR) or specific anti-avoidance rules (SAAR) by the ITA would not result, in itself, in criminal charges against the taxpayer. However, in the case of a "fictitious transaction" (namely, a false transaction that never took place), criminal liability could ensue. Also, the "management and control" rule for determining the residency of a corporation was used as a basis for criminal proceedings, where the actual management and control over the corporation was exercised from a different country than the one reported.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Ordinary tax disputes and appeal proceedings apply also to double taxation situations (namely, administrative and judicial appeals). If the case involves treaty countries, then the taxpayer or the other parties affected by the assessment can request the relevant tax authorities to initiate a MAP. Unless the treaty provides otherwise, MAP requests are at the early stages of the court proceedings, after the administrative proceedings have been exhausted. If a MAP is initiated, the

judicial appeal proceedings are usually stayed until the MAP is exhausted.

If a case involves non-treaty countries only, a MAP is not available. However, in at least one case involving a multinational, the ITA agreed to bring the case before a non-Israeli mediator as an alternative to a MAP. In addition, in certain circumstances, MAP may apply if the case involves both treaty and non-treaty countries in addition to Israel. Israel is not a signatory to any VAT treaties. Accordingly, Israeli courts have ruled in the past that Israeli VAT is to be charged, even if there is a double (VAT) collection.

Under the MLI, Israel has adopted the MAP provisions (subject to a certain reservations), and has chosen not to apply the arbitration article. The MLI measures have not yet had an impact in this domain.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Even though, according to the Israeli Income Tax Ordinance, double taxation treaties override Israeli domestic law, the position of the ITA, accepted in a District Court case, is that domestic anti-avoidance rules also apply to cases to which tax treaties apply.

In this regard, the ITA's position is that the principal purpose test (PPT) introduced by the MLI does not derogate from the existing domestic GAAR and existing case law, which allow the ITA to deny treaty benefit in case of artificial transactions, even if such transactions are international transactions.

As to the amendment of the double tax treaty (DTT) preamble under the MLI, this amendment generally represents a common interpretation of the ITA which has already been used by the ITA in recent years to challenge cross-border transactions and to deny treaty benefits. Such

interpretation was also accepted by the District Court in a court ruling from 2018 (before the MLI provisions came into effect in Israel), in which the court cited the BEPS recommendations and provided that a DTT's purpose is to prevent double taxation as well as to prevent double non-taxation. This court ruling was approved by the Supreme Court of Israel. We expect the reliance of courts on international guiding sources as an interpretative (even if not binding) source will continue, as in the past.

8.3 Challenges to International Transfer Pricing Adjustments

Transfer pricing adjustments are challenged under domestic tax courts and the existing tax treaty mechanisms (MAP).

8.4 Unilateral/Bilateral Advance Pricing Agreements

Unilateral, bilateral and multilateral APAs are available in Israel. However, they are not a common mechanism. In order to obtain an APA, the taxpayer must approach the ITA's transfer pricing department. The request under the APA has to include all the relevant details of the transaction and supporting documents, as well as the pricing arrangement that the taxpayer requests to approve. The ITA is required to provide its decision within 120 days (or 180 days in certain cases) from the day on which the ITA received the full request. If the ITA does not respond to this timeframe then the request is considered to have been approved by the ITA. It is usually possible to file an APA on a "no names" basis or to discuss the request on a no names basis before filing the request. However, an APA will not be provided before the applicant's name is disclosed.

8.5 Litigation Relating to Cross-Border Situations

Transfer pricing in general, and the application of the profit split method on the Israeli compa-

nies of multinationals; business restructuring; and FAR transfer in particular, have probably been the "hottest" issues in recent years in the Israeli tax sphere. They are the subject matter of numerous appeals pending before the ITA and the courts, and of a few MAP procedures. Permanent establishment matters are expected to become more common.

In addition, we expect that residency matters of cross-border workers, high net worth individuals and corporations will become more common. For example, in light of the COVID-19 global restrictions, cross-border workers who hold management positions in foreign companies who do not reside in Israel found themselves forced to stay in Israel for long periods due to COVID-19 movement restrictions. While the OECD published guidance on the application of international tax treaty rules in these circumstances, the ITA's position is that the OECD guidance is relevant only for the purpose of the interpretation of DTTs and does not apply to domestic law.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

No information is available in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

No information is available in this jurisdiction.

9.3 Challenges by Taxpayers

No information is available in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

No information is available in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

According to the guidelines of the Israeli Attorney General, the State of Israel is allowed, under certain conditions, to resolve legal disputes by way of arbitration. However, almost all of Israel's DTTs do not include an arbitration mechanism. A voluntary arbitration clause, which does not bind the Israeli Tax Authority, exists in the DDTs signed by Israel with Ireland and Mexico, and a binding arbitration clause exists only in the DTT signed with Denmark.

The arbitration clauses in the DTT with Ireland and Mexico are not in effect, as they are subject to exchange of diplomatic notes between countries. The arbitration clause in the DTT with Denmark will be in effect once a similar arbitration provision between Denmark and another third country is in effect.

10.2 Types of Matters that Can Be Submitted to Arbitration

Most of the DTTs signed by Israel do not include an arbitration clause. The arbitration clauses that were included in three of Israel's DTTs have not yet entered into effect. In addition, pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

The voluntary arbitration clause, which exists in the DDTs signed by Israel with Ireland and Mexico, does not limit the arbitration to specific matters and does not limit the arbitration from applying, subject to the consent of the contract-

ing jurisdictions and the taxpayer to the arbitration.

The binding arbitration clause which exists in the DTT between Israel and Denmark does not limit the arbitration to specific matters. However, it prevents the arbitration from applying if the disputable matter has already been resolved by a domestic court or administrative tribunal of one of the contracting jurisdictions.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

10.4 Implementation of the EU Directive on Arbitration

Israel is not an EU member and pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

10.5 Existing Use of Recent International and EU Legal Instruments

Israel is not an EU member and pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

10.6 New Procedures for New Developments under Pillar One and Two

Israel has agreed to adopt the two-pillar solution. No practical measures have been announced so far, and no publications have yet been made. It is therefore difficult at this stage to assess the impact of the two-pillar solution on disputes, in particular considering the general reluctance of the ITA with regard to international dispute resolution mechanisms in general and arbitration or similar instances in particular.

10.7 Publication of Decisions

Israel is not an EU member and pursuant to Article 18 of the MLI, Israel chose not to apply part VI of the MLI.

10.8 Most Common Legal Instruments to Settle Tax Disputes

The existing legal instruments to settle tax disputes in Israel are the procedures set out in the domestic tax law (administrative proceedings before the ITA and appeals before courts), and the MAP under the DTTs. In this regard, Israel chose to apply Article 16 of the MLI regarding MAPs while making reservation regarding the first sentence of Article 16(1).

In general, most disputes are settled during the administrative stages before the ITA through agreements or settlements. Regarding cases that reach court – many of these are resolved before the court issues a ruling, by way of a settlement or (when applicable) through a MAP.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Israel does not apply international tax arbitration procedures.

Supreme Court regarding novel and unique legal matters (after the Supreme Court has already rendered a ruling in the appeal) is ILS1,027 Court fees are paid by the appellant at the time of the submission of the appeal. The appellant may request an exemption from payment due to financial difficulties. Certain requests that are filed to court within the appeal require payment of fees in negligible amounts.

Court fees are generally not refundable. However, within the final rulings, the court orders the unsuccessful party to reimburse the other party for court fees and litigation costs (usually such reimbursement amounts are lower than the actual litigation costs).

11.3 Indemnities

Other than litigation costs and repayment of any tax paid in excess (with interest and linkage differentials), the taxpayer is not entitled to any compensation or an indemnity even if a court decides that the ITA's tax assessment is null and void.

11.4 Costs of ADR

No fees are required for the exercise of the procedure before the Attorney General for controversies relating to government entities.

11. COSTS/FEES**11.1 Costs/Fees Relating to Administrative Litigation**

No fees need to be paid to the ITA to litigate at the administrative level.

11.2 Judicial Court Fees

The fee for filing a tax appeal to the District Court is ILS923 and, to the Supreme Court, is ILS3,061, regardless of the amount of tax in dispute or the number of tax years that are the subject of the appeal. The fee for an “additional review” by the

12. STATISTICS**12.1 Pending Tax Court Cases**

No public statistics are available.

12.2 Cases Relating to Different Taxes

No public statistics are available.

12.3 Parties Succeeding in Litigation

No public statistics are available. A few privately held studies have shown that in the majority of court cases (65%–85%), the rulings are in favour of the ITA.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The key strategic guidelines to consider in a tax controversy are as follows.

- Build a team, legal and tax, to handle the case from the first stages of the audit.
- Co-operate – non-co-operation with the ITA can reduce the chances of reaching a fair settlement and can act against the taxpayer in court.
- Maintain a written record of all the communications with the ITA.
- Insist on every procedural and material right; raise all arguments, including procedural and as to the merits (to support your case and against the ITA); and ensure that all supporting materials are provided and prepared (including expert opinions and transfer pricing studies).
- If possible, do not pay the tax in dispute (but note that any outstanding tax bears interest and linkage differentials). Where tax in excess was paid, consider whether a refund is possible.
- Consider whether involvement of other non-Israeli tax authorities is possible and desirable.
- Consider the overall implications of the matter, including on the taxpayer's ongoing operations, any related parties, the shareholders, other tax issues (including with respect to any other taxes), future tax years, and civil and criminal implications.
- Consider if "shifting the pressure" on to the ITA is possible.
- Fight vigorously but at the same time put in place channels for a settlement.
- Try to leverage a settlement to gain certainty for future tax years.
- Not every battle is worth fighting – consider the amounts involved and the additional matters that may arise during a tax controversy.

Herzog Fox & Neeman has a tax department comprised of 55 members (including 20 partners), of whom ten are also Certified Public Accountants, eleven studied in leading universities outside Israel and five have held senior positions at the Israel Tax Authority (ITA). Herzog has acted in tax litigation and tax disputes before the ITA and Israeli courts, and in mutual agreement procedures. Over the past year, Herzog has represented multinational technology groups in Israeli and cross-border tax disputes, including

regarding transfer pricing and business-restructuring matters; one of the largest US global asset management firms in a dispute concerning its Israeli investments and sale of shares; a US digital corporation and its group entities in an income tax audit and a value-added tax audit; an Asian conglomerate in a tax dispute concerning its Israeli sales activity; and a US high net worth individual with respect to a tax audit commenced by the ITA regarding taxation of S corporations.

AUTHORS



Meir Linzen heads the tax department and serves as the chairman of Herzog Fox & Neeman. With over 40 years of experience, he is regarded as one of Israel's leading tax

experts. Meir is known worldwide for his expertise on all aspects of Israeli taxation, including tax controversy and tax litigation, and is involved in advising on most of the significant tax matters that are currently being handled in Israel. He has particular expertise in tax issues relating to international M&A in Israel. Meir also serves as chairman of the Tax Committee of the Israeli Bar and the Scientific Committee of the Israeli branch of the International Fiscal Association.



Yuval Navot specialises in the tax aspects of Israeli M&A, corporate and capital markets transactions as well as in tax audits of multinational groups. As the leader of Herzog Fox &

Neeman's large corporate tax group, Yuval is the principal tax adviser on Israel's largest international transactions and securities offerings, serving all major players in the Israeli market, including clients such as Facebook, Microsoft and Cisco, as well as many of the major global financial institutions and multinational technology groups. He is widely published on tax matters and is frequently interviewed by global tax magazines such as Bloomberg BNA International and Tax Notes on current Israeli tax matters.



Ofer Granot specialises in tax disputes and tax litigation, in domestic and multi-jurisdictional matters. Ofer represents clients in tax audits and administrative tax proceedings before the ITA,

in tax appeals before Israeli courts and in mutual agreement procedures. In recent years, Ofer has led complicated Israeli and cross-border tax audits and tax litigations, including of large multinationals. Ofer also heads Herzog's government incentives practice. He has extensive experience in advising on innovation incentives, in particular in the context of the Israeli Innovation Authority, and has played a central role in international M&A transactions due to the tax and business implications of Israeli incentives laws.

Herzog Fox & Neeman

Herzog Tower
6 Yitzhak Sadah St.
Tel Aviv 6777506
Israel

Tel: +972 3 692 2035
Fax: +972 3 696 6464
Email: linzen@herzoglaw.co.il
Web: www.herzoglaw.co.il



Trends and Developments

Contributed by:

Gil Raveh and Shemer Frenkel

Raveh Haber & Co. see p.245

Redemption of Shares – Income Tax Implications

In recent years, the income tax aspects of the redemption of shares in private companies pursuant to the Israeli Income Tax Ordinance [New Version] 5721-1961 (“Ordinance”) have been examined by Israeli courts and these rulings have been referred to by the Israel Tax Authority (ITA) in several official publications. The different references to the income tax aspects of redemption of shares to the remaining shareholders in a company following the redemption are reviewed below.

Redemption of shares under the Israeli Companies Law

The Israeli Companies Law 5759-1999 (“Companies Law”) provides that a company may distribute all of its earnings and profits. A “distribution” is defined in the Companies Law as the grant of cash or an undertaking to grant cash, directly or indirectly, as well as a purchase of shares. A purchase includes the purchase or grant of funding for purchase, directly or indirectly, by a company or by its subsidiary, or by any other related company, of its shares.

In contrast to the Companies Law, the Ordinance does not define the term “dividend” and does not directly refer to a redemption of shares.

Redemption of shares – the ITA’s position

In 2001, the ITA published Income Tax Circular 10/01, titled “The Effects of New Israeli Companies Law on Tax Laws” (“Circular 10/01”). With respect to the shareholders whose shares are being purchased by the company, the ITA held that in the case of a pro rata redemption, the redemption of shares would be considered to be

a dividend distribution to the redeemed shareholders. However, in the case of a non-pro rata redemption, the redemption of shares would be considered a sale of shares by the redeemed shareholders. However, Circular 10/01 did not include any discussion regarding the shareholders whose shares were not redeemed. The same approach regarding the redemption of shares was included in a tax circular that was published concerning the redemption of shares by a real estate property company pursuant to the Israeli Real Estate Tax Law (Tax Circular 9/2003).

In 2018, following the Tel Aviv District Court rulings that will be discussed below, the ITA published Income Tax Circular 2/2018, titled “Share Redemption Pursuant to the Companies Law” (“Circular 2/2018”). In Circular 2/2018, the ITA changed its position, and stated that the consideration paid to shareholders for the purchase of the redeemed shares should be considered first as a dividend distribution to the non-redeemed shareholders, regardless of whether the redemption of shares is pro rata or non-pro rata. This position of the ITA was based on the premise that the increase in the ownership of the remaining shareholders in the company should be considered a taxable event comparable to a dividend. In regard to the taxable event deemed to occur in a non-pro rata share redemption, Circular 2/2018 provides two approaches; pursuant to both, a deemed dividend is attributed to the non-redeeming shareholders.

It should be noted that the ITA’s position in Circular 2/2018 adopted the same logic of Reportable Position No 42/2017 and tax decisions (see for example Tax Decision 0699/18, Tax Decision 3312/20).

Prior court rulings

In 2014, the Tel Aviv District Court ruled in the cases of Baranowski (Tax Appeal 21268-06-11) and Bar Nir (Tax Appeal 1100-06). Both cases were heard by the same judge. It should be noted that in both cases, the relevant tax assessment office claimed that the redemption of shares was an “artificial transaction” pursuant to Section 86 of the Ordinance, because the redemption of shares did not serve the interests of the company but only the interests of the remaining shareholders of the company. The ITA relied on the Tel Aviv District Court rulings in Circular 2/2018.

On 1 November 2020, the Haifa District Court ruled in the case of Beit Hossen Ltd. (Tax Appeal 71455-12-18) and rejected the previously published position of the ITA. The Court accepted the taxpayer’s appeal and did not accept the ITA’s position as was published in Circular 2/2018, finding that not every redemption of shares is an “artificial transaction.” Moreover, in this case, the Haifa District Court held that a non-pro rata redemption of shares in a company should be considered to be capital gain income to the redeeming shareholders and should not be considered as a deemed dividend to the remaining shareholders.

The Haifa District Court based its ruling on the following general tax law principles.

The realisation principle

This is the principle that a taxpayer should be subject to tax only upon the realisation of gain with respect to their property. If a gain is not yet realised, a taxpayer should not be subject to tax, other than in exceptional cases as may be determined by the legislature.

The enrichment principle

This is the principle that a taxpayer should generally be subject to tax when their personal

wealth has increased and gain was also realised. In that regard, the Haifa District Court held that although the ownership percentage of non-redeemed shareholders in the company was increased due to the redemption of shares, the non-redeemed shareholders were not enriched. The Court explained that, in fact, the actual economic value of the shares was not increased due to the funds expended to purchase the shares from the redeeming shareholder.

Redemption of shares as a transaction that serves an economic purpose

The Haifa District Court also held that a share redemption may also serve the interests of the company and is not always an “artificial transaction”; eg, in the event that a disagreement between the shareholders has a negative influence on the company’s operations.

The case of Beit Seida

On 26 September 2021, the Beer Sheva District Court ruled in the case of Meir Seida (Tax Appeal 38294-02-19) and rejected the taxpayer’s appeal regarding the tax implications of a shares redemption. The case of Meir Seida dealt with two brothers that held shares of a company. The brothers agreed that one of them would purchase the shares of the other, but since the purchaser had no available funds, the company redeemed the shares of the seller. The District Court ruled that for economic purposes the transaction combined dividend distribution and capital gain. The Beer Sheva District Court concluded that a deemed dividend was distributed based on the following three-part test:

- first, the use of the company’s assets for the purpose of financing the acquisition instead of self-financing or third-party financing of the remaining shareholders;
- second, the economic advantage generated by the remaining shareholder, which indicates the use of these profits; and

- third, the lack of business economic purpose for the company.

The Beer Sheva District Court judge did not clarify the distinguishing factors between his ruling and the case of Beit Hosen, but it seems that unlike in Beit Hosen, the purchase of shares in Meir Seida was not for the benefit of the company.

The ITA appealed the ruling of the Haifa District Court to the Israeli Supreme Court (Civil Appeal 9308/20) and the taxpayer appealed the ruling of the Beer Sheva District Court to the Israeli Supreme Court (Civil Appeal 9308/20). The Supreme Court has not yet ruled on either appeal.

Foreign Tax Credit

Following a major tax reform to the Ordinance in 2003, the Ordinance now includes foreign tax credit mechanisms as the methodology for avoiding double taxation. The Ordinance includes provisions that provides a tax credit in the absence of an applicable double tax treaty, under certain terms and conditions. Generally, foreign tax credit in Israel with respect to tax paid in a jurisdiction other than Israel is limited to the applicable Israeli tax payable with respect to the same item of income. Israeli law further limits the tax credit by dividing foreign source income into baskets based on the source of income (eg, rental income, dividend income, interest income and capital gains).

In recent years, Israeli courts have ruled on cases that dealt with the entitlement to or limitation on claiming a foreign tax credit in Israel.

The Case of FK Generators and Equipment Ltd

On 12 July 2021, the Tel Aviv District Court ruled in the case of FK Generators and Equipment Ltd. (Tax Appeal 45306-02-17), rejecting the tax-

payer's appeal regarding a claim for a foreign tax credit with respect to tax paid at a rate that exceeded the applicable tax rate provided in the applicable double tax treaty.

The taxpayer rented generators to a Brazilian subsidiary in 2010–12. Rental income from the generators was subject to 15% withholding tax pursuant to local Brazilian law and the tax was remitted to the Brazilian Federal Tax Authority by the local financial institution in Brazil. However, the double tax treaty between Israel and Brazil (the "Treaty") provided that only 10% tax should have been withheld from such payments (rental income). The ITA refused to provide a foreign tax credit with respect to the 5% excess tax withheld (which resulted in an overpayment of NIS12 million), based on the argument that it should be considered as a voluntary tax payment.

Neither the Israeli parent company nor the Brazilian subsidiary approached the Brazilian Federal Tax Authority for a tax refund with respect to the excess withheld tax. They did, however, make enquires with the Brazilian Federal Tax Authority and received a general reply that a 10% tax rate would apply under the Treaty unless the recipient had a permanent establishment in Brazil.

In addition, the taxpayer filed a request to the ITA to engage with the competent authorities at the Brazilian Federal Tax Authority, pursuant to Article 26 of the Treaty, for a tax refund if the taxpayer had a permanent establishment in Brazil. The ITA refused to approach the Brazilian competent authorities based on the Treaty on the basis that there was no open dispute in the matter.

The Tel Aviv District Court published two separate rulings with respect to the taxpayer. First, with respect to the taxpayer's request to the ITA to engage with the competent authorities in Brazil pursuant to the Treaty. Second, a ruling with respect to the appeal.

On 16 December 2020, the Tel Aviv District Court published its decision on said request. The Court ruled that the taxpayer could not claim during the appeal that it had a permanent establishment in Brazil because it did not raise that factual claim during the assessment procedure prior to the appeal. The Court also ruled that since in these circumstances there was no active dispute with respect to the Treaty, the Court would not order the ITA to start a competent authority procedure pursuant to the Treaty.

On 7 July 2021, the Tel Aviv District Court published its ruling on the appeal. The Court found that the taxpayer was not entitled to claim a foreign tax credit with respect to the excess tax withholdings. Thus, only 10% of the foreign tax should be taken into account as part of the foreign tax credit in Israel, based on the provisions of the Treaty and of the Ordinance (Sections 196, 199 and 200). The Tel Aviv District Court ruled that the taxpayer decided not to apply for a tax refund in Brazil despite being entitled to do so.

The taxpayer appealed the ruling of the Tel Aviv District Court to the Israeli Supreme Court (Civil Appeal 8382/21). The Supreme Court has not yet ruled in this appeal.

Taxation of Cryptocurrency

The Ordinance does not include specific provisions with respect to the tax treatment of cryptocurrencies (such as Bitcoin); however, the ITA has published several circulars on the matter and the Israeli courts have ruled with respect to the classification of cryptocurrency and the tax implications thereof.

Taxation of cryptocurrency – the ITA’s position

The ITA’s published position is that cryptocurrencies should be subject to tax in Israel as a capital asset. The ITA published a Reportable Tax Position (No 32/2017) that cryptocurren-

cies should be classified as an asset, not as a currency. Accordingly, the sale of cryptocurrencies should be subject to capital gains tax. This reportable position was supplemented by Reportable Tax Position No 91/2021, which added that an exchange of one type of virtual coin for another should be considered to be a taxable event.

In 2018, the ITA published Income Tax Circular 5/2018, which deals with the tax implications of the sale of cryptocurrencies (“Circular 5/18”). In Circular 5/18, the ITA officially published its position that cryptocurrencies are not considered to be currency, but are “assets” for Israeli income tax purposes. Accordingly, a seller of a cryptocurrency would be subject to capital gains tax at sale, or to ordinary income tax rates if such sale were considered to be part of a business. Circular 5/18 also provides that for Israeli VAT purposes, a sale of a virtual coin is not subject to VAT. However, if the sale of cryptocurrencies includes business characteristics, such seller may be considered as a financial institution for Israel VAT purposes. In addition, a person who has engaged in cryptocurrency mining would be considered a dealer for Israeli VAT purposes, and their transactions would be subject to VAT in Israel.

In 2018, the ITA also published Income Tax Circular 7/2018, which deals with the issuance of initial coin offerings (ICOs) and the tax implications that apply to the issuance of cryptocurrency tokens to employees and service providers (“Circular 7/18”). Circular 7/18 mentions that the issuance of digital tokens as part of an ICO is a common way of raising funds for business ventures. Under Circular 7/18, such tokens are issued by a central entity, which obliges the issuer to provide a service, or a right to future products currently under development, to those who hold these tokens. Circular 7/18 establishes the tax implication for the issuer, such as when a

taxable event is deemed to occur. Circular 7/17 is consistent with the ITA position with respect to token holders. This means that at a future sale, such holders would be subject to capital gains tax, or ordinary tax rates if the purchase and sale of the cryptocurrencies were considered a business.

Circular 7/18 also marked the first time the ITA had published its position regarding the taxation of the issuance of cryptocurrencies to employees, providing that a taxable event will occur at the sale of the cryptocurrencies, or, if the taxpayer elects, at the issuance of the cryptocurrencies.

Court ruling on the tax status of cryptocurrencies

On 19 May 2019, the Tel Aviv District Court ruled in the case of Noam Kopel (Tax Appeal 11503-05-16-06). This was the first Israeli tax case law regarding the classification and the taxation of gains from the sale of virtual currencies.

The Court rejected the taxpayer's claim and accepted the ITA's position that a virtual coin (in this case, a Bitcoin) should be considered an asset for Israeli income tax purposes. Accordingly, the Court ruled that gains from the sale of the taxpayer's Bitcoin should be subject to capital gains tax, and that a virtual coin may not be exempt from tax as currency under current legislation and the ITA's published positions on the status of virtual coins.

Reportable Tax Positions

As part of Amendment Number 215 to the Ordinance (as of 2016), the Ordinance includes an obligation to report "reportable tax positions" to the ITA. A reportable tax position is one that (i) is contrary to a position that was published by the ITA, and (ii) the application of which provides a tax advantage to the taxpayer that exceeds NIS5 million in the same tax year or NIS10 million over four years. The Ordinance also includes an exemption from reporting for certain taxpayers or if the taxpayer's income in a tax year is below a certain threshold. The taxpayer is required to report any such reportable tax position using a special form. The obligation to report a reportable tax position is incorporated in a variety of Israeli tax laws (such as those dealing with Israeli VAT, customs and purchase tax).

As of today, the ITA has published 134 official reportable tax positions. Such reportable tax positions express the position of the Tax Authority in certain cases, which are sometimes contrary to the rulings of courts or relate to matters for which the interpretation of the law is not entirely clear or has not been established by a court. As of today, in one case, the District Court has criticised a reportable tax position that was cancelled by the ITA thereafter.

Contributed by: Gil Raveh and Shemer Frenkel, Raveh Haber & Co.

Raveh Haber & Co. is the only boutique law firm in Israel specialising in private equity and taxation. The firm has an exceptional reputation and extensive experience, developed over years of practice both in Israel and in the USA. The firm's tax department has a practice that extends across a wide array of local and international tax matters, such as the provision of tax advice to investment funds, their managers and portfolio companies, complex tax solutions for high net worth families with both Israeli and foreign members, income tax and VAT mat-

ters, diverse procedures before the Israel Tax Authority, tax assessment procedures, litigation, obtaining different types of tax rulings, and providing professional guidance and assistance on drafting and submitting tax reports and disclosures. Among the department's clients are private individuals, leading directors and entrepreneurs, private equity and investment firms, hedge funds, hi-tech companies from both Israel and abroad, public and major private companies, and different types of financial institutions.

AUTHORS



Gil Raveh is one of the founding partners of Raveh Haber & Co. For over 25 years, Gil has been providing tax advice to a wide range of clients, including investment funds, their senior

managers and their portfolio companies, institutional investors, and high net worth investors. Gil specialises in the tax aspects of the establishment and operation of a full range of investment funds, representing institutional investors and gatekeepers in their activities in Israel, as well as in providing representation for Israeli clients in international partnerships and ventures, particularly focusing on complex tax aspects of cross-border real estate transactions. Gil has extensive experience in representing clients in the Israeli tax courts, including several cases at the Supreme Court.



Shemer Frenkel is a partner in the tax department of Raveh Haber & Co. Shemer has acquired extensive experience in the field of taxation, including tax advice and representation of

Israeli and foreign corporations, investment funds, institutional investors, trusts and individuals dealing with the income tax and VAT aspects of their operations in Israel and abroad. Shemer provides tax advice and planning regarding immigration matters and capital-based compensation, as well as legal representation to clients in the process of obtaining pre-rulings, procedures related to tax assessment, and litigation in Israeli tax courts, including several cases at the Supreme Court. Shemer is a member of the tax committee of the Israeli Bar.

*Contributed by: Gil Raveh and Shemer Frenkel, **Raveh Haber & Co.***

Raveh Haber & Co.

11 Menachem Begin Rd
Rogovin Tidhar Tower, 16th floor
Ramat Gan
Israel

Tel: +972 3 717 3010
Fax: +972 3 717 3011
Email: Sfrenkel@rhlawyers.co.il
Web: www.rhlawyers.co.il

**RAVEH
HABER**
&Co. Advocates

Law and Practice

Contributed by:

Pietro Piccone Ferrarotti and Andrea Iannaccone

Gatti Pavesi Bianchi Ludovici see p.267



CONTENTS

1. Tax Controversies	p.249	5.3 Judges and Decisions in Tax Appeals	p.256
1.1 Tax Controversies in this Jurisdiction	p.249	6. Alternative Dispute Resolution (ADR) Mechanisms	p.257
1.2 Causes of Tax Controversies	p.249	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.257
1.3 Avoidance of Tax Controversies	p.249	6.2 Settlement of Tax Disputes by Means of ADR	p.258
1.4 Efforts to Combat Tax Avoidance	p.249	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.258
1.5 Additional Tax Assessments	p.250	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.258
2. Tax Audits	p.250	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.258
2.1 Main Rules Determining Tax Audits	p.250	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.258
2.2 Initiation and Duration of a Tax Audit	p.251	7. Administrative and Criminal Tax Offences	p.258
2.3 Location and Procedure of Tax Audits	p.251	7.1 Interaction of Tax Assessments with Tax Infringements	p.258
2.4 Areas of Special Attention in Tax Audits	p.252	7.2 Relationship between Administrative and Criminal Processes	p.259
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.252	7.3 Initiation of Administrative Processes and Criminal Cases	p.259
2.6 Strategic Points for Consideration during Tax Audits	p.252	7.4 Stages of Administrative Processes and Criminal Cases	p.259
3. Administrative Litigation	p.252	7.5 Possibility of Fine Reductions	p.259
3.1 Administrative Claim Phase	p.252	7.6 Possibility of Agreements to Prevent Trial	p.259
3.2 Deadline for Administrative Claims	p.253	7.7 Appeals against Criminal Tax Decisions	p.260
4. Judicial Litigation: First Instance	p.253	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.260
4.1 Initiation of Judicial Tax Litigation	p.253	8. Cross-Border Tax Disputes	p.260
4.2 Procedure of Judicial Tax Litigation	p.253	8.1 Mechanisms to Deal with Double Taxation	p.260
4.3 Relevance of Evidence in Judicial Tax Litigation	p.254	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.261
4.4 Burden of Proof in Judicial Tax Litigation	p.254		
4.5 Strategic Options in Judicial Tax Litigation	p.255		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.255		
5. Judicial Litigation: Appeals	p.256		
5.1 System for Appealing Judicial Tax Litigation	p.256		
5.2 Stages in the Tax Appeal Procedure	p.256		

8.3	Challenges to International Transfer Pricing Adjustments	p.261	10.5	Existing Use of Recent International and EU Legal Instruments	p.263
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.261	10.6	New Procedures for New Developments under Pillar One and Two	p.263
8.5	Litigation Relating to Cross-Border Situations	p.262	10.7	Publication of Decisions	p.263
9. State Aid Disputes		p.262	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.264
9.1	State Aid Disputes Involving Taxes	p.262	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.264
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.262	11. Costs/Fees		p.264
9.3	Challenges by Taxpayers	p.262	11.1	Costs/Fees Relating to Administrative Litigation	p.264
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.262	11.2	Judicial Court Fees	p.264
10. International Tax Arbitration Options and Procedures		p.262	11.3	Indemnities	p.264
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.262	11.4	Costs of ADR	p.264
10.2	Types of Matters that Can Be Submitted to Arbitration	p.263	12. Statistics		p.264
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.263	12.1	Pending Tax Court Cases	p.264
10.4	Implementation of the EU Directive on Arbitration	p.263	12.2	Cases Relating to Different Taxes	p.264
			12.3	Parties Succeeding in Litigation	p.265
			13. Strategies		p.265
			13.1	Strategic Guidelines in Tax Controversies	p.265

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Tax controversies typically arise following tax assessments. Most assessments follow a tax audit, at the end of which the auditors issue a Tax Audit Report. The latter is a report of findings, delivered by the auditors to the taxpayer and to the Tax Agency, and does not qualify as an assessment.

Generally, the Tax Administration cannot issue a tax assessment without a prior audit or formal request of information (some exceptions are provided for registration tax). A request of information may be addressed to the taxpayer and/or to third parties.

If a specific issue arises with respect to a given fiscal year, the Tax Administration always assesses the same finding in all the fiscal years open for assessment.

1.2 Causes of Tax Controversies

With reference to multinational entities (MNEs), corporate income tax and regional tax give rise to most tax controversies, given that transfer pricing claims are the most relevant in terms of amounts and frequency. Withholding taxes and value added tax (VAT) are under the spotlight as well. The sale and purchase of going concerns is often challenged with reference to the declared value of the transaction and to its actual nature (ie, recharacterisation of the sale of a going concern as a sale of goods and vice versa). Moreover, in 2022 taxpayers are facing an extensive assessment activity aimed at recovering the Research and Development tax credit granted in the past fiscal years.

1.3 Avoidance of Tax Controversies

The best way to mitigate any risk of tax controversies is to manage and control tax risks

responsibly. A useful tool in this respect is the right of the taxpayer to file ruling requests to the Tax Administration. The ruling request may concern:

- the interpretation and application of tax provisions when there is an objective uncertainty on their correct interpretation;
- the existence of the conditions and the assessment of the suitability of the evidence required by law for the application of specific tax regimes;
- the application of the abuse of law principle;
- the application of transfer pricing rules and the existence of a permanent establishment; and
- the tax regime of new investments in Italy (if the investment exceeds a certain threshold and determines a significant occupational impact).

The ruling must refer to actual cases and must be filed prior to the execution of the transaction (or to its impact on the tax return of the taxpayer). The Tax Administration has to reply within 90 to 120 days (depending on the kind of ruling; rulings on transfer pricing and international matters have no deadline).

1.4 Efforts to Combat Tax Avoidance

This firm believes that in the short run, tax controversies could increase. Indeed, the recent measures (ie, BEPS recommendations and especially the EU's recent measures to combat tax avoidance, the "Shell Companies" Directive, anti-hybrid mismatch rules) are increasing the Tax Administration's operational field and it is likely that the taxpayer will not be in a position to reshape all the current structures accordingly. In the long run, controversies should be reduced. All the measures are openly aimed at fighting aggressive tax planning and taxpayers are likely to assume a more conservative approach in carrying out their business activities.

1.5 Additional Tax Assessments

All tax assessments require the payment of additional taxes by the deadline for the appeal before the Tax Court. The deadline is 60 days from the serving date and is postponed by law by 90 days if the taxpayer lodges an administrative settlement request. If a settlement is not reached and the taxpayer lodges an appeal, it is mandatory to execute a down payment corresponding to one third of the assessed taxes, plus the related interest for late payment of taxes (but not the penalties).

There are some exceptions: some registration tax assessments require the down payment of the whole amount, while the abuse of tax law claims does not require any payment pending a first-degree judgment. The taxpayer can ask the Tax Administration and the Tax Court to suspend the down payment. The above-mentioned suspension is almost never granted by the Tax Administration, unless extraordinary circumstances are met. The Tax Courts can suspend the payment if:

- after a brief analysis of the reasons for the appeal, the Tax Court holds that the appeal is in principle grounded (*fumus boni iuris*); and
- at the same time, the payment could cause a serious and irreparable damage to the taxpayer (*periculum in mora*).

The latter requirement is theoretically subject to an assessment by the Tax Court of the amounts claimed in relation to the economical and patrimonial condition of the taxpayer. However, the Tax Courts often consider such a requirement as fulfilled if the amounts required are very high, regardless of the condition of the taxpayer (*periculum in re ipsa*). If a mutual agreement procedure pursuant to EU Directive 2017/1852 has been opened and the relevant tax litigation has been suspended, the payment is suspended by law.

Under certain circumstances and subject to certain thresholds, both the infringement of tax payment obligations and violations related to income and VAT reporting may trigger a criminal proceeding.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The frequency of tax audits is established by law and internal regulation issued by the Tax Administration. With regards to those identified as “large taxpayers” (ie, annual turnover above EUR100 million), audits are usually carried out within the year following the one in which the tax return has been filed, also taking into consideration the specific risk profile. Theoretically, these taxpayers should be substantially audited on a “continuous basis”.

Other taxpayers are audited based on a selection carried out through specific risk profiles and automatic cross-checks performed by the Tax Administration through dedicated software databases, which monitor discrepancies in the taxpayers’ behaviour.

General risk profiles are identified with:

- the absence of any tax audits in the previous years;
- a loss position or low profitability for multiple subsequent years; and
- the risk of VAT avoidance.

The guidelines also identify high tax-risk areas and positions as potentially leading to aggressive tax planning, certain tax base erosion schemes through tax refund claims and undisclosed permanent establishment of foreign entities.

2.2 Initiation and Duration of a Tax Audit

The tax system provides a set of mandatory deadlines for the tax authorities to issue and serve tax assessment. Indeed, a tax assessment served beyond the expiry of the statute of limitations is null and void. For fiscal years prior to 2016, the statute of limitation expired at the end of December 31st of the fourth year following the one in which the tax return was filed.

In cases in which the tax return had not been filed, the deadline was December 31st of the fifth year from when it should have been filed; such a statute of limitation was doubled if the alleged tax violations could imply a criminal violation. The 2015 ordinary deadline expired on 31 December 2020.

From fiscal year 2016, the statute of limitation expires on December 31st of the fifth year following the one in which the tax return was filed (December 31st of the seventh year if no tax return was filed).

If the tax return is amended (*dichiarazione integrativa*), the ordinary statute of limitations is calculated from the filing of the amended tax return but limited to the amended items.

However, due to the COVID-19 pandemic, all the assessment activities and statutes of limitation were suspended for a period of 85 days (from 8 March 2020 to 31 May 2020). According to the Italian Tax Authorities such a rule implies that all the ordinary statutes of limitation for all the fiscal years whose assessing terms were pending during such a period are now extended by 85 days. In other words, for the fiscal years from 2016 to 2020 the statute of limitation will expire on 26th March (25th for the leap year) of the fifth (or seventh) fiscal year following the one in which the tax return was filed (or should have had to be filed).

Initiating and Completing a Tax Audit

There is no specific moment in time when a tax audit can be initiated, but given that the commencement of a tax audit does not interrupt the statute of limitations, in practice tax audits rarely start by targeting a fiscal year that is about to expire.

If a tax audit is carried out in the taxpayer's business premises, it can last a maximum of 30 working days; the period can be extended by a further 30 working days. Such a limit must be verified taking into account each day of physical presence of the tax auditors in the premises and not the overall calendar days since the beginning of the audit.

There is no final time limit for the completion of the audit activities carried out by the Tax Administration in its own office. This means that a tax audit could theoretically stand for years if the physical presence in the taxpayer's premises is kept under the above-mentioned limit of number of days.

2.3 Location and Procedure of Tax Audits

Tax audits could be carried out at the taxpayer's premises as well as at the Tax Administration's office, depending on the difficulty of the case, the need for evidence and the activity to be actually performed.

Auditors analyse both printed documents and digital data as long as such documentation is helpful to investigate the taxpayer's behaviour.

One very effective tool is the forensic back-up of the taxpayers' computers and/or server that is taken by the auditors for investigating all the available documentation as well as the email conversations.

2.4 Areas of Special Attention in Tax Audits

In any tax audit the formal requirements, the mandatory fiscal books and the general ledger are scrutinised. There are no rules or limitations as to the substantive issues that the audit may address as they might vary depending on the purpose of the specific audit, the industry in which the audited taxpayer operates and the most recent developments in the Tax Administration's audit activities. The Tax Administration usually issues yearly specific guidelines identifying the areas and the transactions to be audited.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

There has been an increasing prevalence of rules concerning cross-border exchanges of information and mutual assistance between tax authorities is increasing the chances for the Tax Administration to challenge potential tax issues.

Moreover, simultaneous and joint tax audits are both tools in the hands of the Tax Administration.

The former are audits carried out: (i) towards different taxpayers located in different jurisdictions; and (ii) by different Tax Administrations (Italian with other European tax agencies). These audits are performed on a regular basis under the coordination of the Italian Central Directorate of the Revenue Agency jointly with the corresponding foreign body.

In a joint tax audit, two or more tax administrations join together to examine one or several transactions or issues of one or more related taxable persons with cross-border business activities in which the tax administrations have a common interest. Such audits are ruled by EU Directive 2011/16/UE, as amended by Directive 2021/514/UE. By the end of 2022 member

states shall adopt and publish the relevant rules, which will enter into force from 2023.

2.6 Strategic Points for Consideration during Tax Audits

As a general rule, a co-operative attitude always pays higher dividends than an obstructive one. Nonetheless, it is important to disclose data and to describe activities smoothly, balancing the concepts and, as much as possible, replying in writing. A written answer is normally more accurate and precise, and avoids the risk that a brief oral description may draw a picture that involuntarily leads the tax auditors on a wrong path.

Moreover, it is important to bear in mind that all documents whose exhibition is refused cannot be used in favour of the taxpayer in all the following phases (administrative and litigation). Such prohibition applies only if the taxpayer voluntarily refuses to submit the documents, and it does not apply if the documents are lodged with the first-tier appeal and the taxpayer declares that it was impossible to produce them; documents (different from the mandatory books) that are not available to the taxpayer when the audit was carried out are not subject to such a rule.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

As a general rule, the administrative claim phase is optional. Once a tax assessment is served, the taxpayer is entitled to lodge a request to open a settlement procedure. Such a request must be lodged to the tax office in charge for the tax assessment and within the deadline provided for commencing litigation before the Tax Court (ie, 60 days from the serving date); the request automatically postpones the deadline by 90 days.

During the settlement procedure, both parties (taxpayer and Tax Administration) are entitled to discuss the case and try to reach a compromise for the solution of the case. Such a compromise must follow a legally acceptable rationale and therefore it is not possible to settle based simply on a forfeit amount. Any settlement must be justifiable and grounded on tax rules. If a settlement is achieved, the penalties linked to the confirmed higher taxes are reduced to a third of the minimum, therefore they could range from 30% to 45% (depending on the nature of the claim) of the settled taxes (in most cases, this would result in penalties for tax return violations dropping to 30% of the higher taxes due). Any fiscal year is independent from the other and it is theoretically possible to settle a case that has already been decided by a Tax Court; however, once a favourable decision is issued, it is always hard for the tax authorities to disregard its outcome.

For the sake of completeness, there is a mandatory administrative settlement procedure for minor litigations (assessed taxes less than EUR50,000). Once the taxpayer challenges the tax assessment and serves the appeal to the tax office, they are obliged to indicate in the deed a settlement proposal – which could also be the total voidance of the claim – and wait for 90 days to allow the Tax Administration to evaluate it. By this deadline, the Tax Administration could confirm the deed of assessment, accept the taxpayer's proposal or suggest an alternative solution. The taxpayer is free to accept the proposal or to continue the litigation.

3.2 Deadline for Administrative Claims

See **3.1 Administrative Claim Phase**.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

A judicial tax litigation starts at the initiative of the taxpayer who challenges a tax-assessment notice served by the Tax Administration before the first-instance judge (Provincial Tax Court).

4.2 Procedure of Judicial Tax Litigation

The litigation starts with an appeal served by the taxpayer to the tax office that issued the tax assessment (or refused to grant a refund).

The appeal must be mandatorily filed within 60 days from the serving date of the challenged deed. If the Tax Administration does not reply to a refund request lodged by the taxpayer within 90 days from the request, it is assumed that the Tax Administration has implicitly denied the refund request. This implicit denial may be challenged within ten years. Clearly, if at any time the Tax Administration adopts and serves a formal denial of the refund request, the ordinary 60-day deadline to file an appeal from the serving of the formal denial should be observed.

Once the appeal is notified to the office, it must be lodged by the taxpayer before the Provincial Tax Court within the following 30 days.

A delay in challenging the appeal or in lodging it before the Tax Court will make the appeal inadmissible.

The Tax Administration has 60 days from the receipt of the appeal to lodge its observations (*controdeduzioni*) before the Provincial Tax Court to defend its position.

Documents and Hearings

Tax litigation is a “documental” process: it is exclusively grounded on the documents and pieces of evidence provided by the parties. No

witnesses are allowed as evidence. A public hearing to discuss the case in front of the panel of judges is optional, in the sense that any of the parties may request it. If no such request is made, the case is decided by the Court based on the documental evidence and written arguments presented by the parties.

If one of the parties so requires, the procedure provides for a discussion hearing, during which the parties present the case and the related evidence, and the Tax Court may ask questions. Therefore, aside from under exceptional circumstances, there is only one discussion hearing. After the hearing, the panel of judges casts the decision, which is written and published by the Court after a variable amount of time (from a few days to several months, normally between one and three months). The hearing is usually scheduled after a period ranging from six to 18 months from the day on which the appeal is lodged to the Court.

Both parties have the right to:

- file further documents, until 20 “free days” prior to the hearing; and
- file to the Court further written observations to highlight specific topics or to respond to the other party’s observations, until ten “free days” before the hearing.

A “free days” period means a number of days disregarding the first and the last day (ten free days are thus equal to 11 days in standard counting); moreover, if the period ends on a weekend or on a public holiday, the term falls on the first working day before.

COVID-19

Due to the ongoing COVID-19 pandemic, physical presence in the Tax Courts is not allowed and the Court can decide the case without a hearing of discussion, unless a party insists on

it. If this is the case, the hearing is held by videoconference. If such a solution is not feasible, a “written” discussion takes place and each party has the right to:

- file a defensive brief within ten days before the hearing; and
- reply to the counterparty’s brief, within five days before the hearing.

If such terms cannot be respected, the decision must be postponed.

It is expected that the physical presence in the Tax Courts will be allowed again during 2022.

4.3 Relevance of Evidence in Judicial Tax Litigation

Tax litigation is exclusively based on documents. Witness evidence is not allowed. Consequently, producing the appropriate documentary evidence is the only move the taxpayer can rely on to prove the correctness of his position. Third parties’ written statements, appraisal, evaluation, expert opinions as well as other information can be filed to the Court to corroborate the party’s position.

Relevant documents can be submitted directly with the appeal at the beginning of the tax litigation or during the litigation, up to 20 “free days” before the hearing of discussion.

4.4 Burden of Proof in Judicial Tax Litigation

In general, the litigation system provides that the burden of proof should be borne by the party claiming its right. Consequently, the Tax Administration should prove its claims as well as taxpayers should prove theirs. However, in determining the taxable income, the burden of proof applies in a variable manner. For example, while the existence of a taxable revenue is a positive fact from which the tax authorities’ right

to apply the tax derives and hence the burden of proof rests on the Tax Administration, the ability to deduct costs is considered as a taxpayer right and therefore the related burden of proof of cost deductibility is placed on the taxpayer.

In addition, there are some cases in which the law provides for an inversion of the ordinary rules on the burden of proof: for example, Italian citizens that have moved their fiscal residence in blacklisted countries are in any case presumed to be Italian residents unless the opposite is proven.

In a criminal procedure, it is always the State (represented by the public prosecutor) that is required to prove the illegality of the taxpayer's behaviour.

4.5 Strategic Options in Judicial Tax Litigation

The way to manage a litigation changes depending on the specific case. It is not possible to set a standard procedure, but experience helps in selecting the best path to follow.

A first strategic decision concerns the opportunity to pay or not pay the advance down payment (normally corresponding to one third of the assessed taxes). As stated in **1.5 Additional Tax Assessments**, the taxpayer can request the Tax Court to suspend the advance payment obligation. If both requirements are met (*fumus boni iuris* and *periculum in mora*), asking for a suspension is probably the most appropriate strategy; otherwise, it is probably better to avoid filing a request that will most likely be rejected by the Court. Rejection of a suspension request is not advisable for the following reasons:

- upon rejection of the request, the payment will qualify as a late payment and the taxpayer will face a higher payment, increased by the collecting fees;

- although the decision on the suspension request does not address the merit of the case, it is never advisable to start a litigation judgment with a negative decision, even if on a preliminary issue, as this might influence the Court negatively for the subsequent discussion of the merit; and
- it is possible that the Court will charge the taxpayer the court fees linked to the suspension phase.

The timing for producing documents and evidence depends on their availability and on the complexity of the case. Generally, it is better to file all the evidence with the appeal to provide the judge with a more accurate and complete initial statement right from the start. However, if the case is extremely complex (and the appeal is a very long document), it could be helpful to summarise certain arguments and preserve part of the relevant documentation for a defensive brief later on.

If a technical evaluation is needed, the Tax Courts could appoint an expert; the taxpayer can ask the Tax Courts to do this, but there is no obligation by the Court to satisfy such a request.

Settlement

Even during the litigation phase, the taxpayer and Tax Administration may discuss and reach a settlement. The discount in terms of penalties is lower than that which applies if a settlement is reached prior to the start of the litigation process (a 40% reduction in first-degree judgments and 50% in second-degree judgments).

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

While tax judges usually take into consideration domestic case law, especially when coming from the Supreme Court, and the European Court of Justice jurisprudence, they are often reluctant

to rely on international guidelines and jurisprudence.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The first-tier decision may be appealed before the competent Regional Tax Court. Both parties (Tax Administration and taxpayer) have to appeal the Provincial Tax Court decision within the mandatory deadline of six months from the issuance date. The deadline may be reduced to 60 days if one party serves the decision to the other.

The appeal can be submitted once; the arguments of the appeal that had been presented during the first degree of litigation are lost if they are not repeated in the second degree.

5.2 Stages in the Tax Appeal Procedure

The stages of the tax appeal procedure are almost identical to those provided for the first-tier judgment.

The appeal must be notified to the other party by the mandatory deadline (see **5.1 System for Appealing Judicial Tax Litigation**) and then lodged before the Regional Tax Court within 30 days. The appealed party can lodge its observations to the Regional Tax Court within 60 days from the receipt of the appeal.

The Regional Tax Court then schedules the date of the hearing of the discussion, normally between one and two years from the submission of the appeal.

Once the date of the hearing is set, both parties can submit further documentation until 20 “free days” before the hearing. Likewise, both parties can deposit further observations to high-

light specific topics in their defence or respond to the other party’s observations until ten “free days” before the hearing.

The parties have the right to request that the case be discussed in a public hearing before the Tax Court. If such a request is not made, the case is decided by the judges based on the written arguments and evidence presented by the parties. The COVID-19 pandemic procedure applies to the appeal too (see **4.2 Procedure of Judicial Tax Litigation**).

Issuing a Decision

The Tax Court issues the decision after a variable amount of time (from a few days to several months, normally between one and three months).

The Regional Tax Court decisions can be appealed before the Italian Supreme Court (*Corte di Cassazione*), which is the highest level of jurisdiction, and whose mission is to ensure uniformity of jurisprudence and legal certainty. However, it is possible to file an appeal only if the decision of the Regional Tax Court violates a law or suffers from major inconsistencies and lack of motivation. Conversely, it is not possible to request to the Supreme Court a full re-examination of the merits of the case.

The appeal before the Supreme Court must be filed by the same appeal deadline (see **5.1 System for Appealing Judicial Tax Litigation**) and the other party has the right to file a counter appeal by 40 days from the serving date. It takes a significant period before a decision is issued by the Supreme Court: this ranges from six to eight years.

5.3 Judges and Decisions in Tax Appeals

Tax disputes in the first two degrees (Provincial and Regional Tax Courts) are dealt with by

judges who are specialised in tax matters but not professionals (the role of a member of first and second-instance Tax Courts is honorary, not a professional career). Tax Courts of first and second instance are independent bodies deciding in panels of three members.

The Tax Courts are organised in different chambers to which the judges are appointed. Each Tax Court has a president who is in charge of assigning the appeals to individual sections. The control over the general functioning of the Tax Courts (transfer of judges, assessments of incompatibility, disciplinary measures, legislative proposals, professional training) belongs to the High Council for Tax Judiciary, a self-governing body, the members of which are elected every four years between the tax court judges (11) and the Members of Parliament (four).

The third and last degree of judgment is managed by the Supreme Court and is organised into multiple chambers, each chaired by a president and specialised in a specific field of the law; ie, civil, criminal, labour and taxation. Tax cases are heard by the tax chamber, which decides in panels of five members (who are all career judges).

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Many ADR mechanisms are available for the taxpayer to resolve the dispute without resorting to litigation.

- Before any assessment takes place, the taxpayer can opt for the voluntary correction of tax violations (so-called *ravvedimento operoso*), which grants the possibility of

rectifying omissions or irregularities made when completing and submitting the income tax return, and when making the payments. A voluntary amendment of tax violations entails a reduction of the minimum applicable penalties (from one tenth to one fifth of the ordinary applicable penalty, depending on the circumstances).

- After an assessment deed is issued, any mistakes may be self-amended by the Tax Administration, possibly upon a specific request filed by the taxpayer.
- Once a tax audit report or a tax assessment is served, the taxpayer may request the opening of a settlement procedure (*accertamento con adesione*) aimed at settling the case. If the discussions have a positive outcome, the procedure ends with the signing of a settlement deed issued by the office and accepted by the taxpayer. The settlement grants the right to enjoy:
 - (a) the reduction to one third of the minimum penalties calculated based on the settled taxes;
 - (b) the reduction of the penalties envisaged for tax crimes (up to one half) and the non-application of accessory sanctions, if the settlement is signed and the amount paid before the criminal trial starts; and
 - (c) the closing of the whole fiscal year for the relevant tax (unless new and material elements emerge).

A negative outcome of the settlement procedure does not limit the taxpayer's right to pursue the tax litigation without any material downside. However, if the parties do reach a settlement, the outcome of the settlement may not be appealed against by the parties.

Tax Mediation

Tax mediation (*mediazione tributaria*) aims at preventing and avoiding disputes that can be settled without going to court, taking into account

the guidelines of the law and therefore of the reasonably predictable outcome of the trial. Mediation is enforceable and mandatory on tax claims of a value not exceeding EUR50,000. In the event of a negative outcome, the litigation commences.

Judicial Settlement

Judicial settlement (*conciliazione giudiziale*) pending both the first and second-degree litigation allows the parties to close a tax dispute. With the judicial settlement the taxpayer obtains a reduction of the penalties equal to 40% of the minimum if the litigation is pending before the Provincial Tax Court, or 50% of the minimum if the litigation is pending before the Regional Tax Court. No judicial settlement is possible if the litigation is pending before the Supreme Court.

The judicial settlement leads to a decrease of the penalties envisaged for tax crimes, avoids the application of accessory penalties and compensation of the expenses incurred for the judgment. A particularity of the judicial settlement with respect to the settlement procedure is that it allows the parties to carry out a partial settlement; ie, to settle only part of the claims in litigation and continue to litigate on those that have not been settled.

6.2 Settlement of Tax Disputes by Means of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

The ruling (see **1.3 Avoidance of Tax Controversies**) is an opinion issued by the Tax Administration; if the taxpayer acts in conformity to the ruling, the Tax Administration cannot challenge its behaviour. An advance ruling is therefore an effective tool for reducing tax litigations.

However, it is worth underlining that a ruling is just an administrative measure, and it could theoretically be revoked at any time by the Tax Administration. However, this occurs very rarely and even where it does, no penalties would apply.

6.5 Further Particulars Concerning Tax ADR Mechanisms

It is not possible to apply for an arbitration procedure. The only ADR mechanisms are those described in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

There is no ADR mechanism specifically for transfer pricing that is different from those described in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Any tax claim normally entails the application of an administrative penalty, normally proportionate to the amount of assessed higher taxes. Some exceptions are provided, as for the transfer pricing violations, which are not subject to penalties if the taxpayer has duly drafted the specific documentation in a timely manner and applied

for penalty protection (which requires a specific flagging in the income tax return).

The criminal proceeding is independent from the administrative one and may be triggered only if the behaviour of the taxpayer infringes specific criminal statutes, which for certain criminal offences also require that specific thresholds are met. If the tax auditors believe that the taxpayer under audit has incurred in criminal violations, they are required to report the case to the Public Prosecutor's Office, which has the duty to analyse the case and possibly start a criminal proceeding and subsequent trial.

7.2 Relationship between Administrative and Criminal Processes

The litigation process regarding the tax assessment and the possible criminal proceeding run in parallel and in principle do not necessarily affect each other. The criminal proceeding may move forward irrespective of the status of the tax appeal filed by the taxpayer against the assessment deed and vice versa. The outcome of the criminal proceeding may be considered by the tax courts, but it is not binding. It is therefore in principle possible that the outcomes of the two proceedings may differ, even though often the settlement of the administrative proceeding entails a reduction of criminal penalties.

7.3 Initiation of Administrative Processes and Criminal Cases

Tax authorities are legally required to report to the Public Prosecutor's Office any potential criminal violation every time they find evidence of such a violation. This normally occurs in the context or at the end of a tax audit. Therefore, administrative tax audits often trigger an administrative infringement process and a criminal tax proceeding.

7.4 Stages of Administrative Processes and Criminal Cases

With regards to the stages of a tax administrative infringement process, please refer to **4.1 Initiation of Judicial Tax Litigation**, **4.2 Procedure of Judicial Tax Litigation**, **5.1 System for Appealing Judicial Tax Litigation** and **5.2 Stages in the Tax Appeal Procedure**.

The courts in charge of criminal tax cases are different from those deciding the corresponding tax adjustment/assessment. In fact, criminal tax cases are handled by specialised criminal courts and tribunals (*Tribunale and Corte d'Appello*) composed of professional judges.

7.5 Possibility of Fine Reductions

The payment of the additional taxes assessed or the settlement of the administrative proceeding determines the reduction of potential criminal penalties.

7.6 Possibility of Agreements to Prevent Trial

The payment of the assessed taxes, plus interests and penalties, allows a criminal tax trial to be prevented or stopped only with reference to the failure of payment of:

- withholding taxes declared or certified by the withholding agent;
- VAT declared by the taxpayer; and
- taxes linked to an undue compensation of a non-existing tax credit.

In such cases, the taxpayer is required to make the payment before the declaration of the opening of the first-degree hearing of the trial (so-called *dichiarazione di aperturadel dibattimento di primo grado*).

A criminal tax trial could also be prevented in the case of a fraudulent tax return exploiting invoices for non-existent transactions or other artifices

and an unfaithful or omitted tax declaration, if the taxpayer pays all the amounts due within the deadline for filing the tax return relating to the next fiscal year compared to the one in which the violation occurred, provided that any access, inspection or audit has not begun.

7.7 Appeals against Criminal Tax Decisions

The first-tier decision may be appealed before the competent criminal courts (*Corte d'Appello*). Both parties (public prosecutor and taxpayer) must appeal the first decision by the mandatory deadline of 15, 30 or 45 days depending on the time and formality to write the motivation of the decision.

The second-tier decision issued by the second-tier court (*Corte d'Appello*) can be appealed before the Supreme Court, which is the highest level of jurisdiction, and whose mission is to ensure uniformity of jurisprudence and legal certainty. However, it is possible to file an appeal only if the decision violates a law or suffers from major inconsistencies and lack of motivation. Conversely, it is not possible to request to the Supreme Court a re-examination of the merits of the case.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

The application of the general anti-avoidance rule (GAAR) and specific anti-avoidance rule (SAAR) does not lead to criminal charges, as well as the transfer pricing claims. It is possible to challenge a criminal violation only if the taxpayer did not book (and declare) revenues or booked (and declared) non-existent costs, which cannot be the case in such a claim.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

If a double taxation situation occurs, it is common to challenge the deed of assessment before the Tax Court (a late challenge of the deed will imply its finality).

Once the appeal is lodged, the taxpayer may require the opening of a mutual agreement procedure provided by the double tax treaty or by the European Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC).

As for the new international dispute resolution tools, Italy has not ratified the MLI yet, while the EU Tax Disputes Directive was transposed into the Italian regulatory framework in August 2020 and is applicable to fiscal years from 2018 onwards. It is therefore too soon to assess their effectiveness. However, it is expected that in the future all mutual agreement procedures will be subject to the EU Directive or to the MLI binding arbitration process, as the case may be.

Furthermore, the taxpayer is entitled to ask for a unilateral adjustment of his income in case of a transfer pricing claim if alternatively: a) a specific agreement has been achieved in a mutual agreement procedure; b) the claim is the outcome of an audit carried out in the context of an international co-operation activity and its outcome has been approved by the participating states; c) the transfer pricing adjustment is final, compliant with the OECD transfer pricing guidelines, made by a foreign state with which there is in force an effective exchange of information, and a specific instance is filed.

8.2 Application of GAAR/SAAR to Cross-Border Situations

There are no general mandatory guidelines for the application of GAAR and SAAR in cases where there is a bilateral tax treaty. There have been cases in which Tax Courts have acknowledged the treaty protection (non-discrimination clause) against the SAAR concerning the alleged non-deductibility of blacklisted expenses. On the contrary, the GAAR has been invoked for tackling cross-border schemes built on the treaty's provisions and aimed at achieving an undue tax saving (ie, stock lending and dividend washing schemes).

The tax courts have often confirmed claims grounded on the lack of beneficial ownership or, more generally, on treaty shopping, following a substance-over-form approach and, to some extent, regardless of the strict interpretation of the laws; the authors expect that the PPT and the amendment of the DTT preamble will significantly ease the tax authorities in proving the infringement of the DTT provisions. It will therefore be paramount for taxpayers to adopt a conservative approach in exploiting DTT.

8.3 Challenges to International Transfer Pricing Adjustments

There is no specific rule with reference to transfer pricing adjustments. Taxpayers usually open a mutual agreement procedure in all the cases involving EU member states in which the European Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC) is applicable. Indeed, such a convention should guarantee the solution of the case in a relatively short timeframe. For the implications of the MLI and EU Tax Disputes Directive, please refer to **8.1 Mechanisms to Deal with Double Taxation**.

Taxpayers are required to pursue tax litigation in all other cases when it is not possible to open an international dispute resolution mechanism, as well as in cases where the counterparty is not resident in an EU member state. In such cases, it might not be possible to achieve a positive outcome to a mutual agreement procedure in a reasonable timeframe.

8.4 Unilateral/Bilateral Advance Pricing Agreements

APAs are an effective means to avoid or mitigate litigation in the transfer pricing field. They are becoming more common, but recently suffered a setback, mainly due to the time required to reach an agreement with the Tax Administration.

The procedure requires the taxpayer to file a specific application, in which the perimeter of the agreement is outlined. In case of bilateral and multilateral APA applications, taxpayers are required to pay a fee that can vary from EUR10,000 to EUR50,000 depending on the total turnover of the group to which the taxpayer belongs. Fees are reduced by half in the case of a request for renewal of the prior APA.

The Tax Administration opens the procedure and verifies, also through interviews with the employees, the correctness of the facts and circumstances described in the taxpayer's application, the functional and risk profile of the taxpayer, and all other items that are relevant for TP purposes.

Once the analysis is concluded, the parties reach an agreement that is binding for the Tax Administration for the fiscal year in which it is signed and the following four, unless it is proven that the factual circumstances are materially different from what has been agreed in the APA. Moreover, if the factual and legal circumstances underlying the APA are the same in all the open fiscal years irrespective of the date of the filing,

the taxpayer is entitled to require a carry-back of the APA's effects. In particular: for unilateral APA, the taxpayer has the right to ask for the retroactive application of the APA provided that no audit activity has started at the time of execution of the APA; for bilateral and multilateral APA, in addition to the aforementioned condition, it is necessary that the taxpayer has requested the retroactive application in the APA submission, and that the competent authority(ies) of the foreign jurisdiction(s) involved agree to extend the effect of the APA to previous years.

8.5 Litigation Relating to Cross-Border Situations

See 1.2 Causes of Tax Controversies.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

The European Commission has repeatedly declared certain tax concessions incompatible with the ban on state aid. As an example:

- the three-year income tax exemption for SpA majority held by local authorities (EU Commission decision 2003/193/EC of 5 June 2002);
- the exemption from ICI (Real Estate Tax) granted by Italy to non-commercial entities which carried out, in the buildings in their possession, certain activities such as educational or hotel activities (EU Commission decision 2013/284/UE of 19 December 2012).

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

There is not a general procedure for the recovery of state aid. Special rules are issued from time to time to address the recovery of specific state aid. Sometimes the recovery is carried out by the Revenue Agency according to the ordinary procedures of assessment and collection provided

for by income taxes; in other circumstances, the taxpayer is required to spontaneously refund the higher taxes due, without interest and penalties.

9.3 Challenges by Taxpayers

The taxpayer cannot challenge the legitimacy of a decision of the European Commission before national courts during a litigation concerning the enforcement measures taken by the national authorities. It is possible to ask for the suspension of the collecting activity if two conditions are jointly satisfied: a) serious reasons for the illegitimacy of the recovery decision, or an error in identifying the person required to pay back the state aid or in calculating the amount to be recovered (limited to the part exceeding the amount due); and b) the payment would imply an irreparable harm for the taxpayer.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Compensatory actions before national courts are allowed and may be claimed by:

- the beneficiary's competitor against the State;
- the beneficiary against the State;
- third parties against the State;
- the beneficiary's competitor against the beneficiary itself.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Italy opted for the mandatory binding arbitration.

10.2 Types of Matters that Can Be Submitted to Arbitration

Some of the DTTs signed by Italy provide for an arbitration procedure that can be activated only if:

- a proper exchange of notes between the contracting states has been accomplished; and
- both the competent tax authorities are willing to activate the procedure with reference to specific controversy.

This has implied a wide discretion in handling the procedure and the ineffectiveness of this tool in solving tax disputes so far.

Italy has reserved the option to apply Article 19(12) of the MLI to its covered tax agreements, which grants Italy the right to not submit a case to arbitration or to terminate the relevant process if a decision on the same issue has already been issued by a court or administrative tribunal of either of the contracting states.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Italy opted for the Baseball Arbitration and made the reservation under Article 23(3) of the MLI to not open any mandatory binding arbitration with parties that have not taken the same option. If this is the case, the competent authorities of the contracting states shall endeavour to reach agreement on the type of arbitration process that shall apply with respect to that DTT. Until such an agreement is reached, the mandatory binding arbitration shall not apply.

It is likely that the reason for such a choice is pursuing the easier possible procedure. Indeed, the “baseball” or “final offer” arbitration process requires that each party submits its best offer to the arbitrator, who chooses one of the two, without the possibility of amendments. This process

therefore encourages the parties to propose the fairest solution and at the same time simplifies and speeds up the arbitrator’s activity.

10.4 Implementation of the EU Directive on Arbitration

The EU Directive was transposed into the Italian regulatory framework in 2020; it applies to mutual agreement procedures filed since July 2019 and concerning fiscal years 2018 onwards.

10.5 Existing Use of Recent International and EU Legal Instruments

See **8.1 Mechanisms to Deal with Double Taxation.**

10.6 New Procedures for New Developments under Pillar One and Two

Italy is a member of the OECD/G20 Inclusive Framework on BEPS. As far as Pillar One is concerned, a significant portion of it will be in force jointly with the MLI; for Pillar Two, entry into force of a European Directive and the subsequent implementation in Italy is needed. For now, it is not possible to predict the timing of this.

Once the new procedures enter into force, we expect a significant increase in preventing and resolving tax disputes.

10.7 Publication of Decisions

Until the transposition of the EU Directive in the Italian legal framework, the outcome of a mutual agreement procedure was confidential. The new legal framework provides that, for mutual agreement procedures subject to the EU Directive, the competent authorities may agree to publish decisions in full, with the consent of the taxpayers and of all the stakeholders. If such consent is not granted, a summary of the decision is published with a description of the case, the subject, the date, the fiscal years concerned, the legal basis, the industrial sector, a brief description of

the final outcome and of the arbitration method chosen.

10.8 Most Common Legal Instruments to Settle Tax Disputes

See **8.1 Mechanisms to Deal with Double Taxation**.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

It is common practice for an Italian taxpayer to hire a tax adviser specialised in this topic in order to handle the procedure vis-à-vis the Italian Tax Administration. The latter does not hire independent professionals and relies on its specialised officers.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

There is no administrative litigation phase, but only some alternative resolution mechanism procedures as described above; the taxpayer is free to activate them without paying any charge.

11.2 Judicial Court Fees

The mandatory unified contributions for first and second-tier judgments are identical and based on the value at stake in the proceeding. They range from EUR30 to a maximum of EUR1,500 (when the value exceeds EUR200,000). Such contribution is paid by the party introducing the judgment:

- in the first-tier litigation it is paid by the taxpayer; or
- in the appeal before the Regional Tax Court it can be paid by the Tax Administration or by the taxpayer, depending on who is serving the appeal.

The contribution must be paid at the beginning of the judgment.

It is possible that the Tax Court condemns the losing party to refund the expenses incurred by the other party; however, the judges often rule that each party bears its own cost.

11.3 Indemnities

Without prejudice to the fact that each party can always ask for the reimbursement of the costs incurred, it is possible to ask for an indemnity if it appears that the unsuccessful party has acted or resisted in court with bad faith or gross negligence.

11.4 Costs of ADR

In general, the use of an ADR mechanism after the commencement of a tax litigation entails that each party bears its own costs, in particular with reference to the contribution paid at the beginning of the judgment.

12. STATISTICS

12.1 Pending Tax Court Cases

The average number of cases attributed to a judge of first instance in 2020 was 72.1 (125.2 in 2019).

The number of pending cases in first-instance courts as of 31 December 2020 was 204,962, and new cases number 108.634 with a total value of approximately EUR9.7 billion. The number of pending cases in second-instance courts as of 31 December 2020 was 140,333, and new cases 42.683 with a total value of approximately EUR7.4 billion.

12.2 Cases Relating to Different Taxes

The number of cases initiated in 2020 was as follows.

- Individual income tax: 19,332.
- Regional tax on productive activities (Irap): 4,159.
- VAT: 9,058.
- Registration fee: 5,552.
- Mortgage and cadastral taxes: 2,750.
- Tax on corporate income: 6,529.
- Customs duties: 864.
- Tax litigation duties: 738.
- Others: 13,981.
- Taxes on real estate: 23,848.
- Waste taxes: 13,297.
- Road tax: 3,635.
- Advertisement tax: 1,076.
- Public soil taxes: 636.
- Other local taxes: 3,189.
- Total cases: 108,634.

The number of cases terminated in 2020 (first-instance judgment) was as follows.

- Individual income tax: 18,521.
- Regional tax on productive activities (Irap): 5,219.
- VAT: 7,745.
- Registration fee: 6,684.
- Mortgage and cadastral taxes: 3,159.
- Tax on corporate income: 5,004.
- Custom duties: 693.
- Tax litigation duties: 642.
- Others: 11,327.
- Taxes on real estate: 14,483.
- Waste taxes: 13,166.
- Road tax: 9,385.
- Advertisement tax: 1,018.
- Public soil taxes: 445.
- Other local taxes: 4,061.
- Total cases: 101,552.
- Total value: over EUR8.2 billion.

12.3 Parties Succeeding in Litigation

For 2020 the trend in first-instance judgments shows a 49.0% success rate for tax authorities, a 27.4% success rate for taxpayers, 10.9% as

a partial success, 0.4% for judicial conciliation and 12.4% for other outcomes.

The trend in second-instance judgments shows a 48.5% success rate for tax authorities, a 30.8% success rate for taxpayers, 8.6% as a partial success, 0.3% for judicial conciliation and 11.9% for other outcomes.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

In order to define the most effective strategy in handling a potential tax litigation, the first crucial phase has to be a rigorous checking of the facts; it is indeed paramount to understand whether the case revolves around a mere issue of legal interpretation of the applicable rules or if it is also necessary to ascertain the facts with respect to the applicable rules (eg, effectiveness and/or economic reasons of a given transaction, or beneficial ownership of a specific payment), or a quantitative issue (eg, evaluation of a going concern or a transfer pricing issue). Only once a rigorous analysis has been performed is it possible to assess the strengths and weaknesses of the taxpayer's position. In carrying out the analysis, it is also important to perform a proper check of the previous case law, which – notwithstanding the fact that precedents in a civil law system such as the Italian one do not have the same strength of common law systems – is often respected by the tax courts, especially if it is a decision of the Supreme Court.

Once the analysis of the strengths and weaknesses of the tax case is completed, it is in any case appropriate, even if the taxpayer's position is perceived as very strong, to attempt a dialogue with the Tax Administration; any tax litigation is long and, to some extent, uncertain, and it is possible that the Tax Administration would

be interested in avoiding a dispute and achieving a reasonable settlement. The issues that are litigated are often complex, especially if they involve multinational taxpayers and transnational issues. Such issues are a challenge even for the most experienced judges; and more so given that, even if in order to resolve complex technical issues it would theoretically be possible for the Tax Court to appoint technical consultants, judges are usually reluctant to lengthen the process and accumulate costs.

Gatti Pavesi Bianchi Ludovici is a full-service, independent law firm, representing the benchmark for complex corporate and structured finance transactions in Italy. With offices in Milan, Rome and London, the firm advises national and international clients on the structuring of their mergers, acquisitions, listings, restructur-

ings and financial transactions, also providing legal and tax assistance to banks, corporations, public companies and other entities, offering cutting-edge innovative and sophisticated solutions both in corporate and structured finance transactions and in complex litigation matters.

AUTHORS



Pietro Piccone Ferrarotti has been a partner of Gatti Pavesi Bianchi Ludovici from 2021 following the merger with L&P, Ludovici Piccone & Partners, where he was a partner from

2016. He has gained significant experience advising domestic and foreign clients in complex tax audits, pre-litigation and judicial settlements, and defence before tax courts and the Court of Cassation. His areas of expertise include corporate and group taxation, M&A and business restructuring, taxation of real estate, VAT, registration tax and other indirect taxes as well as excise duties and consumption taxes. He is the author of publications on tax matters and often speaks at tax conferences and lectures on postgraduate specialisation courses.



Andrea Iannaccone has been a partner of Gatti Pavesi Bianchi Ludovici from 2021 following the merger with L&P, Ludovici Piccone & Partners, where he was a partner from 2016. His

areas of expertise are corporate and group taxation, M&A, business restructuring and transfer pricing. He also advises domestic and foreign clients in complex tax audits, pre-litigation and judicial settlements, and assists them in defence before tax courts. He is the author of publications on tax matters and often speaks at tax conferences and lectures on postgraduate specialisation courses.

Gatti Pavesi Bianchi Ludovici

Piazza Borromeo 8
20123 Milan
Italy

Tel: +39 02 859751
Email: studio@gpblex.it
Web: www.gpblex.it

GPBL

Trends and Developments

Contributed by:

*Pietro Piccone Ferrarotti and Andrea Iannaccone
Gatti Pavesi Bianchi Ludovici see p.272*

COVID-19 Pandemic Regulatory Framework

The Italian legislature reacted to the COVID-19 crisis with a series of subsequent (and partially uncoordinated) decrees. During the first months of the emergency, due to the impossibility for the Italian Tax Authorities and taxpayers to move on with their standard workflows, the statutory terms related to pending and new tax litigations were suspended. This includes the preliminary activities carried on by the Italian Revenue Agency, the APA procedures, the issuance of rulings by the Revenue Agency and the activities carried on in the Italian Tax Courts as well.

With reference to tax litigation, in autumn 2020 a special procedure was approved for handling the hearings of discussions during the ongoing emergency. More precisely, physical presence in Italian Tax Courts is still not allowed and judges can decide the case law without a court hearing of discussion, unless a party insists on it. If this is the case, the hearing is held by video conference. However, if it is not feasible, a “written” discussion takes place and each party has the right to: (i) file a defensive brief within ten days before the hearing; and (ii) reply to the counterparty’s brief, within five days before the hearing. If such terms cannot be respected, the decision must be postponed. In 2020 and the first half of 2021, we have experienced a de facto impossibility for almost all the Italian Tax Courts to arrange a hearing by video conference. Hence, the court hearings were often postponed indefinitely or, in some cases, the Italian Tax Courts have ignored the parties’ requests and decided on the case law without any court hearing.

Although both outcomes entail some issues, the second is undoubtedly the worst.

On the one hand, postponement implies a longer overall duration of the trial and higher litigation costs. In a system where taxpayers are already burdened with relatively long procedures, this will likely negatively affect their activity. While litigation is pending, taxpayers are indeed required to pay upfront one third of the tax object of the controversy (see **1.5 Additional Tax Assessments** of the Law and Practice guide). Notwithstanding the ongoing emergency, the legislature has not modified such a rule; therefore, taxpayers are required to execute such a down payment, but the postponement will cause a significant delay to the conclusions of trials and to the opportunity for the taxpayers to benefit from the refund of the upfront payments. The legislature has set forth an “expedient” for postponing such mandatory collection activity, allowing the Italian Revenue Agency to serve the 2015 tax assessments by 28 February 2022, that is, 14 months later than the deadline of the statute of limitation (ie, 31 December 2020; see **2.2 Initiation and Duration of a Tax Audit** in the Law and Practice guide).

On the other hand, the issuance of a decision with no hearing of discussion can endanger the outcome of litigation. The hearing is indeed a crucial waypoint in the tax litigation process, and it is the taxpayers’ only chance for interacting with the Italian Tax Court and explaining the details of the case law that might not have been easily understood with a simple deed reading, especially in complex tax litigations regarding international tax matters.

Since the second half of 2021 the Tax Courts have become more and more used to video conference hearings and the normal litigation process still needs to fully resume. It is expected

that during 2022 the litigation procedure will be restored to as it was before the COVID-19 emergency, with physical presence in the Tax Courts.

Trend of Tax Litigation Cases

General overview

In recent years there was a significant decrease in the number of tax litigation cases, and in the value seen in cases overall.

Tax disputes pending by 31 December 2020 (the most recent year for which official statistics have been published) numbered 345,295, with a small increase of 2.8% compared to what was recorded in 2019 (335,279). However, such an increase is due to the effect of COVID-19 on pending tax litigation. In 2020 there was indeed a significant decrease in disputes received before the Tax Commissions (151,317) compared to 2018 (189,039) equal to a 20% decrease, and a decrease of 45.5% if compared to new cases in 2011 (330,133).

However, it is likely that the general slowdown of tax litigation caused by the ongoing pandemic emergency will imply a significant change in this trend. Once the emergency is over, all pending tax assessments will have to be served and postponed hearings scheduled, with an overload of workflows for the Italian Tax Courts, and consequent delay.

Although the COVID-19 emergency will imply a significant delay in handling tax litigation, we expect a reduction in new litigation overall.

Co-operative compliance programme

A significant contribution to the decrease in litigation is expected to result from the application of the co-operative compliance programme between the financial administration and the taxpayer, which allows for identifying, monitoring and jointly managing tax risk (interpreted as the risk of operating in violation of tax regulations or

in contrast with the principles or purposes of the tax system). In particular, the objective of such a tool is to provide legal certainty in relation to a company's tax risks, through a relationship and mutual trust between the Italian Tax Authorities and the taxpayers.

For the moment, only taxpayers equipped with a tax risk detection, measurement, management and control system (ie, a Tax Control Framework) and who possess certain requirements (mainly dimensional) can benefit from the co-operative compliance rules. Since the 2022 fiscal year and for the following two years (2023 and 2024), only companies with revenues of not less than EUR1 billion can apply for the regime. Moreover, such access is granted, regardless of the amount of revenue, for those companies which file a tax ruling request for the so-called "new investments regime". This provision represents a legislative choice in the framework of the rules implemented with the aim of attracting investments (including foreign) to our territory.

The dimensional limits for access to the co-operative compliance programme should be subject to a progressive reduction, and the reduction of the limit to EUR100 million is expected, thus allowing all "large taxpayers" (approximately 3,200 subjects) to access the scheme. As of today, the dimensional requirement has been reduced from EUR10 billion to EUR5 billion, and will be reduced to EUR1 billion starting from 2022. When the accessing threshold to the regime is lowered, there will be an increase in the preventative confrontation and, therefore, a further reduction of tax litigation is expected.

Increase in the number of rulings issued by the Italian Revenue Agency

A further contribution to the litigation decrease is expected from the rulings issued on a regular basis by the Revenue Agency.

Indeed, the legislature extended the right of taxpayers to request rulings to the Italian Revenue Agency. In fact, originally the ruling request could refer exclusively to the application of the abuse of law principle or the interpretation and application of tax provisions when there was an objective uncertainty on their correct interpretation. Conversely, as of today, it is possible to file a tax ruling concerning the existence of the conditions and the assessment of the suitability of the evidence required by law for the application of specific tax regimes. The ruling may also concern the applicable tax regime to new investments in Italy (if the investment exceeds a certain threshold and determines a significant occupational impact). Such opportunity entails an effective reduction of legal uncertainty.

However, notwithstanding the above, in the last year we have experienced a significant growth in the number of rulings published by the Italian Revenue Agency on many different matters and, sometimes, they have not shown a consistent position on the same topic. If this issue is not fixed by the Tax Agency, the efficiency of this important tool might be jeopardised.

Increase in the number of APAs signed by the Italian Revenue Agency

In the coming years we expect that the Italian Revenue Agency will revamp the APA programme (applicable also in respect of the amount of profit to be attributed to a permanent establishment or in respect of whether or not a permanent establishment exists) by lessening the average time to conclude the APA process. Reducing the uncertainty regarding arm's-length pricing of cross-border transactions is expected to have a significant effect on preventing transfer pricing or other tax-related disputes.

Trend of International Tax Disputes Resolution

As regards the resolution of international tax disputes, the well-known difficulties that led to the approval of Action 14 in the context of the BEPS project can also be found in Italy. In fact, to date almost all the disputes subject to Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (the so-called "Arbitration Convention") have been resolved, even if in a significant time span; indeed, it is almost impossible to reach a solution of ordinary mutual agreement procedures within a time compatible with the needs of the economic operators.

However, the scenario should undergo a significant transformation in the near future. Indeed, Directive (EU) 2017/1852 on tax dispute resolution mechanisms in the European Union was transposed into the Italian regulatory framework in 2020 and it is expected that all disputes within the EU related to the application of bilateral conventions against double taxation on income and capital will be solved in a fairly short timeframe; the Directive provides specific rules to solve cases while giving the taxpayer initiative powers in case of inertia of the competent tax authorities. Additionally, we expect that once the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) is ratified by Italy, there will be a further boost in the handling of international tax controversy, given that our country has opted for the introduction of a mandatory and binding arbitration mechanism for resolution of tax disputes.

The Discussion about a Reform of the Tax Justice Framework

With reference to the overall tax justice framework, a long-standing debate is in place to implement a comprehensive reform: the last pro-

posal was indeed (unsuccessfully) discussed in recent months.

If, on the one hand, the first two levels of judgment (first degree and appeal) guarantee a reasonably fast trial (on average two/three years to complete a second-tier judgment), there is on the other hand a “bottleneck” effect at the Supreme Court level where a judgment can be issued even after six/eight years from the filing of the Supreme Court appeal. At the same time, operators complain about the absence of a professional judiciary specialised in tax matters. In the first two judgment tiers, only the tax commissions’ presidents and the presidents of the individual court chambers are part of the judiciary (on duty or retired).

The remaining components are selected based on a certain length of service (generally ten years) and qualification (degree in economics or law) among employees of the public administrations, retired tax police officers, accountants, experts, notaries, lawyers or chartered accountants. For these tax court judges, the appointment does not create a public employment relationship and they are just “honorary” judges.

The main limitation of the current system is the increasing level of uncertainty faced by taxpayers entering litigation, especially in relation to cases characterised by a high complexity for which, even at the Supreme Court level, an adequate analysis from a technical standpoint might not be available. Undoubtedly, the lack of a professional tax judiciary reverberates its effects at the Supreme Court level.

Although the Supreme Court judges are all career magistrates with decades of experience, they have not all had the opportunity to gain suitably extensive experience in tax matters. Moreover, this might be one of the reasons behind the general reluctance, especially in the first two judgment tiers, to adhere to the legal principles enshrined by the Court of Justice and to identify profiles of potential incompatibility of domestic legislation with EU laws, which may justify a reference for a preliminary ruling to the Court of Justice.

Contributed by: Pietro Piccone Ferrarotti and Andrea Iannaccone, Gatti Pavesi Bianchi Ludovici

Gatti Pavesi Bianchi Ludovici is a full-service, independent law firm, representing the benchmark for complex corporate and structured finance transactions in Italy. With offices in Milan, Rome and London, it advises national and international clients on the structuring of their mergers, acquisitions, listings, restructurings

and financial transactions, also providing legal and tax assistance to banks, corporations, public companies and other entities, offering cutting-edge innovative and sophisticated solutions both in corporate and structured finance transactions and in complex litigation matters.

AUTHORS



Pietro Piccone Ferrarotti has been a partner of Gatti Pavesi Bianchi Ludovici from 2021 following the merger with L&P, Ludovici Piccone & Partners, where he was a partner from 2016. He has gained significant experience advising domestic and foreign clients in complex tax audits, pre-litigation and judicial settlements, and defence before tax courts and the Court of Cassation. His areas of expertise include corporate and group taxation, M&A and business restructuring, taxation of real estate, VAT, registration tax and other indirect taxes as well as excise duties and consumption taxes. He is the author of publications on tax matters and often speaks at tax conferences and lectures on postgraduate specialisation courses.



Andrea Iannaccone has been a partner of Gatti Pavesi Bianchi Ludovici from 2021 following the merger with L&P, Ludovici Piccone & Partners, where he was a partner from 2016. His areas of expertise are corporate and group taxation, M&A, business restructuring and transfer pricing. He also advises domestic and foreign clients in complex tax audits, pre-litigation and judicial settlements, and assists them in defence before tax courts. He is the author of publications on tax matters and often speaks at tax conferences and lectures on postgraduate specialisation courses.

Gatti Pavesi Bianchi Ludovici

Piazza Borromeo 8
20123 Milan
Italy

Tel: +39 02 859751
Email: studio@gplex.it
Web: www.gplex.it

GPBL

Law and Practice

Contributed by:

Koichiro Yoshimura

Nagashima Ohno & Tsunematsu see p.291



CONTENTS

1. Tax Controversies	p.275	5.3 Judges and Decisions in Tax Appeals	p.283
1.1 Tax Controversies in this Jurisdiction	p.275	6. Alternative Dispute Resolution (ADR) Mechanisms	p.283
1.2 Causes of Tax Controversies	p.275	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.283
1.3 Avoidance of Tax Controversies	p.275	6.2 Settlement of Tax Disputes by Means of ADR	p.283
1.4 Efforts to Combat Tax Avoidance	p.276	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.283
1.5 Additional Tax Assessments	p.277	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.283
2. Tax Audits	p.277	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.284
2.1 Main Rules Determining Tax Audits	p.277	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.284
2.2 Initiation and Duration of a Tax Audit	p.277	7. Administrative and Criminal Tax Offences	p.284
2.3 Location and Procedure of Tax Audits	p.277	7.1 Interaction of Tax Assessments with Tax Infringements	p.284
2.4 Areas of Special Attention in Tax Audits	p.278	7.2 Relationship between Administrative and Criminal Processes	p.284
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.278	7.3 Initiation of Administrative Processes and Criminal Cases	p.284
2.6 Strategic Points for Consideration during Tax Audits	p.278	7.4 Stages of Administrative Processes and Criminal Cases	p.284
3. Administrative Litigation	p.279	7.5 Possibility of Fine Reductions	p.285
3.1 Administrative Claim Phase	p.279	7.6 Possibility of Agreements to Prevent Trial	p.285
3.2 Deadline for Administrative Claims	p.280	7.7 Appeals against Criminal Tax Decisions	p.285
4. Judicial Litigation: First Instance	p.280	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.285
4.1 Initiation of Judicial Tax Litigation	p.280	8. Cross-Border Tax Disputes	p.285
4.2 Procedure of Judicial Tax Litigation	p.281	8.1 Mechanisms to Deal with Double Taxation	p.285
4.3 Relevance of Evidence in Judicial Tax Litigation	p.281	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.286
4.4 Burden of Proof in Judicial Tax Litigation	p.281		
4.5 Strategic Options in Judicial Tax Litigation	p.281		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.282		
5. Judicial Litigation: Appeals	p.282		
5.1 System for Appealing Judicial Tax Litigation	p.282		
5.2 Stages in the Tax Appeal Procedure	p.283		

8.3	Challenges to International Transfer Pricing Adjustments	p.286	10.5	Existing Use of Recent International and EU Legal Instruments	p.288
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.286	10.6	New Procedures for New Developments under Pillar One and Two	p.288
8.5	Litigation Relating to Cross-Border Situations	p.287	10.7	Publication of Decisions	p.288
9.	State Aid Disputes	p.287	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.289
9.1	State Aid Disputes Involving Taxes	p.287	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.289
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.287	11.	Costs/Fees	p.289
9.3	Challenges by Taxpayers	p.287	11.1	Costs/Fees Relating to Administrative Litigation	p.289
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.287	11.2	Judicial Court Fees	p.289
10.	International Tax Arbitration Options and Procedures	p.287	11.3	Indemnities	p.289
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.287	11.4	Costs of ADR	p.289
10.2	Types of Matters that Can Be Submitted to Arbitration	p.288	12.	Statistics	p.290
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.288	12.1	Pending Tax Court Cases	p.290
10.4	Implementation of the EU Directive on Arbitration	p.288	12.2	Cases Relating to Different Taxes	p.290
			12.3	Parties Succeeding in Litigation	p.290
			13.	Strategies	p.290
			13.1	Strategic Guidelines in Tax Controversies	p.290

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

As a procedural legal matter, a tax controversy will arise when and if:

- a formal tax assessment has been issued upon a taxpayer; and
- the taxpayer initiates the procedure to dispute the assessment, as discussed below.

However, because a formal tax assessment is made only if the difference of views between the taxpayer and the tax authority was not resolved during the preceding tax audit, a tax controversy would begin at the tax audit.

1.2 Causes of Tax Controversies

Every type of Japanese tax may give rise to tax controversies. However, in practice, a significant majority of controversies involve income tax. Among income taxes, for sophisticated corporate taxpayers, corporation tax (ie, national corporate income tax) and withholding tax are the major ones. Also, for high net worth individuals, individual income tax, as well as inheritance and gift taxes, are major sources of tax controversies. Tax controversies relating to consumption tax – ie, VAT – and fixed property tax are also common. While rare, transactional taxes such as stamp duty and liquor tax may also be litigated.

As to the value, there is no threshold for taxpayers to dispute a tax assessment. Sometimes, aggravated and upset individual taxpayers will dispute even if the amount of tax at stake is very small. However, sophisticated corporate taxpayers will generally weigh the benefit of disputing against the associated time and costs, so it is not common for such sophisticated corporate taxpayers to dispute the tax assessment if the amount of tax at stake is small. The only exception may be an assessment of a heavy penalty

tax (along with the principal tax at hand) because the imposition of a heavy penalty tax means that the taxpayer committed fabrication or concealment of facts, generally viewed among the public as indicating an attitude of non-compliance on the part of the taxpayer. So, especially when the taxpayer is a well-known corporate, conscious of its public reputation, it sometimes disputes the assessment of a heavy penalty tax no matter the amount of tax at stake.

1.3 Avoidance of Tax Controversies

Because a tax controversy arises when there is a difference of views in tax audits, it logically follows that this difference of views would not occur if the taxpayer had confirmed the view of the tax authority in advance with respect to the tax treatment of a particular transaction. This can formally be made by seeking a written formal advance ruling with the tax authority; however, because this formal procedure usually takes three to six months in practice, this is not very popular. Instead, many taxpayers use an informal confirmation with the tax authority on a verbal basis that is much easier to obtain than a written formal advance ruling and, solely as a practical matter, the effect would not be significantly different from a written formal advance ruling; ie, even a verbal confirmation is well reviewed and respected within the tax authority, in practice.

It should be noted that even if the taxpayer secures a written formal advance ruling or a verbal informal confirmation, a tax controversy in the tax audit (and then in the administrative and judicial procedures) could still arise if the tax authority finds that the facts as represented by the taxpayer at the time of the ruling or confirmation turned out to be inaccurate or misleading.

Also, in the transfer pricing area, an advance pricing arrangement (APA) is commonly used to

avoid future tax controversy relating to an arm's-length price for a controlled transaction.

1.4 Efforts to Combat Tax Avoidance

To date, Japan has implemented the following Base Erosion and Profit Shifting (BEPS) Actions of the OECD by amending its domestic tax law or tax treaties.

Action 1 – Japan has amended the consumption tax law to impose taxes upon digital or electronic service transactions conducted by foreign enterprises having no base in Japan.

Action 2 – Japan has amended the corporation tax law so that Japan's foreign dividend exemption system does not apply to dividends deductible under the local tax law of the jurisdiction where a foreign subsidiary is located (eg, Brazil) to prevent a D/NI (deduction/non-inclusion) outcome.

Action 3 – Japan has overhauled its controlled foreign corporation (CFC) regime by amending the income tax law and the corporation tax law through the 2017 annual tax reform, in line with BEPS Action 3, to focus more on the substance of the business conducted by the CFC.

Action 4 – Japan has tightened the earnings stripping rules, in response to BEPS Action 4, by including interest payable to third parties (unless the interest is taxed in Japan at the recipient level) and lowering the threshold rate from 50% to 20%.

Action 5 – in response to BEPS Action 5, Japan has implemented measures to ensure the spontaneous exchange of information on tax rulings.

Action 6 – Japan has incorporated in its tax treaties, particularly with advanced countries (such as the USA, the UK, the Netherlands, Switzerland and Germany), various anti-abuse measures

suggested by BEPS Action 6, such as the limitation on benefits (LOB), the principal purpose test (PPT) and the beneficial owner concept.

Action 7 – Japan has amended the definition of a permanent establishment in income tax law and corporation tax law in response to BEPS Action 7, to define more properly an agent permanent establishment to prevent avoidance of an agent permanent establishment through artificial measures.

Actions 8–10 – Japan has incorporated the so-called commensurate-with-income standard and the discounted cash flow (DCF) method to value so-called hard-to-value intangibles, by amending its transfer pricing regulations, in line with BEPS Actions 8–10.

Action 13 – Japan has amended its transfer pricing documentation rules to introduce the master file, country-by-country reporting and the local file, in line with BEPS Action 13.

Action 15 – Japan has signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which took effect on 1 January 2019; as of 21 April 2022, the MLI is applicable to the double tax treaties of Japan with 33 countries, including Australia, Canada, France, Germany, India, Indonesia, Ireland, South Korea, Luxembourg, the Netherlands, Singapore and the UK.

As these BEPS measures are still relatively new, at present, this firm has not seen a meaningful increase or decrease in tax controversies. However, as these measures generate new issues of interpretation, it is expected that tax controversies will increase in the future.

1.5 Additional Tax Assessments

Under the Japanese legal system, even if a taxpayer disputes a tax assessment, in principle, it must first pay the assessed tax. The only exception is a transfer pricing assessment, where the taxpayer will apply for a mutual agreement procedure (MAP). In that case, upon request, the taxpayer may be given a grace period for payment until the resolution of the case via the MAP. However, the taxpayer must provide collateral to secure the payment of the assessed tax.

When a tax return is filed, but the tax authority finds an under-reported tax as a result of the tax audit, a reassessment (*kohsei*) will be made. When a tax return is not filed at the outset, and the tax authority finds any amount of tax due, a determination (*kettei*) will be made. As for withholding tax, a notice of collection (*nozei kokuchi*) will be made. As for taxes that do not require a filing of a tax return (other than withholding tax), an assessment determination (*fuka kettei*) will be made. Another kind of administrative disposition is a tax assessment to reject the taxpayer's request for a downward adjustment of the tax amount from that reported in the originally filed tax return. However, the required procedures to dispute these assessments are substantially the same.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

There is no formal rule under Japanese tax law to determine whether and when a tax audit should be made. It is entirely at the discretion of the tax authority. However, in practice, many corporate taxpayers are audited every three to five years, and certain very large corporates are audited every one to two years. It should be noted that the tax authority has launched a "corporate governance in tax" programme for certain very large corporates, whereby certain highly compliant

taxpayers will receive the benefit of a prolonged (by one year or more) audit cycle. On the other hand, the tax authority has recently launched a programme to monitor high net worth individuals. If the tax authority determines that the individual in question needs close scrutiny, a tax audit may be launched, particularly with regard to individual income tax and inheritance and gift taxes.

2.2 Initiation and Duration of a Tax Audit

There is no formal rule under Japanese tax law that would limit the duration of tax audits. In practice, it varies; some are finished in a few days, whereas, in the case of huge corporates, the audit may last for a few months. Moreover, transfer pricing audits can last for one or two years, depending upon the circumstances.

The Japanese tax law has a statute of limitation of generally five years from the original statutory due date of the return filing (which will be extended to seven years when the issue involves fabrication or concealment of facts). In general, this statute of the limitation period is not suspended or interrupted by a tax audit, and thus, its expiry will prevent a tax audit. As an exception, however, the statute of the limitation period will be extended where a taxpayer is not co-operative in a tax audit, and tax authorities request another jurisdiction for the exchange of information for that reason.

2.3 Location and Procedure of Tax Audits

In practice, in most cases, tax audits are conducted at the premises of the taxpayer. Because of COVID-19, tax authorities refrained from commencing new tax audits for a while, but they resumed in October 2020, and tax audits are generally conducted in the same manner as before (eg, at the premises of the taxpayer).

The accounting books and records and the minutes of the board of directors, and other corporate documents will be examined first. If the taxpayer prepares the accounting books and records in paper form, the paper form will be reviewed, and if the taxpayer prepares them electronically, then the electronic data will be examined. Moreover, in recent practice, external and internal email communications of the taxpayer are frequently examined, where evidence favourable to the tax authority can often be found.

2.4 Areas of Special Attention in Tax Audits

This varies depending upon the type of tax to be examined. For example, in the case of a corporation tax audit, major issues include:

- timing differences of income recognition and cost deduction;
- tax-free reorganisations;
- deductibility of officers' remunerations;
- whether the deducted payments are non-deductible donations; and
- various international tax regimes (CFC, transfer pricing, etc).

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Due to the increasing prevalence of information exchange, in some audits, particularly those of high net worth individuals, the tax authority will have gained, in advance, extensive information on the foreign bank accounts of the taxpayer, which presumably were brought to the tax authority by way of the common reporting standard. In addition, there appear to be:

- an increasing number of tax audit cases where the tax auditors say that the tax authority will request information regarding

the relevant foreign jurisdiction by way of information exchange under the tax treaty; and

- more tax controversy cases where the Japanese government submits as evidence the results of a tax audit conducted by a foreign tax authority pursuant to a request from the Japanese tax authority.

2.6 Strategic Points for Consideration during Tax Audits

If the taxpayer expects that the issue being audited may develop into a tax controversy, it is essential to manage the submissions to the tax authority properly, particularly the external and internal email communications of the taxpayer mentioned in **2.3 Location and Procedure of Tax Audits**. For example, a situation should be avoided where email communications critically adverse to the position of the taxpayer are inadvertently placed in the hands of the tax authority. Under Japanese tax law, while the tax authority cannot physically force the taxpayer to submit the requested information and documents, it can do so somewhat indirectly via the enforcement of criminal penalties if the taxpayer refuses to submit the requested information and documents where they are obliged to do so under law. Under the controlling Supreme Court decision, a taxpayer is obliged to respond to the information and document request of the tax authority, so long as:

- there is an objective necessity to examine the requested information and document in light of the issue being examined;
- that necessity outweighs the privacy of the taxpayer; and
- the discretion of the tax auditor to make such a request is considered reasonable.

Taxpayers may want to argue that, eg, and where feasible, there is little need to examine the requested email communications in light of

the issue being examined so that it may lawfully avoid the submission.

Because no alternative dispute resolution (ADR) mechanism is available for tax purposes in Japan and no settlement is allowed in administrative or judicial tax litigation, in practice, at the stage of the tax audit, the taxpayer and the tax authority often cut a deal to settle the issue effectively. In other words, the tax audit is practically the only stage where an effective settlement can be made. Accordingly, the taxpayer is expected to form a decision, at the tax audit, on whether to try to settle; if not, the taxpayer must continue the tax litigation process, devoting substantial time and expense to it until the final decision or until the taxpayer gives up.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

A formal notice of tax assessment will be served upon a taxpayer once:

- the tax audit has been concluded;
- the taxpayer has made it clear that it will not file an amended tax return reflecting the position of the tax authority voluntarily; and
- the tax authority's internal approval procedures for issuing the tax assessment have been completed.

As a legal matter, the tax assessment takes effect once served upon the taxpayer and will continue to be effective unless cancelled by the ensuing tax controversy procedure.

Request for Reconsideration before the National Tax Tribunal

For the taxpayer's claim to be heard before the courts, an administrative procedure is mandatory. Within three months of receipt of the formal

notice of tax assessment, the taxpayer must file a Request for Reconsideration with the National Tax Tribunal, which is an administrative but quasi-judicial body to review taxpayers' claims. Then, in principle, if the taxpayer's Request for Reconsideration is dismissed by the formal decision of the National Tax Tribunal, the taxpayer can, within six months of the receipt of the decision, initiate a lawsuit to request cancellation of the subject tax assessment with the competent District Court. Alternatively, before filing a Request for Reconsideration with the National Tax Tribunal, where appropriate, the taxpayer may elect to take the additional step of filing a Request for Reinvestigation with the director of the competent Regional Taxation Bureau; however, this Request for Reinvestigation is, for reasons of cost as opposed to benefit, not very often used in practice. No filing fees are required for a Request for Reconsideration or a Request for Reinvestigation.

The National Tax Tribunal will review the taxpayer's Request for Reconsideration by designating a panel of three administrative judges. The administrative judges include attorneys and tax accountants who used to be in private practice, as well as incumbent officials of the tax authority. As in court litigation, the taxpayer and the tax authority will submit and exchange their respective arguments and evidence. Once the panel determines that the review is complete, the National Tax Tribunal will render a decision, dismissing or entirely or partially admitting the taxpayer's Request for Reconsideration. The entire process will generally take one year.

One of the most important functions of the Request for Reconsideration process from the taxpayer's viewpoint is to gather documentary evidence submitted by the tax authority in anticipation of future judicial tax litigation. Upon request, the National Tax Tribunal will allow the taxpayer to take copies of the documentary

evidence submitted by the tax authority. This process is indispensable for preparing for future judicial tax litigation to assess how strong the taxpayer's and the tax authority's arguments are in light of this documentary evidence.

3.2 Deadline for Administrative Claims

As mentioned in **3.1 Administrative Claim Phase**, within three months of receipt of the formal notice of tax assessment, the taxpayer must file either a Request for Reconsideration with the National Tax Tribunal or a Request for Reinvestigation with the director of the competent Regional Taxation Bureau. This deadline is absolutely mandatory save for exceptional cases, and not complying with the deadline ensures that the claim will be dismissed without consideration of its merits or an opportunity for a further administrative or judicial appeal.

If the taxpayer's Request for Reconsideration is entirely or partially dismissed by the decision of the National Tax Tribunal, the taxpayer may, within six months of the receipt of the decision, initiate a lawsuit to request cancellation of the subject tax assessment with the competent District Court. This deadline is mandatory, save for exceptional cases. Furthermore, even before the decision of the National Tax Tribunal is rendered, the taxpayer can initiate a lawsuit so long as three months have passed since the filing of the Request for Reconsideration, thereby effectively bypassing the procedure at the National Tax Tribunal. Such bypassing is often used in practice, where the nature of the issue indicates that it may be difficult to obtain a favourable decision from an administrative body like the National Tax Tribunal.

Unlike judicial tax litigation discussed below, if the taxpayer prevails at the National Tax Tribunal, the tax authority cannot appeal, and the decision in favour of the taxpayer will be final. No settlement is available at the National Tax Tribunal.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation will be initiated by the taxpayer, as petitioner, by filing a complaint against the Japanese government as a respondent by the deadline discussed in **3.2 Deadline for Administrative Claims**. The complaint will identify the subject tax assessment to be cancelled and the reasons for the cancellation and accompany supporting exhibits as documentary evidence. The taxpayer needs to pay court filing fees (eg, if the amount of tax to be cancelled and refunded is JPY100 million, the court filing fees will be around JPY320,000). Once the court has reviewed and approved the formalities of the complaint, it will be served upon the respondent.

In Japan, there is no special judicial court for tax litigation, which, in the first instance, is heard by general District Courts along with other general civil and criminal cases. However, in large cities such as Tokyo and Osaka, there are special divisions for handling administrative law matters and tax litigation will be assigned to one of these administrative law divisions. The administrative law divisions are not specific to tax matters but address other administrative issues such as immigration and social security, but the judges within the administrative law divisions are generally more familiar with technical tax matters than other general civil divisions. In the case of the Tokyo District Court, there are four administrative law divisions, ie, the 2nd, 3rd, 38th and 51st civil divisions. The taxpayer is not allowed to cherry-pick the division to which its case is assigned, and the assignment will be made at random, pursuant to the predetermined rules within the District Court. In practice, the presiding judge of the administrative law division, generally with 25 to 35 years of experience as a professional judge, mainly in administrative law, is regarded as an "elite" within the Japanese judicial branch.

The panel consists of three judges, including the presiding judge and two associate judges, each of whom is a professional judge (ie, not from the private sector).

4.2 Procedure of Judicial Tax Litigation

The first hearing session will generally be held within a few months from filing the complaint. By that time, the respondent should have submitted an answer to the complaint; however, due to the time constraints, it is common for the answer not to contain substantive arguments regarding the issues raised in the case. Then, the petitioner and the respondent will exchange briefs and evidence to establish their respective positions and rebut the other party's position. In doing so, the court will, as appropriate, instruct each party to elaborate on a particular point or points that the court considers important. At the District Court level, in most cases, the exchange of briefs will occur four to six times and the hearing sessions will be held accordingly. In some complicated cases, the exchange may be made ten times or more. In practice, the interval between each hearing session is generally two to three months, during which the party with the initiative will prepare its brief.

After these exchanges, if the court considers that the review is complete and if each party has no intention to submit further arguments, the hearing session will be concluded. Then, a court decision will be rendered in a few months. Judicial tax litigation is always concluded by a court decision, and no settlement is available.

The entire procedure at the District Court level up to the decision will generally take 12–30 months.

4.3 Relevance of Evidence in Judicial Tax Litigation

In judicial tax litigation, most evidence is documentary, and a witness is rarely called upon, either by the petitioner or by the respondent.

This is partly because there is not often a dispute over a finding of “bare” facts (eg, whether someone signed the document). The key issues in judicial tax litigation are the interpretation of tax law as well as how the court should view or characterise the proven facts. From the petitioner's perspective, key documentary evidence should be submitted during the early stages of the litigation, ie, with the complaint or the petitioner's first brief, with a view to persuading the court at the outset of the litigation.

4.4 Burden of Proof in Judicial Tax Litigation

The general rule is that the Japanese government or the respondent will owe the burden of proof to establish that the amount of the assessed tax in the subject tax assessment is correct. However, with respect to a few items, such as the existence and amount of deductible expenses, the taxpayer or the petitioner will owe the burden of proof. In addition, setting aside ordinary reassessments (*kohsei*) or determinations (*kettei*), if the subject tax assessment is the one rejecting the taxpayer's request for a downward adjustment of the tax amount from that as reported in the originally filed tax return, then the taxpayer will owe the burden of proof to establish that such adjusted tax amount as asserted by the taxpayer is correct.

4.5 Strategic Options in Judicial Tax Litigation

As discussed in **4.3 Relevance of Evidence in Judicial Tax Litigation**, from the petitioner's perspective, key documentary evidence should be submitted during the early stages of the litigation – ie, with the complaint or the petitioner's first brief – with a view to persuading the court at the outset of the litigation. As the litigation progresses, where the petitioner thinks that the counter-argument of the respondent is not clear, it often requests clarification of that counter-

argument through the court and will accordingly rebut such argument.

It often happens that some facts that the petitioner asserts (eg, courses of negotiation and planning of the subject transaction) cannot be supported or established by available documentary evidence. In such cases, it is very common in practice that the petitioner will submit as evidence a written statement describing the relevant facts authored and signed by a person involved in and responsible for that matter instead of calling them as a witness. In other words, it is very common in practice to “substitute” witnesses with such written statements. The court will generally prefer this approach, as it is more time-efficient and easy to understand for the judges, as such written statements are usually first drafted by the petitioner’s counsel, bearing in mind the logical and chronological order of the facts as well as the implication of the facts upon the issue of the case.

Also, as to the matter of interpretation of tax law, it is recent common practice that the petitioner, or in some cases the respondent, will submit an expert opinion of a tax law academic to support their interpretation of the issues involved in the case. Petitioners will generally select highly regarded tax academics in the given field of tax law.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The Supreme Court, the highest court of Japan, has expressly recognised that the Commentary to the OECD Model Tax Convention can be a supplementary measure in interpreting tax treaties. However, in their decisions, it is not very common for Japanese courts to refer to foreign jurisprudence or doctrine formed in a foreign jurisdiction.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

If the decision of the District Court entirely or partially dismisses the petitioner’s claim, the petitioner is entitled to appeal up to the competent High Court (eg, the Tokyo High Court has the corresponding jurisdiction over the Tokyo District Court). The appeal period is two weeks from receipt of the official copy of the decision (which is mandatory save for exceptional cases); by that deadline, the petitioner must submit a statement of appeal. Then, within 50 days of submitting the statement of appeal, the petitioner must submit the reasons describing the substantive arguments for the appeal. At the High Court level, there is no restriction on the causes; ie, the High Court is still a trial court and its role is not limited to legal review. The court filing fees for the appeal are one and a half times the amount at the District Court level. If the petitioner prevails at the District Court, the Japanese government or the respondent is also entitled to appeal; it is very common for the Japanese government or the respondent to appeal if it has lost in the District Court.

Some appeal cases will be concluded at the first hearing session, ie, only with one session. Some will be reviewed by a few or several ensuing hearing sessions. The entire procedure at the High Court level up to the decision will generally take from six to 18 months.

Unlike the District Court, as mentioned in **4.1 Initiation of Judicial Tax Litigation**, High Court Judges are generally not specialists in tax or administrative law, but tax cases are heard in the general civil divisions along with general civil matters such as contract and tort. The panel consists of three judges, including the presiding judge and two associate judges; in High Courts,

even associate judges generally have more than ten years of experience. In practice, it is a challenge for the counsel to persuade such judges in complicated and technical tax matters.

5.2 Stages in the Tax Appeal Procedure

If the decision of the High Court entirely or partially dismisses the petitioner's appeal, the petitioner is entitled, under certain limited circumstances, to appeal up to the Supreme Court within two weeks from receipt of the official copy of the decision (which time limit is mandatory save for exceptional cases); by that deadline, the petitioner must submit an application for a writ of certiorari. Then, within 50 days of the receipt of notice from the Supreme Court (which time limit is again mandatory save for exceptional cases), the petitioner must submit the reasons for the application for a writ of certiorari, describing the substantive arguments for the appeal. In the context of tax litigation, practically, the appeal is limited to, or a writ of certiorari is only granted, where the issue at hand involves an important question of law. As such, the reasons for applying for a writ of certiorari have to persuade the Supreme Court that that important questions of law indeed exist.

If the Supreme Court decides that this condition is not met, it will dismiss the appeal without considering the merits. On the other hand, if the Supreme Court decides otherwise, it will accept the appeal, grant a writ of certiorari, and enter into a substantive review. This review is technically made solely within the Supreme Court, and neither party is required to submit arguments or evidence unless and until requested to do so by the Supreme Court; however, in practice, the parties will voluntarily do so in an attempt to do their best. As a result of the substantive review, the Supreme Court will render a decision, either dismissing the appeal, reversing the High Court decision and deciding on its own, or reversing the High Court decision and remanding the

case to the lower courts. Except for the case of remand, the decision of the Supreme Court will be final.

The entire procedure before the Supreme Court up to the final result will generally take from six months to several years.

5.3 Judges and Decisions in Tax Appeals

See **5.1 System for Appealing Judicial Tax Litigation**.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

No ADR mechanism is available for tax purposes in Japan.

6.2 Settlement of Tax Disputes by Means of ADR

No ADR mechanism is available for tax purposes in Japan.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

No ADR mechanism is available for tax purposes in Japan.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

A written formal advance ruling is available under somewhat narrow circumstances and subject to certain conditions, eg, publication of the ruling in an anonymised form. A written formal advance ruling is not technically legally binding, but it is considered that, under the general principles of good faith and estoppel, the tax authorities are not allowed to issue a tax assessment that

is inconsistent with the issued advance ruling, as long as the relevant information provided to the tax authorities in the ruling process remains accurate. For transfer pricing matters, advance pricing agreements (APAs) are commonly used measures to ensure certainty. See also **1.3 Avoidance of Tax Controversies**.

6.5 Further Particulars Concerning Tax ADR Mechanisms

No ADR mechanism is available for tax purposes in Japan.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

No ADR mechanism is available for tax purposes in Japan.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Procedures for tax assessment and criminal tax cases are separate from each other, and thus, the former procedure would not automatically initiate the latter. A criminal case would normally be initiated when the criminal investigation division of the tax authorities becomes aware of any potential tax crime. Judicial precedents, however, allow the taxation division of the tax authorities to share the information acquired through a tax audit with the criminal investigation division of the tax authorities unless the tax audit was conducted for criminal investigation. Thus, where information is so shared, it can lead to scrutiny by the criminal investigation division.

Generally speaking, in practice, a criminal case would be initiated only where the taxpayer wilfully conducted fabrication or concealment of facts or numbers or wilfully failed to submit tax returns. Application of a general anti-avoidance

rule (GAAR) or a specific anti-avoidance rule (SAAR), or tax assessments arising from a difference of views between the taxpayer and the tax authority, are generally for tax assessment purposes only and would not develop into a criminal case in practice. In our experience, it is very rare that tax controversy cases of sophisticated corporate taxpayers develop into criminal cases.

7.2 Relationship between Administrative and Criminal Processes

The procedures for tax assessment and criminal tax cases are separate and independent from each other, and there is no legal requirement that one procedure must be suspended while the other procedure is pending. Similarly, once the criminal tax case is initiated, the taxpayer may be indicted and tried in a criminal court, even if they voluntarily admit the position of the tax authority, file an amended tax return and pay the assessed tax in full together with penalties. However, such voluntary admittance and payment of the assessed tax, if made before indictment, can be taken into account when the prosecutor decides whether to indict a particular case based on the malicious nature of such a case.

7.3 Initiation of Administrative Processes and Criminal Cases

A criminal tax case would be initiated when the criminal investigation division of the tax authorities has become aware of any potential tax crime, eg, the fact or suspicion that the taxpayer wilfully conducted fabrication or concealment of facts or numbers or wilfully failed to submit tax returns.

7.4 Stages of Administrative Processes and Criminal Cases

The criminal investigation division of the tax authorities first conducts its investigation, and if it considers that evidence sufficient for the prosecutor's consideration has been collected, it

makes a criminal accusation with the prosecutor. The prosecutor will then conduct its investigation, and if they consider that evidence sufficient for indictment has been collected, they indict in court.

The general criminal division of the court will review the criminal tax case, but large District Courts such as Tokyo and Osaka have a specialised criminal tax division. In contrast, the legality of the tax assessment will be reviewed by the general civil division of the court (see **4.1 Initiation of Judicial Tax Litigation**).

7.5 Possibility of Fine Reductions

Upfront payment of the tax assessment could be taken into account by the judge as a mitigating factor in determining the amount of a fine or the period of imprisonment, but this is within the discretion of the judges, and there is no legal system that requires a reduction in potential fines or the period of imprisonment in the corresponding criminal case.

7.6 Possibility of Agreements to Prevent Trial

Under a recently introduced criminal proceeding bargaining system, which applies to certain specified economic or financial crimes (including tax crimes), a prosecutor and a taxpayer can enter into an agreement under which the prosecutor agrees not to institute or to withdraw the indictment of the taxpayer on the condition that the taxpayer provides testimony or evidence for, or otherwise co-operates with, the prosecutor's investigation of a certain crime of another person (but not the taxpayer themselves). This system became effective in June 2018, and to the author's knowledge, it has not been applied in criminal tax cases.

7.7 Appeals against Criminal Tax Decisions

There is only one route to appeal against the decision of the District Court, ie, first to the High Court and then to the Supreme Court. Both the taxpayer (if convicted) and the prosecutor (if the taxpayer was acquitted or the amount of fines or the period of imprisonment sentenced at the preceding instance were considered insufficient from the prosecutor's perspective) can appeal to the higher court. The prosecutor's appeal is permitted as not contravening the constitutional principle of prohibition against double jeopardy.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Under Japanese tax law, the SAAR, transfer pricing rules and anti-avoidance rules are for tax assessment purposes only. Tax assessment under these rules, therefore, would not generally give rise to criminal tax cases unless the taxpayer also committed tax evasion or another tax crime (eg, the taxpayer wilfully conducted fabrication or concealment of facts or numbers or wilfully failed to submit tax returns). At this stage, Japanese tax law has no GAAR that could apply without any particular restriction on the scope.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In transfer pricing cases, where economic double taxation arises as a result of a tax assessment, it is common to use MAP if available under the applicable double tax treaty, to avoid such economic double taxation.

In non-transfer pricing cases, if the taxpayer considers that it has received taxation in contravention of the applicable double tax treaty (eg, the existence of a permanent establishment

(PE) in Japan, the amount of profits attributable to a PE, withholding tax in contravention of the treaty) in Japan or the counterparty jurisdiction, that taxpayer can also rely on the MAP. In practice, however, economic double taxation as a result of tax assessment often arises without regard to the double tax treaty, in which case, the taxpayer's sole remedy would be to initiate domestic litigation.

According to the MAP statistics published by the OECD as part of the implementation of BEPS Action 14, Japan had 103 pending mutual agreement procedure cases (excluding those for APAs) as of the end of 2020, of which 91 cases (approximately 89%) are on transfer pricing-related matters.

Where a MAP is not available at the outset or does not effectively solve economic double taxation, the taxpayer can still initiate domestic litigation to solve economic double taxation.

There does not yet seem to have been any particular impact of the measures adopted under the MLI in this domain because the arbitration process provided in the MLI has not become available yet (see **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**).

8.2 Application of GAAR/SAAR to Cross-Border Situations

While the definitions of GAAR and SAAR would vary depending on the commentators, Japanese tax law has no GAAR that could be applied without any particular restriction on the scope. There are:

- a few targeted anti-avoidance rules (TAAR) applicable to certain situations in rather general terms (eg, closely held corporations and corporate reorganisations); and

- other more specific SAARs, including the CFC rules that apply in cross-border situations.

The validity of the CFC rules has been challenged in the past, and the Supreme Court held that taxation under the CFC rules does not contravene the applicable double tax treaty.

While the PPT and amendment to the preamble of double tax treaties, both as introduced by the MLI, should help tax authorities combat BEPS in cross-border situations in one way or another, the scope/impact of the PPT and amendment to the preamble remain ambiguous. Therefore, where the tax authorities deny taxpayers' positions relying on these measures, it is expected that taxpayers would initiate the dispute procedure under the available dispute resolution measures. If the matter is litigated in court, the court would be required to assess the scope/impact of these measures, taking into account, for example, the relevant OECD materials.

8.3 Challenges to International Transfer Pricing Adjustments

Generally speaking, taxpayers often prefer to challenge transfer pricing adjustments via a MAP under the existing double tax treaties mechanism since, in many cases, a resulting agreement between the competent tax authorities would allow the taxpayer to avoid economic double taxation. Where a solution through a MAP is not available (including where the negotiation under the mutual agreement procedure was not successful), taxpayers would challenge the adjustment by the domestic tax controversy procedure. See also **8.1 Mechanisms to Deal with Double Taxation**.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Bilateral APAs are a common mechanism to avoid or mitigate the risks of future tax assessment on transfer pricing matters. Unilateral APAs

are also used, for example, where the potential tax risks are considered rather small, or bilateral APAs are not available in relation to particular jurisdictions. Information on unilateral APAs would be exchanged with relevant jurisdictions under the framework for spontaneous exchange of information in accordance with BEPS Action 5.

As to the main stages of APA procedures, a taxpayer would, after conducting a preliminary economic analysis of the transaction in question, normally have preliminary consultations with the tax authorities to discuss the possibility of an APA and the agreed approach for economic analysis. Based on such a preliminary consultation, the taxpayer would conduct a detailed economic analysis and prepare an application for an APA. After the application is filed with the tax authorities, the application will be first reviewed by the tax authorities of Japan and then, where relevant, a MAP between the competent authorities of Japan and the other applicable jurisdiction(s) would commence.

8.5 Litigation Relating to Cross-Border Situations

In a cross-border context, withholding tax has historically been a major source of litigation. During the past several years, CFC and transfer pricing matters have generated a considerable volume of litigation. There has also been litigation involving corporate reorganisations with cross-border elements. In contrast, there are only a few cases under which the existence of a PE was litigated in court. These trends equally apply to additional or new litigation.

In order to mitigate the risk of litigation, it would be advisable to seek advice from tax advisers at the planning stage and structure transactions in a manner less susceptible to challenges by the tax authorities. For transfer pricing matters, the use of APAs is a common approach among

Japanese taxpayers. See also **1.3 Avoidance of Tax Controversies** and **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

No information is available in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

No information is available in this jurisdiction.

9.3 Challenges by Taxpayers

No information is available in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

No information is available in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Approximately 30 of Japan's double tax treaties provide for mandatory binding arbitration, and among these treaties, competent authority agreements to implement the arbitration process have been signed with eight jurisdictions as of 1 April 2022.

Japan also elected to apply part VI of the MLI to the relevant CTAs, and thus, a set of arbitration provisions will be introduced into the relevant CTAs, if treaty partners also make the same election. As of 1 April 2022, no competent authority agreement has been signed to implement the arbitration process provided in the MLI, and

thus, the arbitration process provided in the MLI has not become available yet.

10.2 Types of Matters that Can Be Submitted to Arbitration

The general treaty policy of Japan is to submit any types of matters to arbitration, as long as they relate to taxation, not in accordance with the provisions of the relevant double tax treaties.

Japan generally followed this policy under the MLI and will submit any types of matters to arbitration, with the following two minor exceptions:

- cases to determine the residency of a person other than an individual where such person would otherwise be treated as a dual-resident (this exclusion is already provided for in the Explanatory Statement to the MLI, and as such, this reservation was made only for clarification purposes); and
- matters which the treaty partner has excluded from the scope of arbitration (this reservation is to make the scope of arbitration reciprocal with the treaty partner).

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Under the MLI, Japan has opted for the independent opinion procedure. While no official explanation was provided for this choice, it seems consistent with Japan's existing competent authority agreements, which generally do not adopt baseball arbitration, as mentioned below.

The existing competent authority agreements to implement an arbitration process do not provide for a specific mode of arbitration, except for:

- the double tax treaty with the USA, for which baseball arbitration is adopted as the sole mode for arbitration; and

- the double tax treaty with the UK, for which baseball arbitration is provided as an optional mode for arbitration.

10.4 Implementation of the EU Directive on Arbitration

As mentioned in **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**, Japan is proactively adopting OECD-based mandatory binding arbitration in its double tax treaties through either bilateral treaty negotiation or the MLI. As a non-EU member state, the EU Directive on Arbitration does not apply to Japan.

10.5 Existing Use of Recent International and EU Legal Instruments

As of 1 April 2022, there is no publicly available information on whether mandatory binding arbitration introduced into double tax treaties has already been used in Japan. As a non-EU member state, EU legal instruments do not apply to Japan.

10.6 New Procedures for New Developments under Pillar One and Two

Both Pillars One and Two will likely take effect in Japan. Both Pillars envisage consistent application of the same substantive tax rules across jurisdictions in an unprecedented manner, and this would likely generate uncertainties and controversies, eg, where jurisdictions take a different interpretation of the same rule or have different views on the same set of facts. While it may be premature to judge the effectiveness of the instruments to mitigate controversies and tax certainty procedures, it is possible that they are not sufficient.

10.7 Publication of Decisions

Under the existing competent authority agreements to implement an arbitration process, no information on arbitration decisions will be published unless both jurisdictions and the relevant

taxpayers agree in writing. With respect to the arbitration process provided in the MLI, while no competent authority agreements have been signed, it is expected that Japan will adopt a similar approach therein.

10.8 Most Common Legal Instruments to Settle Tax Disputes

As of 1 April 2022, there is no publicly available information on whether mandatory binding arbitration has already been used in Japan (see **10.5 Existing Use of Recent International and EU Legal Instruments**).

With respect to the choice of dispute resolution measures under double tax treaties (other than arbitration) and domestic rules, see **8.1 Mechanisms to Deal with Double Taxation**.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

As mentioned in **10.5 Existing Use of Recent International and EU Legal Instruments**, there is no publicly available information on whether mandatory binding arbitration has already been used in Japan. However, it seems reasonable to believe that taxpayers will be allowed to hire independent professionals for the arbitration process. Where the matter is complex, the government may also want to retain independent professionals to achieve the best possible outcome from its point of view.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

In administrative litigation procedures, there will be no costs/fees that a taxpayer has to pay to the tax authorities or the National Tax Tribunal, aside from fees for making copies of evidence

submitted by the tax authorities or collected by the National Tax Tribunal. See **3.1 Administrative Claim Phase**.

11.2 Judicial Court Fees

In judicial litigation procedures, a taxpayer has to pay court filing fees by way of revenue stamps when filing its complaint with the District Court. The amount of such fees will be calculated in accordance with certain formulae prescribed in the law. For example, where the amount in dispute is JPY100 million, the amount of such fees is JPY320,000.

In the second and third instances (ie, hearing on appeal and hearing on final appeal), the appealing party has to pay the court filing fees when filing its appeal. The amount of such fees at each instance equals the amount of such fees at the first instance multiplied by one and a half or two, respectively.

Where a taxpayer ultimately prevails, it can demand that the Japanese government pay the court filing fees back to the taxpayer, but not the attorneys' fees.

11.3 Indemnities

Even if the court decides that the tax assessment is illegal and invalid, the taxpayer is generally not entitled to indemnity under Japanese tax law. Where a taxpayer suffered damage that was unlawfully inflicted by a public officer intentionally or by negligence, the taxpayer can request indemnity under the State Redress Act. Generally speaking, such an indemnity requirement is rather strict, and taxpayers can receive it only in very limited circumstances.

11.4 Costs of ADR

No ADR mechanism is available for tax purposes in Japan.

12. STATISTICS

12.1 Pending Tax Court Cases

According to the latest statistics published by the National Tax Agency (the NTA Statistics), the total number of tax court cases pending at the end of the fiscal year (FY) 2020 (1 April 2020 to 31 March 2021) is 195. The breakdown by instance is 141 cases at the first instance, 35 cases at the hearing on appeal and 19 cases at the hearing on final appeal.

Information on the amount of tax in dispute is not publicly available.

12.2 Cases Relating to Different Taxes

According to the NTA Statistics, the total number of cases that commenced in FY 2020 was 165. The breakdown by the types of taxes involved is 37 cases on corporate income tax, 56 cases on income tax (including withholding tax), 15 cases on VAT, 24 cases on property tax and 33 cases on other tax or tax-related matters.

The total number of cases that closed in FY 2020 was 180. The breakdown by the types of taxes involved is 39 cases on corporate income tax, 59 cases on income tax (including withholding tax), 23 cases on VAT, 23 cases on property tax and 36 cases on other tax or tax-related matters.

Information on the amount of tax in dispute is not publicly available.

12.3 Parties Succeeding in Litigation

According to the NTA Statistics, taxpayers prevailed in 14 cases (8% of the total of 180 cases that closed in FY 2020). To be more precise, taxpayers fully prevailed in seven cases and partially in seven cases. While this percentage of taxpayer success in tax litigations may appear to be rather low, the denominator seems to include cases that had slim chances of success at the outset. In the author's view, sophisticated cor-

porate taxpayers, which commence tax litigation after receiving merits advice from experienced tax attorneys, tend to have higher chances of success.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The importance of taking appropriate actions at each stage of a transaction cannot be emphasised enough.

At the planning stage, well-advised tax planning (including using formal or informal advance rulings or APAs, where available and appropriate) would reduce the future risks of challenges by the tax authorities. See also **1.3 Avoidance of Tax Controversies** and **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**.

At the stage of tax audit, while the tax authorities sometimes stick to their interpretation of tax laws, making an argument based on facts and evidence at an early stage can often prevent the tax authorities from issuing a tax assessment. At the same time, flexibility on the side of the taxpayer may be needed to try to settle the case effectively when the taxpayer's position is not very robust, in light of the time and costs that may be required for future tax litigation proceedings. See also **2.6 Strategic Points for Consideration during Tax Audits**.

At the stage of litigation, effective presentation of complicated tax matters in an easy-to-understand manner, supported by facts and evidence, will increase the chance of success. See also **4.3 Relevance of Evidence in Judicial Tax Litigation** and **4.5 Strategic Options in Judicial Tax Litigation**.

Nagashima Ohno & Tsunematsu has almost 50 years' experience handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also has as advisers Mr Mamoru Toba, a former director-general of the Tokyo Regional Taxation Bureau, and Professor Emeritus Hiroshi Kaneko (not

admitted to the Bar), the foremost authority on Japanese tax law. Key practice areas are tax advice and planning (for all types of commercial transactions, particularly those involving M&A, financing and capital markets), and tax disputes (including tax audits, administrative appeals and court proceedings).

AUTHOR



Koichiro Yoshimura is a tax partner at Nagashima Ohno & Tsunematsu. He has extensive experience in the field of taxation, covering both tax planning and controversy matters. Between 2015 and 2017, he worked as an adviser at the Secretariat for the Committee on Fiscal Affairs of the OECD. In addition to his Japanese legal qualifications, he has an LLM from Harvard Law School and an LLM in Taxation from New York University School of Law. Mr Yoshimura is the author of *Clarifying the Meaning of "Beneficial Owner" in Tax Treaties*, 72 *Tax Notes Int'l* 761 (2013).

Nagashima Ohno & Tsunematsu

JP Tower
2-7-2 Marunouchi
Chiyoda-ku
Tokyo 100-7036
Japan

Tel: +81 3 6889 7000
Fax: +81 3 6889 8000
Email: info@noandt.com
Web: www.noandt.com

NAGASHIMA OHNO & TSUNEMATSU

Trends and Developments

Contributed by:

Yushi Hegawa

Nagashima Ohno & Tsunematsu see p.299

Introduction

While the number of tax controversy cases in Japan is somewhat modest compared to the other major jurisdictions (see the Japan Law & Practice chapter in this guide), recently, there have been several noteworthy tax decisions. These decisions may appear sporadic, but some trends can be observed among them, as discussed below.

The Supreme Court's Interpretation of Tax Law

The Supreme Court of Japan, the final and highest court of Japan, has been playing an active and leading role in the interpretation of tax law, as shown by the following recent decisions. They, of course, have a significant impact on tax law practice in Japan.

Supreme Court decision, 21 April 2022

The Supreme Court decision dated 21 April 2022, commonly known as the Universal Music case, held in favour of the taxpayer and affirmed the High Court's and the District Court's decisions, which reversed a corporate tax assessment that denied deductions taken by a Japanese subsidiary of a multinational media conglomerate in respect of the interest on an intercompany loan from an offshore group financing company. This assessment was based on an anti-avoidance statute embedded in the Corporation Tax Act.

The intercompany loan was made for the Japanese subsidiary to acquire the shares of another Japanese group company, in the form of a so-called international debt pushdown, as part of an intra-group reorganisation of the group's Japan operations. The tax authority alleged that the intercompany loan was made for the principal

purpose of reducing the tax burden of the Japanese subsidiary by taking the interest deduction and was a tax avoidance transaction.

However, the Supreme Court held that the loan could not be found to be economically unreasonable because the overall reorganisation had valid business purposes, and thus the loan had valid business purposes, respecting the business judgment made by the taxpayer. Therefore, the government could not invoke the anti-avoidance statute to deny the interest deduction as the loan was not a tax avoidance transaction.

This case demonstrates that, even if the tax authority alleges tax avoidance, the Court will impartially hear the taxpayer's argument and hold in its favour if the taxpayer successfully establishes a bona fide business purpose for the transaction.

Supreme Court decision, 19 April 2022

The Supreme Court decision dated 19 April 2022 affirmed the High Court's and the District Court's decisions, upholding an inheritance tax assessment, which was made by invoking a general anti-avoidance provision embedded in the inheritance tax valuation administrative circular. The taxpayers allegedly intended to reduce their inheritance tax liability by borrowing significant amounts of money from banks and acquiring a whole condominium building only a few years before the death of the deceased. The valuation method provided in the inheritance tax valuation administrative circular had produced a value for the condominium building that was significantly lower than the fair market value, and they intended to take advantage of that provision.

The Supreme Court did not allow this attempt and justified the inheritance tax assessment in conclusion. While the lower Courts' reasoning was based upon the fact that there was a substantial disparity between the fair market value and the valuation under the inheritance tax valuation administrative circular, the Supreme Court expressly held that such a disparity cannot be a ground to impose additional taxes on the basis of the fair market value rather than the valuation under the inheritance tax valuation administrative circular. However, the Supreme Court finally upheld the assessment, focusing on the resultant tax consequence that the inheritance tax burden was significantly reduced and the fact that the taxpayers had intended to obtain such consequence, and then held that the equality among all taxpayers, including the petitioners, in this case, would otherwise be impaired.

The lower Courts' decisions had given rise to a substantial amount of controversy among tax practitioners. Buying a condominium building by borrowing had been widely recognised and practised as a common and legitimate means to reduce the value of the inheritance estate and thus reduce the amount of inheritance tax, but the tax authority attacked this case alone. Furthermore, the taxpayers simply followed the valuation method provided in the inheritance tax valuation administrative circular, which would generally apply to all inherited estates. Many commentators have criticised the decision as effectively undermining the basic tax law principles of certainty and foreseeability and contravening the rule of law in taxation. However, the Supreme Court did not directly respond to the criticism. It would be fair to say that the Supreme Court takes the position that there is no need to provide certainty and foreseeability for wealthy individuals' tax avoidance attempts. This is what the Supreme Court considers equality among all taxpayers.

In any event, this decision can be perceived as an indication that the Supreme Court may take a notably strict attitude towards tax avoidance by wealthy individuals.

Supreme Court decision, 11 March 2021

The Supreme Court decision dated 11 March 2021, commonly known as the Kokusai Kogyo Kanri case, held that a problematic provision of the corporation tax cabinet order (a subordinate regulation under the statute) was null and void in favour of the taxpayer and affirmed the lower courts' decisions to reverse the corporate tax assessment. This case involved distributions from a US subsidiary to its Japanese parent company out of its retained earnings and capital reserves, and quite an unreasonable result was to be drawn from the calculation under that cabinet order provision.

It is extremely rare for the Supreme Court to nullify a cabinet order promulgated by the executive branch and affirm a taxpayer's argument. This was due to the taxpayer successfully establishing the legislative intent of the statute conferring authority on the cabinet order as well as the deviation of the calculation result from the legislative intent of the statute.

This decision is highly significant in that the Supreme Court reaffirmed the basic principle that tax cabinet orders are not an unlimited prerogative of the executive branch, but they can only be legal and valid within the limitation of statute – ie, the rule of law must be observed when enacting subordinate tax regulations. At the same time, this case reminds the taxpayer of the need to adhere to the legislative intent of the statute as closely as possible and to establish the same vis-à-vis the courts by citing authoritative treatises.

Supreme Court decision, 24 March 2020

In its decision dated 24 March 2020, the Supreme Court held that textual interpretation – a well-established basic principle of tax law interpretation – does not apply to administrative tax circulars. This is because administrative tax circulars are not statutes or regulations but are only interpretations of tax statutes by the tax authority. The Supreme Court then further held that it is crucial to carefully consider whether the interpretations drawn from the administrative tax circulars conform to the legislative intent of tax statutes.

In other words, it makes little sense to develop arguments based upon textual interpretations of administrative tax circulars without paying attention to what the legislative intent of the relevant tax statute is. While leading tax controversy practitioners had already shared this notion and acted accordingly, it is significant that the Supreme Court expressly so held.

In this case, the Supreme Court reversed the High Court's decision and remanded the case to the High Court. This is by no means rare, and the Supreme Court, as the final court, has been very active in reviewing lower court tax decisions with fresh eyes and a sense of justice. This means that tax litigation outcomes are somewhat unpredictable – the taxpayer may ultimately prevail at the Supreme Court even if it has lost at lower courts or may ultimately lose even if it has won at lower courts after several years of litigation and significant costs.

Taxpayers and tax controversy practitioners should once again bear this in mind and develop arguments that are as robust as possible, even at the Supreme Court level, considering what the Supreme Court may hold according to its sense of justice as inferred from its past tax decisions.

High-Profile Tax Controversy Cases Involving Sophisticated International Corporate Transactions

Tokyo High Court decision, 10 March 2022

The Tokyo High Court decision dated 10 March 2022, commonly known as the Mizuho Bank case, related to a corporate tax assessment that was made based upon the anti-tax haven rule or the Japanese controlled foreign corporation (CFC) rule. The District Court had accepted the government's argument that Mizuho's offshore subsidiary, which was a special purpose vehicle in the Cayman Islands to issue preference shares for Mizuho to meet the capital adequacy regulations for banks, had income that should be subject to the CFC rule, and rejected the taxpayer's argument that such taxation was not presupposed by the law. The basis of the taxation was certain provisions of the special taxation measures cabinet order, and the Court affirmed that they are fully valid, rejecting the taxpayer's argument that they contravene the law.

However, the High Court reversed the District Court's decision, cancelling the tax assessment. The High Court reasoned that, in this specific case, the tax assessment is not allowed because it contravenes the spirit of the CFC regulations, and there is no tax avoidance result actually.

While the High Court's decision was favourable to the taxpayer, there is a substantial debate, even among tax practitioners, whether the decision is correct at all because it ignores the express text of tax law while confirming the full validity of the provisions of the special taxation measures cabinet order, and may not be justified by the prevailing interpretative theory of Japanese tax law. The matter is now under appeal by the government and is pending before the Supreme Court.

Tokyo High Court decision, 30 September 2021

The Tokyo High Court decision dated 30 September 2021, commonly known as the Sumitomo Mitsui Trust Bank case, related to a withholding tax assessment made upon interest on so-called Japanese eurobonds (ie, bonds issued by Japanese corporations overseas), based on the ground that the taxpayer failed to file a tax exemption document in a timely manner. The Court fully accepted the government's argument that the provision of the special taxation measures cabinet order setting forth the deadline for the filing of the tax exemption document is within the authority conferred upon it by the statute and rejected the taxpayer's argument that the statute did not intend to have this deadline set by delegating to the cabinet order.

The Court rejected the taxpayer's argument regarding tax cabinet orders. This decision contrasts with the Supreme Court decision dated 11 March 2021, holding that the corporate tax cabinet order was null and void. This reminds taxpayers that it is inherently difficult to overcome the explicit text of tax cabinet orders unless the taxpayer can make robust arguments based on the legislative intent of the underlying statute. This matter is now under appeal by the taxpayer and is pending before the Supreme Court.

Tokyo High Court decision, 14 April 2021

The Tokyo High Court decision dated 14 April 2021, commonly known as the Shionogi case, affirmed the District Court's decision reversing the corporate tax assessment that had denied the tax-free nature of an in-kind contribution of a partnership interest in a Cayman Islands exempted limited partnership, which was made by a Japanese company taxpayer to its foreign subsidiary in connection with an intra-group reorganisation.

The Court effectively held that the subject of the in-kind contribution was the taxpayer's share of the partnership property rather than the partnership interest per se and that it qualified as a tax-free in-kind contribution because the partnership property was managed outside Japan. The government did not appeal, and the decision is now final.

Tokyo High Court decision, 11 December 2019

While this is purely a domestic matter, the Tokyo High Court decision dated 11 December 2019, commonly known as the TPR case, affirmed the District Court's decision and upheld the corporate tax assessment denying the succession of net operating loss carryforwards by the taxpayer from another group company through an intra-group merger by invoking an anti-avoidance statute applicable to mergers and other corporate reorganisation transactions.

The Court held that the merging company in the intra-group merger was substantially a shell company that had no substantial business and only held the net operating loss carryforwards as tax attributes and the intra-group merger had no substance as a business succession and contravened the legislative intent of the rules concerning the succession of net operating loss carryforwards through an intra-group merger. Then, the Court concluded that the attempted succession of the net operating loss carryforwards was an abuse of these rules, justifying the application of the anti-avoidance statute.

While there are debates among practitioners on this case, it is a reminder of the need to substantiate transactions with proper business reasons – other than avoiding taxes – and establish such business reasons vis-à-vis the tax authority with sufficient contemporaneous evidence at tax audits. Without such facts and evidence illustrating convincing business reasons, a court

would be unlikely to be persuaded to hold in the taxpayer's favour no matter what technical legal arguments the taxpayer develops. In other words, when executing corporate reorganisation transactions, it would not suffice if the taxpayers were only to take care of the technical requirements under the individual tax rules (such as the requirements of tax-free reorganisations); they will also have to take into consideration the defences against the anti-avoidance statute. The Supreme Court has rejected the taxpayer's appeal, and the decision is now final.

National Tax Tribunal decision, 1 August 2019

The National Tax Tribunal decision dated 1 August 2019 upheld a tax assessment denying the tax-free nature of a US spin-off transaction conducted by Hewlett Packard (HP) and imposing income tax on a Japanese shareholder of HP. Before discussing the tax-free nature of such a spin-off or company split, the Tribunal held that the spin-off transaction under US law did not fall under the concept of a "company split" under Japanese corporate and tax laws at the outset. This part of the holding may be viewed as problematic as the spin-off transaction under US law in the given case was typical, spinning off an entire integrated business unit of HP from other business units.

While it is not clear whether this matter proceeded to in-court litigation, the holding should hopefully be rectified. At the same time, this case presents difficulties for Japanese shareholders of foreign companies – in practice, when structuring a transaction, the tax-free qualification for Japanese tax purposes would not even be considered on top of the tax-free qualification in the home jurisdiction (in this case, the USA).

Impact of court decisions

The foregoing cases remind taxpayers and practitioners that it is imperative to undertake careful tax structuring and planning, bearing in

mind not only the individual tax rules but also the anti-avoidance statute, for the intended tax position to be eventually sustained through tax controversy procedures. Furthermore, many of the court cases mentioned above suggest that courts are generally impartial, independent and not very pro-government and that a taxpayer's arguments would most likely be accepted if the taxpayer is well represented and advised by experienced counsel in a case that has merit.

It could also be said that the National Tax Tribunal is not necessarily a reliable venue for high-profile tax controversy matters arising from sophisticated corporate transactions as the Tribunal is, after all, effectively an alter ego of the tax authority even though it claims to be independent.

Sophisticated corporate taxpayers are expected to take that into consideration and may want to bypass the procedures before the Tribunal (see the Japan Law & Practice chapter in this guide) to go directly to the courts where appropriate, and at the same time, should not be too concerned even if they lose at the Tribunal.

Tax Controversy Cases Relating to High Net Worth Individuals and Wealth Management *National Tax Tribunal decision, 20 January 2022*

The National Tax Tribunal decision dated 20 January 2022 related to an income tax assessment on the founder/former chairman of a well-known Japanese houseware maker, Sazaby League, in connection with the management buyout and privatisation transaction of the company, which was then a publicly listed company.

The founder/former chairman allegedly sold, in 2015, the preferred shares of the Japanese acquisition vehicle to the vehicle itself (ie, a share repurchase), through his Dutch asset management company, at a value significantly lower than the fair market value as determined by the tax

authority and the assessment was made based upon such fair market value. The founder was disputing the assessment at the National Tax Tribunal and arguing that the repurchase price of the preferred shares was predetermined by the articles of incorporation of the Japanese acquisition vehicle and thus should be respected for tax purposes as well.

The National Tax Tribunal rejected the taxpayer's argument in its entirety; however, it cancelled the assessment in its entirety. The reason for the conclusion was that the Tribunal found that the fair market value of the preferred shares was significantly lower and almost the same as the price argued by the taxpayer if the valuation administrative circular was correctly applied. This ground did not seem to be argued for by the taxpayer so the decision can be said as sort of a "windfall" victory for the taxpayer. This happens because, technically, the Tribunal is not bound by the parties' arguments and can render a decision based upon its own review and deliberation.

In any event, this case suggests that the tax authority closely monitors, and scrutinises in tax audits, the tax planning attempts of wealthy individuals.

Tokyo High Court decision 27 November 2019

The Tokyo High Court decision dated 27 November 2019 held in favour of the taxpayer and affirmed the District Court's decision to reverse an income tax assessment. The tax authority assessed that the taxpayer, a top corporate executive of a Japanese company, was a resident of Japan for tax purposes; however, the Court held that the taxpayer could not be found to be a resident of Japan. Determination of the tax residency of an individual has been one of the most controversial issues in practice, and the tax authority took the position that the taxpayer is a resident of Japan if, among other factors, the taxpayer has stayed in Japan for some

significant period (eg, around six months) and occupies a significant executive role in a Japanese company.

However, the Court focused on the substance of the specific activities undertaken by the taxpayer in the case and determined that the important part of his activities was undertaken outside Japan, and his principal residence was outside Japan. This case indicates that finding a wealthy individual working worldwide to be a resident of Japan is still an active means for the tax authority to impose additional taxes on wealthy individuals and that, at the same time, during in-court litigation, making arguments based upon the specific facts is imperative to persuade the Court in favour of the taxpayer and achieve a favourable outcome. The government did not appeal, and the decision is now final.

Future expectations

Tax controversy cases relating to high net worth individuals and wealth management are definitely expected to increase, principally because the tax authority has recently been taking a very rigorous attitude towards the tax planning made by wealthy individuals and has established dedicated teams within the organisation to cope with these matters. The difficult part of these cases is that the tax controversy procedures may not always be the go-to option for wealthy individual taxpayers. This is because many wealthy individuals care about their reputation and want to avoid sensational press reports that they under-reported their tax liability and are disputing an assessment.

This reputational risk, caused by press reports, tends to deter wealthy individuals from vigorously disputing a tax assessment once it is made, and it is sometimes the case that they acquiesce. This would, in turn, deter them from creative or novel tax planning at the outset. This is not a healthy situation under the rule of law,

but practitioners should be aware of this practical issue.

Conclusion

Overall, the foregoing trends will likely continue in the near future. This will particularly be the case as the COVID-19 crisis continues and the need for tax revenue increases, and dissatisfaction towards “rich” corporates and individuals grows among the non-wealthy general public, who were severely affected by the crisis. There seems to be no reason for the tax authority to halt its aggressive enforcement of tax law even if taxpayers dispute assessments. There are, however, hopes that, even in this situation, the judicial branch will maintain impartiality, equity, integrity and justice when deciding tax controversy cases.

Nagashima Ohno & Tsunematsu has almost 50 years' experience in handling tax matters. Six partners are dedicated to tax issues, including three seasoned partners. The firm also has as advisers Mr Mamoru Toba, a former director-general of the Tokyo Regional Taxation Bureau, and Professor Emeritus Hiroshi Kaneko (not

admitted to the Bar), the foremost authority on Japanese tax law. Key practice areas are tax advice and planning (for all types of commercial transactions, particularly those involving M&A, financing and capital markets), and tax disputes (including tax audits, administrative appeals and court proceedings).

AUTHOR



Yushi Hegawa is a tax partner at Nagashima Ohno & Tsunematsu, with more than 20 years' experience as a tax lawyer advising on the tax aspects of various financial and

other transactions handled by the firm as well as on a number of tax audit and controversy cases. Yushi boasts of his outstanding track record in Japanese tax controversy matters as recognised by many publications such as Nikkei. He serves as a member of the Supervisory Board of the International Fiscal Association (IFA).

Nagashima Ohno & Tsunematsu

JP Tower
2-7-2 Marunouchi
Chiyoda-ku
Tokyo 100-7036
Japan

Tel: +81 3 6889 7000
Fax: +81 3 6889 8000
Email: info@noandt.com
Web: www.noandt.com

NAGASHIMA OHNO & TSUNEMATSU

Law and Practice

Contributed by:

*Mathilde Ostertag and Adrien Kleinschmidt
GSK Stockmann see p.320*



CONTENTS

1. Tax Controversies	p.303	5.3 Judges and Decisions in Tax Appeals	p.309
1.1 Tax Controversies in this Jurisdiction	p.303	6. Alternative Dispute Resolution (ADR) Mechanisms	p.309
1.2 Causes of Tax Controversies	p.303	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.309
1.3 Avoidance of Tax Controversies	p.303	6.2 Settlement of Tax Disputes by Means of ADR	p.309
1.4 Efforts to Combat Tax Avoidance	p.303	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.309
1.5 Additional Tax Assessments	p.304	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.310
2. Tax Audits	p.304	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.310
2.1 Main Rules Determining Tax Audits	p.304	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.310
2.2 Initiation and Duration of a Tax Audit	p.305	7. Administrative and Criminal Tax Offences	p.310
2.3 Location and Procedure of Tax Audits	p.305	7.1 Interaction of Tax Assessments with Tax Infringements	p.310
2.4 Areas of Special Attention in Tax Audits	p.305	7.2 Relationship between Administrative and Criminal Processes	p.311
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.305	7.3 Initiation of Administrative Processes and Criminal Cases	p.311
2.6 Strategic Points for Consideration during Tax Audits	p.305	7.4 Stages of Administrative Processes and Criminal Cases	p.311
3. Administrative Litigation	p.306	7.5 Possibility of Fine Reductions	p.311
3.1 Administrative Claim Phase	p.306	7.6 Possibility of Agreements to Prevent Trial	p.311
3.2 Deadline for Administrative Claims	p.306	7.7 Appeals against Criminal Tax Decisions	p.311
4. Judicial Litigation: First Instance	p.307	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.312
4.1 Initiation of Judicial Tax Litigation	p.307	8. Cross-Border Tax Disputes	p.312
4.2 Procedure of Judicial Tax Litigation	p.307	8.1 Mechanisms to Deal with Double Taxation	p.312
4.3 Relevance of Evidence in Judicial Tax Litigation	p.307	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.312
4.4 Burden of Proof in Judicial Tax Litigation	p.308		
4.5 Strategic Options in Judicial Tax Litigation	p.308		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.308		
5. Judicial Litigation: Appeals	p.308		
5.1 System for Appealing Judicial Tax Litigation	p.308		
5.2 Stages in the Tax Appeal Procedure	p.308		

8.3	Challenges to International Transfer Pricing Adjustments	p.312	10.5	Existing Use of Recent International and EU Legal Instruments	p.315
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.313	10.6	New Procedures for New Developments under Pillar One and Two	p.315
8.5	Litigation Relating to Cross-Border Situations	p.313	10.7	Publication of Decisions	p.317
9. State Aid Disputes		p.313	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.317
9.1	State Aid Disputes Involving Taxes	p.313	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.317
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.314	11. Costs/Fees		p.317
9.3	Challenges by Taxpayers	p.314	11.1	Costs/Fees Relating to Administrative Litigation	p.317
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.314	11.2	Judicial Court Fees	p.317
10. International Tax Arbitration Options and Procedures		p.315	11.3	Indemnities	p.318
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.315	11.4	Costs of ADR	p.318
10.2	Types of Matters that Can Be Submitted to Arbitration	p.315	12. Statistics		p.318
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.315	12.1	Pending Tax Court Cases	p.318
10.4	Implementation of the EU Directive on Arbitration	p.315	12.2	Cases Relating to Different Taxes	p.318
			12.3	Parties Succeeding in Litigation	p.318
			13. Strategies		p.319
			13.1	Strategic Guidelines in Tax Controversies	p.319

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Most tax controversies arise as a result of tax assessments or reassessments.

Besides the traditional issues resulting from taxpayers challenging tax assessment notices, tax litigation in Luxembourg recently saw an increase in cases arising from exchange of information queries from foreign tax administrations. Since the Berlioz case (C 682-15) and the subsequent change of the Luxembourg tax law, the Luxembourg tax administration (LTA) has to verify the purpose and relevance of the inquiry (eg, no fishing expedition). As a result, significant files have been brought forward to the courts to assess the relevance of the exchange of information requests.

Next to the aforementioned cases, the most common cases on direct taxes refer to the application of Luxembourg anti-abuse provisions (*abus de droit*), which are more frequently used by the LTA to challenge a taxpayer's position. In this field, topics such as hidden dividend distributions and managers' or directors' joint and several liability for the payment of taxes constitute the main areas of tax disputes.

Other common issues are requests for an exceptional remission of tax debt, domestic participation exemptions, fiscal unity, treaty benefits or interpretations and ex officio taxation.

1.2 Causes of Tax Controversies

Luxembourg tax disputes mostly involve personal income taxes (generally regarding deduction of expenses/costs and requests for exceptional remittance), dividend withholding tax and corporate income taxes.

1.3 Avoidance of Tax Controversies

Tax disputes may be mitigated by entering into advance tax agreements (ATAs) or advance pricing agreements (APAs) with the Luxembourg direct tax authorities (contrary to other European countries, the Luxembourg VAT authorities do not issue ATAs). ATAs or APAs may provide for legal certainty by determining the future tax liability of taxpayers.

In 2015, Luxembourg introduced a legislative framework for the tax ruling procedure. Each request for a tax ruling is processed by a committee composed of between four to six tax civil servants. The committee provides a final binding answer within a timeframe of generally two to three months after the payment of an administrative fee ranging between EUR3,000 and EUR10,000 (depending on the complexity of the file). Rulings are binding for a period of five years.

However, as a result of LuxLeaks and other scandals (Panama papers, Openlux, etc) over the past years, the number of rulings filed has significantly decreased, with only 95 APAs/ATAs filed in 2019. That number dropped even further to 75 in 2020. This is a general downward trend that continues to be confirmed year after year. The number of APA/ATA filings has increased by 17% for 2021, which is most probably due to the recent major changes of tax laws – and uncertainties deriving thereof – under the ATAD packages.

1.4 Efforts to Combat Tax Avoidance

There has been a steady increase in tax litigation over the last ten years (up almost 77% between 2011 and 2021 according to the LTA in its 2021 annual report). This trend looks to continue with the new provisions and tools available to the administration to combat harmful tax practices and tax avoidance schemes, and a potential increase in reassessments following an audit.

Further, the drop in the filing of ATAs/APAs provides for less fiscal certainty and will de facto lead to increased tax controversies.

Regarding the BEPS recommendations to combat tax avoidance, it should be noted that Luxembourg implemented several EU directives which will have a direct impact on the amount of tax disputes.

Anti-Tax Avoidance Directive

From the authors' point of view, the implementation of the Anti-Tax Avoidance Directive (EU) 2016/1164 (ATAD 1), introducing, inter alia, interest limitation and general anti-abuse rules as of 1 January 2019, and the Anti-Tax Avoidance Directive (EU) 2017/952 (ATAD 2), as regards hybrid mismatches with third countries as of 1 January 2020, should lead to an increase in the number of tax disputes in Luxembourg. Especially, although covered by circulars issued by the LTA, new topics such as the interest deduction limitation rule or CFC rules will most certainly lead to deviating interpretations between the LTA and the taxpayers.

DAC6

The implementation of Council Directive (EU) 2018/822 on mandatory disclosure rules (DAC6) into Luxembourg law, as of 25 March 2020, created great uncertainty among practitioners and taxpayers due to its broad, though vague, scope (especially as to the interpretation of the hallmarks). Until 4 May 2022, the LTA had issued very limited guidance on the interpretation of the hallmarks, which de facto would have led to an increase of tax litigation. With the new FAQ issued on 4 May 2022, a more foreseeable explanation has been provided to taxpayers in the interpretation of key definitions.

ATAD 3/Pillar One/Pillar Two

It is to be expected that the contemplated implementation of (i) the proposal for a Council Direc-

tive laying down rules to prevent the misuse of shell entities (ATAD 3 proposal), (ii) the Pillar One proposal foreseeing taxing rights on profits realised by MNE groups in so-called market jurisdictions, and (iii) the Pillar Two proposal providing for a global minimum corporate income tax at the rate of 15% will lead to more heated debates between the tax administrations and their relevant taxpayers.

1.5 Additional Tax Assessments

The late filing of tax returns can be subject to a penalty of 10% of the tax due and a fine of up to EUR25,000. In practice, for the first offence, the fine is usually EUR800 for individuals and EUR1,200 for companies, respectively.

In the event of a challenge of a tax assessment issued by the LTA, the lodging of a claim does not suspend the obligation to pay the taxes due. Also, the late payment of taxes triggers an automatic default interest of 0.6% per month, so it is usually recommended (when possible) to pay the taxes due upfront, even where the tax assessment is challenged.

Luxembourg law does not, however, impose a preliminary payment or guarantee as a prerequisite to file a claim.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Luxembourg companies are audited on a discretionary basis. However, in recent years, tax audits have been initiated by the Luxembourg tax authorities due to the exchange of information procedure implemented by the respective Directives on Administrative Cooperation (DAC). Also, companies held by individual tax residents are usually under scrutiny by the LTA.

2.2 Initiation and Duration of a Tax Audit

Tax audits may be freely initiated by the LTA if considered necessary. For companies, tax audits often arise, in practice, from the absence, delay or wrongful preparation of account books or tax returns. Once initiated, Luxembourg law does not provide for any specific deadline with regard to the duration of a tax audit.

In the case of direct taxes, the limitation period of the tax audit is five years, starting from the end of the fiscal year in which the tax claim arose.

In the case of concealment, with or without fraudulent intent, the limitation period is extended to ten years.

2.3 Location and Procedure of Tax Audits

The powers of the LTA are broad when it comes to tax audits. The LTA has the right and obligation to request information from taxpayers directly.

Tax audits may be performed remotely by requesting specific documents from taxpayers or “on-site” (which is the preferred route). Luxembourg taxpayers have to provide the requested information in a timely manner. If they do not, the LTA may make its request to any third parties which are likely to hold the relevant information.

The LTA may also proceed to “on-site” inspections of taxpayers’ premises. As a general principle, such “on-site” inspections should occur every three years for large companies. Alongside these “scheduled” inspections, the LTA may perform special “on-site” inspections for taxpayers which are considered “high risk”.

Documents requested by the tax authorities may be given in person or sent by mail.

2.4 Areas of Special Attention in Tax Audits

In principle, the general tax position of a taxpayer is being scrutinised.

Furthermore, with Luxembourg being a global hub for international investments, most transactions bear a cross-border factor. As such, some of the main areas for civil servants include the potential existence of permanent establishments, potential hidden dividend distributions and the deductibility of operating costs. Given the high number of intra-group financings conducted via Luxembourg companies, compliance with the transfer pricing rules is another key area which triggers the attention of the Luxembourg tax authorities.

Since the court ruling from the European Court of Justice in relation to the Danish UBO cases, a focus has been placed on the substance requirements of Luxembourg companies acting as “conduits” within international structures.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Within the framework of the DACs, Luxembourg has exchanged an average of 450,000 files with foreign tax administrations over the last few years, and received approximately 100,000 foreign reports in return.

The automatic exchange of tax information, and in particular the Common Reporting Standard (CRS), led to an increase of tax audits initiated by the LTA.

2.6 Strategic Points for Consideration during Tax Audits

In the course of a tax audit, it is important to assess the background and purpose of the audit. This preliminary assessment phase is rel-

evant in order to provide the appropriate and correct information to the tax authorities.

Although not mandatory, it is recommended that a tax adviser assists in order to streamline the communication with the LTA. The tax adviser may schedule a meeting with the civil servant in charge of the tax audit and negotiate a settlement.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Although direct taxes and indirect taxes are supervised by two segregated tax administrations, the administrative claim phase is now harmonised between the two public bodies.

Direct Taxes

Pursuant to paragraph 228 of the Luxembourg General Tax Law (LGTL), Luxembourg taxpayers may file an administrative claim against their tax assessments issued by the LTA within three months from the notification of the tax assessment. The receipt of the notification is assumed to have occurred three business days after its issuance by the LTA. Such a claim is to be directly addressed to the director (*préposé*) of the competent tax office and be motivated by sound reasons.

Taxpayers may also address a claim to the direct tax authorities, as per paragraph 94 of the LGTL, regarding a specific matter. The filing of an administrative claim on the basis of paragraph 94 of the LGTL does not, contrary to the filing on the grounds of paragraph 228 of the LGTL, grant the taxpayer the right to initiate a judicial litigation in the absence of an answer of the director of the competent tax office.

If the director of the competent tax office rejects the administrative claim, the taxpayer may file a judicial claim within three months from the notification of the rejection.

Indirect Taxes

Article 76 (3) of the Luxembourg VAT law provides for the right to file a claim also within three months from receipt of the VAT assessment notice. If the VAT office rejects the administrative claim, the claim is automatically redirected to the director of the indirect tax authority.

If the administrative claim is rejected by the director of the VAT administration, the taxpayer may file a judicial claim in front of civil courts, also within three months from the notification of the rejection.

3.2 Deadline for Administrative Claims

In Luxembourg, claims regarding direct taxes or indirect taxes are not lodged in front of the same jurisdictions. In both cases, however, the director of the relevant tax administration is not compelled by law to respond within a specific maximum timeframe.

Direct Taxes

If the director of the direct tax administration does not respond within six months from the filing of the administrative claim, the taxpayer is entitled to assume that the absence of an answer is equivalent to a negative decision. The taxpayer may then initiate a judicial claim before the Luxembourg Administrative Tribunal. There is no specific deadline for the filing of the judicial claim if the administrative claim remains unanswered.

Indirect Taxes

If the administrative claim remains unanswered six months after the filing of such a claim, the taxpayer may file a judicial claim in front of the District Court. No specific deadline applies.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

For Luxembourg tax purposes, the judicial phase is considered a second level of jurisdiction. Indeed, in order to be able to initiate the judicial phase, the taxpayer must first have had a claim rejected in the administrative phase, by the relevant tax authorities.

Direct Taxes

For direct tax purposes only, judicial claims must be filed with the Administrative Tribunal. As a general rule, litigation procedures before the administrative courts must, in principle, be initiated by a Luxembourg lawyer.

However, for procedures relating to direct taxes, no specific formalities are required with regard to the representation of the litigants or the filing of the initiation of the litigation procedure. In other words, the taxpayer can represent itself or be represented by a tax adviser, who does not need to be a qualified lawyer.

Indirect Taxes

Luxembourg civil courts are competent for the judicial litigations in relation to VAT and other indirect taxes. Conversely to direct tax procedures before Luxembourg administrative courts, indirect tax procedures brought before civil courts must be initiated by the filing of a writ of summons by a Luxembourg lawyer. The writ of summons must be notified to the counterparty by a bailiff in a timely manner.

4.2 Procedure of Judicial Tax Litigation

Direct Taxes

After the filing of the judicial claim, the registry of the Administrative Court shall forward the judicial claim to the competent tax office.

The procedure before the Administrative Court begins with an exchange of arguments between the parties, which occurs in a limited number of briefs. The first brief occurs within a period of three months, and every subsequent brief occurs within a period of one month. After the exchange of the final subsequent briefs by each party, the Administrative Tribunal fixes oral hearings.

The decision of the Administrative Tribunal should occur approximately one year following the initiation of the judicial tax litigation.

Indirect Taxes

In indirect tax court proceedings, the dates for the exchange of briefs and the oral hearing(s) are set by the District Court. The decision of the District Court should occur approximately two years after the filing of the claim.

4.3 Relevance of Evidence in Judicial Tax Litigation

As the Luxembourg judicial tax procedure is written and based on the adversarial principle, the provision and use of written evidence is essential.

Although uncommon, taxpayers and the tax administration may request witness evidence from a third party to consolidate their case. Where the tax administration requires a third party to act as a witness during the procedure, a party may only refuse under specific conditions (eg, family member or professional secrecy obligations).

Pursuant to the LGTL, witnesses may only provide the relevant information in writing. In cases where written evidence would not suffice in the making of a decision, the court may request an expert witness in order to verify certain open points (eg, valuation of a real estate asset).

4.4 Burden of Proof in Judicial Tax Litigation

Under Luxembourg law, as a general principle, the burden of proof lies with the party who claims for the execution of an obligation.

For tax purposes, the burden of proof remains with the taxpayer who claims a reduction of their taxable income. If the LTA's assessment results in an increase in the taxpayer's taxable income, the burden of proof lies with the LTA.

However, within judicial procedures relating to direct tax matters, the burden of proof is borne by the direct tax authorities.

4.5 Strategic Options in Judicial Tax Litigation

The strategic options which are to be considered in the course of judicial tax litigations should be determined and monitored on a case-by-case basis.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Although not a source of law, Luxembourg tax case law has considerable authority. Furthermore, since most of the Luxembourg legal texts are of foreign origin, practitioners attach great importance to the study of foreign case law. More specifically, Luxembourg tax law has been strongly influenced by German tax law as a result of the German occupation during WWII. As a result, Luxembourg case law often refers to German court decisions in tax matters and follows the same views.

With regard to transfer pricing rules, the Luxembourg Income Tax Law (LITL) expressly refers to the OECD transfer pricing guidelines as an official source of interpretation. Similarly, the LITL also refers to the EU directives and OECD BEPS reports when it comes to the interpretation of hybrid mismatches or CFC rules.

Last but not least, ECJ decisions are also used as an official source of interpretation for domestic courts.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Following the decision of the Administrative Tribunal or the District Court, taxpayers may file an appeal within a period of 40 days following the notification of the decision of the lower courts. While the decisions of the Administrative Tribunal may be challenged before the Administrative Court, appeals against the decisions of the District Court may be filed before the Court of Appeal with the necessary intervention of a bailiff.

Based on unofficial sources (annual MEETINCS conferences, speaker Mr Georges Simon), taxpayers have a higher chance of success (even if only partially) in front of higher courts in contrast to proceedings held in front of lower courts.

From the perspective of the LTA, except in "cases of principle", it generally accepts the decisions rendered by the lower courts.

Decisions of the Administrative Court of Appeal are not subject to a *pourvoi en cassation*. However, taxpayers may submit a *pourvoi en cassation* in front of the Court of Cassation against decisions of the Civil Court of Appeal.

5.2 Stages in the Tax Appeal Procedure

For direct tax matters, the tax appeal procedure is identical to the procedure before the Administrative Tribunal. There is a wide range of arguments that can be raised during the tax appeal procedure.

The brief of the defendant must be filed with the registry of the Administrative Court of Appeal who communicates the claim to the parties within one month. The claimant may reply to the first brief within a month. The same deadline applies to the defendant following the notification of the first brief of the claimant.

The stages of the indirect tax appeal procedure before the Civil Court of Appeal are identical to the procedure applicable before the District Courts.

5.3 Judges and Decisions in Tax Appeals

The Administrative Court of Appeal is composed of five judges and contains one unique panel of three judges.

The Civil Court of Appeal has a specific chamber for tax-related matters composed of three professional magistrates, being a president and two counsels.

The Court of Cassation is composed of one president and four permanent counsels. When the Court of Cassation overturns the decision of the Civil Court of Appeal, the case is sent back before the same Court of Appeal that ruled in the first case.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Luxembourg implemented the EU Directive on tax dispute resolution mechanisms on 20 December 2019. The mutual agreement procedure applies to any disputes relating to Luxembourg income tax, withholding tax, municipal

business tax and wealth tax for all financial years following 2018.

EU-resident taxpayers can file claims to the competent authority (direct tax authorities in Luxembourg) relating to the EU Arbitration Convention and double tax treaties entered into between member states.

6.2 Settlement of Tax Disputes by Means of ADR

Taxpayers may file a claim with the competent tax authority within three years from the notification of the tax assessment.

Upon the filing of a claim, if the competent tax authority does not answer the case within six months from the filing, the claim may be resolved via the mutual agreement procedure within two years from the filing. The dispute is resolved by a commission composed of a judge assisted by independent persons and, on the other side, competent tax officials. The commission shall provide a resolution within a fixed period of six months. The resolution of the commission is binding for the tax authorities.

The mutual agreement procedure may be initiated in parallel to the traditional judicial procedures.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties Ombudsman

Since 2003, it has been possible for any private person or company to reach out to the Luxembourg Ombudsman (either by written request or even orally) to file a claim against the LTA. This is especially the case when the taxpayer considers itself unfairly treated by the LTAs or when the administration acted in breach of its public mission.

For the year 2021, the Ombudsman intervened in approximately 41 cases for direct tax matters.

Remittance of Taxes

The director of direct taxes is empowered to grant a total or partial remission of taxes whose collection would be unfair, considering the particularity of the situation in which the taxpayer finds itself (objective or subjective severity). Situations must be assessed on a case-by-case basis.

There are two kinds of fairness:

- objective fairness, which is intended to correct the rule that proves to be unjust in a particular case, because it leads to taxation contrary to the legislator's intent; and
- subjective fairness in the person of the taxpayer, where the payment of the tax compromises economic existence and deprives indispensable means of substance.

The application for a remission of taxes does not challenge the legality of the tax assessment, but merely invokes considerations of equity. A challenge on the content of the tax assessment itself falls under litigation proceedings.

See **1.3 Avoidance of Tax Controversies**.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

See **1.3 Avoidance of Tax Controversies**.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.2 Settlement of Tax Disputes by Means of ADR**.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.2 Settlement of Tax Disputes by Means of ADR**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Administrative Tax Offences

The LTA may issue additional tax assessments in cases where the taxpayer did not comply with the applicable legal obligations (eg, absence or late filing of tax returns). In such cases, the LTA may impose either lump sum fines or apply interests on the due amount. The LTA may also impose administrative fines for non-criminal infringements of the tax law.

In the context of the taxation process, the LTA may impose individual fines of up to EUR25,000. In the event where the law allows the granting of tax benefits or reliefs, specific conditions may be imposed on taxpayers. The infringement of these conditions may be subject to a fine of up to EUR2,500, even if the taxpayer did not trigger any benefit from such infringement.

In addition, as per the circular LG-A n° 67 issued on 28 July 2021 by the Luxembourg tax authorities (Circular n° 67), taxpayers may be subject to fines for the following infringements:

- intentional inaccuracies in the filed tax returns are subject to a fine ranging between 5% and 25% of the eluded taxes;
- simple tax fraud (ie, a tax advantage unduly obtained by fraud or an intended reduction of the taxable income) is subject to a fine ranging between 10% and 50% of the eluded taxes or unduly reimbursed amounts;

- unintended tax fraud (ie, tax advantage unduly obtained by negligence or unintended reduction of the taxable income) is subject to a fine ranging between 5% and 25% of the eluded taxes or unduly reimbursed amounts.

It is important to note that the fine issued by the LTA must be proportional to the infringement committed by the taxpayer.

Criminal Tax Offences

Since 2017, tax fraud and aggravated tax fraud have been considered as primary offences for anti-money laundering purposes.

As per Circular n° 67, taxpayers may be punished for the following tax-related criminal offences.

- Aggravated tax fraud, which is committed if the eluded taxes/unduly reimbursed amounts (i) exceed 25% of the due taxes for the given year without being lower than EUR10,000, or (ii) exceed EUR200,000. Aggravated tax fraud is punishable by imprisonment of one month to three years and a fine ranging between EUR25,000 and six times the eluded taxes or the unduly reimbursed amounts.
- Tax fraud, which is committed if (i) the amount of eluded taxes constitutes a significant amount with regard to either the total amount due or the taxes due for the given year or the unduly reimbursed amounts, and (ii) results from the systematic use of fraudulent practices having the purpose of concealing facts. Tax fraud is punishable by imprisonment of one month to five years and a fine ranging between EUR25,000 and ten times the eluded taxes or the unduly reimbursed amounts.

7.2 Relationship between Administrative and Criminal Processes

In criminal proceedings, a taxpayer may only be sentenced for tax fraud if it has been proved that the taxes avoided were effectively due. The rela-

tionship between the administrative and criminal procedure is marked by the necessity to determine whether the taxpayer was subject to fiscal obligations. A criminal judge within a tax offence procedure must first wait for the decision of the administrative judge determining whether the defrauded taxes were due or not.

7.3 Initiation of Administrative Processes and Criminal Cases

If the LTA suspects that a taxpayer has committed a tax-related offence, it may initiate a criminal tax procedure by transmitting the file to the public prosecutor. After the transmission, the public prosecutor conducts an investigation.

7.4 Stages of Administrative Processes and Criminal Cases

See **4.2 Procedure of Judicial Tax Litigation**.

7.5 Possibility of Fine Reductions

Under the LITL, there is no reduction of potential fines if the taxpayer proceeds with an upfront payment of the additional tax assessment. Late payment of taxes due is subject to a late payment interest of 0.6% per month.

On a case-by-case basis, and upon circumstanced requests only, the director of the relevant tax administrations may decide to increase or reduce a fine.

7.6 Possibility of Agreements to Prevent Trial

Under Luxembourg law, taxpayers involved in a criminal tax trial may not benefit from any plea bargain by entering into an agreement with the public prosecutor in order to stop or prevent such a trial.

7.7 Appeals against Criminal Tax Decisions

Either the taxpayer or the public prosecutor may file an appeal before the Court of Appeal

against a decision of the Criminal Court related to a criminal tax offence. The deadline for the filing of the appeal ends 40 days following the notification of the decision of the Criminal Court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a result of an audit or a reassessment notice, the LTA may transfer the case to another authority (judicial authority, public prosecutor, etc). In 2021, the direct tax administration transmitted 20 cases to the relevant public bodies in the framework of inter-administrative and judicial co-operation.

Regarding tax litigations, there has been an increase of case laws referring to artificial cross-border transactions challenged by the LTA under the general anti-abuse rule (GAAR). However, the Luxembourg tax courts have set boundaries and more detailed rules for determining whether a transaction is artificial.

Recently, the Administrative Tribunal issued a decision in relation to an exchange of information request of the Belgian tax authorities, which was motivated by the infringement of the GAAR by a cross-border structure using a Luxembourg “conduit” company. It is to be expected that the GAAR will give rise to additional administrative litigation (though rarely to criminal offences).

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In the case where a tax assessment or tax adjustment triggers a double taxation, it is common to initiate a domestic litigation procedure and the mutual agreement procedure mechanism under the applicable double tax treaty.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Since the amendment of the domestic GAAR through the implementation of ATAD 1, Luxembourg tax authorities should not ignore any misuse of forms and institutions of law (ie, an arrangement) which has been carried out primarily for achieving a tax advantage and which is not commercially genuine. An arrangement is considered as “not genuine” if it has not been put into place for valid commercial reasons which reflect economic reality. The GAAR may apply to cross-border situations covered by double tax treaties.

The rationale behind the principal purpose test (PPT) lies in denying the benefit of a double tax treaty to a taxpayer if such a benefit was one of the main motivations for entering into an arrangement. Luxembourg opted for the discretionary relief clause providing taxpayers the ability to request the LTA grant a treaty benefit if such a benefit would have been granted to the taxpayer in the absence of the concerned arrangement.

The denial of a treaty benefit on the grounds of the PPT should be analysed by the LTA on a case-by-case basis. It should be noted that the PPT applies in parallel to the GAAR and, hence, adds an additional layer of complexity with regard to the application of anti-abuse rules.

It is expected that the interpretation of the PPT will trigger additional litigation matters in Luxembourg.

8.3 Challenges to International Transfer Pricing Adjustments

Luxembourg embedded the arm's-length principle, deriving from Article 9 of the OECD Model Convention, in Articles 56 and 56 bis of the LITL. Moreover, the mentioned articles reflect the spirit set out in BEPS Actions 8–10, such as the con-

cept of comparability analysis and a general anti-abuse rule that allows the LTA to disregard a transaction that has been made without any valid commercial or business justification.

The LTA issued Circular No 56/1-56 bis/1 on 27 December 2016, which provides further guidance with regard to substance and transfer pricing requirements in line with the OECD guidelines. As a result, international transfer pricing adjustments can, from a Luxembourg standpoint, be challenged under domestic tax courts if not compliant with the OECD transfer pricing guidelines.

8.4 Unilateral/Bilateral Advance Pricing Agreements

While APAs traditionally constituted a good mechanism for mitigating transfer pricing matters, since the LuxLeaks affair, the committee in charge of the advance pricing agreements procedure, as mentioned in **1.3 Avoidance of Tax Controversies**, has adopted more restrictive conditions for granting APAs to taxpayers. It is estimated that only one in four APA requests is agreed on by the ruling committee.

8.5 Litigation Relating to Cross-Border Situations

Given that Luxembourg companies are often used for international tax structuring purposes, cross-border dividend and interest payments between associated enterprises are a focus of the LTA.

In view of the recent amendments to Luxembourg domestic law made in order to comply with the latest OECD BEPS guidelines (eg, GAAR and PPT), both withholding tax and transfer pricing issues trigger, or will trigger in the near future, additional litigation in Luxembourg.

Further, given that Luxembourg shares its borders with four countries and has a large number

of cross-border workers from France, Germany and Belgium, arbitration for the taxation of teleworkers applies frequently with these respective countries. This topic was heavily discussed and negotiated with the foreign tax administrations and relevant ministries at the beginning of the COVID-19 pandemic due to multiple lockdowns and official work-from-home recommendations for cross-border commuters.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

There are currently several ongoing state aid disputes involving tax rulings granted by the LTA in favour of Luxembourg companies.

On 12 May 2021, the CJEU ruled on the Engie case (cases T-516/18 and T-525/18) which follows the decision of the European (EU) Commission of 20 June 2018 claiming that the State of Luxembourg granted a selective advantage to an entity. In a nutshell, the EU Commission claimed that the LTA had granted a state aid by issuing several tax rulings in relation to intra-group financing between Luxembourg entities of the Engie group. The rulings of the LTA confirmed that accrued but unpaid expenses under a convertible loan were deductible without being included in the taxable income of the holder of the loan. The EU Commission argued the following.

- Luxembourg law did not allow the deduction of expenses at the level of the payor if the related income is not included in the taxable basis of the payee (so-called deduction without inclusion situation).
- Luxembourg granted an advantage to the Engie group which was financed out of the resources of the Luxembourg state due to the loss of tax revenue.

- Additionally, Luxembourg did not apply the anti-abuse rules. In its decision, the CJEU confirmed that the EU Commission has the power to challenge tax rulings for state aid purposes and upheld the claims of the EU Commission. Luxembourg appealed against this judgement on 21 July 2021. The appeal was published on 29 November 2021.

On the same date, the CJEU also ruled on the Amazon case (cases T 816/17 and T 318/18). This case involves a Luxembourg partnership (the SCS) being fully held by US companies of the Amazon group and its subsidiary, a Luxembourg operating company (the OpCo). The SCS granted the use of certain IP rights to the OpCo which in return paid royalties to the SCS. The LTA had confirmed in its ruling the arm's-length nature of such royalty payments and its determination via the transactional net margin method (TNMM). In its decision dated 4 October 2017, the EU Commission claimed that the use of the TNMM method resulted in excessive royalty payments and that the taxable basis of OpCo was hence "artificially reduced". The EU Commission based its arguments on the fact that the following errors resulted in a false calculation:

- the use of the TNMM method;
- the false "testing party";
- the choice of the profit level indicator; and
- the inclusion of a ceiling mechanism.

The CJEU stated in its judgement of 12 May 2021 that the EU Commission failed to demonstrate the existence of methodological errors and the granting of a selective advantage.

Besides, the Huhtamäki case involving a Luxembourg company is still being investigated by the EU Commission. In that case, the EU Commission claims that the LTA issued tax rulings which confirmed that the Luxembourg company of the group would be making an arm's-length

profit margin on its financing activities and could deduct fictitious interest payments made under interest-free loans.

On 3 October 2019, the Luxembourg company requested the EU Commission provide non-confidential versions of the tax rulings and the list of the recipients of the tax rulings communicated by Luxembourg. The EU Commission rejected this request in Decision C(2019) 9417 final dated 18 December 2019 on the grounds that the documents fell under the general presumption of confidentiality. On 2 March 2022, the CJEU issued a judgment which annuls the Decision C(2019) 9417 final on the basis that the arguments of the decision of the CJEU were not valid.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

State aid disputes involving Luxembourg companies often originate from the initiation of a formal investigation procedure by the EU Commission pursuant to Article 108(2) TFEU which requests information from the Luxembourg state. In the cases mentioned under **9.1 State Aid Disputes Involving Taxes**, the Luxembourg state brought an action requesting the annulment of the decisions of the EU Commission.

9.3 Challenges by Taxpayers

In the cases mentioned in **9.1 State Aid Disputes Involving Taxes**, both Engie and Amazon brought an action requesting the annulment of the respective decisions of the EU Commission and take the role of applicant in the judicial procedures.

9.4 Refunds Invoking Extra-Contractual Civil Liability

In the context of state aid disputes involving Luxembourg structures, there are rarely, if any, litigation procedures brought against the Lux-

embourg state invoking extra-contractual civil liability.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Within the framework of the introduction of the MLI on 1 August 2019 in domestic law, Luxembourg has been guided in its choices by a policy of prudence, opting, on the one hand, for provisions that are in line with its current treaty policy and, on the other hand, for provisions introducing minimum standards that are mandatory but can be adopted in a flexible manner.

As for the mandatory provisions, Luxembourg has chosen the options that best suit its contractual policy.

For arbitration matters, Luxembourg opted for the mandatory binding arbitration rule in Article 19 of the Luxembourg MLI law.

This mandatory binding arbitration rule states that in cases of arbitration procedure initiated on the basis of the mutual agreement procedure provided for by the respective double tax treaties, if the taxpayer considers that the decision resulting from such a procedure may not be in line with the applicable laws, or the case has not been resolved within a period of two years, the case should be deferred to an impartial arbitration panel upon the request of the relevant taxpayer.

10.2 Types of Matters that Can Be Submitted to Arbitration

There are currently no provisions under DTTs or the MLI law which limit or restrict the access to arbitration for tax disputes.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Pursuant to Article 23 (1) of the MLI law, Luxembourg opted for the baseball arbitration procedure.

Although the reason behind choosing the baseball procedure was not explicitly mentioned in the draft bill, it can be assumed that this choice was motivated by the desire to promote quick outcomes for arbitration cases by reducing time and costs compared to the independent opinion procedure. The baseball procedure is consistent with the existing options under DTTs and the Arbitration Convention.

10.4 Implementation of the EU Directive on Arbitration

Luxembourg, being an EU member state, followed the trends in international tax arbitration made by the OECD by introducing in its domestic law on 20 December 2019 Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms.

10.5 Existing Use of Recent International and EU Legal Instruments

At present, there is no publicly available information regarding the use of the recent legal instruments for tax dispute resolutions.

10.6 New Procedures for New Developments under Pillar One and Two

On 1 July 2021, the OECD released a statement addressing the two elements of the BEPS 2.0 project, being (i) Pillar One providing for the re-allocation of taxation rights on profits of multi-

national groups (MNEs) to market jurisdictions and (ii) Pillar Two establishing a minimum tax rate for MNEs.

On 22 December 2021, the EU Commission issued a proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union in order to implement the OECD Pillar Two in the EU. As per Article 55 of the proposal, the provisions shall be implemented into the domestic laws of the member states by 31 December 2022 and shall apply as of 1 January 2023. At the current stage, the EU Commission has not issued a draft directive for the implementation of Pillar One.

As MNEs often use Luxembourg holding or financing companies as gateways to European market jurisdictions, the implementation of Pillar One and Two should impact the Luxembourg structures of these MNEs.

Given the complexity of the taxation mechanisms under OECD Pillar One and Two, their implementation may result in uncertainty for states and taxpayers. In particular, there is a risk that taxpayers are unduly subject to multiple taxation in several states and that jurisdictions wrongly apply the taxation rules. As a result, it is to be expected that the implementation of these mechanisms will lead to an increase of tax disputes.

Pillar One

As mentioned above, Pillar One provides for a re-allocation of the taxing rights to market jurisdictions. For this purpose, two categories of profits shall be allocated to market jurisdictions:

- Amount A corresponding to the share of residual profit which is allocated to market jurisdictions regardless of whether the MNE has a physical presence in those jurisdictions; and

- Amount B corresponding to a fixed remuneration for baseline marketing and distribution activities occurring in market jurisdictions.

The Blueprint on Pillar One dated 14 October 2020 intends to provide for tax certainty by effective dispute prevention and resolution mechanisms. As the determination of Amount A should be the main source of disputes, the provisions of Pillar One foresee the following dispute resolution procedure.

1) Establishing and filing of a standardised self-assessment return for Amount A by the co-ordinating entity with the lead tax administration. Alternatively, the MNE may request early tax certainty with the lead tax administration.

2) The lead tax administration circulates the self-assessment to other tax administrations of jurisdictions in which the MNE has constituent entities and validates the self-assessment return or the early tax certainty. As an option, the lead tax administration shall perform an initial review and determine whether a panel review is necessary.

3) If required, a review panel will be constituted which is formed by the concerned tax administrations and has the purpose of pursuing an amical settlement via consensus.

4) If the review panel cannot agree on an outcome, a determination panel shall be constituted which is formed by individual panellists.

5) The outcome is presented to the MNE. The MNE may (i) accept the outcome which is binding for all involved jurisdictions and the MNE and resolves the dispute, or (ii) deny the outcome, withdraw the early certainty request and use domestic dispute resolution procedures.

As mentioned above, MNEs should benefit from dispute prevention and resolution mechanisms

which ensure tax certainty under Pillar One. However, given the current climate with regard to ATAs/APAs as mentioned in **1.3 Avoidance of Tax Controversies**, it should be clarified to what extent the LTA will grant early tax certainty to MNEs. The directive implementing Pillar One should provide further clarification in this regard.

Pillar Two

The Blueprint for Pillar Two and the proposal for a directive implementing Pillar Two do not provide for tax dispute resolution mechanisms. However, the Blueprint foresees that taxpayers may rely on the dispute resolution mechanisms provided by tax treaties.

10.7 Publication of Decisions

As per Article 18 (2) of the MLI, the LTA may publish, via the European Commission, an anonymised summary of its decisions mentioning the legal issue, the facts, the date, the relevant fiscal years, the legal basis, the business sector and the final decision.

However, the LTA and, if applicable, the foreign tax authorities may publish the entire decision with the consent of the relevant taxpayer. Before the publication of the decision, the LTA must notify the relevant taxpayer. Upon receipt of the notification, the taxpayer then has 60 days to request the LTA not publish any information relating to a commercial, industrial or professional secret, or a commercial procedure, or which would be contrary to the public order.

Under the MLI law, there are no obligations to publish the decisions taken by the Arbitration Commission.

10.8 Most Common Legal Instruments to Settle Tax Disputes

While the tax dispute resolution mechanism under the MAP Directive applies exclusively to tax disputes deriving from the application of

DTTs entered into between EU member states, the mechanism under the MLI applies to issues arising from the application or interpretation of DTTs entered into by states that opted for the same options under the MLI. Thus, the choice of the mechanism is determined on a case-by-case basis.

Regarding double tax disputes involving the EU member states that implemented the MLI, taxpayers may choose between a procedure under the MLI or the MAP.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Given that tax disputes arising in Luxembourg usually involve foreign investors or shareholders, corporate taxpayers generally involve their local tax adviser in order to initiate and co-ordinate the international tax arbitration procedure.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

In administrative litigation proceedings relating to direct tax claims, taxpayers are not obliged to act through a bailiff in order to file a claim or an appeal before the Administrative Tribunal or the Administrative Court of Appeal. Accordingly, the costs arising from such administrative direct tax procedures remain low.

11.2 Judicial Court Fees

Conversely to administrative tax procedures, judicial claims relating to indirect taxes must be initiated by means of a writ of summons filed by a Luxembourg lawyer and notified to the counterparty by a bailiff. Taxpayers must be represented by a Luxembourg lawyer in front of the judicial court, which triggers further fees. Pay-

able amounts imposed by the courts are due upon the notification of their decision. The courts may require that one of the parties pays a guarantee in advance of the decision.

The Luxembourg civil procedure law provides that certain costs arising from the judicial procedure may be attributed to one of the parties of the procedure. In practice, the procedure costs are borne by the party that loses the case. Legal costs arising from the mandate of a lawyer may only be partially attributed to the unsuccessful party.

11.3 Indemnities

Luxembourg law does not provide for any indemnities in the event where the court decides that the initial additional tax assessment issued by the LTA is null and void.

11.4 Costs of ADR

Under Luxembourg law, no court fees are due if a taxpayer opts to use any alternative dispute resolution mechanisms.

12. STATISTICS

12.1 Pending Tax Court Cases

There are no official statistics regarding the number of pending tax court cases in Luxembourg.

12.2 Cases Relating to Different Taxes

Direct Taxes

Based on the annual reports from the direct tax administration, during 2019, the direct tax administration registered 1,635 claims filed by taxpayers against tax assessments. Approximately 251 direct tax claims resulted in the introduction of an administrative claim before the Administrative Tribunal. In 2020, the number of claims lodged dropped to 193, which is only due to the suspension of the deadlines as an extraordinary measure against the COVID-19

pandemic. Surprisingly, 177 claims have been introduced before the Administrative Tribunal in 2021.

The tax administration stresses that the cases are increasingly complex and involved various issues relating to domestic and European topics, tax assessments, joint payment of taxes and exchange of information.

Indirect Taxes

With regard to indirect taxes, the VAT administration registered 268 claims against VAT assessments and 912 claims against additional VAT assessments during 2019. During the same year, taxpayers assigned the VAT administration before the civil courts in 25 cases. According to the VAT administration's statistics, in the vast majority of disputes between the taxpayer and the VAT administration, the courts essentially confirmed the VAT administration's position.

In 2020, the VAT administration registered 998 claims, where 304 related to claims against a VAT assessment and 694 were claims against administrative penalties. Within the same year, 41 claims were lodged in front of the civil courts against decisions from the VAT administration.

In 2021, the VAT administration registered 1,583 claims, of which 310 were filed against VAT assessment notices and 1,273 against administrative penalties.

12.3 Parties Succeeding in Litigation

Statistics regarding the outcome of litigation procedures are not published in Luxembourg.

Based on unofficial sources (annual MEETINGS conference, speaker Mr Georges Simon), for 2021, 29% of the Administrative Tribunal's decisions were in favour of the taxpayer (either fully for 23% or partially for 6%), while 49% of the decisions were unfavourable to the taxpayer.

Regarding the higher courts, a total of 54% of the Administrative Court's decisions were in favour of the taxpayer (with 28% fully and 26% partially), while 46% of the decisions were unfavourable to the taxpayer.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

When it comes to procedural matters, meeting the deadlines provided by the law remains one of the main considerations. With Luxembourg being a global hub for international investments, investors are usually residing in foreign jurisdictions.

Given that the claims and the writs of summons must be sent via registered mail or bailiff to the respective courts or counterparties, postal delays should be taken into consideration for the meeting of deadlines. However, litigants residing in foreign jurisdictions may appoint local legal counsel in order to co-ordinate the litigation procedure.

Further, given the large number of international groups using Luxembourg companies as a gateway to Europe, tax litigation procedures usually involve cross-border cash flows between linked entities residing in different jurisdictions. Such cases result in international tax issues which require a close monitoring and co-ordination between the involved entities and their respective legal counsels.

GSK Stockmann is a leading independent European corporate law firm with over 200 professionals across its offices in Germany and Luxembourg. It is the law firm of choice for real estate and financial services. In addition, it has deep-rooted expertise in key sectors including funds, capital markets, public, mobility, energy and healthcare. For international transactions and projects, it works together with selected reputable law firms abroad. Its advice combines an economic focus with entrepreneurial

foresight. In Luxembourg, GSK Stockmann is the trusted adviser of leading financial institutions, asset managers, private equity houses, insurance companies, corporates and fintech companies, with both a local and international reach. Its lawyers advise domestic and international clients in relation to banking and finance, capital markets, corporate/M&A and private equity, investment funds, real estate, regulatory and insurance, as well as tax.

AUTHORS



Mathilde Ostertag is a partner and heads the tax practice at GSK Stockmann in Luxembourg. Her areas of expertise include domestic and international tax law, in particular tax planning, private equity (venture capital), real estate, debt and other foreign investment structures. She also has in-depth knowledge on capital market and securitisation transactions, cross-border restructurings, inter alia, inbound and outbound migrations, mergers and acquisitions and debt restructuring. Mathilde holds a master's degree from the Université Robert Schuman, Strasbourg, and a postgraduate degree in Corporate and Tax Law (DJCE). She is President of the Ladies in Law Luxembourg Association (LILLA), which aims at actively promoting gender diversity and women in senior positions in the legal sector. She is also a member of the International Fiscal Association (IFA) and the International Bar Association (IBA), and publishes regularly. Mathilde is fluent in French, English, German and Portuguese.



Adrien Kleinschmidt is an associate at GSK Stockmann in Luxembourg. He studied at the University of Saarbrücken and the University of Metz and holds an LLM from the University of Trier with an emphasis on international and European tax law. Adrien's practice areas include international and European tax law, domestic Luxembourg taxation, tax planning and restructuring. He is a member of the IFA, and is fluent in English, German and French.

GSK Stockmann

44, Avenue John F. Kennedy
L-1855 Luxembourg

Tel: +352 2718 0200

Fax: +352 2718 0211

Email: luxembourg@gsk-lux.com

Web: www.gsk-lux.com



Trends and Developments

Contributed by:

*Jan Neugebauer, Alain Goebel and Marie Demmerlé
Arendt & Medernach see p.327*

Introduction

Tax disputes in Luxembourg are on the rise in terms of both quantity and complexity. At the same time, there is an increasingly systematic use of litigation by the tax authorities, with this trend expected to further intensify in the coming years. This is attributable to several factors, such as the increase in tax audits, and the absence of formal guidance from the tax administration paired with the implementation of particularly sophisticated new domestic legislation based on EU and international rules, onto a market whose approach to their interpretation is still less than consistent.

Impact of COVID-19

The state of emergency declared in the wake of COVID-19 ended on 24 June 2020, after which the Luxembourg court system resumed normal operations. During the state of emergency, several Grand Ducal regulations were passed that suspended the procedural deadlines for nearly all Luxembourg court proceedings, but this suspension has since been lifted for most of them.

Procedural Factors

Income tax audits

As in the preceding year, the pandemic had a considerable impact on the functioning of the Luxembourg tax administration in 2021, drastically restricting its ability to schedule visits to various parties, including on-site visits, or simultaneous inspections in co-operation with the Registration Duties, Estates and VAT Authority.

In recent years, the Luxembourg tax administration has been known to impose tax audits even in response to procedures that were only initiated as part of the exchange of information, in

particular by using requests received from foreign tax authorities and subsequent data. In relatively short order following the entry into force in January 2021 of the DAC 6 reporting obligations in Luxembourg, the tax administration launched a written audit procedure with regard to those obligations for certain intermediaries. This type of close scrutiny is expected to increase in the coming years, not just in relation to DAC 6 obligations, but also for FATCA and CRS.

It is also important to mention the work in progress that continued throughout 2021, including the digitalisation of the tax administrations and the domestic inter-administrative and judicial co-operation bill. These measures will enable the Luxembourg tax authorities to plan more precisely targeted tax audits and efficiently manage the increasingly large and complex data volumes at their disposal.

VAT audits

The last few years have seen the number of VAT taxpayers located in Luxembourg increase consistently, with the number of VAT audits keeping pace. The VAT authorities are moving away from traditional audit techniques involving manual data processing, towards new and digitalised techniques (such as online access to VAT accounts and submission of VAT refund claims) and sophisticated e-audits.

For VAT audits, the Luxembourg VAT authorities apply the OECD's Standard Audit File for Tax (SAF-T, also referred to as the Fichier Audit Informatisé AED, or as FAIA). SAF-T is a standard file designed to export data from the taxpayer's accounting or enterprise resource planning (ERP) system upon request by the VAT authori-

ties. In addition to static data, this file can include details of transactions from the general ledger, purchase and sales ledgers, fixed assets, and inventory. Strengthening digitalisation as well as increasing taxpayers' satisfaction in their relations with the authorities figure among the objectives of the Luxembourg VAT authorities' work programme "Zukunft AED" for 2022 to 2024.

Finally, a number of the VAT audits performed in Luxembourg are based on administrative co-operation and the automatic exchange of information between EU Member States. These may be triggered by reporting mismatches for cross-border supplies out of the VIES system, and may also concern specific questions for the VAT authorities' anti-fraud department on intra-community missing trader fraud, or "carousel fraud".

Relationship between taxpayers and the Luxembourg tax authorities

With respect to direct taxes, taxpayers who wish to contest their tax assessment must first lodge a complaint with the head of the direct tax authorities. The claim must be submitted in writing within three months of receipt of the tax assessment. The head of the direct tax authorities then has six months to give the taxpayer a formal answer. If no answer is given within this timeframe, the taxpayer can petition the administrative tribunal directly. Unfortunately, the latter has become more and more frequent and taxpayers have to wait the entire six months, before they are able to file a petition with the courts.

Where the response by the tax office and the head of the direct tax authorities is unfavourable, each of these authorities has a positive obligation to disclose the information that led them to modify the taxation applied to the taxpayer.

Even though in such context the head of the direct tax authorities has the power to adjust

taxation *in pejus* (ie, a taxpayer may find that, following submission of the claim, the head of the direct tax authorities opts to apply taxation even less favourable than that previously applied by the tax office), recent case law again confirmed that the head of the direct tax authorities must respect the adversarial principle when deviating substantially and unfavourably from the tax office's chosen treatment, which grants taxpayers additional protection in such a case.

Trends in Tax Litigation

Focus on a broad understanding of abuse of law

One thing that both the tax administration and the courts have recently been homing in on is the broad concept of abuse of law. Here, the recurring subjects in recent Luxembourg case law are, in particular:

- the use of tax loss carry-forwards;
- financing instruments;
- restructuring;
- fiscal unity; and
- retroactive mergers.

The Luxembourg tax authorities may use a variety of different legal bases to challenge a given type of structure or transaction, some favourites being the general anti-abuse rule, the provisions on hidden dividend distributions and the arm's-length principle.

It is frequently pointed out that the taxpayer is entitled to choose the path of least taxation, subject to the possibility that the chosen method could be recharacterised as an abuse of law. In a recent case, an abuse of law was asserted as grounds for denying a claim to deduct depreciation on goodwill, but in the final decision of 26 October 2021 by the administrative court, the judges rejected the position of the tribunal and the tax authorities, stating that the cumulative

conditions for an abuse of law had not been met. These were:

- the use of forms or institution of private law;
- a circumvention or reduction of the tax burden;
- the non-genuine character of the legal route chosen; and
- the absence of valid economic reasons justifying the legal route chosen.

In another recent case, the Luxembourg tax administration successfully defeated a taxpayer's argument that in Luxembourg, mandatorily redeemable preference shares (MRPS) can be treated as debt for tax purposes. (In this case the court did not deem it necessary to consider the concept of abuse of law, having found it sufficient merely to consider the nature of MRPS.) In essence, the administrative court rejected the argument that, based on an economic approach, the MRPS should be treated as debt for Luxembourg tax purposes, instead determining that they should be treated as equity. Still, the court seemed open to the idea that such an economic approach could apply with regard to purely contractual arrangements (as had already been indicated in prior case law).

Based on constant case law, while a tax structure may be found abusive, an abuse of law cannot be presumed; the Luxembourg tax authorities must provide prima facie evidence of its existence. If they can do so, the burden of proof is shifted to the taxpayer, which must then prove that its structure is not abusive by demonstrating, for example, that there are valid economic reasons for it and/or that it does not create a tax advantage. The provision of prima facie evidence of existence of abuse is thus a powerful tool for taxpayers in such context.

OECD/EU influence on Luxembourg abuse of law

It should be stressed that the concept of abuse of law rests on the idea that tax law cannot be circumvented by an abuse of legal forms and institutions. With effect from 1 January 2019, the new general anti-abuse rule (the GAAR) deriving from the Luxembourg law of 21 December 2018 implementing Council Directive (EU) 2016/1164 (the ATAD I) introduced certain amendments to align the existing abuse of law concept with the ATAD I concept of artificial arrangements. The resulting concept of abuse of law developed in Luxembourg retains the principal features of its predecessor (according to which "tax law cannot be circumvented by an abuse of forms and legal constructions") while also tying in concepts from the GAAR stemming from the ATAD I.

The new Luxembourg definition of abuse of law is not expected to have too great an impact in Luxembourg, and the existing case law on abuse of law is likely to remain largely relevant. The aim of the new Luxembourg definition of abuse of law is to supplement the provisions already in force to integrate the anti-abuse clause from the ATAD I and ensure a degree of continuity of application.

However, no judgments have yet been issued based on the new Luxembourg definition of abuse of law, and only time will tell.

Generally speaking, the legal anti-abuse toolkit relevant to taxation has certainly been reinforced in recent years: both by EU legislation through a series of directives, such as the ATAD I, and by the Organisation for Economic Co-operation and Development (OECD) with a multilateral instrument amending bilateral tax treaties (in particular, with a broad anti-abuse rule based on a principal purpose test). In addition, recent rulings by the European Court of Justice provide further interpretation of EU law in the con-

text of abuse of law. With the “Danish cases” (C-116/16, C-117/16, C-115/16, C-118/16, C-119/16 and C-299/16), the European Court of Justice addressed domestic anti-abuse measures in the framework of the EU Parent-Subsidiary Directive and the EU Interest and Royalties Directive, and clarified the concept of beneficial ownership. The European Court of Justice will likely continue to refine the scope of this concept in its forthcoming decisions with a view to harmonising EU tax law.

The European Commission and the judgment by the European General Court in May 2021 in the *Engie* case have also shed new light on the concept of abuse of law. They consider that the non-application of an anti-abuse provision could in itself constitute illegal state aid. In the *Engie* case, both *Engie* and the Luxembourg tax authorities denied that tax benefits constituted state aid, but the judges saw the structure in place as being in apparent conflict with the intentions of the Luxembourg legislature. An appeal has now been filed against this judgment, and the European Court of Justice is expected to render its decision in 2022.

Other direct tax disputes

Increasingly, the Luxembourg tax authorities are using the liability of company directors to ensure the payment of tax debt. This is done by means of an *appel en garantie*, a secondary liability proceeding. What makes this such an effective tool is that it enables the Luxembourg tax authorities to choose freely among the liable parties and, in certain circumstances, even to petition for the payment of tax debt incurred by the company before the targeted director was appointed. In addition, where more than one party is liable, although the liability is joint and several, the tax administration can opt to bring its action against just one or a selection of the parties, provided that makes an effective and explicit assessment

of the particular circumstances leading to the decision to sue only those parties.

Another trend concerns the principle of regular bookkeeping, and the increasingly stringent assessment of taxpayers’ correct application of Luxembourg generally accepted accounting principles. More and more, the Luxembourg tax authorities perform a detailed audit of annual accounts with a focus on the principle of clarity (which requires that financial statements be easy to read and understand). For example, several Luxembourg court decisions have expressly noted that taxpayers must make a clear link between accounting figures and supporting documentation. This is particularly important for taxpayers because, in case of a challenge, the Luxembourg tax authorities will no longer be bound by the accounting and it will therefore be more difficult for them to contest the tax assessment issued by the Luxembourg tax authorities.

Finally, taxpayers should bear in mind the ongoing evolution in Luxembourg of legislation and case law in the field of exchange of information, eg, the *Berlioz* case (C-682/15) and *Berlioz bis* cases (C-245/19 and C-246/19) out of the European Court of Justice. The question of what constitutes foreseeable relevance of requested information and procedural rules is regularly refined by decisions of the Luxembourg courts. With respect to these developments, the European Court of Justice once again has a particularly important role to play, including via the use of preliminary rulings, with a direct impact on Luxembourg court decisions.

Transfer pricing disputes

In light of the recent update of the OECD transfer pricing guidelines, the Luxembourg tax authorities regularly monitor the compliance of structures with applicable transfer pricing rules.

In particular, the authorities are paying more attention to the taxpayer's application of the arm's-length principle and whether the taxpayer is able to justify interest rates through a transfer pricing report and appropriate documentation to support the pricing of transactions. Both the tax authorities and the courts are inevitably less receptive to transfer pricing studies undertaken when litigation is already underway.

It should be noted that taxpayers have been afforded greater legal certainty as to the application of the arm's-length principle to profit-participating loans, by a final decision of the administrative tribunal of Luxembourg issued on 13 July 2021. Here, the tribunal held that interest on profit-participating loans cannot be recharacterised as a hidden profit distribution as long as it can be shown that it does not exceed arm's-length interest. This judgment is one of the few major transfer pricing decisions in Luxembourg case law.

VAT disputes

The past few years have seen an increase in the number of VAT disputes in Luxembourg (in 2021, 51 cases were tried against decisions of the VAT authorities), as well as in the complexity of such cases. These disputes relate to a broad range of VAT topics, and may concern the taxation imposed by the authorities on taxpayers, procedural aspects or director liability. In 2021, the Luxembourg courts issued nearly 30 VAT decisions. The vast majority of such cases are decided in favour of the VAT authorities.

As ever, a major topic for VAT disputes is tax neutrality, a core principle of the VAT system providing that businesses party to taxable transac-

tions should not bear the cost of VAT. Due to the large number of Luxembourg-based companies that engage in holding or financing activities, the right to deduct input VAT remains a key issue for VAT disputes at the local level. In litigation, the Luxembourg VAT authorities unfailingly demand proof of a direct and immediate link between the costs for which the taxpayer asserts input VAT to be deductible and the output activity entitling it to deduct input VAT.

Litigation is time-consuming, and it may be several years before a final decision is reached in Luxembourg. It is therefore advisable to try to resolve the VAT questions raised by the authorities in the pre-litigation phase of the VAT claim process (by contesting the VAT assessment with the director of the Luxembourg VAT authorities, within the deadlines set by the Luxembourg VAT law).

Final Notes

The development of fiscal policy and practice has accelerated even further in recent years. Combined with the increase in tax litigation and audits, this phenomenon should prompt taxpayers to review their business models regularly and carefully, in order to identify and mitigate tax risks stemming from new legislation and evolving case law in Luxembourg. Finally, with respect to criminal tax litigation, this is likely to pick up pace, given the addition of tax crimes to the list of primary anti-money laundering offences and the decision to increase the staff of Luxembourg's Financial Intelligence Unit over the last few years, including with tax specialists. In the near term, these intensifying measures are unlikely to be without a corresponding rise in litigation.

Arendt & Medernach is a leading legal, tax and business services firm of lawyers, regulatory consultants, business advisers, and tax, corporate and funds services experts. The firm bridges the gap between legal advice and its implementation, and takes an integrated approach to solving clients' business issues. As the leading independent business law firm in Luxembourg,

the firm's international team of 380 legal professionals represents clients in all areas of Luxembourg business law, with representative offices in Hong Kong, London, New York and Paris. Its service to clients is differentiated by the end-to-end specialist advice it offers, covering all legal, regulatory, taxation and advisory aspects of doing business in Luxembourg.

AUTHORS



Jan Neugebauer is a partner in the Tax Law practice of Arendt & Medernach. He specialises in both national and international tax structuring for corporate entities and private investment

funds, including private equity, buyout, real estate and debt funds. He advises on a broad range of issues, including leveraged and management buyouts, secondary transactions, divestments and distributions, real estate transactions, M&A cross-border transactions and finance taxation (including refinancing and distressed debt work). Jan's expertise encompasses tax questions related to the structuring of capital market transactions, including IPOs, debt issuance, as well as structured finance vehicles.



Alain Goebel is a partner in the Tax Law practice of Arendt & Medernach, where he advises an international clientele on the tax and transfer pricing aspects of Luxembourg and cross-

border transactions, in particular corporate reorganisations, acquisitions and financing structures. He has published several papers on tax law, including national reports for IFA and AIJA, and is co-author of the Luxembourg chapter of the International Guide to the Taxation of Holding Companies published by the IBFD (Amsterdam). He has been a member of the Luxembourg Bar since 2002. He is a member of ALFI, LPEA, IFA and AIJA.

*Contributed by: Jan Neugebauer, Alain Goebel and Marie Demmerlé, **Arendt & Medernach***



Marie Demmerlé is a senior associate in the Tax Law practice of Arendt & Medernach. She specialises in domestic and international tax advisory matters, focusing on

multinational corporations, private equity and the real estate fund industry. She advises regulated and unregulated investment fund structures on general and international tax planning, as well as tax matters related to cross-border reorganisations. She has experience in all areas of Luxembourg income tax law, with an emphasis on corporate taxation.

Arendt & Medernach

41A avenue JF Kennedy
L-2082 Luxembourg

Tel: +352 40 78 78 288
Email: franck.hamann@arendt.com
Web: www.arendt.com



Law and Practice

Contributed by:

Ana Pinto Moraes, Rui Filipe Oliveira and Tiago Vilhena

MdME Lawyers see p.347



CONTENTS

1. Tax Controversies	p.331	5.3 Judges and Decisions in Tax Appeals	p.341
1.1 Tax Controversies in this Jurisdiction	p.331	6. Alternative Dispute Resolution (ADR) Mechanisms	p.341
1.2 Causes of Tax Controversies	p.331	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.341
1.3 Avoidance of Tax Controversies	p.331	6.2 Settlement of Tax Disputes by Means of ADR	p.341
1.4 Efforts to Combat Tax Avoidance	p.331	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.341
1.5 Additional Tax Assessments	p.332	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.341
2. Tax Audits	p.333	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.341
2.1 Main Rules Determining Tax Audits	p.333	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.341
2.2 Initiation and Duration of a Tax Audit	p.333	7. Administrative and Criminal Tax Offences	p.341
2.3 Location and Procedure of Tax Audits	p.334	7.1 Interaction of Tax Assessments with Tax Infringements	p.341
2.4 Areas of Special Attention in Tax Audits	p.334	7.2 Relationship between Administrative and Criminal Processes	p.342
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.334	7.3 Initiation of Administrative Processes and Criminal Cases	p.342
2.6 Strategic Points for Consideration during Tax Audits	p.335	7.4 Stages of Administrative Processes and Criminal Cases	p.342
3. Administrative Litigation	p.335	7.5 Possibility of Fine Reductions	p.342
3.1 Administrative Claim Phase	p.335	7.6 Possibility of Agreements to Prevent Trial	p.343
3.2 Deadline for Administrative Claims	p.337	7.7 Appeals against Criminal Tax Decisions	p.343
4. Judicial Litigation: First Instance	p.337	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.343
4.1 Initiation of Judicial Tax Litigation	p.337	8. Cross-Border Tax Disputes	p.343
4.2 Procedure of Judicial Tax Litigation	p.338	8.1 Mechanisms to Deal with Double Taxation	p.343
4.3 Relevance of Evidence in Judicial Tax Litigation	p.338	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.343
4.4 Burden of Proof in Judicial Tax Litigation	p.338		
4.5 Strategic Options in Judicial Tax Litigation	p.338		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.339		
5. Judicial Litigation: Appeals	p.339		
5.1 System for Appealing Judicial Tax Litigation	p.339		
5.2 Stages in the Tax Appeal Procedure	p.340		

8.3	Challenges to International Transfer Pricing Adjustments	p.343	10.5	Existing Use of Recent International and EU Legal Instruments	p.344
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.343	10.6	New Procedures for New Developments under Pillar One and Two	p.344
8.5	Litigation Relating to Cross-Border Situations	p.343	10.7	Publication of Decisions	p.344
9. State Aid Disputes		p.344	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.344
9.1	State Aid Disputes Involving Taxes	p.344	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.344
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.344	11. Costs/Fees		p.345
9.3	Challenges by Taxpayers	p.344	11.1	Costs/Fees Relating to Administrative Litigation	p.345
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.344	11.2	Judicial Court Fees	p.345
10. International Tax Arbitration Options and Procedures		p.344	11.3	Indemnities	p.345
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.344	11.4	Costs of ADR	p.345
10.2	Types of Matters that Can Be Submitted to Arbitration	p.344	12. Statistics		p.345
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.344	12.1	Pending Tax Court Cases	p.345
10.4	Implementation of the EU Directive on Arbitration	p.344	12.2	Cases Relating to Different Taxes	p.345
			12.3	Parties Succeeding in Litigation	p.345
			13. Strategies		p.345
			13.1	Strategic Guidelines in Tax Controversies	p.345

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

The number of tax disputes in Macau is historically low. This has changed significantly since 2014, due to the tax authority's increase of audits which ultimately led to an increase of tax controversies and litigation. Most tax controversies arise as a result of tax reassessments and tax assessments following tax audits.

1.2 Causes of Tax Controversies

Recent disputes relating to tax matters mostly relate to stamp duty, complementary income tax ("profits tax"), tourism tax and motor vehicle import tax. The most relevant stamp duty disputes relate to whether certain documents and transactions should be subject to stamp duty, including transactions involving real estate property, lease agreements, grant of use agreements relating to the use of retail spaces in shopping centres and the adjudication on auctions. The range in value of these disputes is very wide, in accordance with the tax base. For example, each stamp duty dispute involving grant of use contracts and real estate property transfers can reach tens of millions of patacas, whereas tourism tax and complementary income tax disputes may involve, each, a few million per year.

1.3 Avoidance of Tax Controversies

There aren't many legal mechanisms currently available to prevent tax controversies. For example, it is not currently possible to seek tax agreements or binding opinions from the tax authority in relation to tax issues. One of the possibilities available to prevent tax disputes is to consult with the tax authority on their views, both in relation to specific transactions and with the interpretation of tax laws.

Although there is currently no specific tax procedure to request the tax authority's opinion on

tax issues, the tax authority is, under the principles of co-operation, good faith and decisions applicable to administration in general, obliged to provide information, namely on tax matters, to private individuals and corporations. As such, taxpayers may always seek, both verbally and in writing, the tax authority's opinion on specific tax queries they may have. The Macau tax authority is usually responsive and co-operative in replying to such queries, although, in more complex issues, such replies may take time (usually two to three months).

The legislative process for approval of a tax code is currently ongoing (the "new tax code"). Under the initial draft of the new tax code, the above principles are densified in several legal provisions to establish the tax authority's duty to provide written, clear, detailed and complete information in relation to any tax issues, including the interpretation of tax laws and the status of their tax affairs, as well as legal recourse mechanisms in case the latter fails to comply with such duties.

Although the information obtained from the tax authority will not be binding, if provided in writing it will exempt taxpayers from any liability resulting from non-compliance with their ancillary tax obligations (but not exempt them from payment of any tax due). Under the draft bill to the new tax code, transfer pricing agreements may also be previously requested and agreed with the tax authority, in which case they will be binding and limit the ability to make corrections to the taxable income.

1.4 Efforts to Combat Tax Avoidance

In 2019, the Macau Legislative Assembly amended the Complementary Income Tax Law (CTL) to implement OECD's Action 13 on Base Erosion and Profit Shifting (BEPS Action 13) to define and impose on large multinational enterprises (MNEs) based in the Macau SAR

to prepare a country-by-country (CbC) report with aggregate data on the global allocation of income, profit, taxes paid and economic activity among tax jurisdictions in which it operates. Only final mother entities of MNEs with a total income exceeding MOP7 billion (approximately USD866 million), according to their consolidated financial statements, are required to comply with such disclosure obligations.

Consistently, in 2020, new accounting standards were approved, which included IFRS 10, establishing, for the first time, the obligation for certain entities to prepare consolidated accounts. The new accounting standards became mandatory from the financial year of 2022 onwards, except for final mother entities, in relation to which the standards became applicable to their 2019 accounts onwards. As only a few entities based in Macau qualify under these requirements, no increase to tax controversies associated with these changes is yet recorded.

In 2017 Law 5/2017 was approved, establishing the general legal framework for the exchange of tax information with other regional and international tax jurisdictions. Together with the amendments to the CTL, they form the legal framework for cross-border exchange of information and co-operation between tax jurisdictions. This system provides for:

- the exchange of information on request of a foreign tax authority;
- spontaneous exchange of information; and
- automatic exchange of information for certain entities, which include foreign tax residents, multinationals based in Macau and other individuals and entities defined in international treaties.

As a result, since 2019 the use of cross-border information exchange and mutual assistance among tax authorities has risen, which had an

impact on tax audits and exchange of information. Such an impact is expected to translate into an increase of disputes in the short term.

1.5 Additional Tax Assessments

Additional tax assessments may be disputed by administrative and judicial claims. The legal recourse mechanisms to dispute the tax assessments are not uniformised and are scattered throughout the tax laws applicable to each type of tax. As a matter of principle, taxpayers will have to use two routes to dispute additional tax assessments:

- administrative review, which includes a review application to the same body that has issued the decision and a hierarchical appeal; and
- judicial review.

Also, as a matter of principle, taxpayers will have to follow the administrative review process before they can submit the case to court. The administrative review process usually suspends the enforcement of the decision, whereas the judicial review does not. As such, in case the taxpayer does not pay the additional tax due during the judicial process stage, the tax debt may be enforced directly by the tax authority under tax enforcement proceedings. Should the taxpayer wish to avoid any foreclosure of its assets, it will have to pay the tax (which shall be refunded if the assessment is annulled by the court) or provide a bond during the tax enforcement proceedings.

For those taxes which require taxpayers to submit tax statements declaring the taxable events, both administrative and criminal penalties may be applicable if taxpayers do not declare their taxable income in a timely and accurate manner. Such penalties, however, vary significantly depending on the type of statement, the tax involved and the fault of the taxpayer. Failing to pay the tax due following a tax assessment

may imply penalties and interests, which, again, depend on the type of tax involved. For example, failure to pay stamp duty tax following an additional tax assessment may imply the payment of a fine that can reach three times the amount of tax due, whereas for other stamp duty tax obligations, the fine can go up as much as ten times the amount of the tax due.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The Macau tax system is fundamentally based on the taxpayer's self-assessment or, in certain cases, on its assessment and withholding by other tax subjects. As such, the tax authority's audits are mostly focused on the taxpayer's tax statements (or lack thereof).

Tax audits are commonly triggered due to inconsistencies in the taxpayers' statements, either intrinsic or when cross-examined with other taxpayers' statements. Although the tax administration is subject to a duty of legality and, as such, to pursue all indications of tax evasion or irregularities, tax audits may also be randomly determined based on a predetermined policy. Most tax audits are focused on specific issues or transactions which are previously detected or queried by the tax authority, as opposed to a full inspection.

Despite the plethora of statutes resulting from each tax law applicable to each type of tax including their own rules regarding tax audits, such rules are quite standardised. The tax authority's audit rights include the right to request any information and documents from taxpayers and from other government departments, as well as the right to inspect taxpayers and other tax subject's books.

The 2020 reform to the stamp duty law has significantly expanded the tax authority's audit powers regarding stamp duty. Under the revised stamp duty law, the tax authority may have access to any commercial and industrial establishments, shops, warehouses, financial institutions, auction houses, clubs and government premises to conduct audit inspections, including, if necessary, by requesting police authorities' assistance in case of refusal or resistance. In relation to stamp duty, the tax authority may also request information from any third parties, and certain entities traditionally subject to professional privilege duties (such as lawyers, accountants, insurers and financial institutions) are excluded from such duty and required to provide any information relating to payment of stamp duty.

Depending on the type of tax involved, certain government departments and other public officials (such as notaries, registrars, and the land and public works department) have the duty to regularly report to the tax authority certain events which may be relevant to verify the tax statements and inspect compliance with the taxpayers' obligations.

2.2 Initiation and Duration of a Tax Audit

Tax audits should be concluded within a maximum period of 90 days. Such a deadline may be extended for an additional period of 90 days based on the complexity of the issues or the need to involve other public or private entities in the audit. Failure to comply with such time limits, however, does not have any implications on the audit itself. Tax audits that are focused on specific issues or transactions are normally concluded within 60 days, but the duration may vary depending on the complexity of the issues involved and on the taxpayer's co-operation and ability to provide relevant information.

Tax audits, however, do not suspend the statute of limitation period. There are statutes of limitation applicable to the right of the tax authority to assess any tax due (five years) and to the right to demand payment of the tax after its assessment (which may range from five to 20 years, depending on the type of tax involved). The commencement of such periods varies for each type of tax. As such, taxpayers and other tax subjects who are required to assess and collect taxes are normally required to keep the relevant books and information available for a period of five years.

The lapse of the statute of limitation period applicable to the tax assessment may allow the taxpayer to refuse to provide the information requested by the tax authority, provided such information is not relevant to assess the taxes relating to other financial years which have not yet fallen within the statute of limitation period. However, since 2022, if the information requested by the tax authority is based on a cross-border information request, the five-year statute of limitation period may not be used to prevent any audit or information request.

Under the draft bill for the new tax code, it is anticipated that a report on the tax audit will be prepared within 30 days from when the audit is concluded, but there is currently no special provision setting out a different duration of the tax audit.

2.3 Location and Procedure of Tax Audits

Tax audits may be conducted by (i) requesting information and documents to be provided and submitted by the taxpayer, or (ii) inspection of books and documents, normally at the taxpayers' offices.

Inspection of books and documents is normally based on printed documents. As a matter of principle, the tax authority should notify the

taxpayer prior to any inspection to inform them an inspection will take place. Such notification should include the date and time of the inspection and, in most cases, an indication of the documents and/or transactions to be inspected. The draft bill for the new tax code expressly provides that inspections may include testing of the software systems used in the bookkeeping of the taxpayer, which may result in a shift towards electronic data inspections.

2.4 Areas of Special Attention in Tax Audits

As previously discussed, tax audits are, in most cases, addressed to specific issues or transactions in relation to which the tax authority has found some inconsistency or indication of irregularity. The range of matters normally involved is, therefore, wide. Taxpayers who are required to have audited accounting need to have their books organised and available at their head office. Failure to provide books and documents may result in fines and allow the tax authority to assess taxes based on presumptive methods.

Typical issues raised during tax audits are the tax deductibles, in particular costs with consultants, costs resulting from businesses carried overseas, provisions for bad debt and related parties' transactions.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Macau is continuously improving its legal framework regarding cross-border exchange of information. In addition to the increasing number of treaties and regional agreements on the matter, Macau has enacted the general legal framework on cross-border exchange of information in 2017 (Law 5/2017), which was recently amended by Law 1/2022. The recent changes mainly concern:

- the inclusion of the non-mandatory central providence funds and private pensions under the scope of cross-border exchange of information;
- the elimination of the five-year restriction to the time period in relation to which the information could be requested; and
- the inclusion of additional penalties relating to the breach of duties relating to the automatic exchange of information.

Although it is not clear whether the topics are related, an increasing scrutiny on related party transactions, particularly transfer pricing methods, has been noted in recent years. Taxpayers have experienced some information requests based on cross-border exchange requests, but the total number of cases is likely still relatively low.

2.6 Strategic Points for Consideration during Tax Audits

The fundamental considerations to observe in the context of a tax audit are mostly of a preventative nature: (i) proper bookkeeping, and (ii) its form and substantial consistency. During a tax audit, taxpayers are advised to clearly understand the scope and focus of the audit and to provide co-operation based on this.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

The Macau legal system provides a general right for individuals and private corporations to seek the judicial review of all decisions taken by the administration which may affect them. Naturally, this includes the taxpayer's right to dispute the tax authority's decisions relating to tax matters.

There is, however, no unified regime for tax disputes. The rules and procedures for taxpayers to

contest and challenge the tax authorities' decisions relating to tax matters are provided in the laws that set and regulate each tax. This makes the system quite complex and, in certain cases, inconsistent, creating a prolonged phase of administrative litigation and a de facto division in the judicial system, where both the Administrative Court (which is a court of first instance) and the Court of Second Instance serve as courts of first instance, depending on the tax and type of decision involved.

With virtually all taxes, an administrative litigation phase mandatorily precedes the judicial review. The government administration is fundamentally organised under a hierarchical structure and, as a matter of principle, an administrative decision can only be judicially challenged after the administrative process becomes definitive, ie, once the decision can no longer be further reviewed within the administration's structure. This means that taxpayers are required to exhaust the administrative review procedures before they can finally be submitted to the courts. The administrative recourse path, however, is different depending on the type of decision taken by the tax authority.

The administrative recourse means generally available are (i) tax reviews, which are normally performed by the same entity that has issued the decision or, exceptionally, by another body which is not in a hierarchical position, and (ii) hierarchical appeals. These mechanisms may be necessary, when the law requires the taxpayer to use them prior to submitting the case to a judicial review, or optional, when the law allows taxpayers to submit any decision immediately to court.

Administrative reviews are to be submitted within 15 days from the decision being notified to the taxpayer. Hierarchical appeals may be optional or mandatory. Mandatory hierarchical appeals

are to be submitted within 30 days and optional hierarchical appeals to the Chief Executive are to be submitted within two months, whereas other optional hierarchical appeals are to be submitted within 45 days.

The mandatory administrative reviews and hierarchical appeals suspend the effects of the decisions challenged, which means the tax authority will be prevented from proceeding to collect the debt before the matter is decided.

Complementary Income Tax

The review of the taxable profit assessment made by the tax department needs to first be submitted to a Review Committee (“the Complementary Tax Review Committee”). The administrative review needs to be submitted within 15 days from the decision being notified to the taxpayer and suspends the liquidation and computation of the amount of the tax due. The decision of the Complementary Tax Review Committee may then be submitted to judicial appeal to the Administrative Court. The deadline to submit the judicial appeal to the Administrative Court is 45 days.

Any other decisions relating to the assessment, liquidation, notification and penalties applicable in connection with tax matters are required to be submitted to the administrative review by the Director of the Macau Finance Department, and also to be filed within 15 days from the notification. The Director of the Macau Finance Department’s decision is then subject to an administrative hierarchical appeal to the Macau Chief Executive, whose authority is delegated to the Secretary for Economy and Finance. This hierarchical appeal needs to be submitted within two months. The decisions issued by the Chief Executive or by the Secretary for Economy and Finance may then be submitted to a judicial appeal, to be lodged with the Court of Second Instance, which, in this case, will serve as a

first-instance court. The deadline for the judicial appeal is two months.

Professional Tax

Similar to the complementary tax, the review of the assessment of the taxable income subject to professional tax needs to first be submitted to a Professional Tax Review Committee. The decision of this Review Committee is subject to judicial appeal to the Administrative Court.

Also, any other decisions relating to the assessment, liquidation, notification and penalties applicable in connection with tax matters are required to be submitted to administrative review by the Director of the Macau Finance Department.

The latter’s decision is then subject to a mandatory hierarchical appeal to the Chief Executive or to the Secretary for Economy and Finance prior to being submitted to judicial review. The judicial review of the hierarchical decision issued by the Chief Executive or the Secretary for Economy and Finance belongs to the Court of Second Instance, which serves as court of first instance for such matters.

Stamp Duty Tax

The review of the officious or additional liquidation of stamp duty payable for the transfer of real estate property which is based on the dispute of the value attributed to the property is necessarily subject to administrative review by a Review Committee (the “Stamp Duty Review Committee”). The decision of the Stamp Duty Review Committee may then be subject to judicial review by the Administrative Court.

Similar to professional and complementary tax, any other decisions relating to the assessment, liquidation, notification and penalties applicable relating to stamp duty are required to be submitted to administrative review by the Director of the Macau Finance Department.

The latter's decision is then subject to a mandatory hierarchical appeal to the Chief Executive or to the Secretary for Economy and Finance prior to being submitted to judicial review. The judicial review of the hierarchical decision issued by the Chief Executive or the Secretary for Economy and Finance belongs to the Court of Second Instance, which serves as court of first instance for such matters.

3.2 Deadline for Administrative Claims

Please refer to **3.1 Administrative Claim Phase**.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

The Macau judicial system is composed of a three-tiered hierarchical court system, which includes the Courts of First Instance, comprehending the Judicial Based Court and the Administrative Court, the Court of Second Instance and the Court of Final Appeal. Despite the Macau judicial system Basic Law stipulating the general competence of the Administrative Court to rule on administrative, fiscal and customs matters, the Court of Second Instance serves, in many tax disputes, as a court of first instance. This is the result of a forum privilege granted to certain judicial disputes involving the decisions issued by the members of the highest bodies of the administration, which include decisions on tax matters.

Whether a decision is submitted for judicial review to the Administrative Court or to the Court of Second Instance depends on the administrative procedure, in particular, the government body that issues the final administrative decision. If such a decision is issued by the Macau Chief Executive or one of the Secretaries, the competent court to review the case as court of first instance is the Court of Second Instance. If such

a final decision is issued by a lower rank court, the competent court is the Administrative Court. For example, under the Complementary Income Tax Law, the administrative decision determining the taxable income is subject to review by a Review Committee. The decision issued by the Review Committee is final and may be judicially appealed to the Administrative Court.

On the other hand, the decision issued by the Tax Bureau's Director regarding stamp duty assessment is subject to (i) administrative review by the Director and, subsequently, (ii) mandatory hierarchical appeal to the Macau Chief Executive. From the Macau Chief Executive's decision, the taxpayer may seek its judicial review from the Court of Second Instance.

However, if the Tax Bureau Director's decision consists of an additional assessment or ex officio assessment relating to stamp duty applicable to the transfer of real estate property and the reason for the dispute is the valuation of the assets made by the tax administration, the assessment is subject to (i) administrative review by a Review Committee and, subsequently, (ii) judicial appeal to the Administrative Court.

The decisions issued by the tax administration may be judicially challenged once they become administratively definitive, ie, they are issued by the body that, in the administrative chain, has the final word. This entity varies depending on the type of decision involved. The legal recourse available is the judicial review (also designated as judicial appeal). Generally, taxpayers have 45 days to submit the tax authorities' decisions to judicial review. However, when the appeal is submitted from a decision issued by the Chief Executive or by the Secretaries, the deadline is two months.

The proceedings are initiated with a statement of claim, where the taxpayer will outline the

facts, legal arguments and evidence supporting its claim. This statement of claim is addressed and delivered to the competent court (either the Administrative Court or the Court of Second Instance) and should identify the decision under appeal and the government body that issued it. The taxpayer needs to be represented by a lawyer and submit and/or request all the evidence necessary to establish its claim, including documents, witnesses, and expert evidence.

4.2 Procedure of Judicial Tax Litigation

The first-instance process (which may take place at the Administrative Court or at the Court of Second Instance) is fundamentally divided into three stages, as follows.

- Pleadings – where the taxpayer submits its claim to the relevant government body and, eventually, any opposed interested parties are summoned to submit their defence.
- Evidence/trial stage – where the parties may be allowed to produce evidence which the court finds relevant to decide the case.
- Final arguments and court’s decision – in the final arguments, the taxpayer may claim additional causes for invalidation of the decision under review provided the taxpayer could only know or be aware of such causes after the decision had been issued. The taxpayer may also reduce its claim. The administrative body under appeal may also raise new objections and strike out causes in its final arguments.

When the Court of Second Instance acts as a first-instance court, the interim procedural decisions shall be taken by the judge rapporteur, whereas the judgment on the merits shall be issued by majority of a panel of three judges.

In judicial litigation, the Public Prosecutor also participates in the proceedings as an impartial party to defend legality and may issue its opinion

as to the decision to be issued by the court. After the final arguments and the Public Prosecutor’s opinion, the case is submitted to the court for a decision.

The decision issued by the court in the first instance may be appealed (please see **5.1 System for Appealing Judicial Tax Litigation**).

4.3 Relevance of Evidence in Judicial Tax Litigation

Most tax litigation fundamentally relies on documentary evidence. Witnesses may also be called, and expert evidence may also be requested. All evidence should be submitted to or requested by the court with the statement of claim. Although the courts are often lenient regarding the amendment of the witness roll, any subsequent changes to the evidence offered or requested may only be accepted by the court if the parties demonstrate they only became aware of relevant facts or evidence which may justify such change.

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof in civil tax litigation lies with the party that argues a fact in its favour. As such, the tax administration has the burden to prove the facts which support its decision, in particular the facts which support their tax assessment. The taxpayer has the burden to prove the facts which he/she claims to be relevant to dispute such a decision.

In criminal litigation, the burden of proof lies with the Public Prosecutor’s office, given the defendant’s presumed innocence (unless proved otherwise).

4.5 Strategic Options in Judicial Tax Litigation

As previously discussed, all the evidence and arguments supporting the claim must be submit-

ted with the statement of claim. Parties should choose carefully if they need witness and expert evidence and, if so, to apply for such evidence to be produced from the statement of claim.

When the administrative body that issued the decision files its defence, it is required to submit, at the same time, the administrative file which documents the administrative proceedings supporting the decision. A careful examination of such proceedings often provides additional documentary evidence or arguments to support the judicial review process.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Macau's tax system (written and unwritten) principles are inspired by the Portuguese tax system and, as such, both scholars' opinions and court decisions issued by the Portuguese courts are considered as reference by the Macau courts. The draft bill of the new tax code is fundamentally inspired by Portugal's General Tax Law, which will likely increase the references to the Portuguese courts' decisions and scholars' opinions.

As the Macau legal system begins implementing international recommendations on matters such as exchange of information, BEPS, double taxation and taxation of profits, international guidelines and interpretations provided by OECD and any relevant jurisprudence that may be issued in comparable jurisdictions are expected to become more relevant.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The decisions issued by the courts may be appealed under ordinary or extraordinary appeals.

Ordinary appeals are allowed for all decisions, subject only to general requirements, including standing and value. The court's decision can only be appealed if the claim value is over MOP15,000, irrespective of the decision being issued by the Administrative Court or by the Court of Second Instance as a first-instance court. The awards issued as first-instance decisions by the Court of Second Instance may be appealed to the Court of Final Appeal. However, whereas the appeal from the Administrative Court to the Court of Second Instance may dispute both factual judgement and matters of law, the appeal of the Court of Second Instance's decision to the Court of Final Appeal can only dispute matters of law (both substantive and procedural law) or be based on the nullity of the decision under appeal.

Tax decisions can only be subject to a double judicial review. As such, the decisions issued by the Administrative Court may only be reviewed by the Court of Second Instance, whereas the decisions issued by the Court of Second Instance as first-instance decisions will only be reviewed by the Court of Final Appeal.

Extraordinary appeals are based on specific (extraordinary) circumstances and only operate if the decision cannot be subject to ordinary appeal. The extraordinary appeal mechanisms include:

- the appeal based on contradictory decisions; and
- the revision appeal.

Parties may use the appeal based on contradictory decisions in the following circumstances:

- when a decision issued by the Court of Final Appeal contradicts another decision from the same court;

- when a decision issued by the Court of Second Instance as a second-instance court contradicts another decision issued by the same court or by the Court of Final Appeal;
- decisions issued by the Administrative Court or by the Court of Second Instance, as first-instance decisions, that cannot be appealed due to their value or that relate to conflicts of jurisdiction and competence of the court, which are contradictory to a decision issued by the Court of Second Instance or by the Court of Final Appeal.

Decisions are considered to be contradictory when they fundamentally decide the same legal issue within the same substantial legal framework.

The revision appeal is based on very specific circumstances relating to external facts of the decision, including:

- malfeasance, concussion or corruption of the judge or any of the judges who intervened in the decision, demonstrated by a final judgement;
- falsification of a document or judicial act, of a testimony or of an expert statement, which may have determined the decision to be reviewed, which is demonstrated by a final decision issued by the court, unless the matter of falsity has been discussed in the proceeding in which the decision was rendered;
- the discovery of a document that, by itself, would be sufficient to modify the decision in a direction more favourable to the party;
- when it is shown that the summons was missing, or the summons effected is void; or
- when the decision is contrary to another that constitutes a *res judicata* decision for the parties, formed previously.

5.2 Stages in the Tax Appeal Procedure

The tax appeal procedure is initiated with a leave for appeal submitted by the losing party. Such a submission is addressed to the same court that has issued the decision. If the leave is not granted, the appellant may submit the issue to the justice president of the court of appeal or, if the rejection is issued by the Court of Second Instance, to the collective panel.

If the leave is granted, the appellant shall have 30 days to submit the arguments of appeal. The appellees shall have 30 days to submit their arguments to counter the appeal, counted from the expiry of the appellant's deadline. Following all the parties having submitted their arguments of appeal or expiry of their respective deadlines, the case will be submitted to the court of appeal.

In the court of appeal, the case will be distributed to a panel of three judges, with one of them being appointed the rapporteur and in charge of the procedural decisions necessary for the regular course of the proceedings, as well deciding any matters that would prevent the appeal from being trialled. If any of the parties intends to dispute any interim decision issued by the rapporteur, it shall be required to request the review of such a decision by the collective panel. The Public Prosecutor also intervenes in the appeal stage, except when the Prosecutor is the appellant or is representing the appellee.

Following the Public Prosecutor's opinion, the case is submitted to the rapporteur, who shall prepare a proposal for decision, which shall be discussed and voted on by the panel. If the decision of the majority is different from that proposed by the rapporteur, another justice will be appointed to prepare the draft decision accordingly.

After the vote, the decision will be issued and notified to the parties. Although the decision

issued by the court of appeal may not be subject to further ordinary appeal, the parties may still claim to the same court against any irregularities, obscurities or the nullity of the decision based on, for example, contradictions or omission to decide matters which formed part of the appeal.

5.3 Judges and Decisions in Tax Appeals

The decision issued by the Administrative Court is issued by a single judge, whereas the decisions issued by the Court of Second Instance and by the Court of Final Appeal are collective decisions, issued by three justices. Neither court has any specialised section or justice for tax matters, which obviously has an impact on the judicial system's efficiency.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Arbitration is not available for tax disputes under Macau law.

6.2 Settlement of Tax Disputes by Means of ADR

Due to the administration's duty to act strictly according to law, the tax authorities are not allowed to enter any settlements or contractual arrangements regarding tax matters. However, as noted before, under the draft bill for the new tax code, the tax authority may be allowed to enter into transfer pricing agreements, subject to certain requirements and conditions which will be set by a Macau Chief Executive order (which has not yet been announced).

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Tax controversies may not be settled by ADR mechanisms and no agreements can be reached to reduce tax assessments, interests or penalties.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Please refer to the answer provided under **1.3 Avoidance of Tax Controversies**.

6.5 Further Particulars Concerning Tax ADR Mechanisms

This is not applicable for this jurisdiction.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

This is not applicable for this jurisdiction.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Macau's tax system fundamentally relies on the taxpayer's obligations to self-assess and declare the relevant taxable events. Failure to comply or defective compliance with such obligations may result in administrative infringements and in additional tax assessments.

Tax infringements are typically administrative infringements which are subject to the payment of an administrative fine. The law usually defines a range which includes a maximum and minimum amount payable as a fine. Such penalties, however, can only be applied based on the taxpayer's fault. Additional tax assessments may result from events which are attributable to the taxpayer's fault or not.

Whenever the additional assessment results from irregularities caused by the taxpayer, such as failure to declare any taxable event or any misrepresentations in tax statements, a fine may apply. Such a fine may be higher if such actions are intentional and will be lower if the failure is due to negligence.

There are, however, circumstances where additional tax assessments may take place without any fault being attributable to the taxpayer, such as when the additional tax assessment results from a re-evaluation of the property being transferred, errors and mistakes by the tax authority, or when the taxpayer's failure is based on information provided by the tax administration.

7.2 Relationship between Administrative and Criminal Processes

No information on this topic is available.

7.3 Initiation of Administrative Processes and Criminal Cases

An administrative infringement process may be initiated whenever the tax authority finds any indication that the taxpayer has committed an administrative infringement. Where the tax authority finds any indication that a criminal offence may have been committed, it may report any evidence it may have in that respect to the Public Prosecutor for investigation.

There aren't many specific criminal tax offences and, as such, in most cases, the potential criminal implications relating to tax offences relate to document frauds, which is an intentional offence, ie, it can only be punished if committed intentionally. It is not common for tax infringement investigations to evolve into criminal cases, unless there is strong evidence of an intentional misrepresentation in a tax statement.

7.4 Stages of Administrative Processes and Criminal Cases

The administrative infringement process is entirely processed by the tax authority. The tax authority will investigate, charge and apply any fines resulting from the taxpayers' infringements. The decisions issued by the tax authority in that respect may be challenged to the Administrative Court.

Criminal proceedings are divided into three stages (i) the investigation stage; (ii) the pre-trial stage; and (iii) the trial stage.

The investigation stage is directed by the Public Prosecutor, which will investigate the relevant facts. Upon concluding the investigation, the Public Prosecutor may produce an indictment, if it finds sufficient evidence to do so, or archive the investigation. In case the Prosecutor decides to produce an indictment, the defendant may request such a decision to be reviewed by a pre-trial court, or simply let the matter go for trial.

During the pre-trial stage, the pre-trial court will review the Public Prosecutor's decision and decide on whether the case should be submitted to trial.

If the case is submitted to trial, a criminal court (which may be composed of one or three judges, depending on the type of crime and the penalties applicable), will issue a judgment on whether any criminal offence may have been committed. Both the judge(s) and the Public Prosecutor that participate in the case cannot have had any prior contact with the case.

7.5 Possibility of Fine Reductions

Generally, the voluntary submission of the taxable events determines a special reduction of the fines applicable.

7.6 Possibility of Agreements to Prevent Trial

The possibility for the Public Prosecutor to enter into any agreements in relation to criminal offences is very limited. In the event the criminal offence is punishable with imprisonment up to three years or only with a fine, the Public Prosecutor may agree to suspend the criminal proceedings for a period up to two years, subject to certain requirements, and to the defendant complying with certain injunctive measures, which may include payment of the taxes and other amounts due. In case the defendant complies with the obligations imposed, the case shall be archived and cannot be reopened. Although this mechanism is widely available, the Public Prosecutor is usually very reluctant to use it.

7.7 Appeals against Criminal Tax Decisions

The decisions of the criminal court are subject to appeal to the Court of Second Instance. The appeal may be filed by the defendant, if he is convicted, or by the Public Prosecutor, in case the defendant is acquitted.

The possibility to appeal from the Court of Second Instance's decision to the Court of Final Appeal is limited to criminal offences punishable with imprisonment over eight years.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Corrections made by the tax authority to the taxable base and disputes in that respect are frequent. As previously discussed, transfer pricing awareness is developing, and new rules will be enacted soon. We are not aware, however, of any disputes having evolved into tax infringements or criminal investigations.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Although Macau Law 2/2003 provides the Macau Chief Executive the authority to adopt any necessary measures to avoid double taxation situations, in practical terms the mechanisms available are international and regional tax treaties. Macau has currently entered into seven double taxation agreements with other jurisdictions, including Mainland China, Hong Kong and Portugal.

Disputes are usually resolved under the mutual agreement procedures provided under the treaties or, in certain cases, through administrative litigation. We are not aware of any situations involving judicial litigation.

8.2 Application of GAAR/SAAR to Cross-Border Situations

There are currently no relevant court decisions that may be used as reference in this respect.

8.3 Challenges to International Transfer Pricing Adjustments

No information is currently available on challenges to international transfer adjustments of Macau courts or any other mechanisms.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Please refer to **1.3 Avoidance of Tax Controversies** and **7.8 Rules Challenging Transactions and Operations in this Jurisdiction**.

8.5 Litigation Relating to Cross-Border Situations

Although the awareness and inspection activity by the tax authority relating to cross-border transactions is noticeably increasing, there is no current record of litigation in this regard.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

This is not applicable for this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

This is not applicable for this jurisdiction.

9.3 Challenges by Taxpayers

This is not applicable for this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

This is not applicable for this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Macau is currently not a party to the MLI. In any event, the DTTs entered into by Macau do not include arbitration clauses. The reason for this is the view that taxation is a matter of strict legality which does not allow any room for discretion by the administration and, as such, does not qualify for arbitration.

10.2 Types of Matters that Can Be Submitted to Arbitration

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.4 Implementation of the EU Directive on Arbitration

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.5 Existing Use of Recent International and EU Legal Instruments

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.6 New Procedures for New Developments under Pillar One and Two

The Macau tax authorities have publicly mentioned further consideration is required regarding the implications and impact of Pillars One and Two in the Macau economy, as well as its consistency with the low taxation principle on income taxes currently enshrined in the Macau Basic Law. In any event, it is unclear whether such implementation would have any relevant practical impact on any multinational enterprises with activity in Macau.

10.7 Publication of Decisions

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Please refer to **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

The administrative litigation process does not involve, as a matter of principle, any fees. Exceptions include the request for review of the taxable income to the Complementary Income Tax Review Committee – in case of rejection, the Review Committee may apply fees up to 5% of the tax due, and the request for review of the evaluation of real estate property to the Stamp Duty Review Committee, which may apply administrative fees of 5% of the tax due where the difference between the final evaluation and the initial valuation is less than 5%.

11.2 Judicial Court Fees

Court fees are due both in the first instance and in the appeal instance. The court fees in the first instance may range from MOP910 to MOP27,300 for the Administrative Court. If the case is submitted to the Court of Second Instance as a first-instance court, the fees may range from MOP1,365 to MOP36,400. Fees may be added for procedural incidents and costs for expenses incurred with witnesses, experts and mail.

Advance fee payments are required upon commencement of the proceedings, in the amount of MOP910 for the Administrative Court and MOP1,365 when the case is submitted to the Court of Second Instance as a first-instance court. Advances on account of expenses may be requested if the court is to incur costs relating to witnesses and experts. The final amount of fees will be determined by the judge, upon issuing their decision, based on the complexity of the matter and activity of the court.

11.3 Indemnities

Taxpayers may request payment of interest for any taxes paid in excess of the amount of tax due.

11.4 Costs of ADR

This is not applicable for this jurisdiction.

12. STATISTICS

12.1 Pending Tax Court Cases

Complete statistics are not available. As previously discussed, the judicial competence to resolve tax cases as a first-instance court is, in practical terms, divided between the Administrative Court and the Court of Second Instance. The Court of Second Instance does not provide individual statistics on tax disputes. As of May 2022, the number of pending tax cases in the Administrative Court is nine (including five judicial reviews and four tax enforcement proceedings).

12.2 Cases Relating to Different Taxes

Statistics relating to the different types of taxes are not available.

12.3 Parties Succeeding in Litigation

Statistics relating to the different types of taxes are not available.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The best approach to tax controversies is always to prevent any disputes with the tax authority (please refer to the answer provided in **1.3 Avoidance of Tax Controversies**). Taxpayers should always seek tax advice and have organised and well-kept bookkeeping. Taxpayers should also be precise and clear when providing

any information to the tax authority, focusing on the substance of the relevant issues and avoiding unnecessary queries or misunderstandings which may increase the complexity of the matters involved.

MdME Lawyers is an international law firm with offices in Macau, Hong Kong and Lisbon and a strong reputation in the Asia-Pacific region for providing high-quality and innovative legal insight to its clients.

AUTHORS



Ana Pinto Moraes is an experienced and qualified lawyer who joined MdME Lawyers in 2022 as counsel. She has over 16 years of professional experience in

domestic and international tax structuring, tax consultancy and strategic advice, assisting multinational groups, corporations and financial institutions, on a broad variety of international tax and corporate matters, including financial and operational restructurings. She also has extensive expertise regarding audit defence and tax investigations, as well as in high-profile projects related to energy, oil and gas, real estate in prime places, family wealth structuring and private wealth management. Ana has significant experience in tax advisory, with a focus on international taxation, treaties and EU directives, transfer pricing policies, corporate and individual income tax, stamp tax, tax benefits, VAT and general tax compliance services. Prior to joining MdME Lawyers, Ana worked with Andersen Tax & Legal and spent several years at PwC (Corporate and International Tax Structuring Group Lisbon).



Rui Filipe Oliveira is widely recognised as one of the leading business lawyers in Macau, and advises multinational and domestic corporations on a wide range of M&A transactions,

including complex corporate and financial restructurings, private investments and joint ventures. In particular, he has substantial experience working with local conglomerates on a range of corporate, governance, commercial and regulatory matters. Rui uses his multidisciplinary expertise to provide clients with valuable insight into complex transactions, delivering commercial outcomes at board and shareholder levels. In addition to his corporate work, Rui has a significant track record in dispute resolution, having advised in the context of a number of high-profile shareholders disputes, land concession and patent litigation.



Tiago Vilhena has over 15 years of experience in the market and is currently leading MdME Lawyers' Corporate Services practice. He is also the firm's key contact for the retail

industry, having been involved in the largest retail projects launched or announced in Macau since 2007 and representing key players in such projects. In his corporate and M&A practice, Tiago has assisted numerous global brands and major international groups and investors in establishing their businesses in Macau, providing continuous legal assistance to their entities. Tiago has also been involved in several cross-border acquisitions and restructurings and in major local retail and commercial projects. Over the years, Tiago has been able to anticipate risks and address clients with business-minded solutions that can be integrated with their corporate structure and commercial activities.

MdME Lawyers

Avenida da Praia Grande, 409
China Law Building,
21/F
Macau

Tel: +853 2833 3332
Fax: +853 2833 3331
Email: mdme@mdme.com.mo
Web: www.mdme.com.mo/en/

M d M E
L a w y e r s

Trends and Developments

Contributed by:

*Ana Pinto Moraes, Rui Filipe Oliveira and Tiago Vilhena
MdME Lawyers see p.358*

Introduction: General Overview of the Macau Tax System

Macau is a special administrative region of the People's Republic of China (the "Macau SAR"), created pursuant to Article 31 of the People's Republic of China's Constitution and enacted on 20 December 1999, following the handover of Macau's administration. Its fundamental law – defining its political, economic and legal system – is the Macau Basic Law, which includes several provisions on the Macau tax system. Pursuant to the principles of continuity and a high degree of autonomy set under the Macau Basic Law, the Macau SAR has kept its tax system fundamentally unchanged since the Portuguese administration. Its structural tax laws were approved in the final years of the 1970s and, despite legislative amendments, their fundamental architecture remains unchanged, regardless of being noticeably outdated.

As set forth under the Macau Basic Law, the Macau SAR adopts an independent tax system based on a low taxation policy; it has full autonomy to approve its tax laws and the state does not collect any taxes in Macau. All taxes are subject to the principle of legality, which implies that all tax laws need to be approved by the Macau Legislative Assembly and that the Macau government is not allowed to produce laws to create or amend taxes, although the legislative process is dependent on a proposal to be submitted by the latter.

The key taxes provided under Macau law can be summarised as follows.

Direct Taxes

- Industrial contribution tax, which is set as an annual fixed fee, the amount of which depends on the type of business operated in Macau and ranges from MOP150 to MOP80,000. For most businesses, the tax rate is MOP300.
- Professional tax, which is an income tax levied on the income from labour and other professional activities, at progressive rates ranging from 7% to 12% over the taxable income.
- Complementary income tax, which is levied on the profits deriving from commercial and industrial businesses, at progressive rates ranging from 3% to 12% over the taxable income.
- Urban property tax, which is an annual tax levied on the rental income or on the rental value of urban real estate property, at a standard tax rate of 6% for non-leased properties and 10% for leased properties.

Indirect Taxes

- Tourism tax, which is levied on the typical services provided by hotels and similar establishments, health clubs, saunas, massage parlours and karaoke venues, at a standard rate of 5%.
- Excise duty, which is levied only on the importation or production of certain alcoholic drinks and tobacco. The rate is 10% for alcohol, while the tax on tobacco is set on the basis of a fixed fee per unit or kilogram, depending on the type of product.
- Motor vehicle import tax, which is levied on the first transfer to the consumer of new motor vehicles or on the importation for self-use of new motor vehicles, based on the

estimated market value of the vehicle. The progressive tax rate is based on the vehicle's estimated value, ranging from 50% to 90% for automobiles and from 35% to 45% for motorcycles.

- Road tax, which is an annual tax levied on motor vehicles and industrial machines that is based on progressive fixed fees that depend on the cylinder capacity for motorcycles and automobiles, and on the gross weight for transportation vehicles and industrial machines.
- Stamp duty, which applies to certain documents and to the transfer of real estate property as well as on the transfer, for no consideration, of certain movable property that is subject to registration in Macau. The tax rate is set as a fixed fee, a standard rate or a progressive rate, depending on the documents/transactions involved. The Macau tax system on income is therefore essentially characterised by its schedular nature. The income derived from professional activities is taxed under professional tax, whereas income derived from commercial and industrial activity is taxed under complementary tax. The assessment of the taxable profit is determined differently for the two groups of taxpayers, as follows.

- (a) Group A taxpayers' taxable profits are determined based on their actual profits according to their accounts, prepared in accordance with the accounting principles applicable and eventually subject to corrections imposed under the Complementary Tax Law (CTL).
- (b) Group B taxpayers' taxable profits are determined based on their presumed profits as determined by a Fixation Committee. The low taxation policy, however, does not apply to the revenue to be obtained from concessions, which is, according to the Basic Law, subject to a special regime. The financial needs of the

Macau SAR largely depend on taxes collected from gaming revenues (in the pre-pandemic years, the gaming revenue generally exceeded 80% of the total ordinary income of the government) and, as such, the taxation of the gaming concessions is at a much higher rate, which is currently 35% over the gross gaming revenue. Most taxes are collected based on the taxpayer's obligation to self-assess and declare tax triggering events. This applies to practically all taxes, with the exception of urban property tax and industrial tax, which, in any event, require certain reporting statements by the taxpayers.

Recent amendments to the tax system

In recent years, the Macau SAR has increased the pace of the production of new tax agreements and amendments to its tax laws. Since 2011, the Macau SAR has entered into 15 tax information exchange agreements and in 2019 completed its eighth double taxation agreement. Several amendments were introduced to the stamp duty law in 2011, 2012, 2018 and 2020, and to the CTL in 2019; the offshore regime was cancelled; and a new law was approved to provide for a general legal regime on the exchange of tax information. In 2022 Law 5/2017 was amended to:

- include non-mandatory central providence funds and private pensions under the scope of cross-border exchange of information;
- eliminate the five-year restriction to the time period in relation to which the information could be requested; and
- include additional penalties relating to the breach of duties regarding the automatic exchange of information – with the exception of the most recent stamp duty law reform, which aims to modernise and improve stamp duty taxation, these changes are fundamentally driven by the aim of complying with

international standards and obligations to limit tax erosion as well as to enact particular government policies, such as curbing real estate prices.

The annualisation of tax laws

Notwithstanding the crystallisation of the fundamental structure of Macau's tax laws, significant adjustments are annually made to the tax system through the government's annual budget law and other administrative decisions. Such laws and administrative acts have become an important source of tax law and provide for relevant adjustments to the tax system. These adjustments are generally introduced as tax benefits and have been providing increasingly important tax relief, and include the following.

- A total exemption on industrial contribution tax.
- A total exemption on complementary tax up to MOP600,000, thus creating a de facto standard rate of 12% over all taxable income.
- A total exemption of professional tax up to MOP144,000 and a deduction of 30% to the tax due.
- A partial exemption on stamp duty for the purchase of a first property by residents.
- An exemption on stamp duty on banking interests and commissions.

Although these benefits are formally valid for each fiscal year only, they have not only been continuously renewed, but their scope has been significantly expanded and other benefits added. For example, the industrial contribution tax has been waived since 2002 and since the current gaming concessions were granted in 2002, the Macau SAR has continuously exempted, on an annual basis, gaming concessionaires' income from gaming activities from complementary tax. The nature, scope and constancy of these benefits mould the tax system's characteristics

and play an important role in the private sector's business choices and investments in Macau.

Tax authorities

Apart from excise duty and road tax, the competent authorities for which are the Economic and Technological Development Bureau and the Institute for Municipal Affairs, respectively, all other taxes fall under the competence of the Macau Finance Bureau.

Increase of Tax Controversies and Tax Litigation

The number of tax litigation cases has historically been reduced in Macau, which can be explained not only by the jurisdiction's size but also by the low taxation policy and the tax surplus generated from gaming taxes. However, especially since 2014, a considerable increase in tax disputes has been observed, some of which have led to landmark court decisions that have crafted some of the recent changes to the tax laws. Although complete statistics are not available, the number of tax cases in the Administrative Court alone jumped by 1,000% from 2013 to 2014. An analysis of the most recent court decisions suggests that such a spike in tax disputes results from a more active role by the tax authorities in the audit and assessment of taxpayers' statements. The most relevant recent tax controversies relate fundamentally to stamp duty, tourism tax, motor vehicle import tax and complementary income tax.

Stamp duty controversies

Recent disputes relating to stamp duty fundamentally concern whether certain transactions and documents were subject to stamp duty. Some of the most relevant decisions in recent years relate to the taxation of contracts for the grant of use of spaces in shopping centres. The tax authority has taken the initiative to tax the agreements executed between the promoters, operators or managers of shopping centres and

retailers as lease agreements, which are subject to stamp duty at a rate of 5% over the rent payable for the duration of the agreement. Especially for agreements relating to shopping malls located in so-called integrated resorts, the consideration payable by the retailers is, in many cases, astronomical, which implies a hefty tax burden. Such assessments, however, were subsequently annulled by the Court of Second Instance (and later confirmed by the Court of Final Appeal) on the basis that grant of use agreements cannot be considered as lease agreements and, pursuant to the principle of legality, they should not be subject to taxation. These decisions inspired the most recent reform of the stamp duty law, which was amended to expressly include the taxation of contracts for the grant of use of spaces in shopping centres.

In other landmark disputes, the Macau Finance Bureau has decided to levy stamp duty on the adjudication of any assets in auction sales, irrespective of the transfer of such assets effectively taking place. According to the private auction regulations, the transfer of the title to the assets put up for auction would only occur after the execution of a sale and purchase agreement and after full discharge of the consideration due. The Finance Bureau has decided that taxation would occur on adjudication, which would correspond to the decision by the auctioneer to award the assets to the highest bid, irrespective of the effective transfer of the property of such assets. The Court of Second Instance has also decided to annul the tax assessment and the decision was confirmed by the Court of Final Appeal. Similarly, the matter was addressed in the amendments to the stamp duty law, which now expressly state that the triggering event of the stamp duty payable for adjudication in private auctions (and other public sales) is the acceptance by the adjudicating entity of the highest bid, irrespective of the assets being effectively transferred.

Tourism tax controversies

Several of the recent disputes that were submitted to courts concerning tourism tax relate to its tax reach; in particular, to the definition of complementary hotel services for tax purposes. Tourism tax applies over the price of the specific services provided by hotels and similar establishments (as defined in law), health clubs, saunas, massage parlours and karaoke venues. Hotel specific or typical services are legally referred to as accommodation and “other complementary services”, with the exception of telecommunication and laundry services. The expression “other complementary services” leaves broad room for interpretation, and since 2015, the Macau Finance Bureau has taken a closer look at the tax statements submitted by taxpayers and has considered that certain ancillary services provided by hotels, their subsidiaries or other related companies should also be subject to tourism tax. These included, in some cases, transportation services, limousine services, bookings of flights and tickets for shows with other entities, and entertainment or amusement services provided in hotel facilities. With few exceptions, the courts have taken a particularly broad interpretation of the “complementary services” associated with the hotel business, hence upholding the tax authority’s assessments in these matters in most cases.

Complementary tax controversies

A number of disputes relating to complementary tax are related to its assessment; in particular, to the corrections introduced by the tax authority to deductible costs or to taxable income. Some of the most notable controversies arise from the tax authority considering the variable remuneration payable by a retailer under a grant of use contract, which consisted of a (high) percentage of the profits resulting from its business not being tax deductible, due to the particular contractual arrangement being intended to evade complementary tax, despite there being no express

anti-tax law evasion provisions in the Macau legal system. This position was upheld by the Court of Second Instance in October 2020.

Other relevant disputes relate to the scope and extension of the complementary tax exemption annually granted to gaming concessionaires. Certain entities have argued that their income deriving from certain contracts executed with gaming concessionaires should be exempted from complementary tax, as such income should be covered by the exemption provided to the gaming concessionaires. The tax authority has assessed the taxable profit of these entities and corrected the taxable profits to include such income, which quintupled their tax results in some cases. The courts have confirmed the tax exemption provided to the gaming concessionaires is purely subjective and does not exclude taxation over the income itself deriving from the gaming operations.

Recently, the Macau Finance Bureau has adopted a peculiar interpretation of an exceptional tax benefit introduced by the annual budget law to provide additional relief to businesses due to the economic impact of the COVID-19 pandemic. Such benefit consisted of a tax deduction of MOP300,000 to the tax amount payable after tax computation in relation to the 2019 fiscal year. As a result of the operation of this tax benefit, the said tax authority has, in practical terms, cancelled a deduction to the taxable profits allowed under the CTL to avoid economic double taxation, which ultimately resulted in a tax aggravation to the taxpayers. The matter has been submitted to the courts, but no decisions have yet been issued.

Cross-border exchange of information and mutual assistance between tax authorities

In 2017, Macau approved Law 5/2017, which sets a general legal framework for the exchange of tax information with other regional and inter-

national tax jurisdictions. Such effort was complemented with the amendments to the CTL in 2019, which aimed to implement measures against tax base erosion and profit shifting (BEPS), and by the execution of a significant number of tax information exchange treaties. Together, they form the legal framework for cross-border exchange of information and cooperation between tax authorities. This system provides for the following:

- the exchange of information on request of a foreign tax authority;
- spontaneous exchange of information;
- automatic exchange of information for certain entities, including foreign tax residents, multinationals based in Macau and other individuals and entities defined in international treaties.

As a result, in the course of 2019 and 2020, the use of cross-border information exchange and mutual assistance among tax authorities increased significantly, which had an impact on tax audits and exchange of information. Such an impact may translate into an increase of administrative and judicial litigation.

Taxpayers' Rights and Recourses: Administrative and Judicial Appeals *Taxpayer's fundamental rights and protections*

The taxpayer's interests are protected not only by the possibility of disputing the tax authorities' decisions, but also by a number of legal provisions and principles that limit the authorities' actions.

The rule of law

The principle of legality referred to above is transversal to the entire administrative and tax system. This principle carries strict implications for the tax system, mandating the following.

- That all taxes need to be formally approved by a Legislative Assembly law.
- That such a law defines the essential elements of the tax, including the scope, the tax benefits and the recourse mechanisms available.
- That the collection of all taxes needs to be authorised annually by the Legislative Assembly under the Government Budget Law (“no taxation without representation”). Furthermore, any and all actions taken by the government authorities are generally subject to a legality principle: the administration in general, and the tax authorities in particular, can only act if authorised and within the limits prescribed by law.

The right to be informed

Taxpayers have the right to be notified of any decisions that may affect their rights and interests protected by law. On the other hand, the tax authorities have the duty to explain and to provide the reasons for their decisions to taxpayers. This combination is intended to allow the taxpayers to effectively be informed and understand any tax decisions concerning their rights and interests, and, ultimately, to dispute such decisions.

The right to take part in the tax assessment

The fundamental stage of any tax liquidation process is the assessment of the taxable income or tax value of the relevant transactions or assets subject to taxation. The taxpayers are generally granted the right to, directly or through representation, participate in the process of determination of the tax base. The particular manner that allows such participation varies from tax to tax. For some taxes, such as income taxes, such participation derives from the taxpayers’ initiative to submit the tax statements. For stamp duty and property tax, such participation is guaranteed through the appointment of a taxpayer’s representative to the valuation committees. Further-

more, in all cases, the taxpayer is guaranteed the right to seek a review of the assessment made by the tax authority, through administrative and judicial means. The administrative review is made by specialised committees that, in theory, have the expertise to deal with the specific issues relating to the assessment.

Statutes of limitation

The assessment of any taxes is subject to statutes of limitation, which are generally five years. This means that the tax authority will not be able to initiate and collect any taxes after expiry of the statute of limitations. Recent changes to tax laws intend to effectively extend such statutes of limitation for certain transactions, such as in relation to stamp duty applicable to lease and grant of use agreements, in which case the statute of limitation period only commences after the agreements expire. The obligation to pay any taxes assessed within the statute of limitation period is subject to a larger statute of limitation period of 20 years, as recently decided by the Court of Second Instance.

Tax litigation

The Macau legal system provides a general right for individuals and private corporations to seek a judicial review of all decisions taken by the administration that may affect them. Naturally, this includes the taxpayer’s right to dispute the tax authorities’ decisions relating to tax matters. There is, however, no unified regime for tax disputes. The rules and procedures for taxpayers to contest and challenge the tax authorities’ decisions relating to tax matters are provided in the laws that set and regulate each tax. This makes the system quite complex and, in certain cases, inconsistent, creating a prolonged phase of administrative litigation and a de facto division in the judicial system, where both the Administrative Court (which is a court of first instance) and the Court of Second Instance serve as courts of

first instance, depending on the tax and type of decision involved.

In virtually all tax disputes, an administrative litigation phase mandatorily precedes the judicial review. The government administration is fundamentally organised under a hierarchical structure and, as a matter of principle, an administrative decision can only be judicially challenged after the administrative process becomes definitive; ie, once the decision can no longer be further reviewed within the administration's structure. This means that taxpayers are required to exhaust the administrative review procedures before the matter can finally be submitted to the courts. The administrative recourse path, however, is different depending on the type of decision taken by the tax authority. Arbitration is not available for tax disputes under Macau law. Due to the administration's duty to act strictly within the law, the tax authorities are not allowed to enter into any settlements or contractual arrangements regarding tax matters.

Enforcement of tax debts

The process for enforcement of tax debts is a source of many controversies under Macau law. The Fiscal Debts Enforcement Code (FDEC) is dated from 1951 and remains materially in force, being used as the legal regime applicable to the coercive collection of tax debts, but only to the extent that its legal provisions do not infringe the sovereignty of the People's Republic of China and are not contrary to the Macau Basic Law and other laws enacted by the competent Macau authorities. Its application is therefore not easy to administer, not only because it is a completely obsolete and anachronous law, requiring a massive effort of adaptation and interpretation to the current times to ensure private entities can effectively exercise their opposition rights, but also because the process of determining which provisions are contrary to other Macau laws is not, in many cases, simple. The direction taken

by the courts in this respect is not always clear, which makes the system precarious.

For example, the Court of Second Instance has ruled that tax debts are subject to a higher ordinary statute of limitations (20 years) than common debts under the Civil Code (15 years), due to the provisions of the FDEC having a specific nature in relation to those of the Civil Code. Yet, in another ruling by the Court of Second Instance, the court has found that the reversion of tax debts against the directors of the company set forth under the FDEC does not apply due to being found contrary to general law, specifically the provisions of the Macau Commercial Code.

Tax debts can be enforced directly by the Macau Finance Bureau, which has the authority to directly order the seizure or apprehension of private property, monies and other rights or entitlements and proceed directly to their public sale. The taxpayer may oppose the enforcement based on limited grounds. Issues strictly relating to the tax assessment can only be disputed under the administrative and judicial recourse means referred to above.

The law provides for two opposition mechanisms, one being the opposition by "simple application", in which the taxpayer does not have to appoint legal counsel, and the other the so-called opposition by "embargoes". Both need to be submitted within ten days from the service of notice of the enforcement proceedings and are decided by the Administrative Court. The opposition by simple application is limited to certain straightforward grounds, such as the debt being paid or having fallen under statutes of limitation. Embargoes allow the taxpayer to use all the grounds allowed under the opposition by simple application and more, including the illegality of the taxation based on the fact that the type of tax or its collection is not authorised by law, forgery of the documents that serve as title

for the enforcement and to dispute the seizure of any assets, due to their title being the subject of controversy or simply not belonging to the taxpayer.

Penalties: Criminal and Administrative Penalties

The sanctions framework is also regulated separately for each type of tax, which individually typify the different types of infringements of tax laws. Notwithstanding the disparity of laws regulating the matter, the key types of tax infringements relate to:

- non-compliance with the tax reporting obligations;
- failure to self-assess or withhold the relevant taxes;
- failure to pay the tax amounts due;
- inaccurate and delayed tax reporting; and
- failure to co-operate with the tax authority.

Subject to certain requirements, both corporations and individuals can be liable for the payment of fines and in certain tax laws, there is joint and several liability of certain individuals that participate in the offence. This includes the directors and other de facto administrators of corporations, as well as other representatives and auxiliaries. Despite several references to criminal liability, the only penalties applicable pursuant to tax laws are fines, except for a crime of disobedience stipulated in the stamp duty law, which applies to those who may prevent tax authority officials from entering or remaining at the premises of the establishments, offices and other locations for the purposes of conducting audit inspections. The law also does not provide for the possibility of such fines being converted into imprisonment sentences if they are not paid, which strongly suggests that the penalties specifically provided under the tax laws are of an administrative nature only.

The fines applicable are usually set within certain fixed value ranges provided in the law, the specific amount depending on the seriousness of the offence. In other cases, the law provides that the fines may range between the amount of the tax and a multiple of this amount. In the case of stamp duty, for example, the range can go from one to ten times the amount of the tax due for certain infringements, including the failure to pay the tax due in a timely fashion. Administrative penalties are applied by the relevant tax authority. However, several criminal provisions provided under the Criminal Code may apply in the context of tax matters, such as document fraud. Any potential criminal infringement depends on prosecution by the Public Prosecutor and will be tried by the criminal courts under a due process.

New Trends

New tax code

A draft bill for a new tax code is currently under review by the Macau Legislative Assembly and is expected to be approved during 2022. The new tax code will expressly provide for a unified set of tax principles and definitions which are commonly accepted as part of the tax system, despite some of them not being currently written in the law, as well as for unified procedural tax rules. Other key features of the currently envisaged tax code include:

- the definition of “tax domicile” and the obligation to appoint a tax representative;
- secondary liability of the members of corporate bodies, administrators, asset managers and of the tax representative;
- possibility for the tax authority to constitute mortgages and pledges over the taxpayer’s assets;
- possibility for the tax authority to issue injunctions and to seize property to secure its tax credits;

- exclusions from the duty of confidentiality by financial institutions, lawyers, and chartered accountants;
- regulation of inspection procedural rules;
- express possibility to seek the tax authority's interpretation of tax laws and of its compliance in writing;
- possibility for requesting transfer pricing agreements;
- specific rules for judicial tax litigation;
- regulation of the tax enforcement proceedings.

Although the new tax code will not bring any changes to the substantive tax framework, it is expected to make a significant contribution to the internal cohesion and robustness it currently lacks due to the dispersion of procedural rules, resulting from the different legal instruments applicable to the different types of taxes.

International Tax Reform

The two-pillar solution

Macau has adhered to the OECD/G20 two-pillar agreement on the Inclusive Framework on Base Erosion and Profits Shifting to reallocate taxing rights and to establish a minimum corporate tax rate of 15% for Multinational Enterprises (MNEs).

The tax authority has publicly commented on its considering the impact of the two-pillar solution implementation, in particular, the implementation of a minimum corporate tax rate of 15% to MNEs and its consistency with Macau's low taxation principle enshrined in the Macau Basic Law, as well as its impact on Macau's regional and international tax competitiveness.

Macau will likely wait until the two-pillar solution is implemented by other OECD jurisdictions, before it follows suit.

MdME Lawyers is an international law firm with offices in Macau, Hong Kong and Lisbon and a strong reputation in the Asia-Pacific region for providing high-quality and innovative legal insight to its clients.

AUTHORS



Ana Pinto Moraes is an experienced and qualified lawyer who joined MdME Lawyers in 2022 as counsel. She has over 16 years of professional experience in domestic and international tax structuring, tax consultancy and strategic advice, assisting multinational groups, corporations and financial institutions, on a broad variety of international tax and corporate matters, including financial and operational restructurings. She also has extensive expertise regarding audit defence and tax investigations, as well as in high-profile projects related to energy, oil and gas, real estate in prime places, family wealth structuring and private wealth management. Ana has significant experience in tax advisory, with a focus on international taxation, treaties and EU directives, transfer pricing policies, corporate and individual income tax, stamp tax, tax benefits, VAT and general tax compliance services. Prior to joining MdME Lawyers, Ana worked with Andersen Tax & Legal and spent several years at PwC (Corporate and International Tax Structuring Group Lisbon).



Rui Filipe Oliveira is widely recognised as one of the leading business lawyers in Macau, and advises multinational and domestic corporations on a wide range of M&A transactions, including complex corporate and financial restructurings, private investments and joint ventures. In particular, he has substantial experience working with local conglomerates on a range of corporate, governance, commercial and regulatory matters. Rui uses his multidisciplinary expertise to provide clients with valuable insight into complex transactions, delivering commercial outcomes at board and shareholder levels. In addition to his corporate work, Rui has a significant track record in dispute resolution, having advised in the context of a number of high-profile shareholders disputes, land concession and patent litigation.



Tiago Vilhena has over 15 years of experience in the market and is currently leading MdME Lawyers' Corporate Services practice. He is also the firm's key contact for the retail

industry, having been involved in the largest retail projects launched or announced in Macau since 2007 and representing key players in such projects. In his corporate and M&A practice, Tiago has assisted numerous global brands and major international groups and investors in establishing their businesses in Macau, providing continuous legal assistance to their entities. Tiago has also been involved in several cross-border acquisitions and restructurings and in major local retail and commercial projects. Over the years, Tiago has been able to anticipate risks and address clients with business-minded solutions that can be integrated with their corporate structure and commercial activities.

MdME Lawyers

Avenida da Praia Grande, 409
China Law Building,
21/F
Macau

Tel: +853 2833 3332
Fax: +853 2833 3331
Email: mdme@mdme.com.mo
Web: www.mdme.com.mo/en/

M d M E
L a w y e r s

Law and Practice

Contributed by:

D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma

Rosli Dahlan Saravana Partnership see p.381



CONTENTS

1. Tax Controversies	p.363	5.3 Judges and Decisions in Tax Appeals	p.371
1.1 Tax Controversies in this Jurisdiction	p.363	6. Alternative Dispute Resolution (ADR) Mechanisms	p.372
1.2 Causes of Tax Controversies	p.363	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.372
1.3 Avoidance of Tax Controversies	p.364	6.2 Settlement of Tax Disputes by Means of ADR	p.372
1.4 Efforts to Combat Tax Avoidance	p.364	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.372
1.5 Additional Tax Assessments	p.364	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.372
2. Tax Audits	p.365	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.373
2.1 Main Rules Determining Tax Audits	p.365	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.373
2.2 Initiation and Duration of a Tax Audit	p.365	7. Administrative and Criminal Tax Offences	p.373
2.3 Location and Procedure of Tax Audits	p.365	7.1 Interaction of Tax Assessments with Tax Infringements	p.373
2.4 Areas of Special Attention in Tax Audits	p.366	7.2 Relationship between Administrative and Criminal Processes	p.374
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.366	7.3 Initiation of Administrative Processes and Criminal Cases	p.374
2.6 Strategic Points for Consideration during Tax Audits	p.366	7.4 Stages of Administrative Processes and Criminal Cases	p.374
3. Administrative Litigation	p.367	7.5 Possibility of Fine Reductions	p.374
3.1 Administrative Claim Phase	p.367	7.6 Possibility of Agreements to Prevent Trial	p.375
3.2 Deadline for Administrative Claims	p.367	7.7 Appeals against Criminal Tax Decisions	p.375
4. Judicial Litigation: First Instance	p.368	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.375
4.1 Initiation of Judicial Tax Litigation	p.368	8. Cross-Border Tax Disputes	p.376
4.2 Procedure of Judicial Tax Litigation	p.368	8.1 Mechanisms to Deal with Double Taxation	p.376
4.3 Relevance of Evidence in Judicial Tax Litigation	p.369	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.376
4.4 Burden of Proof in Judicial Tax Litigation	p.369		
4.5 Strategic Options in Judicial Tax Litigation	p.370		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.370		
5. Judicial Litigation: Appeals	p.370		
5.1 System for Appealing Judicial Tax Litigation	p.370		
5.2 Stages in the Tax Appeal Procedure	p.371		

8.3	Challenges to International Transfer Pricing Adjustments	p.377	10.5	Existing Use of Recent International and EU Legal Instruments	p.378
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.377	10.6	New Procedures for New Developments under Pillar One and Two	p.378
8.5	Litigation Relating to Cross-Border Situations	p.377	10.7	Publication of Decisions	p.378
9. State Aid Disputes		p.377	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.378
9.1	State Aid Disputes Involving Taxes	p.377	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.378
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.377	11. Costs/Fees		p.379
9.3	Challenges by Taxpayers	p.377	11.1	Costs/Fees Relating to Administrative Litigation	p.379
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.377	11.2	Judicial Court Fees	p.379
10. International Tax Arbitration Options and Procedures		p.378	11.3	Indemnities	p.379
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.378	11.4	Costs of ADR	p.379
10.2	Types of Matters that Can Be Submitted to Arbitration	p.378	12. Statistics		p.379
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.378	12.1	Pending Tax Court Cases	p.379
10.4	Implementation of the EU Directive on Arbitration	p.378	12.2	Cases Relating to Different Taxes	p.379
			12.3	Parties Succeeding in Litigation	p.379
			13. Strategies		p.380
			13.1	Strategic Guidelines in Tax Controversies	p.380

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

There are two revenue bodies that govern tax matters in Malaysia: the Inland Revenue Board (IRB) and the Royal Department of Customs Department (RMCD). The IRB governs matters pertaining to income tax, stamp duty and real property gains tax, while the RMCD oversees issues concerning customs, duties and indirect taxes.

Malaysia implemented a self-assessment system for companies in 2001, and for businesses, partnerships, co-operatives and individuals in 2004. Under this system, taxpayers are responsible for determining and computing their respective tax liabilities based on existing tax legislation, policies and guidelines. The self-assessment system applies only for income tax returns.

Tax controversies may arise due to disagreements regarding the treatment of a particular transaction and/or arrangement between the revenue officers and the taxpayer. These would normally arise during tax audits conducted by the officers or through information obtained from third parties.

In cases involving stamp duty, tax controversies may arise upon the stamping of the relevant instrument at the Stamp Office. There may be disagreements regarding the market value of the Memorandum of Transfer, the nature of the document and the availability of stamp duty relief to a taxpayer, among other matters.

A point of particular interest is whether voluntary disclosure of under-reported incidence of tax by a taxpayer can give rise to a tax controversy. In 2018, the government of Malaysia introduced the Self Voluntary Disclosure Programme (SVDP) to encourage taxpayers who had under-report-

ed their incidence of tax in previous years of assessment to voluntarily declare such unreported income, giving assurances that a declaration under the SVDP would not expose the taxpayer to subsequent tax audits or investigations. There have been some recent controversies and allegations that the government is renegeing on this assurance.

1.2 Causes of Tax Controversies

Income taxes form a large proportion of the government's tax revenue, so most tax controversies arise due to disagreements regarding the interpretation and application of the Income Tax Act 1967 (ITA), which governs both corporate income tax and individual income tax.

The case of *TNB v KPHDN* (unreported) involved the largest sum of corporate tax in dispute in history, amounting to a whopping MYR7 billion (USD1.7 billion). The issue in dispute related to the taxpayer's claim for reinvestment allowance under Schedule 7 of the ITA. The IRB was of the view that the taxpayer did not "manufacture" electricity but was merely a service provider and therefore did not qualify for reinvestment allowance. The High Court in this case ruled in the favour of the taxpayer by allowing the taxpayer's application for reinvestment allowance. This is a landmark decision as it highlights that the IRB should not interpret and apply a tax incentive provision narrowly so as to defeat its purpose. This win certainly puts the taxpayer in a favourable position in relation to its other ongoing tax appeals for different years on the same issue, where the additional taxes amount to about MYR5.8 billion. The major win in this case will certainly pave the way for the other similar cases and contribute significantly as a precedent. Further, this case shows that despite taking account of the government's need to realise taxes, the court is prepared to protect taxpayers from incorrect assessments.

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

For individual income tax, the IRB has initiated civil proceedings against the former Prime Minister of Malaysia to recover outstanding tax amounting to MYR1.7 billion. The Court of Appeal in this matter has affirmed the High Court decision and for the former Prime Minister to pay the income tax arrears.

1.3 Avoidance of Tax Controversies

During audits and/or investigations by the revenue officers, the taxpayer can mitigate tax controversies by providing economic reasons and a commercial rationale for why a treatment or arrangement was made in a certain manner. Commonly, a taxpayer has a statutory obligation to keep and retain in safe custody sufficient records for a period of seven years. This includes invoices, vouchers, receipts and such other documents as are necessary to verify the particulars in a return. Taxpayers are encouraged to maintain these records beyond seven years, as it is not uncommon for the revenue officers to conduct tax audits beyond the statutory prescribed period.

Tax controversies are easier to mitigate where the taxpayer displays the qualities of a good taxpayer, which include providing full and frank disclosure of the taxpayer's affairs, honesty in tax determination, filing tax returns and forms properly and in good time, and co-operating with the revenue officers to the extent required by law.

1.4 Efforts to Combat Tax Avoidance

As Malaysia implemented the Base Erosion and Profit Shifting (BEPS) recommendations relatively recently, their contributory effects on tax controversies have yet to be seen.

1.5 Additional Tax Assessments

Tax Assessments by the IRB

The IRB has repeatedly declared its intention to conduct tax audits every five years on both individuals and companies. In most tax audit cases,

the IRB will issue preliminary findings letters and give taxpayers the opportunity to respond to the issues raised.

Audits are concluded with the issuance of a final audit findings letter stating the alleged underpaid taxes. Taxpayers may sign a letter of acknowledgment of the IRB's position and pay the taxes. If the taxpayers refuse to do so, tax assessments may be issued in respect of such alleged underpaid taxes.

Notice of Additional Tax Assessment (Form JA) or Notice of Tax Assessment (Form J) commonly requires the taxes to be paid within 30 days. In the absence of a stay order from a court of law, the taxes stated under the additional tax assessments are payable notwithstanding an appeal.

Section 91(1) of the ITA allows assessments to be raised within five years of the relevant year of assessment (seven years for transfer pricing matters under Section 91(5) of the ITA). However, the statutory time limit does not apply where there is evidence of fraud, wilful default or negligence.

Where the taxpayer fails to file an income tax return, the Director General of Income Tax (DGIR) may issue best judgment assessments against the taxable person. Failure to furnish an income tax return is a criminal offence punishable under Section 112(1) of the ITA. Upon conviction, the taxpayer may be liable to a fine of between MYR200 and MYR20,000, or to imprisonment for a term not exceeding six months, or both.

Tax Assessments by the RMCD

The RMCD oversees both indirect tax and customs matters. Goods and Services Tax (GST) was introduced in 2014 but subsequently repealed in 2018. For completion, this chapter will also address issues relating to GST as there are cases pending resolution.

Tax assessments issued by the RMCD on customs and indirect tax matters are commonly required to be paid within 14 days. Under the Sales Tax Act 2018, the Service Tax Act 2018 and the Goods and Services Tax Act 2014 (GST Act 2014), the Director General of Customs (DGOC) may raise notices of assessment up to six years after the date that the alleged tax was due and payable. Similarly, the time limit does not apply where the DGOC is of the opinion that there is fraud or wilful default.

Under Section 41 of the GST Act 2014, persons who are considered taxable persons are required to furnish a return to the DGOC on a monthly or quarterly basis. Failing to furnish a GST return will empower the DGOC to raise best judgment assessment on the amount of tax due and payable under Section 43 of the GST Act 2014. Failure to furnish a GST return is also a criminal offence and, upon conviction, may be liable to a fine not exceeding MYR50,000 and/or imprisonment for a term not exceeding three years.

Under Section 26 of the Sales Tax Act 2018 and the Service Tax Act 2018, taxable persons are required to furnish a return to the DGOC on the last day of the month following the end of the taxable period to which the return relates. Where a taxable person fails to furnish a return, the DGOC may raise best judgment assessments on the amount of taxes due and payable. Failure to furnish a return is a criminal offence punishable with a fine not exceeding MYR50,000 and/or imprisonment for a term not exceeding three years.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Tax Audits by the IRB

Although the IRB has publicly declared a routine tax audit on taxpayers every five years, the audit

cycle is not fixed as the selection is determined through risk-based assessments and information from third parties, such as taxpayers' returns.

Tax audits are conducted across broad-based but certain industries, with higher tax exposures scrutinised more intensely by the IRB. In recent years, the IRB has tended to focus on Labuan companies, companies with a high volume of related party transactions and companies claiming a high level of tax allowance and/or reliefs.

Tax Audits by the RMCD

Conversely, the indirect tax regime in Malaysia took a big shift in 2014 with the introduction of the GST Act 2014, which replaced the previous Sales Tax Act 1972 and the Service Tax Act 1972. However, the GST Act 2014 was short-lived as it was repealed four years later by the Goods and Services Tax (Repeal) Act 2018 (GST Repeal Act). Due to the GST Repeal Act, the RMCD has been active in carrying out tax audits and investigations on GST to expedite the disposal of all matters relating to GST.

2.2 Initiation and Duration of a Tax Audit

The initiation and duration of tax audits depends on a range of factors, such as the complexity of the matter, the amount in dispute and whether there is any binding case law suggesting an established legal position.

There are no time limits for the revenue officers to commence tax audits, but the issuance of notices of assessment and/or findings must comply with the relevant statutory time limit and legal principles.

2.3 Location and Procedure of Tax Audits

The DGIR and DGOC are armed with wide powers under the relevant acts to conduct tax audits. These include powers to call for the production

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

of relevant documents such as books, bank account statements and certificates, for access to buildings and documents, and for all such information that may be relevant. Tax audits may be conducted as desk audits and field audits.

2.4 Areas of Special Attention in Tax Audits

Depending on the area of tax under audit, the revenue officers may require the provision of certain documents as evidence and substantiation. For example, for transfer pricing matters, the revenue officers will commonly request transfer pricing documents, financial statements of comparables, the methodology of the selection of comparables and benchmarking analyses.

Where a company is claiming relief and the issue is whether the company is eligible to claim said relief, the revenue officers may require evidence that the taxpayer has duly met the conditions whereby the relief is granted.

In highly technical tax areas, lawyers or expert representatives are encouraged to be present to communicate with the revenue officers more effectively.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Malaysia is a participating country of the automatic exchange of information (AEOI) system initiated by the Organisation for Economic Co-operation and Development (OECD), and has also publicly declared its commitment to the Common Reporting Standard (CRS).

Under the CRS, Malaysian financial institutions are required to collect and report financial account information on non-residents to the IRB, which will exchange this information with the participating foreign tax authorities of those non-

residents. Malaysia would also receive financial account information on Malaysian residents from other countries' tax authorities. This will ensure that residents with financial accounts in other countries are complying with their domestic tax laws, and act as a deterrent to tax evasion.

Tax information exchange agreements with treaty countries and non-treaty countries are provided for under Sections 132 and 132A of the ITA, respectively. Section 132B of the ITA serves to facilitate mutual administrative assistance in tax matters with government authorities outside Malaysia involving simultaneous tax examinations, automatic exchange of information or tax administrations abroad.

2.6 Strategic Points for Consideration during Tax Audits

During tax audits, taxpayers should demonstrate utmost co-operation with the revenue officers and provide the relevant evidence. The evidence and supporting documents should contain cogent technical reasons for the adoption of a certain tax treatment.

It would be prudent for taxpayers to engage tax consultants and lawyers for their representations during tax audits with the revenue officers. Such representation would provide credence and support to the underlying reasons for a certain tax treatment and ensure that they are clearly articulated to the revenue officers.

Taxpayers should always remain vigilant and err on the side of caution when submitting any document to the tax authorities. Evidence that is cloaked with the veil of privilege can be withheld from disclosure to the tax officers.

Furthermore, any proposed settlement discussions between the taxpayer and the IRB should be conducted strictly on a without-prejudice basis to preserve the taxpayer's right of appeal.

It is pertinent that any settlement agreement must be crafted in a manner that does not suggest any admission of liability.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Judicial Review

A taxpayer who is aggrieved and dissatisfied with a decision of any revenue officers, including a tax assessment, may appeal through judicial review where exceptional circumstances exist. If this is the case, the matter is automatically directed to the judicial phase without reference to the administrative claim phase.

Taxpayers will have to appeal decisions by the DGOC on GST matters after the implementation of the GST Repeal Act through judicial review, due to the abolishment of the GST Tribunal.

Appealing to the Special Commissioners of Income Tax (SCIT)

A taxpayer who is aggrieved by an assessment raised by the DGIR may file a notice of appeal (Form Q) with the SCIT, together with the grounds of the appeal, within 30 days of the date of service of the notice of assessment.

The DGIR has a 12-month review period upon receipt of the Form Q, during which dispute resolution proceedings may be initiated and held. The purpose of the dispute resolution proceedings is to reach an amicable settlement without the matter being litigated in court.

If parties are unable to reach an agreement during the review period, the Form Q will be forwarded to the SCIT for registration of the appeal.

Appealing to the Customs Appeal Tribunal (CAT)

A person aggrieved by the DGOC's decision may make an application for the DGOC to review the decision within 30 days of being notified of the decision. The DGOC will then review his decision and aim to decide on the application within 60 days of receiving the application. However, it is common for the DGOC to take up to six months to decide.

Where a person remains dissatisfied with the DGOC's review decision, they may appeal to the CAT within 30 days of the review decision being communicated to them.

Under the GST regime, a person aggrieved with a decision of the DGOC may file a notice of appeal to the GST Tribunal within 30 days of the date the DGOC's decision was communicated.

Appealing against a Decision of the Collector of Stamp Duties

Stamp duty matters are directed to the Collector of Stamp Duties, who is a part of the IRB. If a person is dissatisfied with the assessment by the Stamp Office, he or she may object to the assessment by giving written notice to the Collector of Stamp Duties within 30 days of the date of assessment, giving all the relevant particulars and information to support the objection.

Upon review, the Collector of Stamp Duties may cancel or maintain the same assessment. If the person is not satisfied with the review by the Collector of Stamp Duties, he or she may appeal to the High Court within 21 days of being notified of the result of the review in writing.

3.2 Deadline for Administrative Claims

For administrative claims (ie, an appeal to the DGIR, DGOC or Collector of Stamp Duties), there are statutory deadlines for tax authorities

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

to decide an appeal, but these are extendable upon request.

Taxpayers should stay vigilant and aware that any communication by the revenue officers during the administrative claim, such as failure to respond and/or take appropriate action before the expiry of the statutory timeframe, may prejudice the right to appeal.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation may be initiated via two routes: judicial review or an appeal to the SCIT and CAT. However, stamp duty matters are heard directly by the High Court by way of an appeal.

Judicial Review

Although taxpayers may appeal the decision of the revenue officers via judicial review, there can only be judicial review where there are exceptional circumstances, such as:

- a clear lack of jurisdiction;
- a blatant failure to perform some statutory duty; or
- a serious breach of the principles of natural justice.

Taxpayers should note that the dispute under judicial review should be restricted to questions of law as opposed to questions of fact. An application for leave to commence judicial review under Order 53 Rule 2 of the Rules of Court 2012 must be made within 90 days of the date of the impugned assessment or a decision to the High Court.

Appeal before the SCIT

When parties cannot reach a resolution following the process outlined in **3.1 Administrative**

Claim Phase, the matter is forwarded to the SCIT and registered accordingly. The SCIT shall fix a place and date of hearing, and give the taxpayer and the DGIR at least 28 days' notice of such.

In practice, the SCIT will give directions for parties to file cause papers (ie, issues to be tried, statement of facts and index of the agreed bundle of documents) before fixing the hearing dates.

Appeal before the CAT

A taxpayer aggrieved by the decision of the DGOC may appeal before the CAT, or can apply to the DGOC to review the decision. The process for an application to the DGOC to review his decision is as provided in **3.1 Administrative Claim Phase**.

The taxpayer can also appeal to the CAT, without referring to the DGOC for a review decision. A taxpayer aggrieved by the DGOC review decision or a decision would need to file a notice of appeal (Form A) under Section 143 of the Customs Act 1967, Section 96 of the Sales Tax Act 2018 and Section 47 of the Excise Tax Act 1976, within 30 days of the date the decision was communicated to the taxpayer.

Appeal on Stamp Duty Matters

A person aggrieved by the decision of the Collector of Stamp Duties may appeal to the High Court via an originating summons pursuant to Section 39 of the Stamp Act 1949 read together with Order 55A of the Rules of Court 2012.

4.2 Procedure of Judicial Tax Litigation

Judicial Review

Once an application for leave for judicial review is filed, the High Court will set a date for the hearing of the application for leave to commence judicial review. This may involve both parties filing affidavits, documentary evidence and both

written and oral submissions. Upon hearing the respective parties' submissions, the High Court may allow or deny leave for judicial review.

If leave is denied, the taxpayer may appeal the matter before the Court of Appeal.

If leave is granted, the matter will be set down for hearing on the substantive merits of the judicial review application. This may involve further exchanges of affidavits and written submissions to be filed by both parties. Upon hearing the parties' submissions, the High Court may allow the judicial review or decide against the taxpayer.

Appeal before the SCIT

The procedure for hearings at the SCIT and the powers of the SCIT are stipulated under Schedule 5 of the ITA. Briefly, appeals before the SCIT are heard before a panel consisting of one to three commissioners. Taxpayers may be represented by either an advocate or a tax agent or both during the hearing.

During the hearing, the SCIT will hear witness evidence from both the taxpayer and the IRB. Upon conclusion of the hearing, parties may file post-hearing written submissions and an oral submission may be scheduled for the parties to be heard.

Appeal before the CAT

Tribunal hearings are heard before a panel of three members. However, the matter may be heard before a single tribunal member in the interests of expediency and the efficient conduct of the appeal. Where an appeal to the CAT is made, the same issues cannot be in another court unless the other proceedings have been commenced earlier or unless the appeal before the CAT is withdrawn, abandoned or struck out.

Similar to the process in the SCIT, the CAT will hear witness evidence from both the taxpayer

and the RMCD. Upon conclusion of the hearing, parties will file post-hearing written submissions and then an oral submission will be scheduled for the parties to be heard. Decisions of the CAT are deemed to be an order of a Sessions Court and are enforceable as such.

Appeal on Stamp Duty

For an appeal of stamp duty matters, a hearing will be conducted at the High Court, commonly before one judge. Parties will tender evidence via affidavits and may apply for permission to call for witnesses (commonly valuation experts) to provide oral evidence to assist the judge in coming to a determination. Upon hearing the parties' submissions, the judge may affirm, vary or cancel the notice of stamp duty assessment raised by the Collector of Stamp Duties.

4.3 Relevance of Evidence in Judicial Tax Litigation

Matters litigated through judicial review and stamp duty appeals are often restricted to evidence tendered through affidavits, and no witness evidence will be given as there should be no dispute of fact. However, parties may request to cross-examine witnesses via an application supported with an affidavit under Order 38 Rule 2 of the Rules of Court 2012.

4.4 Burden of Proof in Judicial Tax Litigation

In a judicial review application, the burden of proof is canvassed in Section 101 of the Evidence Act 1950. If the taxpayer is seeking a court judgment on any legal right or liability, the taxpayer must prove the facts asserted. Similar provisions are found under paragraph 12 Schedule 5 of the ITA, Section 83 of the Sales Tax Act 2018 and Section 68 of the Service Tax Act 2018.

However, there are circumstances whereby the burden of proof is shifted to the revenue officers. In *Ketua Pengarah Hasil Dalam Negeri v Rain-*

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

forest Heights Sdn Bhd [2018] MLJU 2158, the High Court held that the burden of proving any avoidance of tax by the taxpayer rests with the revenue officers.

4.5 Strategic Options in Judicial Tax Litigation

When choosing which litigation route to take, the taxpayer should assess the merits and strength of its case. The difference in choosing the judicial review route as opposed to an appeal to the SCIT or the CAT is that only the High Court is empowered to grant a stay under the Rules of Court 2012. However, a stay order is at the discretion of the court of law and will only be given where the court is satisfied that there are special circumstances that warrant a stay.

In *Government of Malaysia v Jasanusa Sdn Bhd* [1995] 2 CLJ 701, the apex court held that the possibility of arbitrary or incorrect assessments brought about by fallible officers who have to fulfil the collection of a certain publicly declared targeted amount of taxes may be influenced by the target to be achieved rather than the correctness of the assessment. In such circumstances, a stay should be granted.

However, the recent amendment of the Finance Act 2020 may impede the ability of the taxpayer to plead for a stay from the High Court. The addition of Section 103B of the ITA mandates that the initiation of any proceedings under any written law against the government or the DGIR shall not relieve any person from liability for the payment of any tax. It is arguable that the amendment does not restrict the power of a court of law to grant a stay, but the full force of the amendment has yet to be determined.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Although Malaysia is not a member of the OECD, the domestic law and policy relating to trans-

fer pricing mirrors the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 (OECD Guidelines), including the arm's-length principle and the preparation of contemporaneous transfer pricing documentations and methodology in Malaysia.

In *Damco Logistic Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC 30-033, the Malaysian courts held that the OECD's Commentaries on the Model Tax Convention on Income and on Capital 2014 were a persuasive authority when interpreting double taxation agreements.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Judicial Review and Appeals against the Collector of Stamp Duties

Where a person is dissatisfied with the decision of the High Court in the judicial proceeding or with the stamp duty appeal against the Collector of Stamp Duties, the matter may be appealable, to the Court of Appeal and thereafter to the Federal Court, which is the highest court in the country.

An appeal to the Court of Appeal does not require prior leave where the amount in dispute is more than MYR250,000, as provided under Section 68(1)(a) of the Courts of Judicature Act 1967 (CJA). Correspondingly, leave by the Court of Appeal is required where the amount in dispute is MYR250,000 or less.

The threshold to appeal to the Federal Court is high, and prior leave from the Federal Court is required. Section 96(a) of the CJA, read together with *Terengganu Forest Products Sdn Bhd v Cosco Container Lines Co Ltd* [2011] 1 MLJ 25,

states that the requirements to appeal to the Federal Court are as follows:

- the High Court heard the matter in its original jurisdiction;
- the appeal must be against the decision of the Court of Appeal;
- the appeal must involve a question of law of general principle that has not been previously decided by the Federal Court;
- where leave is sought on the ground of “public advantage”, the applicant must satisfy the leave panel that it is a point of general public importance for which further argument is required; and
- there is a good prospect of success in the appeal.

Appeal against the SCIT or CAT

Similarly, a person aggrieved by the decision of the SCIT or the CAT may appeal against the decision twice – to the High Court and the Court of Appeal, the latter of which is the highest appealable court. In an appeal against the decision of the SCIT or CAT, the High Court hears the matter in its appellate jurisdiction, so one of the conditions required to appeal to the Federal Court is not fulfilled.

5.2 Stages in the Tax Appeal Procedure

Where either party is dissatisfied with the decision of the SCIT, the appellant would appeal against the SCIT decision through a notice in writing within 21 days of the date of the decision of the SCIT, as stated under Paragraph 34 Schedule 5 of the ITA. Thereafter, the appellant is required to file a record of appeal containing the following documents, among others:

- the notice of appeal;
- the statement of facts and issues;
- the memorandum of appeal;
- the deciding order;
- the notes of proceedings;

- the grounds of decision; and
- relevant documentary exhibits.

When hearing dates at the High Court are determined, the parties file their respective submissions and a hearing before the judge is conducted.

An appeal from the High Court to the Court of Appeal is similar but is governed under the Rules of the Court of Appeal 1994. The aggrieved party would be required to file a notice of appeal within 30 days of the date of the High Court’s decision or of the date where leave is granted, if relevant. The appellant would thereafter be required to file a record of appeal containing documents similar to those listed above, *mutatis mutandis*, within three months of the date of the decision. When the hearing dates are set, the parties file their respective submissions and a hearing before the Court of Appeal is conducted.

Any appeal to the Federal Court would require leave by the Federal Court. The procedure to appeal to the Federal Court is similar except for a requirement under Section 96 of the CJA wherein leave of the Federal Court is required under Section 97 of the CJA. Once leave is granted, the same process would apply, *mutatis mutandis*.

5.3 Judges and Decisions in Tax Appeals

SCIT and CAT

Between one and three judges sit in the SCIT and CAT, depending on the complexity of the matter.

The SCIT is established under Section 98 of the ITA, which states that there shall be, at the time of writing, a minimum of three commissioners, who are appointed by the *Yang di-Pertuan Agong* (the Ruler of Malaysia) and whose tenure,

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

remuneration and allowance are determined by the Minister of Finance.

The CAT is constituted under Section 141B of the Customs Act 1967. The CAT shall consist of a chairman and a maximum of two deputy chairmen from the judicial and legal service, alongside a minimum of seven members who have wide knowledge or extensive experience in tax or customs matters. All members are appointed by the Minister of Finance, who also determines the remuneration, qualifications, terms and conditions of the members of the CAT.

High Court, Court of Appeal and Federal Court

Where the matter is heard before the High Court, there will commonly be only one judge. A hearing in the Court of Appeal will commonly involve three judges. Finally, between three and seven judges will make a determination on cases at the Federal Court.

The judge presiding over the matter in the appellate courts (High Court and above) may not be experienced in the area of tax but will be conversant with all areas of civil law.

Under Article 122B of the Malaysian Federal Constitution, the appointment of a judge in the High Court, the Court of Appeal and the Federal Court is by the *Yang di-Pertuan Agong*, acting on the advice of the Prime Minister.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

The first alternate dispute resolution mechanism is mandatory, and involves resolving tax disputes through the Dispute Resolution Pro-

ceedings (DRP) under Section 101 of the ITA. The DRP allows for a 12-month review period after the notice of appeal (Form Q) is filed. This may involve IRB officers from the DRP and the taxpayer attempting to come to a common resolution, along with the tax consultant or legal representative. If the matter is not resolved, it would be forwarded to the SCIT for registration.

The second alternate dispute resolution mechanism is an appeal to the DGOC to review a decision. As mentioned in **3.1 Administrative Claim Phase**, a person aggrieved by the decision of the DGOC may apply for him to review his decision within 30 days of notification of the decision. The DGOC will review and give his review decision within 60 days. Unlike the DRP, an appeal to the DGOC for a review decision is not mandatory, as taxpayers may file an appeal to the CAT without further reference to the DGOC.

6.2 Settlement of Tax Disputes by Means of ADR

During the DRP and review decision by the DGOC, parties would communicate with each other through letters, emails and meetings to attempt to come to a common ground, which may come into fruition in a settlement agreement.

However, the ADR process has not been very successful, as seen in the large number of cases under appeal.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

There is no mediation or arbitration for tax disputes.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

It was previously considered that an Advance Ruling under Section 138B of the ITA could

reduce the possibility of tax disputes, as it ensured certainty of tax treatment and transparency in tax administration. However, case law has cast doubts on whether Advance Rulings can truly reduce tax controversies.

In SKFBISB v KPHDN (unreported), the High Court found that the taxpayer's non-compliance with the requirements under the Income tax (Advance Ruling) Rules 2008 was fatal to the taxpayer's Advance Ruling application. Paragraph 3(a) of the Income tax (Advance Ruling) Rules 2008 states that the DGIR shall not make an advance ruling where the arrangement for which the advance ruling is sought has already been entered or effected. In this instant case, the application for an advance ruling was made four months after the agreement was entered into, so it was inapplicable to the taxpayer.

Furthermore, in IBM Malaysia Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (unreported), the Federal Court upheld the Court of Appeal's decision against the taxpayer. The Court of Appeal was of the view that the Advance Ruling, although unfavourable towards the taxpayer, had not adversely affected the taxpayer until tax returns were filed and tax was assessed. Furthermore, the Court of Appeal held that IBM should have applied to the SCIT to appeal against the Advance Ruling and not bring a judicial review application.

In Teruntum Theatre Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri [2006] 4 MLJ 685, the Court of Appeal held in favour of the IRB in deciding that no person can raise an estoppel against himself to defeat a positive duty imposed upon him by a statute. The DGIR cannot raise an estoppel against himself from discharging his statutory duty to raise a correct assessment under the appropriate law if the basis of treating the gain as a capital gain was not within the meaning

ascribed to it by the Real Property Gains Tax Act 1976 and no real property gains tax is payable.

6.5 Further Particulars Concerning Tax ADR Mechanisms

This is not relevant in Malaysia.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

No ADR mechanisms other than DRP are available for transfer pricing cases.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Failure to pay the taxes under an assessment or a bill of demand is generally a civil offence as opposed to a criminal offence. The taxpayer's failure to pay the amount of taxes as stated in the assessment or bill of demand before the prescribed date, in the absence of a stay order by a court of law, may result in civil proceedings by the IRB or RMCD through the government of Malaysia as a debt due to the government.

The plaintiff to the civil proceedings will be the government of Malaysia, which will serve a writ of summons and statement of claim unto the taxpayer, as the named defendant. The taxpayer will have 14 days to enter appearance by filing a notice of appearance, and another 14 days to file the statement of defence.

A taxpayer may be liable to a criminal offence if it is found that they defaulted in furnishing the relevant documents, filed incorrect information returns or reports, attempted to leave Malaysia without paying the outstanding taxes or obstructed officers in carrying out their duties under the relevant acts.

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

7.2 Relationship between Administrative and Criminal Processes

A civil proceeding does not prevent the initiation of criminal litigation or an appeal against the notice of assessment, but either may be struck out by the court for duplicity of proceedings or as an abuse of court process if they are based on the same facts and cause of action.

In the interest of justice, the taxpayer may ask the court for either matter to be stayed pending the outcome of the other case, to prevent inconsistent decisions or rendering either decision academic.

7.3 Initiation of Administrative Processes and Criminal Cases

In a recent landmark ruling in *SMSB v Ketua Pengarah Kastam & Anor* (unreported), the Federal Court dismissed the DGOC's application for leave to appeal the decision of the Court of Appeal, which held that the Bills of Demand for purported non-compliance with conditions of a duty-free licence were ultra vires.

While it is common for civil recovery proceedings to be taken against the taxpayer to recover outstanding taxes due and payable, it is uncommon for underpaid taxes to lead to criminal prosecution, especially where a court of law has declared the cause of action to be void.

7.4 Stages of Administrative Processes and Criminal Cases

As mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**, the legality of an assessment or decision by the revenue officers is often a civil matter rather than a criminal matter. As such, the correctness of a tax assessment is determined by the civil courts and not the criminal courts.

Criminal litigation commonly starts at the Magistrate or Sessions Court, depending on the grav-

ity of the offence. Firstly, the alleged offender (the Accused) will be charged and the charge is read and explained to him before the judge. The Accused will be asked to plead guilty or otherwise.

If the Accused pleads guilty, the plea shall be recorded and he may be convicted.

If the Accused does not plead guilty and proceeds to trial, the court shall take all such evidence in support of the prosecution. The prosecutor bears the burden of proving a prima facie case against the Accused. If the court is not convinced that a prima facie case was made against the Accused, the Accused may be acquitted.

If a prima facie case is made, the Accused will be asked to enter a defence. The Accused may adduce evidence required and call witnesses to prove his case. The Accused himself has three options: he can give sworn evidence from the witness box, give unsworn evidence from the dock or remain silent.

At the end of the trial, the court shall consider all evidence and decide whether the prosecution was successful in proving its case beyond a reasonable doubt. If the prosecution was successful, the Accused shall be found guilty and may be convicted. Otherwise, the Accused should be acquitted.

7.5 Possibility of Fine Reductions

It is settled law that although the IRB and the RMCD are empowered under the relevant acts to impose penalties where they are of the view that taxes have been underpaid by the taxpayer, the discretion to impose such penalties cannot be fettered and must be based on legitimate considerations.

In *Office Park Development Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC

30-023, it was held that a penalty should not be imposed where the taxpayer had acted in good faith, taken professional advice and made full disclosure, and the matter in dispute arises from a technical adjustment.

However, the IRB may also compound the penalty to resolve and settle the issue in dispute expeditiously.

7.6 Possibility of Agreements to Prevent Trial

Parties may enter into a settlement agreement with the tax officers and/or the government of Malaysia to stop a criminal trial at any time before the pronouncement of a decision by the judge. Since discussions are commonly conducted in private and are not disclosed to the public, the exact terms of the settlement agreement are not known.

7.7 Appeals against Criminal Tax Decisions

Any person aggrieved by the decision of the judge in the subordinate court (Magistrate and Sessions Court) can appeal to the High Court under Section 303A of the Criminal Procedure Code (CPC). The notice of appeal must be filed with the relevant subordinate court within 14 days of the date of the decision of the court.

Upon receiving the grounds of decision, the appellant shall file a petition of appeal (Form 51) to the High Court, stating the substance of the judgment appealed against and the particulars of the points of law or of fact from which the subordinate court is alleged to have erred. Upon hearing the parties, the High Court judge may dismiss or allow the appeal and order acquittal, conviction or retrial.

An appeal against the decision of the High Court to the Court of Appeal is largely the same; the only difference is that, if the matter originated

from the Magistrate Court, leave of the Court of Appeal is required, except where the appellant is the prosecutor, and it is limited to questions of fact. An appeal to the Court of Appeal originating from the Sessions Court or High Court does not require leave.

Appeals to the Federal Court are available only where the High Court heard the matter in its original jurisdiction.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

In recent years, the IRB has been actively invoking Section 140 of the ITA (the general anti-avoidance provision) in alleging tax avoidance cases by taxpayers. However, the IRB has repeatedly failed to appreciate that, if there is commercial justification or if the transaction is a bona fide transaction, the DGIR is not entitled to disregard or vary that transaction. This is known as tax mitigation, and it is an established principle of tax law that a person may do all things within the law to minimise his incidence of tax.

Recently, the Court of Appeal dismissed the IRB's appeal and upheld the High Court's decision in *Ketua Pengarah Hasil Dalam Negeri v Rainforest Heights Sdn Bhd* [2018] MLJU 2158. In this case, a company was incorporated for a property development project. One of the terms of the shareholders' agreement was that the partners will purchase a unit from the project at the price of MYR380 per square feet as at the material time the developer licence had not been obtained by the taxpayer. When the company was granted a housing developer's licence, several units from the project were sold to each of the parties at the price of MYR380 per square feet.

The IRB invoked Section 140 of the ITA and alleged tax avoidance. Aggrieved, the taxpayer appealed to the SCIT, which found in favour

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

of the taxpayer. The IRB appealed to the High Court.

The High Court held in favour of the taxpayer. In upholding the decision in *Port Dickson Power Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2012] MSTC 30-045, the failure of the IRB to specify the subparagraph of subsection 140(1) of the ITA rendered the notice of additional assessment null and void. Additionally, the IRB's failure to furnish the particulars of the adjustment together with the notice of assessment rendered the notice of assessment null and void.

The IRB's appeal to the Court of Appeal was unanimously dismissed.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In the event of alleged double taxation under a tax assessment, taxpayers must use the domestic litigation process to appeal against the assessment – either an appeal to the SCIT or judicial review. In the event of a conflict between the provisions of the tax legislation in Malaysia and the Double Taxation Agreement with a country, the latter takes precedence.

In *Orange Rederiet Aps v Ketua Pengarah Hasil Dalam Negeri* (2018) MSTC 30-160, the High Court held that the Malaysia–Denmark DTA had been ratified in Malaysia subsequent to the enactment of Section 4A and must have clearly been intended by Parliament to take precedence over the ITA.

To date, Malaysia has entered double taxation agreements with 76 countries. The Article on Mutual Agreement Procedure (MAP) in Malaysia's Tax Treaties allows the Malaysian Compe-

tent Authority (CA) to interact with the CAs of Treaty Partners with the intent of resolving international tax disputes involving double taxation and inconsistencies in the interpretation and application of a Tax Treaty.

In the Mutual Agreement Procedure Guidelines, the IRB has stated that all information obtained or generated during the MAP process is protected by the confidentiality provisions in the ITA and the provisions of the applicable Tax Treaty. As far as is known, there has not yet been any appeal against the outcome of a decision from the MAP, as they are concluded in private.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Although there may be overlaps between the application of the general anti-avoidance rules (Section 140 of the ITA) or the specific anti-avoidance rules and matters under the tax treaties, it is held that where there are inconsistencies between the ITA and tax treaties, the latter prevails.

Malaysia signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the MLI Convention) in January 2018 and has adopted the first approach, the Principal Purpose Test (PPT). Under the PPT approach, treaty benefits are to be denied “if it is reasonable to conclude... that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit”.

The exception is where it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention. This led to the ratification of the MLI Convention in local legislation and with amendments to Sections 132(1A), 132B(1A) and 132

of the ITA and Section 21(1)(b) of the Labuan Business Activity Tax Act 1990.

8.3 Challenges to International Transfer Pricing Adjustments

A taxpayer aggrieved by any transfer pricing adjustments under a notice of assessment by the IRB can initiate a challenge through an appeal to the SCIT or judicial review.

8.4 Unilateral/Bilateral Advance Pricing Agreements

The advance pricing arrangement (APA) regime is regulated under Section 138C of the ITA. An application for an APA is a determination by the DGIR or the CA with the taxpayer of the transfer pricing methodology to ensure the arm's-length transfer prices in relation to a transaction.

Under Rule 4 of the Income Tax (Advance Pricing Arrangement) Rules 2012, a taxpayer must first write to the DGIR for a pre-filing meeting for an APA at least 12 months prior to the first day of the proposed covered period. Both unilateral and bilateral APAs are entered into by consent of the taxpayers and the DGIR and/or the CA, so it is likely that an APA can reduce litigation in transfer pricing matters.

8.5 Litigation Relating to Cross-Border Situations

In view of the current COVID-19 pandemic, there is likely to be an increase in issues relating to permanent establishments and transfer pricing as these were among the biggest concerns for multinational enterprises (MNEs). Concerns over permanent establishment issues may arise in relation to the question of whether a person's continued existence in a foreign country or in Malaysia may result in the accidental creation of a permanent establishment.

A company may obtain financial assistance from a related company overseas to sustain business

and cushion the impact of the COVID-19 pandemic. Possible controversies may arise regarding whether the provision of financial assistance by a related company complies with the "arm's-length" price principle. Another area of concern is whether the IRB can expect contract manufacturers of MNEs to earn their routine profit notwithstanding the unprecedented economic conditions and rising operational cost due to the requirement to comply with Standard Operating Procedures prescribed by the government.

Taxpayers can mitigate their risks by maintaining proper evidence and documentation proving a certain course of action adopted with cogent commercial reasoning. For example, the provision of financial assistance and the determination of the corresponding interest should take the prevailing interest rate at the time, credit-worthiness, credit risks and credit ratings into consideration, among other matters.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

This section is not relevant in Malaysia.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

This section is not relevant in Malaysia.

9.3 Challenges by Taxpayers

This section is not relevant in Malaysia.

9.4 Refunds Invoking Extra-Contractual Civil Liability

This section is not relevant in Malaysia.

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

This section is not relevant in Malaysia.

10.2 Types of Matters that Can Be Submitted to Arbitration

This section is not relevant in Malaysia.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This section is not relevant in Malaysia.

10.4 Implementation of the EU Directive on Arbitration

This section is not relevant in Malaysia.

10.5 Existing Use of Recent International and EU Legal Instruments

This section is not relevant in Malaysia.

10.6 New Procedures for New Developments under Pillar One and Two

The OECD has introduced its Two-Pillar Solution under BEPS 2.0 to address the tax challenges arising from the digitalisation of the economy in the form of Pillar One and Pillar Two. Although the Two-Pillar Solution has yet to be implemented in Malaysia, it is expected that the nation will move in that direction sooner rather than later.

Following the implementation of Pillar One, it is expected that Malaysia may have the potential to increase its tax revenue. Pillar One aims to eliminate the possibility of double taxation, although this requires a largely co-ordinated global agreement involving multiple nations. If such an agreement is able to be made available, it would certainly be able to mitigate the contro-

versies surrounding the implementation and will provide further certainty to individuals as well as entities. In the absence of such a co-ordinated global agreement, the issues of double taxation that Pillar One aims to address will still arise, even if Malaysia were to introduce digital service taxes and applied Pillar One elements through its own local domestic legislation. However, Pillar One may not be the focus of the nation as the MNEs in Malaysia are less likely to be impacted by it.

Pillar Two, on the other hand, would be the focus of Malaysian taxpayers as it introduces a global minimum tax of 15% for MNEs with a global annual revenue above EUR750 million. It is a high possibility that a top-up tax will be imposed on a parent entity in respect of the low-taxed income of its subsidiaries when its subsidiaries do not meet the minimum tax of at least 15%.

Malaysian subsidiaries of large MNEs that are currently enjoying the tax benefits of paying concessionary tax rates that are far below 15% are expected to be impacted by Pillar Two. Similarly, Malaysian-based MNEs with overseas subsidiaries that are enjoying low tax rates overseas could be subjected to a top-up tax in Malaysia following the implementation of Pillar Two.

10.7 Publication of Decisions

This section is not relevant in Malaysia.

10.8 Most Common Legal Instruments to Settle Tax Disputes

This section is not relevant in Malaysia.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

This section is not relevant in Malaysia.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

The sum of fees payable to the tax authorities is directly proportional to the level of appeal: the higher the appellate court, the higher the fees payable to the authorities.

As a ballpark figure, the scale of sums payable is as follows:

- SCIT/CAT – costs will be awarded if the decision of the revenue officers under appeal is vexatious and frivolous;
- High Court – MYR5,000;
- Court of Appeal – MYR10,000; and
- Federal Court – MYR30,000.

11.2 Judicial Court Fees

Fees are payable by both parties at each stage of the litigation, with the amount depending on the nature of the document filed and the level of the court of law, among other factors. The higher the court, the higher the filing fees will be.

11.3 Indemnities

Unfortunately, as explained in **11.1 Costs/Fees Relating to Administrative Litigation**, the taxpayer may recover some costs but such payments are very meagre, because any tax proceeding is an action against the government of Malaysia. Since any sum payable in any tax proceeding is meant for the purposes of social welfare, the actual costs granted by a court of law are much lower than the costs awarded in civil proceedings between private parties.

However, a taxpayer can claim for interest if it is found that the revenue officers were unlawful in withholding the taxpayer's money. In *Pelangi Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC 30-036, the High Court echoed the House of Lords' sentiments in *Woolwich Build-*

ing Society v Inland Revenue Commissioners (No 2) [1992] 3 All ER 737, where Lord Stynn held that it is unacceptable to deny a taxpayer interest when the taxpayer paid large sums of money to the Revenue based on invalid regulations, which were retained free of interest, pending a court decision.

Accordingly, the High Court awarded interest of 4% to the taxpayer from the date the IRB had use of the money.

11.4 Costs of ADR

An appeal to the DRP or the DGOC to review his decision does not involve any costs becoming payable to the other party.

12. STATISTICS

12.1 Pending Tax Court Cases

There is no publicly available information or statistics on the number of tax court cases pending in each instance, or the value thereof. As such, it is difficult to ascertain the number of cases before each court.

12.2 Cases Relating to Different Taxes

There is no publicly available information on the number of cases initiated and terminated each year relating to different areas of tax and the values thereof. As such, it is difficult to estimate the accurate number and value.

12.3 Parties Succeeding in Litigation

The statistics on a party succeeding in litigation are not publicly available, and depend on the facts of each case.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The taxpayer should consult a tax lawyer at an early stage to preserve their rights to appeal against the decision of the revenue officers. The taxpayer should first determine the course of action – ie, to appeal against the assessment raised via judicial review or to the SCIT or CAT by reviewing the facts of the case and obtaining a legal opinion on the most suitable course of action.

Judicial review is available where the issue relates to a clear and flagrant breach of the law and there are exceptional circumstances in the form of a clear lack of jurisdiction, failure to perform a statutory duty or a serious breach of the principles of natural justice. However, where the issue involves a substantial question of fact or contains an allegation of time-barred assessment and fraud, the matter should be referred to the SCIT instead.

Another relevant consideration is whether there are also special circumstances warranting a stay order. As mentioned earlier, only the High Court and higher courts are empowered to grant a stay, but not the SCIT. As a general rule, the court will only grant a stay order where the applicant satisfies the court that there are special circumstances warranting a stay.

The economic downturn due to COVID-19 has not deterred the government of Malaysia from initiating civil proceedings against taxpayers to recover taxes. On the contrary, civil recovery proceedings by the government of Malaysia have been higher and stricter than ever. It is not surprising for a writ action to be served on the taxpayer a day after he defaults to pay the taxes by the due date.

In the absence of a stay order, the taxpayer would have to pay the taxes under assessment forthwith. However, the DGIR and the DGOC have discretion to allow the payment of taxes under assessment in instalments instead of the full sum immediately. Applications for an instalment payment scheme addressed to the DGIR or the DGOC would commonly require evidence of the financial circumstances of the person for a specified period. It is recommended for taxpayers to make an application for instalment payments as soon as possible, to prevent the imposition of a penalty.

Rosli Dahlan Saravana Partnership is led by a team of leading litigation, tax and corporate lawyers who are dedicated to providing innovative and effective solutions. The partners have been involved in many notable cases and transactions, and offer unrivalled expertise across various areas of practice. RDS is a full-service commercial law firm active primarily in capital markets matters, civil and commercial disputes,

corporate and commercial matters, M&A, real estate transactions and tax, sales and service tax and customs. The firm is committed to understanding and answering clients' needs with skill, tenacity and integrity. In an increasingly dynamic and complex environment, RDS remains steadfast and rooted in its commitment to serving as a strong, responsive legal counsel for clients' interests.

AUTHORS



D P Naban is a highly experienced practitioner and a senior partner at Rosli Dahlan Saravana Partnership. He specialises in civil, commercial and tax disputes, and has

championed taxpayers' rights in some of Malaysia's most significant tax disputes. Naban has appeared before the Special Commissioners of Income Tax, the High Court, the Court of Appeal and the Federal Court for various tax and civil matters. He is also active in the corporate practice, advising clients on an extensive range of corporate and commercial transactions, including M&A, project finance and the issuance of financial instruments.



Saravana Kumar heads Rosli Dahlan Saravana Partnership's Tax, Sales & Service Tax and Customs practice. His main area of practice is acting on contentious tax matters and

advising clients on a range of tax matters, such as indirect tax, stamp duty, trade facilitation and transfer pricing. Saravana has appeared in benchmark litigation matters, with a sizable volume of wins in tax disputes. In addition to having authored numerous tax-related publications, he is a frequent speaker at tax seminars and chairs the Taxation Section of LAWASIA.

Contributed by: D P Naban, Saravana Kumar, Kar Ngai Ng and Dharshini Sharma, Rosli Dahlan Saravana Partnership



Kar Ngai Ng is an associate with Rosli Dahlan Saravana Partnership's Tax, Sales & Service Tax and Customs practice. Kar Ngai's practice includes tax litigation and tax

advisory, with a focus on income tax disputes. Kar Ngai has represented large corporations and conglomerates in the country, as well as international and multinational companies from various industries. She has appeared before the Special Commissioners of Income Tax, the High Court, the Court of Appeal and the Federal Court. Kar Ngai has also contributed to various publications, including The International Tax Review and The Tax Guardian, an official journal of the Chartered Tax Institute of Malaysia.



Dharshini Sharma is a pupil with Rosli Dahlan Saravana Partnership's Tax, Sales & Service Tax and Customs practice. Dharshini read law at the University of Warwick and

completed her Bar course at City, University of London prior to being called to the Honourable Society of Middle Temple.

Rosli Dahlan Saravana Partnership

Level 16, Menara 1 Dutamas
No. 1, Jalan Dutamas 1
Solaris Dutamas
50480 Kuala Lumpur
Malaysia

Tel: +603 6209 5400
Fax: +603 6209 5498
Email: enquiry@rdslawpartners.com
Web: www.rdslawpartners.com



Law and Practice

Contributed by:

Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba
and Pablo Ramírez Morales

Ortiz Abogados Tributarios see p.405



CONTENTS

1. Tax Controversies	p.385	5.3 Judges and Decisions in Tax Appeals	p.394
1.1 Tax Controversies in this Jurisdiction	p.385	6. Alternative Dispute Resolution (ADR) Mechanisms	p.394
1.2 Causes of Tax Controversies	p.385	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.394
1.3 Avoidance of Tax Controversies	p.385	6.2 Settlement of Tax Disputes by Means of ADR	p.394
1.4 Efforts to Combat Tax Avoidance	p.385	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.395
1.5 Additional Tax Assessments	p.386	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.395
2. Tax Audits	p.386	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.396
2.1 Main Rules Determining Tax Audits	p.386	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.397
2.2 Initiation and Duration of a Tax Audit	p.388	7. Administrative and Criminal Tax Offences	p.397
2.3 Location and Procedure of Tax Audits	p.388	7.1 Interaction of Tax Assessments with Tax Infringements	p.397
2.4 Areas of Special Attention in Tax Audits	p.388	7.2 Relationship between Administrative and Criminal Processes	p.397
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.389	7.3 Initiation of Administrative Processes and Criminal Cases	p.398
2.6 Strategic Points for Consideration during Tax Audits	p.389	7.4 Stages of Administrative Processes and Criminal Cases	p.398
3. Administrative Litigation	p.390	7.5 Possibility of Fine Reductions	p.398
3.1 Administrative Claim Phase	p.390	7.6 Possibility of Agreements to Prevent Trial	p.399
3.2 Deadline for Administrative Claims	p.390	7.7 Appeals against Criminal Tax Decisions	p.399
4. Judicial Litigation: First Instance	p.390	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.399
4.1 Initiation of Judicial Tax Litigation	p.390	8. Cross-Border Tax Disputes	p.399
4.2 Procedure of Judicial Tax Litigation	p.390	8.1 Mechanisms to Deal with Double Taxation	p.399
4.3 Relevance of Evidence in Judicial Tax Litigation	p.391	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.399
4.4 Burden of Proof in Judicial Tax Litigation	p.392		
4.5 Strategic Options in Judicial Tax Litigation	p.392		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.392		
5. Judicial Litigation: Appeals	p.393		
5.1 System for Appealing Judicial Tax Litigation	p.393		
5.2 Stages in the Tax Appeal Procedure	p.393		

8.3	Challenges to International Transfer Pricing Adjustments	p.400	10.5	Existing Use of Recent International and EU Legal Instruments	p.401
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.400	10.6	New Procedures for New Developments under Pillar One and Two	p.401
8.5	Litigation Relating to Cross-Border Situations	p.401	10.7	Publication of Decisions	p.402
9. State Aid Disputes		p.401	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.402
9.1	State Aid Disputes Involving Taxes	p.401	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.402
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.401	11. Costs/Fees		p.402
9.3	Challenges by Taxpayers	p.401	11.1	Costs/Fees Relating to Administrative Litigation	p.402
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.401	11.2	Judicial Court Fees	p.402
10. International Tax Arbitration Options and Procedures		p.401	11.3	Indemnities	p.402
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.401	11.4	Costs of ADR	p.402
10.2	Types of Matters that Can Be Submitted to Arbitration	p.401	12. Statistics		p.402
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.401	12.1	Pending Tax Court Cases	p.402
10.4	Implementation of the EU Directive on Arbitration	p.401	12.2	Cases Relating to Different Taxes	p.403
			12.3	Parties Succeeding in Litigation	p.403
			13. Strategies		p.403
			13.1	Strategic Guidelines in Tax Controversies	p.403

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Tax controversies usually arise as a consequence of the audit attributions of the Mexican tax authorities (*Servicio de Administración Tributaria* – SAT), which lead to tax assessments of alleged unpaid amounts.

Tax controversies may also arise as a result of the denial of the refund of a favourable balance or of an undue amount paid by the taxpayer.

In both instances, tax controversies at the federal level have their origin in the issuance of an official letter by the tax authorities containing an assessment or a rejection of a refund.

1.2 Causes of Tax Controversies

Most tax controversies are related to income tax or value added tax, as these are the principal sources of tax revenue for the Mexican government, and are triggered by every kind of commercial activity, so almost every productive entity is obliged to pay those contributions.

Two specific issues can be identified in the vast majority of controversies, since the authorities challenge the effective execution of the acts that trigger tax effects: (i) transfer pricing adjustments, and (ii) the substance of the transactions.

As of 2020, an additional issue has given rise to a large number of controversies, although it does not imply any assessment or economic liability: the cancellation of taxpayer's electronic seals to issue electronic invoices.

As per the 2020 reform to the Federal Tax Code, the legal causes that entitle the authorities to cancel these seals have been increased as a way of preventing the issuance of artificial invoices by shell companies, a practice that has had a

major evasion effect to the detriment of tax collection.

Additionally, it is important to consider that a new rule entered into force in 2021, according to which Mexican tax authorities will make public the parameters of what they consider to be reasonable profit margins, deductions and effective tax rates for each economic sector.

Although the SAT's parameters are not mandatory and the aforementioned notice is not a formal audit, it is foreseeable that audits will be carried out, and eventually assessments will be issued against the companies that do not comply with the parameters issued by the authorities.

There are no statistics available to determine the values involved in each specific case.

1.3 Avoidance of Tax Controversies

Once the authorities have initiated an audit, it is unlikely that a controversy can be avoided or mitigated.

If the taxpayer is not able to demonstrate with sufficient evidence that there has been no avoidance, it is entitled to rectify its tax situation by accepting the observations made by the authorities during the audit. Depending on the stage the audit has reached when the corrections are made, a reduction of fines and penalties may occur.

Another method to avoid a tax controversy is to enter into an alternative dispute resolution process, as outlined under **6. Alternative Dispute Resolution (ADR) Mechanisms**.

1.4 Efforts to Combat Tax Avoidance

The base erosion and profit shifting (BEPS) recommendations made by the OECD to combat tax avoidance, and the modification of domestic legislation following those recommendations,

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

have not contributed substantially to reducing or increasing tax controversies; they have been used and applied by the authorities to audit taxpayers' obligations, but have had little influence on the number of controversies.

As of 2020, several BEPS recommendations have been included in Mexican legislation, such as:

- a general anti-abuse rule (GAAR);
- the obligation of tax advisers to disclose specific structures;
- the non-deductibility of payments made to preferential tax regimes; and
- the non-deductibility of interest if it is higher than a specific threshold in terms of the taxpayer's profit.

It can be expected that these rules will be applied at audit procedures, but not that they will substantially increase or diminish the number of audits.

Regarding double tax treaties, Mexico has not amended a significant number of the international agreements it has signed related to such matters. Nevertheless, Mexico signed the Multilateral BEPS Treaty, although it is not yet in force as it has not been ratified by the Senate.

1.5 Additional Tax Assessments

The taxpayer has no obligation to guarantee the tax assessed in order to be able to lodge an administrative or judicial claim against the corresponding ruling.

Nonetheless, if the assessment is not paid or guaranteed, the authorities have full capacity to carry out a foreclosure procedure as stated in the Federal Tax Code.

There are only two cases in which any foreclosure file is suspended without the need of

a guarantee: (i) if the taxpayer challenges the assessment through an administrative claim, and (ii) if the assessment is challenged through a substance trial (as explained in **4.2 Procedure of Judicial Tax Litigation**).

The relationship between tax assessments and a criminal filing against the taxpayer is explained in **7. Administrative and Criminal Tax Offences**.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

As a rule, entities to be audited are selected randomly. Nevertheless, the authorities adopt specific criteria to determine an audit against a specific company or group. Entities must be one of the following.

- Taxpayers in the oil industry.
- High income taxpayers – as defined by Mexican law, a company is considered to be of high income when its annual revenue exceeds approximately USD62.5 million.
- Multinational groups, specifically regarding their transfer pricing obligations.
- Taxpayers that declare, in their return, information that may amount to uncommon behaviour in comparison to previous years – examples include:
 - (a) an unusual deduction;
 - (b) losses when historically profits have been generated; or
 - (c) any transaction that has been audited for one year but has multi-annual effects (a questioned back-to-back credit that generates deductible interest in several years).
- Taxpayers that perform any inappropriate practice, as described in the catalogue published by the tax authorities.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

The SAT's Chief Officer has declared, publicly and privately, that high income taxpayers and multinational groups will be carefully audited, with no exception, in order to increase the collection of taxes.

In addition, there is the legal possibility of initiating a direct audit against a specific taxpayer or group, when the authorities have knowledge that that entity has taken part in any misconduct, such as issuing artificial invoices that correspond to operations that, in substance, did not take place.

Operation Master Plan

In April 2022, the SAT released its Operation Master Plan for 2022 (the Master Plan), which outlines the main goals and strategies in terms of audit and collection for this year.

The Master Plan identifies the following economic sectors as ones that will be prioritised by the SAT in 2022:

- tobacco and alcoholic beverages;
- financial entities;
- energy-related companies;
- telecoms;
- the food industry;
- the car industry;
- the construction and real estate industry;
- commercial entities;
- corporate management and business support services;
- pharmaceuticals and;
- steel and mining.

It also specifies the topics and transactions on which the SAT's auditing efforts will be focused, which include:

- payments to related parties resident abroad, whether they reside in a preferential tax regime or not;

- refund of favourable balances;
- tax benefits for taxpayers in the northern and southern border regions;
- generation and application of net operating losses (NOLs);
- corporate restructurings;
- repatriation of capital;
- transfer of stocks and shares; and
- transfer of intangible assets.

In order to audit and collect taxes from taxpayers in the above-mentioned industries and with regard to the preceding list of transactions, SAT has outlined the following strategic actions:

- focusing on economic groups, corporate restructurings, recent fiscal years, taxpayers that have not been audited before and the principal high income taxpayers;
- issuing solid observations and preliminary findings at the audit stage, in order to promote self-correction by taxpayers;
- avoiding litigation, instead ruling in administrative appeals in a way that promote the self-correction of the taxpayer;
- identifying unlawful refunds of favourable balances and recovering the corresponding amounts; and
- avoiding assessments, promoting self-correction by the taxpayer.

Effective Tax Rates

During 2021, SAT issued several publications on its website regarding what it considers to be the reasonable effective tax rate parameters in different sectors of the economy, for the fiscal years 2016 through 2019.

Such effective tax rates have been calculated according to the annual tax returns submitted by the taxpayers in the corresponding sector.

The effective tax rate is defined as the amount of income tax effectively paid, as a proportion

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

of the total taxable income received by the taxpayer; ie, this parameter does not consider legitimate deductions that companies can take and the application of NOL's of previous years, as permitted by statute.

It is foreseeable that audits will be triggered against taxpayers that do not comply with these effective tax rate parameters.

Nevertheless, it is important to bear in mind that such parameters are not mandatory for taxpayers and that they are fully entitled to demonstrate before the authorities at the audit stage, or even before the courts, that deductions, NOLs or other issues were legally applied in order to determine the amount of tax paid in the relevant tax year.

Is to be expected that during 2022 tax authorities will issue further publications and parameters on the effective rate for other sectors of the economy and for the years 2020 and 2021.

2.2 Initiation and Duration of a Tax Audit

Authorities may initiate an audit at any time, unless the statute of limitations period has been exceeded.

The legal term to conduct an audit is 12 months. The period may be extended to 18 months when the audited taxpayer is part of the financial system, or to two years if the authorities request information from a foreign tax agency, or if the audit involves transfer pricing issues.

When the audit ends, within the aforementioned period, the authority has six months to issue an official letter and notify the results of the assessment.

The statute of limitations period is five years from the date the taxpayer files its ordinary tax return,

or from the day any amended return is filed but limited to the issues that were modified.

When an audit is initiated, the statute of limitations period is suspended but in no case can it exceed six years and six months.

In some exceptional cases, the statute of limitation term may be extended up to ten years.

2.3 Location and Procedure of Tax Audits

There are two main types of audit: those that take place at the authority's headquarters (*revisión de escritorio*) and those that occur on the taxpayer's premises (*visita domiciliaria*). There is no general rule, and the authority executes both options equally.

As a rule, audits are based on printed documents, although the taxpayer may submit documents and information in a digital format.

A new type of audit has recently been introduced by Mexican law: the electronic audit, which is based on the electronic information that taxpayers are obliged to submit monthly through the electronic systems implemented by the authorities.

2.4 Areas of Special Attention in Tax Audits

Auditors put a special focus on requesting that the taxpayer demonstrate, through documentary evidence, the substance of the transactions that trigger tax effects (mainly deductions and creditable VAT).

Contracts, invoices and payment receipts are no longer sufficient evidence to demonstrate that a certain transaction took place – ie, that a service was effectively provided or merchandise was acquired.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

Auditors also place an emphasis on the taxpayer demonstrating, for example, that a service provider effectively has the technical capabilities to render the service.

Additionally, auditors request that the taxpayer demonstrate the business reason for executing a specific transaction, instead of any other alternative.

Until 2019 there was no rule of substance over form in Mexican legislation; therefore, the analysis of the substance of taxpayers' activities was made from a practical point of view.

As of 2020, however, a GAAR is in force according to which the SAT is entitled to ignore the tax effects of legal acts lacking a business reason, but that create a tax benefit for the taxpayer; therefore, it can be expected that the substance of such transactions will also be challenged from a tax point of view.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The increasing prevalence of rules concerning cross-border exchanges of information and mutual assistance between states has not increased the number of tax audits in Mexico.

However, Mexican authorities have used the mechanisms to exchange information as an additional tool to audit companies that are part of multinational groups.

Mexican authorities have requested information from foreign tax agencies in audits, including those in the USA, the Netherlands, Luxembourg and Ireland.

2.6 Strategic Points for Consideration during Tax Audits Evidence Provision

From a strategic point of view, the key thing that a taxpayer must do during an audit is provide all the evidence necessary to demonstrate the substance of, and the business reason behind, the transactions questioned during that audit (please refer to **2.1 Main Rules Determining Tax Audits**).

It is important to bear in mind that, according to a precedent of the Supreme Court of Justice, evidence that was not submitted at the audit stage or during the administrative claim will not be accepted by the courts in any subsequent judicial litigation.

Therefore, it is highly important for the taxpayer to provide the authorities with all the evidence to support the facts and the nature of the transactions carried out by the company. Legal arguments and the interpretation of the applicable laws may be stated before the courts, but no additional evidence may be rendered.

Certainty of Date

Additionally, a recent mandatory precedent from the Supreme Court has stated that, in order to be a valid support for the existence and substance of a transaction, the documentary evidence must provide full assurance of its date of issuance or creation; that is, there must be complete certainty of the date a contract was signed or a transaction took place.

According to this precedent, there will be certainty over the date of a document when it is registered at the Public Registry of Property, is ratified by a public notary or by the death of any of the parties in the contract.

Therefore, taxpayers would have to ratify every contract or agreement they enter into before a

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

public notary, in order to provide conviction of its date and, accordingly, to be a valid support for the tax effects derived from that transaction.

Nevertheless, among practitioners there is a broad discussion as to whether there are other means to provide certainty of the date of a piece of documentary evidence.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

In order to challenge a tax assessment, the taxpayer can decide to file either an administrative claim or pursue a judicial trial, as the former is optional before initiating the latter.

The taxpayer has a legal term of 30 business days from the date of notification of the resolution to file the administrative claim before the legal area of the tax administration that determined the assessment.

Mexican law provides an additional term of 15 business days after the claim is filed to announce the evidence that will be rendered, and another 15 days to submit it.

3.2 Deadline for Administrative Claims

Formally, authorities have a legal term of three months to issue a decision on the administrative claim. The absence of a resolution is considered a tacit negative decision and can be challenged by lodging a judicial claim before the Tax Court; however, it is unusual to appeal a tacit negative decision.

Taxpayers regularly wait until the resolution is issued since, within the time of the administrative appeal, there is no obligation to guarantee the assessment. When the claim is resolved or the tacit negative decision challenged, a bond

or letter of credit, among other means, must be put in place to avoid any potential foreclosure procedure.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is lodged either directly against the assessment or in order to challenge the decision of the administrative appeal.

The judicial claim is filed before the Federal Court of Administrative Justice (Tax Court), within a legal term of 30 business days from the date of the notification of the resolution to be challenged.

4.2 Procedure of Judicial Tax Litigation

As mentioned in **4.1 Initiation of Judicial Tax Litigation**, the taxpayer has a legal term of 30 business days to file the judicial claim before the Tax Court; tax authorities have a legal term of 30 business days to file their written response to the claim.

If evidence from an expert witness is to be rendered, the Tax Court will request that the experts appointed by the parties appear before the corresponding judicial officer to accept their assignment within the next ten business days after the response of the authority has been submitted. The experts will have an additional 15-day term in which to render their opinions.

If those opinions are contradictory, the Tax Court will appoint a third, independent expert to accept the assignment and render their report in the same terms as mentioned above.

Once the experts' reports have been rendered, the parties will be granted a term of ten business

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

days in which to prepare and file their written closing arguments.

The Court has a legal term of 45 business days to issue its verdict, but there is no legal sanction if it takes longer.

Substance Trials

As of 2017, there is a new form of the procedure available before the Tax Court: the so-called substance trial.

Through this special variant of the annulment complaint procedure, the taxpayer is entitled to argue only substance arguments before the Court, in order to challenge a tax assessment determined by the authority. This means that the plaintiff renounces its right to formulate legal arguments in order to demonstrate violations of the procedural rules that regulate tax audits.

Substance arguments must be understood as the interpretation of the applicable legal provisions, the qualification of the nature of the facts and transactions in question, and the evaluation of the evidence submitted at the audit.

Although the legal term to initiate the substance trial is also 30 business days, the terms of the internal phases of the procedure are shorter.

The most relevant difference between the ordinary trial and the substance trial is that, at the substance trial, there is a hearing in which both parties (taxpayer and authority) verbally present the main arguments to challenge or defend the legality of the assessment to the magistrates of the Tax Court.

The substance trial has become a highly recommendable option for taxpayers to challenge assessments that involve relevant or strategic issues, and that implicate an assessment of a

large amount (as the threshold to file the substance trial is approximately USD325,000).

Another relevant advantage of the substance trial is that the law waives the taxpayer's obligation to guarantee the assessment during the period in which the procedure takes places.

4.3 Relevance of Evidence in Judicial Tax Litigation

Documentary evidence is relevant in order to support the substance and business reasons for the transactions carried out by the taxpayer; however, no additional evidence can be submitted before the courts that was not rendered at the audit or with the administrative claim.

It is important to bear in mind that any document, with which taxpayers intend to support their transactions, has to provide certainty of its date of issuance, as explained in **2.6 Strategic Points for Consideration during Tax Audits**; although it is not a legal requirement, it has been construed by the Supreme Court in a precedent that is mandatory for the inferior courts, such as the Tax Court.

The opinion of expert witnesses is appropriate evidence to be rendered at the judicial level if it is necessary to sustain any technical issue that goes beyond the legal interpretation of the law or the appreciation of the facts and evidence. Recurrent examples include expert opinions in accountancy, in economics regarding a transfer pricing controversy, or in engineering if the litigation is related to the oil industry.

Documentary evidence must be submitted with the claim. If not submitted, the court will grant an extra five-day term in which to do so. The expert opinion will be rendered according to the proceeding described in **4.2 Procedure of Judicial Tax Legislation**.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof lies with the taxpayer in civil and administrative tax litigation, as the resolutions of the authority are deemed to be legal and lawful.

In criminal litigation, the burden of proof rests with the public prosecutor, as the Mexican Constitution establishes the presumption of innocence in favour of the defendant.

4.5 Strategic Options in Judicial Tax Litigation

Documents and evidence must be submitted according to the legal terms, as explained in **4.2 Procedure of Judicial Tax Litigation** and **4.3 Relevance of Evidence in Judicial Tax Litigation**. It is important to remember that any evidence that was not rendered at the audit or with the administrative appeal will not be accepted by the courts, including the expert witness opinion.

There are several non-binding precedents stating that if the taxpayer did not submit the expert witness opinion as evidence with the administrative appeal, it cannot do so before the courts at the judicial litigation stage.

Additionally, documentary evidence must provide certainty of its date of issuance, according to a precedent of the Mexican Supreme Court of Justice.

Legal arguments also have to be stated at the claim, as no new arguments can be drafted at the appeal stage; any aspect that was not challenged at the claim may not be refuted at the appeal stage.

It is also important to bear in mind that legal arguments must directly challenge the legal grounds of the assessment and/or the resolution to the administrative appeal, its interpretation of

the applicable legal provisions, the appreciation of the facts, and evidence rendered at the previous stages.

Legal arguments that do not aim to challenge these aspects will not be considered by the courts, as the purpose of a judicial claim is to refute the concrete legal grounds of a resolution that determines a tax assessment.

During a judicial claim there is no legal chance to enter into a settlement; these kind of agreements between the tax authorities and the taxpayer can only be reached as explained in **6. Alternative Dispute Resolution (ADR) Mechanisms** (in order to initiate such a process, it is necessary that no assessment has been determined).

At the same time, during a judicial trial, the question of whether or not to pay the assessment has no impact on the outcome of the litigation process. On the contrary, the taxpayer has to decide – when the corresponding resolution is notified – if the assessment is paid or guaranteed.

If the taxpayer decides to pay, this does not interfere with its right to litigate, but any interest or increase due to inflation will be accrued in its favour. This may be an important cash outflow for the company.

Expert reports shall be submitted following the process and terms explained in **4.2 Procedure of Judicial Tax Litigation**, when the controversy relies, even in part, on technical issues that go beyond the interpretation of the law.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The jurisprudence issued by the Supreme Court of Justice and the Circuit Court is mandatory for the Tax Court. However, not every precedent is binding – only those that have ruled five cases

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

in the same sense by a Circuit Court, or when the Supreme Court resolves a contradiction of criteria between two or more Circuit Courts.

Additionally, the legal considerations contained in the verdicts issued by the Supreme Court of Justice will be mandatory when they are approved by a specific majority.

On the other hand, international jurisprudence, doctrine (domestic or international) and other international documents are merely guidelines that courts can take into consideration, but which they are not obliged to defer to. Therefore, precedents other than domestic jurisprudence are rarely applied by the courts to resolve tax controversies.

However, according to Mexican legislation, the OECD Transfer Pricing Guidelines are applicable regarding the interpretation of transfer pricing rules.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

As a rule, there is only one definitive form for appealing a verdict issued by the Tax Court, which is the direct constitutional injunction (*juicio de amparo directo*). In general terms, that is the proper remedy to challenge verdicts issued by courts.

The appeal is ruled on by a Circuit Court, which depends on the Federal Judicial Power.

There is no threshold or burden in order to appeal a verdict issued by the Tax Court, since it is a constitutional right for any private person or entity to challenge any verdict that causes any harm to its rights.

There are no limitations in terms of the nature or value of the controversy, unless the final and decisive stage of appeal, according to the law, has been reached and ruled on.

It is important to note that, if the verdict issued by the Tax Court is favourable to the taxpayer, the authorities are entitled to challenge that verdict through a petition for review, which will also be ruled by a Circuit Court.

5.2 Stages in the Tax Appeal Procedure

As mentioned before, as a rule there is only one stage in tax appeal procedures: the direct constitutional injunction.

The procedure is simple, as this appeal cannot contain any legal arguments that were not stated during the judicial claim, and no new evidence may be rendered.

The legal arguments to be drafted at the constitutional injunction must challenge the legal grounds of the verdict issued by the Tax Court – ie, the interpretation of the applicable legal provisions, the nature of the facts according to the evidence, and the evaluation of the significance of the evidence rendered at the procedure.

The only case in which there is a second stage for appeal is when the taxpayer claims the unconstitutionality of the legal provisions applied by the authorities and the Tax Court in order to determine and confirm the assessment, or when the direct interpretation of a constitutional rule is implied.

In both cases, the taxpayer can file an exceptional petition for review before the Supreme Court of Justice, which review will be limited to attending to the constitutional issues of the controversy that, in the Supreme Court's view, may lead to an important and relevant precedent from a constitutional point of view.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

It has become common practice for the Supreme Court to regard tax issues as not complying with the importance and relevance standard; therefore, the majority of the exceptional petitions for review are rejected, even when the controversy involves the constitutionality of a tax law, or its violation of an international tax treaty.

If the Supreme Court does not accept this extraordinary petition for review, there is no further remedy in order to challenge the decision.

5.3 Judges and Decisions in Tax Appeals

Circuit Courts are formed by three magistrates, and their decisions are taken by majority or unanimity. One of the magistrates prepares a draft, which is then discussed and approved or rejected at a public hearing.

Magistrates are appointed by the Federal Judicial Council, the administrative agency of the Federal Judicial Power, from among the candidates that pass the corresponding public examinations.

The Justices of the Supreme Court of Justice are appointed according to the procedure stated in the Constitution: the President submits a shortlist of three candidates to the Senate, which then has to appoint one candidate through the favourable votes of two thirds of the Senators.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Mexican law provides only one alternative dispute resolution (ADR) mechanism for tax disputes: mediation by the Mexican Taxpayers'

Ombudsman (*Procuraduría de la Defensa del Contribuyente* – Prodecon).

The purpose of the mediation process is to achieve a settlement between the taxpayer and the authorities regarding the true nature of the facts and transactions carried out by the taxpayer, and their tax effects.

This is not a controversy stage, but a collaborative procedure, in which both parties have expressed their intention to reach a settlement based on evidence.

Prodecon, acting as a mediator, provides all the legal means necessary to conduct the negotiation process by procuring the understanding, from each party, of the other's position and the analysis of the evidence rendered by the parties.

6.2 Settlement of Tax Disputes by Means of ADR

The last stage of a review process, prior to determining an assessment, is the observations letter, in which the authority states in writing the issues discovered that may indicate an omission by the taxpayer. The audited entity will have a legal term of 20 business days in which to submit any evidence and express any legal arguments in order to demonstrate the contrary.

The relevance of said observations letter, or pre-assessment, is that the authority qualifies the nature of the facts and transactions as well as their legal effects.

Once this qualification is issued by the tax authorities, the taxpayer is entitled to initiate a conclusive agreement procedure before Prodecon. It is important to bear in mind that the corresponding request must be filed within a legal term of 20 business days after the notification of the observations letter.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

In this request, the taxpayer shall indicate what they believe to be the true nature of the facts and transactions, and their legal effects, and propose the terms in which they consider a settlement should be reached.

The authorities will have 20 business days in which to agree with the taxpayer's proposal, reject it or make a counterproposal.

If both parties demonstrate their disposition to achieve a settlement, Prodecon shall call for working sessions, where the taxpayer may submit additional evidence and express legal arguments in order to enter into a negotiation process regarding the proper evaluation of the facts, transactions, legal provisions and evidence provided by the parties.

At the end of the process, both the authorities and the taxpayer may reach a settlement regarding every issue in dispute or only some of them. The rest may be substance for an assessment and a litigation process.

If a settlement is reached, both parties must sign a written document in which the terms and conditions of the agreement and the corresponding duties applying to each of them are stated.

Prodecon's role is to facilitate the negotiation process, make suggestions and express its point of view, which does not have to be followed by any of the parties; therefore, the procedure may end without an agreement being reached between the parties. If that is the case, it is most likely that the authorities will issue an assessment regarding all the omissions discovered during the review process.

As of 2022, mediation processes before Prodecon are limited to a 12-month period; if such term is exceeded without an agreement being

reached, the process will be closed and the audit process will continue.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

If an agreement is reached as a result of the mediation process, the potential contingency may be reduced, as both parties agree that the facts have a different nature than that attributed to them by the authorities, but they also have different effects than those reflected by the taxpayer on its tax return.

Surcharges shall be reduced in the same proportion as the potential contingency, as they are an accessory to the principal amount.

Penalties will be cancelled in full if it is the first time that the taxpayer has entered into a conclusive agreement. In subsequent cases, penalties should be applied and reduced according to the applicable laws.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Taxpayers are entitled to make a ruling request before the tax authorities regarding the tax effects of a specific transaction, a set of related transactions or a complete corporate restructuring. The only condition is that the petition has to address actual and concrete situations, and the taxpayer has to propose the tax treatment that they consider to be appropriate.

The response to the petition is mandatory for the tax authorities if the ruling supports the position proposed by the taxpayer, which may lead to any dispute being avoided.

On the contrary, if the resolution on the ruling request does not endorse the criteria proposed by the taxpayer, it is not mandatory on the latter. Nevertheless, it may raise a flag to the authori-

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

ties to audit the transactions discussed in the ruling request.

6.5 Further Particulars Concerning Tax ADR Mechanisms

There is no limitation regarding the type of controversy, or any threshold with regard to the value of the claim or possible assessment, about which a taxpayer may request a conclusive agreement before Prodecon.

Taxpayers have the right to make a petition in this sense before the authorities issue the assessment. Therefore, the only limitation is time, as the taxpayer has a 20 business day term to file its petition for a settlement, from the date the observations letter is notified.

Prodecon has a 20-day term after the authorities submit their response in which to call for a meeting with the parties in order to sign the conclusive agreement. However, in practice, Prodecon procures the execution of as many working sessions as needed (within a prudent basis), in order to reach an agreement.

Before 2022, mediation procedures could take up to two years, but as of this year, the parties have a 12-month period to reach an agreement or the procedure will be closed, and the audit process will continue its path.

If both parties reach an agreement and proceed with the signing of a settlement, the terms of that settlement cannot be challenged before the courts. The only exception is when the authorities discover that the facts the agreement is based on are untrue or were simulated, in which case the complete agreement may be challenged.

If the agreement is only partial, authorities may issue an assessment regarding the issues for which there was no consensus between the par-

ties. These issues may be challenged through the regular procedures described in **3. Administrative Litigation** and **4. Judicial Litigation: First Instance**.

There are no strict rules regarding the number of mediators and their appointment, as they are Prodecon officers who work full time as public servants at said agency, and are appointed according to the corresponding administrative rules.

The precedence of previous settlements does not necessarily have an influence on the result of a concrete mediation process; the precedence of jurisprudence may have an impact on the qualification of facts and their tax effects, with the same importance as in any other legal procedures regarding a controversy between a taxpayer and the authorities.

Agreements stated at the settlement must be based on strict law; nevertheless, in order to apply those criteria, the parties and the mediator tend to give preference to the substance of the transactions over the form, with the provision that there is sufficient documentary and technical support for the conclusions reached by the parties.

Limitations on ADR

It is important to have in mind that, as of 2021, taxpayers will not be entitled to initiate ADR in those cases in which the controversy consists in:

- favourable balances refunds;
- the issuance of invoices that support non-existent transactions;
- third parties are being audited; and
- the audit procedure is being carried out in compliance to a judicial verdict.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

Transfer pricing cases are settled according to the exact same procedure and rules as used for other tax disputes. It is important that the parties provide the technical elements that support their positions and the agreements they reach in order to determine a certain valuation of transactions between related parties.

In fact, with regard to transfer pricing issues, mediation has become the preferred option for taxpayers to resolve a controversy before entering into the litigation process.

Regarding indirect methods, there are specific rules that establish legal presumptions and ADR mechanisms that may be a useful tool to settle disputes. There is an additional path to demonstrate, in a collaborative manner, the origin of deemed income before entering into a litigation process in which the burden of proof lies with the taxpayer. Nevertheless, ADR has not become a significant mechanism through which to resolve controversies regarding potential contingencies derived from the use of indirect methods.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

In Mexican legislation, there are only two types of liability for taxpayers related to tax payment omissions: administrative (as explained in previous sections) and criminal.

There are other administrative infringements that correspond to defaults of formal obligations; as a rule, the penalty for administrative infringements is a monetary fine.

Administrative infringements are regularly determined by the authorities during the same audit process as tax assessments and, accordingly, are challenged with the same legal remedies (unless the taxpayer chooses the substance trial).

It is important to keep in mind that, if the authorities issue a tax assessment against a specific taxpayer, this does not automatically lead to a criminal procedure. In general terms, although there are concrete legal provisions, criminal offences occur in cases where the taxpayer commits fraud by misleading the tax authorities, simulates transactions in order to avoid any tax consequences or issues artificial invoices.

If tax authorities discover a fact or transaction that may indicate a criminal offence, they can notify the federal prosecutor for tax matters (*Procuraduría Fiscal de la Federación*) so that they can make all the necessary investigations. If that special prosecutor finds merit in the case, then they could ask the federal prosecutor (*Fiscalía General de la República*) to initiate the criminal procedure stated according to criminal law; the tax authorities will act as the offended party.

A significant reform, in force as of 2020, ensures that tax fraud and the issuance of artificial invoices are considered as organised crime, and therefore require preventative prison sentences for the defendant, until the conclusion of the criminal trial.

7.2 Relationship between Administrative and Criminal Processes

Administrative and criminal files are related, as the former may be evidence to the public prosecutor of the latter. Nonetheless, both processes may be carried out in parallel, as the criminal procedure does not have to be suspended while the Tax Courts issue their ruling regarding a tax assessment.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

Additionally, the definitive ruling of one file does not determine the result of the other. As several precedents of federal courts have established, the reason for this relates to the burden of proof: at the administrative level, the taxpayer is obliged to demonstrate that the assessment has no legal grounds; while at the criminal level, the public prosecutor has to demonstrate that the defendant was involved in conduct that is described as a criminal offence.

7.3 Initiation of Administrative Processes and Criminal Cases

As mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**, administrative infringement processes are the same as those to determine and challenge tax assessments.

Criminal cases are initiated when tax authorities discover that the taxpayer has been involved in an act that is described as a crime regarding the applicable laws – ie, tax fraud, the simulation of transactions or the issuance of artificial invoices. Administrative processes may evolve to a criminal case only in such cases.

7.4 Stages of Administrative Processes and Criminal Cases

It is important to mention that this firm does not litigate criminal cases, so its expertise regarding the criminal tax offences is limited to general knowledge of the criminal process and its stages.

If the tax authorities discover that the taxpayer has been involved in an act that may indicate a possible crime, they are entitled to make the formal accusation before the federal prosecutor for tax matters, as mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**.

This special prosecutor will, in turn, begin the investigation phase, where they will gather all the evidence needed to determine whether or

not the taxpayer committed a criminal offence; if the prosecutor finds such evidence, they have to turn it over to the federal prosecutor.

If the conclusion is that there is enough evidence to implicate the taxpayer, the public prosecutor will formulate the formal accusation before the courts in order to proceed to criminal trial.

In those cases in which the omitted contributions or the amount of the artificial invoices do not exceed a threshold equivalent to USD400,000, prior to the initiation of the trial, there is the possibility for the victim – in this case, the tax authorities – and the defendant to arrive at an alternative resolution before the court in order to repair the damage caused by the taxpayer.

If there is no agreement between the parties, or the threshold previously mentioned is exceeded, the formal trial will take place according to the rules established in the National Criminal Procedures Code, which is a verbal procedure, where the prosecutor and the defendant will lay out their legal arguments and provide the corresponding evidence to support their positions.

The criminal judge will issue their resolution, whereby they will declare whether or not the defendant is guilty of the offence alleged by the prosecutor.

The courts that may hear criminal tax cases are the federal criminal courts, which may also hear any other kind of criminal case; there are no criminal courts specialised in tax offences.

Criminal courts that decide tax felonies are totally different from those that rule on the legality of the tax assessment.

7.5 Possibility of Fine Reductions

If the taxpayer covers the unpaid taxes, plus surcharges and penalties, the tax authorities may

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

request that the public prosecutor or the criminal court dismiss the case; this is a discretionary action that may be or may not be executed.

Additionally, if the taxpayer restitutes the unpaid amount during the process, the penalty may be reduced by 50%.

Finally, if the taxpayer pays the omitted taxes before the authorities discover the omission, the tax authorities will not execute any action before the public prosecutor.

7.6 Possibility of Agreements to Prevent Trial

As described in **7.4 Stages of Administrative Processes and Criminal Cases**, there is the possibility to enter into an agreement with the tax authorities to prevent a criminal trial; the only condition of entering into such an agreement is the approval of the tax authorities, as the victim, and the defendant.

7.7 Appeals against Criminal Tax Decisions

In order to challenge a decision adopted by the court of first instance, the National Criminal Procedures Code establishes an appeal procedure that will be ruled by an Appellate Collegiate Court (*Tribunal Colegiado de Apelación*), led by a federal magistrate. The resolution of this Court may be challenged through a direct constitutional injunction (*juicio de amparo directo*).

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a general rule, transactions challenged by the tax authorities under the GAAR, SAAR, transfer pricing rules or anti-avoidances rules do not give rise to criminal cases. The reason is that these rules are too technical for a public prosecutor to demonstrate that the taxpayer participated in any fraud or simulation, as the burden of proof for criminal cases lies with the authorities.

Authorities tend to focus on the tax assessment procedures, unless there are very strong elements that may lead to a criminal case, or the issue acquires public relevance.

Nevertheless, authorities are expected to focus, from a criminal point of view, on prosecuting companies or taxpayers that are deemed to issue artificial invoices, as this practice is now recognised as a form of organised crime.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

If a double taxation situation occurs due to an additional tax assessment or tax adjustment in a cross-border transaction, the most common path to challenge the corresponding ruling is domestic litigation and/or the ADR mechanisms described in previous sections.

Also, mutual agreement procedures (MAPs) under double tax treaties signed by Mexico are a feasible way to obtain the nullity of the assessment.

A MAP is much less common but both procedures can be triggered by the taxpayer; if a MAP is filed before a foreign tax agency, the domestic litigation process will be suspended.

The MLI has not yet (May 2022) entered into force in Mexico, as it has not been approved by the Mexican Senate; therefore, none of its measures or mechanisms have had any impact.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Mexican jurisprudence has not addressed the issue of whether the GAAR or SAAR apply in

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

cross-border transactions covered by bilateral tax treaties.

Nevertheless, authorities have applied a SAAR to such situations, usually overlooking the provisions stated in the applicable double taxation treaties signed by Mexico.

The new GAAR, in force as of 2020, does not limit its application to either domestic or cross-border transactions, even those covered by tax treaties; therefore, in a litigation process, whether the specific transaction is covered by a treaty benefit that has been overlooked by the authorities in its application of the GAAR should be considered.

As mentioned in **8.1 Mechanisms to Deal with Double Taxation**, the MLI has not been approved by the Mexican Senate; therefore, it is not yet mandatory for Mexican authorities nor taxpayers.

Regarding the principal purpose test (PPT) and the amendment of the double taxation treaty (DTT) preamble, it is important to mention that Mexican authorities, when auditing cross-border situations in which the parties have applied a treaty benefit, regularly demand that the taxpayer demonstrate that the beneficial owner of the revenue is a resident of the other contracting state, in order to avoid treaty abuse.

The MLI provisions will grant additional instruments in order to prevent BEPS through structures and transactions that have the sole purpose of treaty-shopping.

8.3 Challenges to International Transfer Pricing Adjustments

As a rule, and in accordance with Mexican transfer pricing rules, resolutions issued by the authorities regarding transfer pricing adjustments that involve cross-border transactions focus on the

determination of income and deductions of the Mexican resident taxpayer. Therefore, litigation against said assessments is regularly carried out before the Tax Court.

Additionally, transfer pricing adjustments can be challenged through the MAP foreseen in double taxation treaties signed by Mexico.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Advance pricing agreements (APAs) are established in Mexican legislation and are a useful mechanism to avoid or mitigate controversies in transfer pricing matters, as taxpayers and authorities achieve a consensus regarding the methodology implemented by the former in controlled transactions.

The result of the procedure carried out by the parties is a ruling that will be in force in the fiscal year in which it was issued, in the previous year and in the following three years.

The APA can derive from a direct negotiation between the taxpayer and Mexican authorities, but also from an arrangement with foreign tax agencies of countries that have signed a double taxation treaty with Mexico.

The procedure is not expressly regulated by Mexican law, but it takes the path of a regular administrative procedure: the taxpayer shall file his or her petition before the tax authority, submitting the documentary, technical and legal evidence that supports his or her position. The authority may request additional information and documentation; there is the possibility of having working sessions in order to achieve an agreement and the notification of the corresponding ruling.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

8.5 Litigation Relating to Cross-Border Situations

As a rule, cross-border situations that relate to transfer pricing generate more litigation. In order to mitigate such litigation, many taxpayers have chosen to enter into a conclusive agreement procedure before Prodecon, as described in **6. Alternative Dispute Resolution (ADR) Mechanisms**, in order to achieve a settlement with the authorities.

The probable reason for this is that the Mexican government and Mexican tax authorities do not want third parties to decide whether or not they are entitled to collect a specific amount of taxes.

None of the relevant DTTs signed by Mexico has an arbitration clause.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

Mexico is not an EU state and these issues do not arise.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

Mexico is not an EU state and these issues do not arise.

9.3 Challenges by Taxpayers

Mexico is not an EU state and these issues do not arise.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Mexico is not an EU state and these issues do not arise.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Mexico did not opt for mandatory binding arbitration, according to Article 18 of the MLI.

10.2 Types of Matters that Can Be Submitted to Arbitration

Mexico has not opted for mandatory binding arbitration, either in terms of the MLI or in any of the relevant DTTs, none of which has an arbitration clause.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Neither baseball arbitration nor independent opinion procedures are possible with regard to international tax disputes in Mexico. See **10.2 Types of Matters that Can Be Submitted to Arbitration**.

10.4 Implementation of the EU Directive on Arbitration

Mexico is not an EU state.

10.5 Existing Use of Recent International and EU Legal Instruments

None of the recent international legal instruments regarding the settlement of tax disputes have been used yet in Mexico.

10.6 New Procedures for New Developments under Pillar One and Two

It is likely that Pillars One and Two will be introduced into Mexican legislation sometime in the future; nevertheless, it is also likely that Mexican authorities will harmonise the corresponding rules to foreign legislation.

Therefore, it is not expected that this will happen in the following two years.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

10.7 Publication of Decisions

Mexico has not opted for mandatory binding arbitration, either in terms of the MLI or in any of the relevant DTTs.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Mexico has not opted for mandatory binding arbitration, either in terms of the MLI or in any of the relevant DTTs.

Therefore, there are no domestic rules implementing the rulings issued by arbitration courts, in terms of the MLI.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Mexico has not opted for mandatory binding arbitration, either in terms of the MLI or in any of the relevant DTTs.

Therefore, there are no criteria adopted by taxpayers in order to hire independent professionals.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

In the Mexican justice system, there are no fees for pursuing litigation at the administrative or judicial level regarding tax issues, nor any other matter (civil, criminal, labour). Therefore, taxpayers do not have to pay any fee before the tax authorities or the judicial courts to submit a claim and obtain a resolution.

The same criteria apply to the ADR mechanism of mediation before Prodecon, as it is a public agency funded within the federal budget.

Finally, taxpayers may request an indemnity from the tax authorities, when a tax assessment does not express its legal grounds or reasoning (*fundamentación y motivación*), or is issued against a mandatory precedent of the Supreme Court of Justice regarding the proper interpretation of the legal provisions applied.

11.2 Judicial Court Fees

See **11.1 Costs/Fees Relating to Administrative Litigation** for relevant information.

11.3 Indemnities

See **11.1 Costs/Fees Relating to Administrative Litigation** for relevant information.

11.4 Costs of ADR

See **11.1 Costs/Fees Relating to Administrative Litigation** for relevant information.

12. STATISTICS

12.1 Pending Tax Court Cases

According to the annual report of the Tax Court (the annual report), by the end of 2021 there were 87,138 cases pending at the Tax Court. The global monetary value of the cases handled by the Tax Court during 2021 was MXN850 billion (approximately USD4,109 billion).

The report does not disclose the number of cases attributed to each chamber of the Tax Court.

On the other hand, the annual report of the Supreme Court of Justice and the Federal Judicial Council provides information regarding the number of cases resolved by the former, but does not disclose how many of them are related to tax issues, nor the number of cases ruled by the Federal Circuit Courts across the country.

*Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, **Ortiz Abogados Tributarios***

12.2 Cases Relating to Different Taxes

According to the annual report, during 2021 a total number of 165,970 cases were initiated and 169,140 cases were terminated. However, the report does not disclose the number of the cases relating to different taxes or matters (as the Tax Court also has jurisdiction regarding social security, intellectual property, antitrust and other administrative issues), nor their monetary value.

12.3 Parties Succeeding in Litigation

The annual report only provides statistics about the party that succeeds in litigation, regarding the cases resolved by the Superior Chamber, which attends a limited number of cases, depending on the matter and the monetary threshold of the controversy.

Also, there are statistics regarding the number of verdicts issued by the Tax Court that were challenged and overruled by the Circuit Courts: during 2021, 118,323 verdicts were challenged (by the taxpayer or by the authorities) and 40,045 appeals were resolved, with the verdict of the Tax Court being revoked in 8,376 cases.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

There are some strategic guidelines that taxpayers must consider in order to prevent a tax controversy or, when one is triggered, to defend themselves successfully.

Providing Evidence

First, the taxpayer should try to support its transactions with as much evidence as possible, such as contracts, invoices, payment receipts, communications with suppliers and services providers or any other material evidence that demonstrates the substance of the operations that generate tax effects.

Additionally, documentary evidence has to provide full proof of its date of issuance, in order to support the effects and substance of an agreement or transaction, according to the new precedent of the Supreme Court of Justice.

According to this precedent, a document will provide certainty of its date, by its ratification before a Public Notary or registration before a public registry, nevertheless, there has been broad discussion among practitioners around other means to provide proof of this matter; therefore, legal advice on this issue is critical for taxpayers.

When an audit is initiated, the taxpayer should provide the tax authorities with all the evidence that supports the nature, substance and effects of the transactions that are being questioned by the auditors. Not disclosing information to the authorities is not a reasonable strategy, as evidence that is not provided to the auditor will not be accepted by the courts.

What the auditors must understand

Additionally, if auditors do not understand or are not convinced of the nature of the business, the business reasons of any transaction or restructuring, or the business model implemented by the company, they will likely issue an assessment without making a detailed and accurate analysis of the particular case.

It is crucial that the authorities understand the following:

- the business reasons for making and deducting any specific expenditure or investment;
- the relationship between the main activity carried out by the company and the profits, current or future, generated by said deduction, if the person that provided the questioned good or service actually has the physical, human

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

- and technical resources to provide such services; and
- its residence for tax purposes, in the case of a cross-border transaction that involves a benefit prescribed in a double taxation treaty.

Taxpayers will be in a better position to litigate before courts, or even at the level of the administrative claim, if the controversy deals with the interpretation of legal provisions, rather than the material support of the substance, nature and business reasons of the transactions, as the burden of proof relies on the taxpayer.

Even where the authorities determine an assessment based on a lack of material support, the more evidence submitted to the auditors, the better the position of the taxpayer to litigate or enter into a settlement process.

Cross-Border Transactions and Transfer Pricing

Regarding cross-border transactions, it is also advisable to disclose – as many times as expressly requested by the auditors – if the company did take any benefit from a tax treaty, and to provide the legal ground according to which the invoked treaty is applicable, at both the audit level and the litigation stages.

When it comes to transfer pricing controversies, the best strategy is to enter into a settlement process, in which the parties may achieve an agreement through the mediation of Prodecon.

Close Involvement of Legal Advisers

For these reasons, it is important for the legal adviser to be involved in every stage of a tax matter, from the very beginning of an audit, as the defence of the case is built through the entire review process, and not only at the litigation stages.

Contributed by: Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios

Ortiz Abogados Tributarios is a Mexican law firm with more than 30 years of experience in tax law, covering comprehensive advisory, consultancy, litigation and alternative dispute resolution in tax controversies, with regard to both domestic and cross-border transactions. The firm is composed of four partners, two associates and two law clerks, and its offices are located in Mexico City. As a boutique firm,

from the very beginning Ortiz Abogados has provided personalised, strategic and timely attention, regardless of the client's size or the case's complexity. The firm recently handled a complex transfer pricing controversy regarding a multinational company in the technology industry, which was resolved through a mediation mechanism before the Mexican Taxpayers' Rights Defence Agency.

AUTHORS



Gabriel Ortiz Gómez is a founding partner at Ortiz Abogados Tributarios. He has devoted more than 40 years to tax affairs and specialises in tax consultation and tax litigation.

Gabriel is a former president of the Mexican Bar Association (2013/2014), and lectures on fiscal affairs for several organisations, such as the former Federal Tax Court and the Supreme Court of Justice. He has published a number of articles on domestic and international taxation and legal issues. He has been appointed as an expert witness in Mexican tax law before US courts on several occasions.



Carlos Yáñez Alegría is a senior partner at Ortiz Abogados Tributarios. His expertise lies in tax litigation, tax controversy and consultancy, as well in administrative law litigation.

Carlos is a member of the Mexican Bar Association and lectures on tax matters for various institutions, including the Mexican Public Accountants College. He has regularly published professional articles on taxation issues.

Contributed by: *Gabriel Ortiz Gómez, Carlos Yáñez Alegría, Carlos Monárrez Córdoba and Pablo Ramírez Morales, Ortiz Abogados Tributarios*



Carlos Monárrez Córdoba is a senior partner at Ortiz Abogados Tributarios. He works primarily in tax litigation and tax advisory. For 2022, Carlos is President of the National Association of Tax

Specialists, the Honour and Audit Committees of the Mexican Institute of Public Accountants and the Transfer Pricing Committee of the Mexican Public Accountants College. He participates in conferences in various forums, and also lectures on fiscal matters for organisations such as the American Chamber of Commerce. He has published diverse articles on taxation and legal issues, and is a Postgraduate Professor at the Escuela Libre de Derecho.



Pablo Ramírez Morales is a junior partner at Ortiz Abogados Tributarios. He has more than 18 years' experience in tax litigation and tax consultancy, on both domestic and cross-border

transactions. He previously worked as an in-house tax attorney at a multinational steel group. Pablo participates on a regular basis in the Tax Committee of the National Association of Corporate Lawyers and in the Tax Committee of the Mexican Public Accountants College. He lectures on tax law at the Law School of Universidad Panamericana in Mexico City, and has published articles in several publications specialising in tax issues.

Ortiz Abogados Tributarios

Sierra Candela 111
Piso 9, Miguel Hidalgo
Ciudad de México
Mexico, C.P. 11000

Tel: +52 55 5540 7800
Fax: +52 55 552 02140
Email: pramirez@oat.com.mx
Web: www.oat.com.mx



ORTIZ
ABOGADOS TRIBUTARIOS

Trends and Developments

Contributed by:

*Guillermo Villaseñor, Luis Antonio González, Emilio García
and Pedro Palma*

Sánchez DeVanny see p.415

Overview

For the last two years, the Tax Administration Service (*Servicio de Administración Tributaria*, or SAT) has continued to improve its tax collection procedures.

Even though the Mexican economy has been damaged by the COVID-19 crisis, the SAT has improved and perfected mechanisms to collect taxes, based on:

- seeking co-operation from taxpayers in pre-formal investigation activities;
- electronic institutional systems that collect information derived from taxpayer transactions; and
- requiring extensive supporting documentation of transactions.

Co-operation with the tax authorities and complying with requirements regarding tax compliance are important to avoid any future contingency.

Pre-formal investigations do not legally oblige taxpayers to submit the information requested, since they are not part of an audit process. However, not answering the letters produced by the SAT would, given the powers of verification of the SAT, bring about a formal tax audit and lead to the loss of the opportunity to self-correct any tax situation without triggering penalties.

To attend pre-formal or even formal investigations initiated by the SAT, taxpayers must collect the supporting documents of the reviewed transactions.

Pre-formal Investigations/Invitation Letters

These are not new, but are being increasingly used by the SAT to pre-audit taxpayers without using its powers of verification.

Invitation letters are documents served on taxpayers explaining possible tax omissions, taking into consideration the information collected by the SAT through its institutional electronic systems.

The SAT uses metadata that contains information from the electronic invoices issued by taxpayers: income reported and taxes paid, deductions considered by taxpayers, etc.

The SAT compares the information from the metadata and the taxes paid by the taxpayers. If differences exist, it reports possible tax omissions, granting a certain period to file information and evidence showing the taxpayer complied with its tax obligations.

This type of pre-audit using the invitation letter and the metadata of the SAT could be questionable, considering that the information used by the SAT does not necessarily match with the taxes paid. Thus, for tax years before 2022, there could be, for example, invoices pending cancellation by taxpayers.

However, is important to deal with invitation letters. If not, it is highly likely that the SAT will begin a formal audit through its powers of verification.

Finally, it is important to consider that if a taxpayer wishes to correct any observation during

the invitation letter period, surcharges and fines will not be applicable.

Formal Audits/Auditing Process

Tax audits in Mexico may be conducted through:

- on-site inspection of the taxpayer to review their accounting, goods and merchandise;
- desk reviews, in which the tax authorities may require that taxpayers submit their accounting records, data and other required documents;
- information in possession of the tax authorities; or
- electronic reviews.

The Mexican tax authorities conduct audits based on information provided by the taxpayer. A key issue is that this information must be reproducible for the purposes of the review. The tax legislation in force requires all taxpayers to prepare and keep documentation that proves that all the transactions carried out during the year are in compliance with the requirements of Mexican tax law.

Taxpayers have to be ready to submit relevant information to the tax authorities. In many cases they require information related to the transaction observed, and also documents that could be considered background to the same, notwithstanding the statute of limitations. Therefore, it is advisable to prepare defence files on relevant transactions, including old background information relating to these, such as capital contributions, mergers, the price paid in acquisitions of shares, and amortisation of tax losses.

In addition, taxpayers must also disclose information through informative returns (*Declaración Informativa Múltiple*, or DIM) regarding the transactions performed during the year, such as salary payments to employees, foreign resident payments, and transactions with foreign related parties. Likewise, companies that are required to

file an informative return (*Declaración Informativa sobre Situación Fiscal*, or DISIF) must also submit the following appendices with comparative information from the previous year: (i) balance sheet, (ii) income statement, (iii) cash flow statement, and (iv) capital contribution variations and their notes.

In Mexico, taxpayers must allow inspections to verify tax compliance and provide all documentation requested by the tax authorities. If the tax authorities believe that a taxpayer has not complied with its obligations adequately, that taxpayer must provide all the evidence necessary to demonstrate such compliance.

The burden of proof lies, originally, with the taxpayer, which must prepare documentation to demonstrate that its transactions are in compliance with the tax law. If the tax authorities review this information and find that the taxpayer is not in compliance, the burden of proof is reversed and the tax authorities are responsible for determining a tax liability, considering the information available or otherwise identified for such purposes.

The Defence File

The preparation of supplementary documentation – ie, a defence file – is highly recommended. A defence file provides additional protection for the taxpayer from potential questioning of the transaction by the tax authorities and assessment of additional tax liability. Thus, the identification, gathering, classification and organisation of evidence, which confirms realisation of operations or transactions and the validity of the level of settlements, are very important.

Some of the necessary information or documentation included in the defence file includes:

- accounting records;
- financial statements;

Contributed by: Guillermo Villaseñor, Luis Antonio González, Emilio García and Pedro Palma, Sánchez DeVanny

- documentation and information that certifies the reality, substance and effective receipt of goods or services;
- control transactions in foreign currencies (related to exchange rate fluctuations);
- electronic fiscal invoices in accordance with applicable formalities under the tax law;
- transaction payment vouchers;
- information on the persons for whom tax has been withheld, including their qualification to claim a double tax convention benefit, if applicable;
- information on customers and suppliers, or, as the case may be, a statement of transactions with third parties (DIOT);
- transfer pricing documentation in transactions with non-resident related parties; and
- documentation that proves the correct application of double tax conventions.

Likewise, if the dispute goes before the Tax Court, the taxpayers are only allowed to submit evidence that was either showed to the SAT during the formal audit process, or formally filed as proof at a contentious administrative stage, making a proper and timely integrated defence file of the utmost importance.

Owing to the lengthy process for resolving disputes in the administrative and judicial arenas, a path for mediation during the audit process was created, called the “conclusive agreement”. Regarding ADR mechanisms, the Office of the Taxpayers’ Ombudsman (PRODECON) arose from the need to strengthen the relationship between the tax authorities and taxpayers, creating a neutral meeting place for agreement and mutual trust. At this stage, it is also essential to provide the corresponding defence file, thereby speeding up the resolution process.

From all of the above, the need is evident to adequately integrate the defence file that will

be used in the different stages and instances (described below) of any tax audit.

Conclusive Agreement Procedure/Mediation Procedure

The conclusive agreement procedure was created in Mexico with the number of audits issued by the SAT, and the possible assessments that may arise from them, in mind. It is a mediation-type dispute resolution process that takes place between taxpayers and the SAT, overseen by PRODECON.

To initiate the procedure, it is necessary that a tax audit is open and that the SAT has indicated that a potential tax contingency may exist for the taxpayer.

With a 2022 tax reform, the term to file a conclusive agreement was modified. Before 2022, the procedure could be initiated at the request of the taxpayer, prior to the assessment of a tax deficiency, by completing an audit process.

Now the Federal Tax Code states that the conclusive agreement can be requested at the beginning of the audit (once the authority observes a possible contingency) and before a 20-day period after the notification of the writ of observations, the final act or the provisional resolution, lapses.

The procedure is initiated at the request of the taxpayer, prior to the actual assessment of a tax deficiency, by completing an audit process.

When requesting the conclusive agreement procedure, taxpayers have to file their petition with PRODECON, describing the scope and specifics of the tax audit and providing arguments and evidence supporting their tax position. Note that a robust filing must be made in terms of supporting documentation and evidence.

The normal response from the SAT is against accepting an agreement or offering their own terms to settle the case. It would be PRODECON's decision to instruct and call the parties to discussion meetings and to open a discussion about the transactions subject to investigation.

It is important to note that the SAT is not compelled to settle the case and that PRODECON has no binding authority over the case. In the authors' experience, it is possible to reach a favourable outcome for taxpayers.

In addition, the tax reform of 2022 also included a requirement that the conclusive agreement be concluded within 12 months. In the event of a negative outcome for them, taxpayers would be entitled to contest the tax assessment through the available legal options described below.

Legal Means of Defence against Tax Assessments

Administrative appeal

Once a tax assessment is determined by the SAT, taxpayers are entitled to file an administrative appeal before the legal section of the SAT. By filing the appeal, several advantages can be achieved.

The main characteristics of the administrative appeal are the following.

- Taxpayers will be relieved from securing a guarantee in the amount of the deficiency assessed (normally a bond), until a ruling at the appeal level is rendered.
- It is optional – if a taxpayer decides to challenge the assessment directly before the Tax Court, it will be required to secure the tax contingency.
- Taxpayers are allowed to submit any documentary evidence and information related to the audit that was not presented during the investigation stage, and to eventually

strengthen the legal defence and merits of the case if appearing before the Federal Tax Court.

- Taxpayers are allowed to offer additional evidence during the 15-day term after the filing of the recourse and to file the same during the next 15 days counted as from the offering writ.

A binding precedent issued by the Supreme Court prevents taxpayers from filing documentary evidence and information directly at the Tax Court level, when such documents were not disclosed and presented during the audit stage or at the administrative appeal level.

Although the taxpayer is entitled to challenge an assessment directly before the Tax Court, the chances of prevailing will be jeopardised if the file is not properly integrated during the tax investigation stage.

An adverse ruling on the appeal will grant the taxpayer the opportunity to file a nullity claim directly before the Tax Court.

Nullity claim/Tax Court

A tax assessment must be challenged before a Tax Court through a nullity claim. This procedure can be filed under an ordinary trial, a trial for exclusive ruling on substantive merits, or an online trial.

Ordinary trial

As mentioned, this trial can be filed directly against the notification of a tax assessment or against the ruling issued in an administrative appeal procedure. It is focused on getting a ruling that determines the legality or illegality of the tax assessment.

Typically, if a trial is well integrated and it is followed up properly and discussed with the magistrate in charge of the case, a taxpayer could

Contributed by: Guillermo Villaseñor, Luis Antonio González, Emilio García and Pedro Palma, Sánchez DeVanny

get a favourable ruling. However, in some cases, the study of the arguments filed within the complaint is not complete and it is necessary to file a constitutional means of defence or direct amparo in order to obtain a better outcome, and to not consent with parts of the ruling that could place the plaintiff in a better position.

A decision by the Federal Tax Court may ultimately be challenged by the taxpayer and/or by the tax authorities, as the case may be, before the Federal Circuit Courts.

Trial for exclusive ruling on substantive merits

In this trial, only substantive matters of the tax authority's resolutions will be analysed, so through this procedure, no formal aspects can be alleged based on the principles of promptness, oral proceedings, substantial resolution and proportionality. A specialised chamber of the Tax Court with three magistrates specialised in complex tax cases is responsible for following this procedure.

Only final resolutions derived from the exercise of the powers of verification of the tax authorities – consisting in desk reviews, domiciliary visits and electronic review – can be challenged through this particular trial. Also, based on criteria issued by the Superior Chamber of the Tax Court, this trial can be initiated to contest the rejection of tax refund claims.

A condition to admitting a case under this trial form is that the tax assessment or the controversy must exceed approximately MXN7 million, since this amount reflects matters that imply greater substantive complexity and that are related to the essential elements of taxes.

If the plaintiff chooses this form of trial, it will not be allowed to change the trial to an ordinary one.

It is worth mentioning that with this trial, the plaintiff will be relieved of guarantying the payment of the tax assessment until the case is ruled on by the Tax Court. With the admission of the lawsuit the magistrate will immediately order the suspension of the execution of the challenged act.

The essential stage of this trial is the hearing for the determination of the dispute, in which the magistrate briefly explains the nature of the controversy raised by the parties and gives them the opportunity to argue orally for their rights.

In addition, the parties may also request a private hearing with the magistrate, in which both parties will be present, providing them the same opportunity to approach, generating procedural balance and equality in the trial.

Such a trial is convenient, since it deals only with substantial matters and results in the effective delivery of justice, allowing the taxpayers to state their arguments orally, and to have a closer relationship with those who will resolve the substantive issues in the case.

An important characteristic of this form of trial is that the specialised chamber responsible for the case is allowed to render a decision without being compelled to follow criteria from the Superior Chamber of the Tax Court, to the extent that it justifies its interpretation and application of the law.

Recently, the Superior Chamber of the Tax Court has issued criteria by which it strengthened the nature of this trial, stating that substance has to be prioritised over form. In cases where taxpayers omit to file a notice or format required by the law, they should not be deemed to be in non-compliance with their tax obligations when other support or evidence exists to demonstrate the opposite, particularly given that a formal mistake

is not enough to show that taxpayers are not complying with their tax obligations.

Online trial

The online trial was introduced into the Federal Law of Contentious-Administrative Procedure by the Decree of 12 June 2009, and is based on the use of information and communication technologies.

As a general rule, the plaintiff has to provide an email and any writ must contain the advanced electronic signature and password that have to be obtained from the Online Justice System. Without this requirement it would not be considered to have been submitted.

The evidence must be filed legibly stating whether it is an original, a simple copy or a certified copy, with the further detail of containing – or not – the autograph signature. Non-documentary evidence must be offered in the initial lawsuit and presented before the Specialised Online Trial Chamber.

The notifications in this trial must be made through the Tax Court's Online Justice System and the official of the Court must prepare the corresponding electronic minute where they will specify the action or resolution to be issued and the attached documents, as well as provide their advanced electronic signature.

The online procedure is intended to achieve remote access to files, 365 days a year, 24 hours a day; security in the use of advanced electronic signatures, as well as in notifications; reduction of time taken by the trial process; and trust in the individuals and the reduction of paper, among other things.

In the authors' experience, the online trial is very useful because this trial is conducted without the

need to physically file the corresponding writs before the Court.

However, it is worth noting that the Specialised Online Trial Chamber takes a lot of time to resolve these trials, which reduces their effectiveness, since they were intended to reduce the time taken by the trial process, which as yet has not been achieved by the Court.

Final Notes

The SAT is increasing the number of audits and procedures to push taxpayers to comply with their tax obligations under pre-formal investigations and formal audits processes.

Through the 2022 tax reform, the government has focused on achieving greater control over taxpayers, stating additional requirements that need to be fulfilled in order for taxpayers to comply with their tax obligations.

The Federal Tax Code has continued to be reformed in order to include additional assumptions of digital certification temporary restriction and, eventually, cancellation.

With the reform of 2022, the Federal Tax Code states as grounds for digital certificate temporary restrictions, the following acts.

Omitting to file income tax payments

Taxpayers subject to the Simplified Taxation Regime, who omit the filing of three or more monthly estimated payments of income tax in a calendar year, consecutive or not, or the filing of the annual declaration of income tax.

Obstructing auditors

Taxpayers who resist or obstruct the exercise of auditing attributions; ie, by not providing the required information or not allowing access to auditors, among other things. For these purposes, the tax authorities must have previously noti-

Contributed by: Guillermo Villaseñor, Luis Antonio González, Emilio García and Pedro Palma, Sánchez DeVanny

fied the taxpayer of the fine for having relapsed into conduct that obstructs the exercise of auditing attributions.

Responsibilities of partners or shareholders with effective control

Taxpayers falling into either of the two following situations are liable to face digital certificate temporary restrictions.

- Where partners or shareholders that have effective control of the taxpayer and fall under the scope of:
 - (a) Articles 17-H, Sections X, XI, or XII of the Federal Tax Code (eg, not clarifying the causes of the temporary restriction, issuing invoices did not distort the non-existent transactions observed, and not distorting the observation related to improper transfer of tax losses); or
 - (b) Article 69, Sections I to V of the Federal Tax Code (eg, unguaranteed tax assessments, tax crimes, or failure to pay a tax assessment).
- Where the taxpayer is a partner or shareholder with effective control of another legal entity which falls into the situations described in the aforementioned articles, and which not corrected its tax situation.

In this regard, it is highly advisable to prepare defence files to support transactions performed and be ready to respond to a pre-formal investigation or a formal audit process, demonstrating the substance of the transactions or initiating a means of defence against a tax assessment already determined.

During the first quarter of 2022, the SAT has taken an aggressive position, issuing a high number of audits against taxpayers, and the activity of the tax and collegiate circuit courts has been reactivated, resolving cases that were on hold because of the pandemic. The SAT has just announced an extensive audit programme focused on large taxpayers with the clear objective of increasing revenue collection by reviewing recent transactions and reorganisations, tax refunds, and any application of reduced or beneficial treatments under the law or international treaties.

Contributed by: Guillermo Villaseñor, Luis Antonio González, Emilio García and Pedro Palma, Sánchez DeVanny

Sánchez DeVanny is a leading Mexican law firm, with offices in Mexico City, Monterrey, and Querétaro, that provides full-service legal advice to both Mexican and international clients. With distinct practice areas that regularly collaborate with one another, the firm helps clients make better decisions for their businesses as a whole, especially in the energy, automotive, retail, real estate, pharmaceuticals, and manufacturing industries. Sánchez DeVanny builds

enduring client relationships that go beyond individual service contracts, every effort is made to understand clients' businesses and expectations; to serve as an ally; and to provide complete, accessible and personalised advice. Throughout the firm, pride is taken in serving clients with a combined approach of experience and creativity; when you know how things are done it is easier to think outside the box.

AUTHORS



Guillermo Villaseñor is a tax partner at Sánchez DeVanny with more than 19 years of experience in tax planning, including taxation of corporate restructuring transactions, M&A,

and general tax advice; especially for business and multinational groups with operations in Mexico, where he provides advice on achieving fiscal efficiency and developing tax policies for ongoing operations. His experience extends to transfer pricing, including the legal analysis of the implementation of policies, documentation and elaboration of economic studies and defence files to protect companies against potential tax investigations. Guillermo has acted before the Mexican judiciary through constitutional (amparo) proceedings to contest the creation or amendments of tax laws that produce relevant negative economic effects, achieving tax refunds and the protection of future payments.



Luis Antonio González is a partner and member of the tax practice group at Sánchez DeVanny. He possesses broad experience in national and international tax audits, anti-

money laundering and anti-corruption compliance strategies particularly focused on multinational enterprises (MNEs). His practice focuses on Mexican MNEs going outbound and foreign MNEs coming inbound to Mexico on highly complex matters, particularly those that refer to related-party transactions and international taxation. Before joining Sánchez DeVanny, he had a distinguished 20-year career at the Mexican Tax Administration Service, where he served as central audit administrator and international audit administrator, both at the large taxpayers' division.

MEXICO TRENDS AND DEVELOPMENTS

Contributed by: Guillermo Villaseñor, Luis Antonio González, Emilio García and Pedro Palma, Sánchez DeVanny



Emilio García joined Sánchez Devanny in 2012 as part of the tax practice group, where he advises domestic and foreign clients on tax issues, especially in litigation. He has 14 years of professional experience. His practice is mainly focused on tax, administrative and social security litigation, tax audits, administrative proceedings before the tax authorities and the Federal Taxpayers' Attorney, as well as the amparo process. He has extensive experience in closing tax audits before a tax assessment.



Pedro Palma was part of the Mexican Tax Administration Service (SAT) from 2009–12. He worked in the international tax audits, international tax legal affairs, and large taxpayers legal affairs departments. Pedro participated in audits on foreign tax residents, the issuance of tax rulings, and exchange of information procedures with international authorities; he also attended mutual agreement procedures. In 2011, Pedro participated in OECD Working Party No 1 as part of the Mexican delegation. He has written widely on tax issues, including multiple award-winning papers.

Sánchez Devanny

Av. Paseo de las Palmas #525 Piso 6
Col. Lomas de Chapultepec
11000 Miguel Hidalgo
Ciudad de México
Mexico

Tel: +52 55 5029 8500
Fax: +52 55 5029 8571
Email: marketing@sanchezdevanny.com
Web: www.sanchezdevanny.com

sánchez
devanny®

NETHERLANDS

Law and Practice

Contributed by:

Reinout de Boer, Michael Molenaars, Rogier van der Struijk
and Mieke Lavreysen

Stibbe see p.439



CONTENTS

1. Tax Controversies	p.419	5.3 Judges and Decisions in Tax Appeals	p.424
1.1 Tax Controversies in this Jurisdiction	p.419	6. Alternative Dispute Resolution (ADR) Mechanisms	p.424
1.2 Causes of Tax Controversies	p.419	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.424
1.3 Avoidance of Tax Controversies	p.419	6.2 Settlement of Tax Disputes by Means of ADR	p.426
1.4 Efforts to Combat Tax Avoidance	p.419	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.427
1.5 Additional Tax Assessments	p.419	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.427
2. Tax Audits	p.420	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.427
2.1 Main Rules Determining Tax Audits	p.420	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.428
2.2 Initiation and Duration of a Tax Audit	p.420	7. Administrative and Criminal Tax Offences	p.428
2.3 Location and Procedure of Tax Audits	p.421	7.1 Interaction of Tax Assessments with Tax Infringements	p.428
2.4 Areas of Special Attention in Tax Audits	p.421	7.2 Relationship between Administrative and Criminal Processes	p.428
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.421	7.3 Initiation of Administrative Processes and Criminal Cases	p.429
2.6 Strategic Points for Consideration during Tax Audits	p.422	7.4 Stages of Administrative Processes and Criminal Cases	p.429
3. Administrative Litigation	p.422	7.5 Possibility of Fine Reductions	p.430
3.1 Administrative Claim Phase	p.422	7.6 Possibility of Agreements to Prevent Trial	p.430
3.2 Deadline for Administrative Claims	p.422	7.7 Appeals against Criminal Tax Decisions	p.430
4. Judicial Litigation: First Instance	p.422	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.430
4.1 Initiation of Judicial Tax Litigation	p.422	8. Cross-Border Tax Disputes	p.430
4.2 Procedure of Judicial Tax Litigation	p.422	8.1 Mechanisms to Deal with Double Taxation	p.430
4.3 Relevance of Evidence in Judicial Tax Litigation	p.423	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.431
4.4 Burden of Proof in Judicial Tax Litigation	p.423		
4.5 Strategic Options in Judicial Tax Litigation	p.423		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.423		
5. Judicial Litigation: Appeals	p.423		
5.1 System for Appealing Judicial Tax Litigation	p.423		
5.2 Stages in the Tax Appeal Procedure	p.423		

8.3	Challenges to International Transfer Pricing Adjustments	p.432	10.5	Existing Use of Recent International and EU Legal Instruments	p.435
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.433	10.6	New Procedures for New Developments under Pillar One and Two	p.435
8.5	Litigation Relating to Cross-Border Situations	p.433	10.7	Publication of Decisions	p.435
9. State Aid Disputes		p.433	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.436
9.1	State Aid Disputes Involving Taxes	p.433	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.436
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.434	11. Costs/Fees		p.436
9.3	Challenges by Taxpayers	p.434	11.1	Costs/Fees Relating to Administrative Litigation	p.436
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.434	11.2	Judicial Court Fees	p.436
10. International Tax Arbitration Options and Procedures		p.434	11.3	Indemnities	p.436
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.434	11.4	Costs of ADR	p.437
10.2	Types of Matters that Can Be Submitted to Arbitration	p.434	12. Statistics		p.437
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.435	12.1	Pending Tax Court Cases	p.437
10.4	Implementation of the EU Directive on Arbitration	p.435	12.2	Cases Relating to Different Taxes	p.437
			12.3	Parties Succeeding in Litigation	p.437
			13. Strategies		p.437
			13.1	Strategic Guidelines in Tax Controversies	p.437

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In the Netherlands, tax controversies can arise in various ways. Tax disputes may arise as a result of a tax audit initiated by the Dutch Tax Authorities (DTA), or questions raised by the DTA (for example, after having reviewed a tax return filed by a taxpayer or as a result of a sample by the DTA). It may also occur that the DTA take notice of a transaction in the press, or receive information from foreign tax authorities, which also may result in a tax audit by, or questions from, the DTA.

1.2 Causes of Tax Controversies

Generally, it is difficult to pinpoint which taxes and matters give rise to more tax controversies than others. Tax audits of the DTA can have a broad scope and vary from individuals (personal income tax, inheritance tax), through small-sized business (income tax), to large companies (corporate income tax). Tax audits can also be focused on levies such as value-added tax (VAT), wage taxes or Dutch dividend withholding tax. Recent case law shows that the DTA do not look favourably on cases in which a mismatch is created by the taxpayer (ie, a deduction of a payment, without an inclusion), or where deductible interest expenses are created artificially (for example, to offset against taxable profits), or which are considered abusive from an EU law perspective.

1.3 Avoidance of Tax Controversies

It is up to the DTA whether to initiate a tax audit. Sometimes, with respect to certain sectors, a standard audit policy is applied; for example, to audit taxpayers in that sector once every few years. The risk of a tax audit can be mitigated or reduced by way of pre-consultation (ie, by having pre-empting discussions that would otherwise be conducted after the fact) with the DTA

or by applying for an advance tax ruling (ATR) or advance pricing agreement (APA). Under certain circumstances, taxpayers also have the possibility of entering into a “horizontal monitoring” agreement with the DTA (see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**). The aim of such an agreement is to have an interactive relationship with the DTA and to inform and discuss transactions with them on a real-time basis (to pre-empt discussions arising after the DTA review the tax return).

1.4 Efforts to Combat Tax Avoidance

At this moment, the exact impact of the Base Erosion and Profit Shifting (BEPS) project of the OECD on the number of tax controversies in the Netherlands is difficult to indicate. It is, however, the expectation that the number of controversies with respect to cross-border transactions and investments will increase in the coming period, since jurisdictions may interpret the BEPS rules in their own manner. In this respect, the exact impact of EU Anti-Tax Avoidance Directives (ATAD) 1 and 2 (implemented respectively by the Netherlands in 2019 and 2020) also needs to be considered.

The same expectation exists with respect to the impact of the EU Mandatory Disclosure Directive (MDD) (also known by its acronym DAC6), under which taxpayers are obliged to report potentially aggressive cross-border tax structures as of 1 January 2021 (in the Netherlands) with retroactive effect to 25 June 2018. The Netherlands implemented this directive in the Act on International Assistance.

1.5 Additional Tax Assessments

If a taxpayer files an appeal against a tax assessment issued by the DTA, then upon request of that taxpayer, in principle, a postponement of payment is granted by the DTA. Depending on the circumstances this may work out differently; for example, in cases where the DTA require

security from the taxpayer to safeguard the payment of the tax assessment in the future. The DTA have the authority to issue – concurrently with the additional tax assessment – a fine to a taxpayer; for example, in the case of a late or incorrect filing of a tax return or not paying tax in due time.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The DTA have discretion over whether to initiate a tax audit or not. In this regard, the DTA have certain areas of focus. For example, within the group of individuals, very high net worth individuals (with assets of more than EUR25 million) are a specific area of attention. When dealing with large companies, combating and preventing tax avoidance is an important area of focus, as well as transfer pricing. The DTA often points out certain themes of focus in the so-called *Jaarplan* (annual plan), such as VAT carousel fraud in the *Jaarplan 2021*. In the annual plan for 2022 reference is made to VAT carousel fraud and the possibility of abuse by way of liquidating a company via a simplified procedure (“turbo-liquidations”).

2.2 Initiation and Duration of a Tax Audit

The decision of whether to initiate a tax audit is driven by various factors, such as the (tax) attitude and behaviour of the relevant taxpayers, information derived through company interviews and samples, or information from third parties. Based on these factors (amongst others), a risk analysis is made by the DTA to determine whether to carry out a tax audit. In principle, there is no time limit regarding the finalisation of the audit, but of course, the DTA do need to take into consideration the time limits within which a tax assessment should be issued to the taxpayer (see further below).

Regarding the statute of limitations rules, a distinction should be made between taxes that are levied by means of a tax assessment issued by the DTA after a taxpayer has filed a tax return (such as the Dutch corporate income tax and personal income tax) and taxes that are based on a self-assessment (such as VAT and wage tax).

With respect to taxes that are levied by way of a tax assessment, the tax inspector is, in principle, required to issue a (final) assessment within three years after the end of a tax year. Further to that, the DTA have, under certain circumstances, the authority to issue an additional assessment to a taxpayer, which, in principle, needs to be issued within five years after the relevant tax year (under certain circumstances, notably in relation to foreign income, the period of five years is extended to 12). To issue an additional tax assessment, a so-called qualifying new fact must be present. This is not required if the taxpayer has acted in bad faith. There are also specific rules under which the tax inspector may impose, under particular circumstances, an additional assessment to a taxpayer, such as in the case of a so-called recognisable error (*kenbare fout*) in the (final) assessment or in specific situations related to disclosed DAC6 information.

With respect to taxes that are based on self-assessment, the taxes are payable shortly after the self-assessment has been made. In those cases, in principle, the tax return is the formal basis for the levy and no separate tax assessment is issued by the tax inspector. In the case of an underpayment of tax, the DTA have the possibility to issue an additional tax assessment to a taxpayer within five years after the year in which the taxable event took place.

In the case of a tax audit, the statute of limitations described above needs to be respected. In practice, the DTA have the authority to issue an

ex officio tax assessment if, during a tax audit, there is a risk of exceeding the terms referred to above.

2.3 Location and Procedure of Tax Audits

Tax audits are generally performed at the premises of a taxpayer. In principle, an audit can be performed based on printed documents or data made available electronically. The DTA may perform the audit by reviewing (hard) copies of documents provided by the taxpayer, or via data derived from software applications used by the taxpayer.

2.4 Areas of Special Attention in Tax Audits

As set out in **2.1 Main Rules Determining Tax Audits**, the DTA focus on combating and preventing tax avoidance as well as transfer pricing when dealing with large companies. In this respect, the DTA hold the view that (international) tax avoidance can be best tackled in co-operation with other jurisdictions, civil society organisations and private parties; for example, by way of bilateral or multilateral tax audits. It is also the expectation of the DTA that the country-by-country report(s) that need(s) to be filed will provide further information for tax audit purposes. This is also true for filings that need to be made as of 1 January 2021 for the purposes of DAC6.

More generally, it is the objective of the DTA that individuals and companies comply with their tax obligations on their own as much as possible (“voluntary compliance”). To achieve this, companies have, under certain circumstances, the possibility of entering into a horizontal monitoring agreement with the DTA, which in essence means that a taxpayer exchanges information regarding its (tax) strategy, tax control framework and transactions that could have a (material) tax impact on a real-time basis. Accordingly, applying horizontal monitoring is expected to result in

fewer tax audits for a taxpayer. As of 2020, the horizontal monitoring rules have become stricter (see **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**).

The DTA published two reports on horizontal supervision in September and December 2021, discussing the outline and further development of the reform, respectively. Both reports provide extensive insight into how to deal with horizontal supervision. Based on the reforms, so-called individual horizontal supervision is only possible for larger organisations and wealthy individuals, whereas horizontal supervision via tax service providers is a form of co-operation between tax service providers and the DTA. The latter is aimed at small and medium-sized companies that do not qualify for an individual horizontal supervision agreement. The objective and thinking behind the horizontal supervision concept did not change.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

It is difficult to assess at this moment whether the rules concerning cross-border exchanges of information and mutual assistance between the tax authorities (on tax audits) have led to a marked increase of tax audits in the Netherlands, as official numbers are not available. However, the general sentiment is that international administrative co-operation may lead to an increase of audits inspired by data or queries that are exchanged.

If a foreign tax authority has questions in relation to a Dutch taxpayer, these questions will be asked by the Dutch tax inspector, which assumes that the Dutch and foreign tax inspector are in contact with each other, but it is also possible that the Dutch tax inspector is assisted, in person, by a (foreign) tax inspector.

2.6 Strategic Points for Consideration during Tax Audits

A key point that should be taken into consideration is the scope of the audit. Next to that in importance is asking the DTA to put their questions in writing, which gives the taxpayer the opportunity to properly think through the questions raised by the DTA.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

If a taxpayer does not agree with a tax assessment issued by the DTA (or would like to lodge an objection against a tax that was levied based on self-assessment by the taxpayer; see **2.2 Initiation and Duration of a Tax Audit**), the taxpayer has the possibility to file an “administrative appeal” against the tax assessment. The appeal needs to be filed within six weeks after the tax assessment has been issued. If a taxpayer does not respect the period of six weeks, the appeal is in principle declared inadmissible. During the administrative appeal phase, a taxpayer has certain rights (such as a hearing and consultation of its tax file). The aim of the administrative appeal is a reconsideration of the tax assessment by tax inspectors that are new to the case. The initiation of an administrative appeal does not trigger costs for the taxpayer. The administrative appeal is finalised with a decision of the DTA, which can be challenged before a court (see **4. Judicial Litigation: First Instance**). Under certain circumstances, the taxpayer and the DTA may agree to skip the administrative appeal, which, however, is not common practice. Finally, filing an administrative appeal should, in principle, not put the taxpayer in a worse position as compared to the tax assessment issued by the DTA.

3.2 Deadline for Administrative Claims

The DTA, in principle, need to decide on the administrative appeal within six weeks. If the DTA fail to decide on the administrative appeal in time, the taxpayer can lodge an appeal (ie, when the term to decide on the appeal has passed, the law assumes that a decision has been taken that can be appealed by the taxpayer).

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Once the administrative procedure has been finalised (see **3. Administrative Litigation**), a taxpayer may bring the case before a court. At first instance, the case will be judged by a Lower Court (*Rechtbank*). The procedure at first instance is initiated by filing an appeal against the decision made by the DTA during the administrative appeal procedure. The appeal needs to be filed within six weeks after the decision on the administrative appeal; otherwise the appeal will, in principle, be declared inadmissible. To initiate the appeal, the taxpayer needs to pay a registration fee.

4.2 Procedure of Judicial Tax Litigation

During the appeal, the taxpayer further substantiates the grounds of appeal, whereas the tax inspector is expected to file a statement of opposition. Under certain circumstances, parties are given the opportunity by the court to respond to each other’s views in writing. Parties have the right to file documents with the court up to ten days before the date of the court hearing (which in principle is not a public session). It is not required that a lawyer or tax adviser represent the taxpayer during the procedure.

During the court procedure in first instance, the facts of the case will be debated as well as the underlying tax question. In principle, the

court will take a decision within six weeks from the court hearing. This term may however be extended. The decision of the court may be published on an anonymised basis. Finally, the court has the possibility to ask the Dutch Supreme Court (*Hoge Raad*) for a preliminary ruling, which may occur if it concerns a legal (tax) question that stretches beyond the pending case.

4.3 Relevance of Evidence in Judicial Tax Litigation

This depends on the tax question pending. If the case deals particularly with the interpretation of tax law, there is little need to involve witnesses in the case (unless, for example, the opinion of an expert witness may be helpful to convince the court). On the other hand, in very factual cases, witnesses may be helpful to support a case, especially in situations where the burden of proof lies with the taxpayer. In those situations, the taxpayer may work with both written statements from witnesses and formal statements during the court hearing.

4.4 Burden of Proof in Judicial Tax Litigation

This would depend on the case. However, as a general rule, if the taxpayer is the party claiming a deduction or an exemption, the burden of proof lies with the taxpayer and it is up to the Dutch tax authorities to underpin the plausibility of an upward correction. With regard to fines/penalties, the burden of proof is always on the DTA.

4.5 Strategic Options in Judicial Tax Litigation

Strategic options depend on a case-by-case analysis and are not easily described in general terms.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Dutch (tax) case law has determined that the OECD Commentary is a relevant factor that should be taken into consideration when deciding on a case. The (tax) court(s) also take the jurisprudence of the ECJ and ECHR into account when deciding on cases. The Dutch (tax) court also may defer a case to the ECJ if it deems it relevant. In addition, the Dutch Supreme Court (and certain other courts) may defer preliminary questions to the ECHR.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

A taxpayer (as well as the DTA) has the right to file an appeal against the decision by the Lower Court. The appeal should be filed within six weeks after the decision of the Lower Court (a one-time opportunity). In appeal, the case will be handled by a Court of Appeal (*Gerechtshof*).

If a taxpayer or the DTA (or both) do not agree with the decision of the Court of Appeal, the parties have the possibility to lodge an appeal with the Dutch Supreme Court (*Hoge Raad*). In this cassation procedure before the Supreme Court, parties no longer have the possibility to discuss the facts of the case. The Supreme Court (in short) will only test whether there has been a breach of law, or whether the decision has been inadequately motivated (or is incomprehensible).

5.2 Stages in the Tax Appeal Procedure

The procedure before the Court of Appeal is similar to the procedure before the Lower Court (referred to in **4.2 Procedure of Judicial Tax Litigation**).

The procedure in cassation starts with the filing of an appeal within six weeks after the decision of the Court of Appeal. The other party in the procedure will be entitled to file a statement of opposition followed by a reply and a rejoinder. In important cases, an advocate-general often takes an (independent) conclusion to give their view on the case. Generally, it is not common that a hearing takes place in person or in writing, including pleadings. In its ruling, the Dutch Supreme Court has the authority to declare the appeal unfounded or founded. In the latter case, the Dutch Supreme Court may itself give a final judgment or refer the case to another Court of Appeal.

5.3 Judges and Decisions in Tax Appeals

At first instance and appeal, the tax case is decided by one or three judges, depending on the type and complexity of the case. Cases before the Dutch Supreme Court are decided by three or, in more difficult cases, five judges. Judges are appointed by way of a royal decree. It is up to the court to determine the composition of the judges who will decide on a case.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

There are several ADR mechanisms in the Netherlands to resolve tax disputes between taxpayers and the DTA. The Dutch ruling practice, which to some extent may be considered an ADR mechanism, is covered first. Horizontal monitoring, which serves the purpose of avoiding (future) tax disputes and disagreements, is discussed next. Subsequently, mediation is elaborated upon as a way to resolve tax disputes between the DTA and the taxpayers.

Dutch Ruling Practice

The Dutch tax ruling practice allows taxpayers to obtain certainty in advance from the DTA on certain transactions in the form of an APA or an ATR. An APA provides certainty in advance on the Dutch transfer pricing treatment of certain intragroup dealings of the taxpayer. It is also possible to conclude a multilateral APA with other jurisdictions involved. An ATR provides certainty in advance on a variety of Dutch tax topics in relation to particular transactions.

The Dutch tax ruling practice essentially brings forward any disagreement or dispute between the DTA and the taxpayer on the interpretation of Dutch tax law or the Dutch tax treatment of certain transactions. It provides taxpayers the opportunity to openly discuss with tax specialists of the DTA the relevant facts and circumstances of the case at hand, as well as the correct Dutch tax treatment thereof, prior to entering into such transactions. If parties come to an agreement, the DTA and the relevant taxpayer enter into an APA/ATR settlement agreement.

However, the conclusion of an APA/ATR settlement agreement does not preclude the DTA from conducting tax audits. Especially in respect of APA settlement agreements, taxpayers may expect regular tax audits from the DTA to check whether the transfer prices that are being used are in accordance with the APA settlement agreement.

The Dutch tax ruling practice for international tax rulings has been revised as of 1 July 2019. Under the revised rules, taxpayers must meet stricter measures to obtain a Dutch international tax ruling:

- the relevant taxpayer needs to have sufficient “economic nexus” with the Netherlands;

- the sole or decisive motive of the relevant structure must not be to avoid Dutch or foreign taxes; and
- the relevant transaction or structure is not carried out with a country that is mentioned on the Dutch list of so-called “low-tax jurisdictions” and/or the EU list of non-cooperative jurisdictions.

Procedural aspects of the Dutch ruling practice

A request for an APA/ATR ruling is generally filed with the competent tax inspector of the taxpayer. The request should in any case include:

- a detailed description of the relevant facts and circumstances;
- factual information on the relevant companies; and
- a list of the other jurisdictions concerned.

APA/ATR requests generally have an international angle (eg, cross-border investments, foreign shareholders), in which case the competent tax inspector will involve the “International Fiscal Affairs Team” (*Behandelteam IFZ*) of the DTA. To the extent necessary, the DTA will ask follow-up questions and/or request further information from the taxpayer on, inter alia, the relevant facts and transactions set out in the request. In the course of the Dutch tax ruling process, a taxpayer may thus be communicating directly with the tax specialists of the DTA. The DTA aims to process an APA/ATR request within six to eight weeks.

Under the revised rules for international tax rulings, the “College of International Fiscal Affairs” (*College IFZ*), must sign-off all tax rulings with an international character. This aims to ensure uniformity and quality of international tax rulings. In addition, an anonymised summary of each international tax ruling is published on the DTA’s

webpage. The same holds true for a withdrawn or denied ruling request.

Horizontal Monitoring

Rather than being subject to “vertical monitoring”, which is based on auditing the taxpayer’s affairs retrospectively, taxpayers can also be subject to horizontal monitoring. In horizontal monitoring, the DTA and the taxpayer formally commit to build and have a relationship based on mutual trust, understanding and transparency. This essentially means that the DTA will rely on the willingness of the taxpayers to file correct tax returns. The taxpayer that is subject to horizontal monitoring is generally obliged to submit its view on all relevant matters to the DTA as soon as practically possible, so that any possible differences of opinion between the DTA and the taxpayer are resolved before the tax return is filed. Hence, horizontal monitoring may also be considered a form of ADR.

Procedural aspects of horizontal monitoring

Horizontal monitoring originally focused on large and medium-sized corporate taxpayers being “in control” of their tax affairs. If the DTA and the taxpayer agree to horizontal monitoring, they enter into a horizontal monitoring agreement (*handhavingscovenant*), which lays down the fundamentals and underlying principles forming the basis of their relationship to achieve an effective and efficient mode of operation. It should however be noted that a horizontal monitoring agreement does not preclude the DTA from conducting tax audits.

As of 2020, the DTA distinguish between three types of companies for the purposes of horizontal monitoring. The first group contains small and medium-sized companies. They can only opt for horizontal monitoring through a tax service provider. The second group consists of large-sized companies. They can enter into individual agreements with the DTA for horizontal monitor-

ing. This has been subject to stricter supervision rules since 2020. The third group covers the 100 largest and most complex companies. Individual plans are drawn up for companies in this group, which are reassessed every year. The exact treatment and development of this new form of horizontal monitoring is still unclear. However, two reports by the DTA on horizontal monitoring were published in September and December 2021, discussing the outline and further development of the reform, respectively. One of the reports, among other things, foresees a transitional arrangement for small and medium-sized companies that can no longer enter into individual agreements with the DTA for horizontal monitoring.

Mediation

In 2005 the DTA introduced a pilot programme for mediation to resolve tax disputes/disagreements with taxpayers. Since then, mediation has taken a modest step forward; it is, however, still not commonly used to resolve tax disputes/disagreements with taxpayers.

At any stage of the tax dispute it is possible to initiate mediation. This can be at the request of the DTA, or the Dutch taxpayer and, in some cases, through referral by a Dutch tax court. Not all disputes are suitable for mediation. Mediation is in principle generally only suitable for disputes that go beyond the mere interpretation of law. Tax disputes resolved through mediation generally also have a “personal element” to them; a taxpayer may, for instance, be upset about the way in which they were approached or treated by the DTA during a tax audit. During the mediation, the regular administrative or judicial procedure between the DTA and the taxpayer is put on hold. The procedure only resumes if the dispute is not, or only partially, resolved through mediation. If mediation has partially resolved the dispute, the regular administrative or judi-

cial procedure resumes only in respect of the unresolved items.

Procedural aspects of mediation

For mediation, the DTA usually works with independent mediators who are registered with the Dutch federation of mediators (MFN). The mediator should adhere (and is subject) to the mediation regulations and professional conduct standards of the MFN. The mediator first meets with the taxpayer and the relevant tax inspector to explain their approach to them. A taxpayer may bring their tax adviser/lawyer to provide assistance (this may be helpful if there are technical legal aspects to the dispute). Both parties then enter into a mediation agreement, which sets out the general terms of the mediation procedure and their procedural rights and duties. Confidentiality plays a pivotal role in mediation. All that is said and done during mediation is in principle strictly confidential and cannot be used by either party in any context other than the mediation. The costs of mediation are generally lower than the costs of a regular administrative and judicial procedure. Generally, if a Dutch tax court initiates mediation through referral, the parties have to split the costs of the mediation.

6.2 Settlement of Tax Disputes by Means of ADR

Under the existing and above-mentioned ADR mechanisms in the Netherlands, tax disputes and disagreements between the DTA and taxpayers are in principle resolved by means of entering into a settlement agreement. The settlement agreement is a Dutch civil law agreement governed by the general principles and provisions of the Dutch Civil Code. In principle, a settlement agreement is binding on both parties. Settlement agreements generally include provisions pursuant to which parties agree and acknowledge to refrain from (continuing) any further administrative or judicial proceedings.

Based on the published policy of the Dutch State Secretary of Finance, the DTA are prohibited from concluding settlement agreements that are in clear violation of Dutch (tax) law (certain other restrictions are imposed on the DTA as well). In addition, the DTA must at all times abide by general Dutch public law principles (eg, the general principles of equality, due care, fair play and protection of legitimate expectations) in its dealings with taxpayers. With respect to settlement agreements, in some cases this might lead to situations in which parties entered into a valid settlement agreement according to Dutch civil law standards, but the settlement agreement cannot be binding on the taxpayer, because the DTA did not abide by the general public law principles. An example could be a situation in which the taxpayer was not given sufficient time to review and comment on the settlement agreement proposed by the DTA.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

If parties resolve their tax dispute through mediation, they generally enter into a settlement agreement. It is established case law that settlement agreements may also be concluded to resolve disputes or disagreements on the amount of tax due or the applicable interest and/or administrative penalties. However, based on the policy of the Dutch State Secretary of Finance, the DTA are prohibited from settling any dispute or disagreement on applicable interest, administrative penalties and/or legal costs if, in combination therewith, a trade-off took place between the DTA and the taxpayer on certain other elements regarding the levy and/or collection of taxes.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

During the term of an APA/ATR settlement agreement (generally five years), the DTA may in principle not impose tax assessments that deviate

from what is agreed in the APA/ATR settlement agreement, provided that in the meantime there are no major changes in tax law or the underlying facts and circumstances (and in certain cases – as per July 2019 – a change in jurisprudence or policy of the DTA). Similarly, the taxpayer can in principle not lodge an objection against a tax assessment that is imposed in accordance with what is agreed in the APA/ATR. In view of the foregoing, the Dutch tax ruling practice is an effective way for taxpayers to obtain certainty in advance and to mitigate tax disputes with the DTA.

6.5 Further Particulars Concerning Tax ADR Mechanisms

The DTA and the taxpayer may, at any time, try to resolve a (future) dispute or disagreement through bilateral negotiations and bilateral settlement without the involvement of a court or mediator. Bilateral settlements between the DTA and the taxpayer do not have a prescribed form or procedure. It is nonetheless relevant to mention that in its (legal) relationship with the taxpayer the DTA are bound by general public law principles (eg, the general principles of equality, due care, fair play and protection of legitimate expectations). This also applies if the DTA and the taxpayer are in negotiations to resolve their tax dispute.

Under certain double tax treaties, taxpayers with a cross-border footprint that are confronted, or are likely to be confronted, with double taxation may apply for a mutual agreement procedure (MAP) to eliminate double taxation emanating from their cross-border activities. In the EU, the EU Arbitration Convention and the EU Tax Dispute Resolution Mechanisms Directive, which was adopted on 10 October 2017 by the European Council and implemented by the Netherlands in the Tax Arbitration Law provide taxpayers with the possibility of initiating a MAP and, if necessary, under certain circumstances,

a tax arbitration procedure to eliminate double taxation. In addition, the Multilateral Convention regarding tax treaty-related measures to prevent BEPS (MLI) also has an (optional) mandatory binding treaty arbitration provision. The Netherlands has opted to apply this arbitration provision. See **10. International Tax Arbitration Options and Procedures** for more information on the possibilities of arbitration. The MAP and tax arbitration procedures strictly speaking, do not directly involve the taxpayer; the taxpayer is only an interested party to a procedure between two jurisdictions. In view of this, there will be no further elaboration on these procedures in this section on ADR mechanisms.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

If a taxpayer is confronted with an additional tax assessment, the additional assessment can be increased with interest on unpaid taxes (*belastingrente*) or interest on overdue taxes (*invorderingsrente*) and tax penalties. In some cases, the upfront payment of taxes mitigates the risk of interest on tax being imposed.

In Dutch tax law, three types of tax penalties can be distinguished (two types of administrative penalties and one category of criminal penalties). The legal basis for this is found in the General Dutch State Taxes Act (GSTA), which is the source of administrative law on Dutch taxation/tax laws and, inter alia, sets out the manner in which the DTA can levy Dutch taxes, provides taxpayers with the means to object to infringe-

ments of their rights, and provides for the legal basis for the DTA to impose administrative tax fines/penalties on Dutch taxpayers in certain situations.

The two types of administrative tax penalties that can be imposed by the DTA on taxpayers are as follows: (i) for minor omissions such as late filing or payment (punishable with minor administrative tax penalties) (*verzuimboetes*); and (ii) for tax offences (both acts and omissions) involving wilful misconduct or gross negligence (punishable with administrative tax penalties) that, for instance, deal with the failure to pay taxes in a timely fashion or file tax returns correctly (*vergrijpboetes*).

The GSTA also provides for criminal penalties. Criminal tax offences are imposed on taxpayers by a Dutch court following a public prosecution by the public prosecutor's office. In addition, the Dutch Criminal Code also provides for a legal basis to penalise criminal offences in relation to taxes (eg, forgery of documents or participation in a criminal organisation with the purpose of committing crimes).

Penalties for tax offences (*vergrijpboetes*) and criminal penalties may also be imposed on aiders and abettors, which, for the avoidance of doubt, can include a tax advisor. In addition, penalties for tax offences imposed on advisors in respect of aiding or abetting in relation to tax avoidance or fraud in respect of allowances may be made public on the website of the DTA as of 1 January 2020.

7.2 Relationship between Administrative and Criminal Processes

Administrative tax cases or tax audits may trigger criminal investigations into a taxpayer's affairs. Embedded in Dutch law is the *una via* principle, pursuant to which taxpayers are generally protected from double sanctioning. In other words,

a taxpayer's tax offence should be handled by the DTA by means of an administrative procedure or by the public prosecutor by means of criminal procedure. In addition, notwithstanding the fact that administrative penalties are not criminal penalties, they are – due to their punitive character – for certain purposes characterised as so-called criminal charges. This entails that the structure and level of administrative legal protection must meet international human rights standards that apply to criminal tax charges.

In addition, the DTA can request that taxpayers furnish them with information for the purpose of, or in connection with, imposing correct tax assessments. The DTA and the prosecutor's office also have the power to impose tax penalties on, or commence tax criminal proceedings against, taxpayers. Tension exists between these powers in light of the *nemo tenetur* principle (ie, taxpayers have the right to remain silent and not incriminate themselves). In so far as it concerns evidentiary material whose existence is dependent on the will of the taxpayer (will-dependent material), the principle is that the surrender of such material may be coerced for the purposes of levying tax. However, if a taxpayer is, or will be, subject to punitive charges, the DTA or the prosecutor's office are prohibited from resorting to such will-dependent evidence obtained through methods of coercion or oppression. If the DTA cannot exclude the possibility that will-dependent material may also be used in connection with a "criminal charge" against taxpayers (ie, punitive charges), the DTA must provide safeguards to the taxpayers, so they can effectively exercise their right not to incriminate themselves. In the event that such will-dependent material is coerced for the purposes of levying tax and subsequently used for the purpose of imposing punitive tax penalties, it will be for the Dutch courts to decide what consequences it attaches to the use thereof; the evidence could potentially be excluded. The taxpayer's privilege

against self-incrimination does not extend to the use of materials that exist independent of the will of the taxpayer and that are obtained from the taxpayer through recourse to compulsory powers.

7.3 Initiation of Administrative Processes and Criminal Cases

It is not uncommon that tax crimes are discovered during a tax audit or administrative proceedings. It is also not uncommon for the public prosecutor's office to commence general criminal law proceedings against taxpayers following, or simultaneously with, the administrative proceeding against the relevant taxpayers. This does not necessarily contravene the *una via* principle if the taxpayer faces two materially different charges. In view of this, there would be no need to suspend punitive criminal or administrative proceedings while a tax court verifies the amount of taxes due.

7.4 Stages of Administrative Processes and Criminal Cases

First instance criminal proceedings comprise of two phases. They start with the pre-trial criminal investigations performed under the supervision of, and directed by, the prosecutor's office. Subsequently, the investigating judge starts the preliminary judicial investigation. On the basis of these phases the prosecutor's office eventually has to determine whether to drop the case, settle the case out of court or prosecute the taxpayer.

A case is generally dropped if the prosecutor's office feels it has insufficient material to prove the charges. If the prosecutor's office decides to prosecute the taxpayer, the trial stage starts, during which the taxpayer has the right to be heard. Criminal tax offences are dealt with by the Dutch criminal courts. Court hearings are held in public (certain exceptions apply).

7.5 Possibility of Fine Reductions

Upfront payment of tax assessments may, in certain situations, help to mitigate interest and penalties being charged (notably interest and penalties imposed on taxpayers for late payment). Penalties due because of tax offences involving gross negligence or intention may generally not be mitigated by upfront payment.

7.6 Possibility of Agreements to Prevent Trial

The prosecutor's office may opt to settle a tax criminal case by means of a transaction, whereby the taxpayer generally has to pay a sum of money to the Dutch treasury and/or fulfil one or more (financial) conditions. A transaction can be offered if the crime carries a statutory prison sentence of less than six years. Guidelines on the offering of transactions exist in an effort to mitigate arbitrariness and create uniformity with respect to the cases that are settled through transactions.

7.7 Appeals against Criminal Tax Decisions

If a taxpayer or the prosecutor's office wants to appeal a judgment of the district court, it can file for appeal with the competent Court of Appeal (*Gerechtshof*). Subsequently, parties may bring their case before the Dutch Supreme Court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

It is not uncommon for criminal tax cases to commence following, or simultaneously with, regular tax proceedings. However, it generally requires more than transactions that are merely challenged on the basis of tax concepts such as general anti-avoidance rules (GAAR) or transfer pricing rules. An example in the Netherlands that has led to criminal tax proceedings deals with VAT carousel fraud, which generally requires more than one participant. Hence, in the Netherlands taxpayers involved in VAT carousel fraud

have been subject to administrative proceedings (eg, failure to file correct tax returns and/or pay the correct amount of VAT, including penalties) and general criminal proceedings; eg, participation in a criminal organisation for the purpose of committing crimes.

With reference to Dutch case law, we furthermore note that, in cases where a GAAR is applied (for the first time), it may be challenging for the DTA to issue a fine because, based on for example available tax literature and parliamentary history, the taxpayer may have a defensible position (*pleitbaar standpunt*).

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Economic double taxation generally occurs between associated enterprises of different states as a result of an upward transfer pricing adjustment by one of the states. Judicial double taxation refers to a taxpayer being subject to tax on the same income in more than one jurisdiction; for instance, because the taxpayer is considered a resident of two jurisdictions and as such is potentially subject to full taxation in both jurisdictions.

The Netherlands has an extensive network of double taxation treaties, the majority of which include a provision allowing taxpayers to request a mutual agreement procedure to eliminate double taxation. Taxpayers, in cases of both economic and legal double taxation, can invoke this mechanism. As a result, the component authorities are obliged to *endeavour* to resolve such cases. The MLI mutual agreement procedure provision introduces or amends this provision in covered tax agreements of the Netherlands. In 2020, 218 mutual agreement procedures were

started in the Netherlands. Traditionally, double taxation treaties have generally not imposed a binding obligation on both contracting states to eliminate the double taxation of a taxpayer. However, a shift has occurred in recent years. In treaty negotiations, the Netherlands now generally pushes for a provision for binding arbitration and has also opted for the MLI arbitration provision to apply. Within the EU, the EU Arbitration Convention and EU Tax Dispute Resolution Mechanisms Directive (implemented by way of the Tax Arbitration Law) provide for the elimination of double taxation by agreement between the member states. For further analysis on arbitration, see **10. International Tax Arbitration Options and Procedures**.

In addition, most Dutch double tax treaties contain a provision that allows for the elimination of double economic taxation arising from transfer pricing disparities. This provision obliges a contracting state, whether after a mutual agreement procedure or not, to make a corresponding downward adjustment, if the other contracting state makes an upward transfer pricing adjustment.

Double taxation can also be combated at national level by filing an appeal against the Dutch tax assessment. The advantage of a domestic procedure over a mutual agreement procedure is that the domestic procedure can in certain cases lead to a faster resolution of the case. The disadvantage is that an (often) two-sided problem of double taxation, is reviewed from only one side. Different treaties and conventions have different rules on whether or not arbitration proceedings can be initiated after domestic proceedings. Therefore, which procedure (ie, domestic appeal or request for a mutual agreement procedure) is preferable will depend on the specific case.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Dutch GAAR

Dutch tax law includes the unwritten doctrine of abuse of law (*fraus legis*). Under the *fraus legis* doctrine, a tax inspector may substitute a fact pattern that does not lead to taxation with a fact pattern that does if:

- the taxpayer has created a situation in which tax cannot be imposed, but which approximates one in which tax could be imposed;
- tax avoidance is the taxpayer's predominant motive; and
- the purpose and intent of the tax law would be frustrated if the non-taxable fact pattern is not treated as a taxable fact pattern.

Furthermore, amendments have been made to Dutch law to implement the GAAR included in the EU Parent-Subsidiary Directive, which is designed as a common minimum anti-abuse rule within the EU, aimed at preventing misuses of the Directive through arrangements or series of arrangements that are not genuine and do not reflect economic reality. The implementation of the GAAR has been limited to modifications of two existing anti-abuse rules: (i) the corporate income tax anti-abuse rules for foreign shareholders with a shareholding of 5% or more (ie, a substantial interest) in a Dutch resident company; and (ii) the dividend withholding tax anti-abuse rules for co-operatives.

The GAAR included in the ATAD consists of three requirements that need to be met for an arrangement or a series of arrangements, for the purposes of calculating the tax liability, to be ignored:

- the main purpose or one of the main purposes is obtaining a tax advantage (“subjective criterion”);

- that defeats the object or purpose of the applicable tax law (“objective criterion”); and
- that is/are not genuine having regard to all relevant facts and circumstances.

The Dutch government is of the opinion that there is no need for the Netherlands to implement the ATAD GAAR, as these cases should be covered under *fraus legis*.

Application of GAAR to Cross-Border Situations

The DTA uses the above-discussed anti-abuse test in the Dividend Withholding Tax Act and the Corporate Income Tax Act to tackle specific situations of cross-border BEPS. The DTA have found it difficult to apply the Dutch doctrine of abuse of law (*fraus legis*) in cross-border situations but have done so in specific cases to challenge the deductibility of interest in intra-group situations. The Supreme Court has also shown willingness to apply the abuse of law concept (*fraus legis*) in very specific cases (see **8.5 Litigation Relating to Cross-Border Situations**). In this regard it should be noted that the Dutch Supreme Court has ruled that even if the DTA successfully argues *fraus legis*, the taxpayer may still have a reasonably arguable position, which prevents a penalty for a tax offence (*vergrijpboete*) as set out in **7.1 Interaction of Tax Assessments with Tax Infringements**.

In principle, a treaty provision can restrict the national taxing right, even if this taxation results from invoking the GAAR. This can frustrate the DTA in combatting BEPS in cross border situations. *Fraus conventionis* is a doctrine with respect to the application of double taxation treaties under which a (non-taxable) fact pattern may be ignored and substituted by a taxable fact pattern under the relevant double taxation treaty to the extent that the former would frustrate the object and purpose of the double taxation treaty. The Dutch Supreme Court has generally

not applied this doctrine in cross-border situations and in some cases has even ruled against it. It should however be noted that these cases were decided based upon the “old” OECD commentary, making it unclear whether today this is still the view of the Dutch Supreme Court. One should be aware that last-minute tax planning to obtain treaty benefits may in some specific cases be vulnerable to a “substance over form” approach. Some authors believe that because of the “Danish cases” which the ECJ ruled on 26 February 2019, treaty benefits may no longer be claimed in situations where the DTA invokes the EU law abuse concept. However, it is still unclear whether the DTA and courts will follow such a view.

Impact of the MLI

The Netherlands signed the MLI in double taxation treaty situations. The MLI entered into force with regard to the Netherlands on 1 July 2019. As a result, tax treaties concluded by the Netherlands might be affected by the MLI as of 1 January 2020. Under the MLI, the relevant measures will amend the double taxation treaties concluded by the Netherlands (the timing thereof depends on the ratification process of its treaty partners). Important changes that will affect all the submitted Dutch covered double taxation treaties relate to the introduction of a principal purpose test (PPT) and the amendment of the preamble to the extent that double taxation treaties are not intended to create double non-taxation or reduced taxation. The former might make it easier for the DTA to combat BEPS in cross-border situations as it provides ground to prevent the granting of treaty benefits in cross-border situations found to be inappropriate.

8.3 Challenges to International Transfer Pricing Adjustments

In recent years, there has been an increase in MAP proceedings. Furthermore, taking into account the implementation of the Tax Dispute

Resolution Mechanisms Directive, it is expected that more taxpayers will challenge transfer pricing adjustments.

8.4 Unilateral/Bilateral Advance Pricing Agreements

The conclusion of APAs is a common mechanism in the Netherlands to mitigate transfer pricing litigation in the Netherlands. The common features and procedural aspects have been set out in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

8.5 Litigation Relating to Cross-Border Situations

A fair share of litigation in respect of cross-border situations comes from transfer pricing issues. Further, it is expected that the share of withholding tax issues will increase in the coming years, prompted by EU case law from the ECJ regarding the concept of beneficial ownership and tax avoidance, such as the “Danish cases” in which the ECJ ruled on 26 February 2019. All in all, an increase of tax litigation in cross-border situations is expected; on the one hand, because of the BEPS project and the implementation of the EU regulations countering tax avoidance that should give the DTA new instruments to tackle tax avoidance and contest the tax positions of taxpayers, and on the other hand, because of the BEPS and EU initiatives that should provide better protection to taxpayers who are faced with double taxation due to their cross-border footprint.

Currently, various cases on private equity structures with foreign investors are pending or have been ruled on by the Dutch Supreme Court. In these cases, foreign investors finance a Dutch takeover, resulting in a large interest deduction in the Netherlands. In each case, the question is whether the DTA can invoke the interest deduction limitation provision of Article 10a of the Dutch Corporate Income Tax Act or, alterna-

tively, *fraus legis* to limit the deduction of interest in the Netherlands. Illustrative is the case of the Dutch Supreme Court of The Hague of 16 July 2021 (ECLI:NL:HR:2021:1152) where the Supreme Court ruled in favour of the DTA and stated that the deduction of interest was limited due to *fraus legis*.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

In recent years, several state aid disputes involving taxes have been pending, indeed some are still pending. In these cases, Dutch taxpayers had obtained certainty in advance from the DTA on certain transactions in the form of an APA. In each case, these APAs have been tested by the European Commission in connection with possible state aid. Illustrative are the Starbucks Case, the Inter Ikea Case and the Nike Case.

In the Starbucks Case, the European Commission concluded in 2015 that unlawful state aid was provided as a result of the APA with the DTA. The Dutch government lodged an appeal against the decision of the European Commission on 23 December 2015, where the General Court of the European Union annulled the state aid decision of the European Commission. The European commission decided to not appeal the case.

In the Inter Ikea Case, the European Commission started a formal state aid investigation in 2017 into two APAs between the DTA and Ikea. In 2020, the European Commission extended this investigation by way of also reviewing the tax assessments imposed on Ikea in further detail. To date (May 2022), the European Commission has not yet taken a final position.

Lastly, the European Commission opened a formal state aid investigation into five rulings

between the DTA and Nike in 2019, whose investigation is still pending.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

If the European Commission determines that unlawful state aid has been provided, member states are obliged to recover the state aid from the beneficiary. With respect to fiscal state aid, recovery will take place by means of the usual tax instruments (ie, by way of issuing additional tax assessments). As mentioned in **2.2 Initiation and Duration of a Tax Audit**, certain conditions would in principle need to be met to impose an additional tax assessments on a tax payer, such as a new fact and the statute of limitation period not having passed. These conditions are, however, not applicable with respect to the recovery of state aid.

9.3 Challenges by Taxpayers

The beneficiary of state aid has, in principle, the usual rights to challenge a tax assessment. Hence, a beneficiary can lodge an objection or file an appeal with a tax court.

State aid recovery involves not only the interests of the beneficiary but arguably also those of third parties. Competitors of the beneficiary may also have an interest in this regard. Based on case law of the Court of Justice of the European Union, third parties may challenge a non-recovery action of the European Commission before the Court of Justice of the European Union.

9.4 Refunds Invoking Extra-Contractual Civil Liability

In principle, unlawful state aid could result in extra-contractual civil liability for the beneficiary if the requirements of a so-called wrongful act (*onrechtmatige daad*) are met in respect of a competitor. The authors are not, however, aware of specific (Dutch tax) cases in which this position was taken by a third party.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Signatory states to the MLI have the right, but not the obligation, to apply Part VI to the CTA's. The Netherlands has opted to apply these mandatory binding arbitration provisions of the MLI. Few states have made this choice, as such, the arbitration provisions will be introduced in (only) 13 DTTs through the MLI. The Netherlands however already included an arbitration clause in a number of existing DTTs. Three of these existing arbitration provisions will be amended because of the MLI.

10.2 Types of Matters that Can Be Submitted to Arbitration

Arbitration is the final stage of the MAP. In principle, arbitration is available for all types of disputes on the interpretation and application of the relevant treaty. Contracting states may however agree to limit the scope to certain topics; an arbitration clause may contain a negative list of subjects, which are not open to arbitration, or a positive list with an exhaustive list of subjects that are open to arbitration.

The Netherlands does not insist on certain restrictions in arbitration provisions when negotiating treaties. The Netherlands also opted for unlimited arbitration in the MLI. However, because many other states do use restrictions, most arbitration provisions in Dutch tax treaties contain a negative list of subjects which are not open to arbitration.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

In baseball arbitration, both competent authorities make a proposal to the arbitration commission for the resolution of the dispute. The arbitration commission then chooses one of these solutions (without substantiation). In independent opinion arbitration, the arbitration commission makes a reasoned award based on the facts and the applicable law.

Under the MLI arbitration provision, baseball arbitration is the “default” option. States may however opt for independent opinion arbitration. However, states may also make a reservation against the use of the independent opinion procedure in the arbitration provision. The Netherlands has, in order to achieve as many matches as possible with other contracting parties, opted for baseball arbitration under the MLI, and has not made a reservation against the use of the independent opinion procedure.

Furthermore, aside from the MLI, the type of procedure employed differs per treaty and instrument. For example, the Tax Arbitration Law and the EU Arbitration Convention both work with independent opinion procedures.

10.4 Implementation of the EU Directive on Arbitration

The EU Directive on Arbitration is implemented in the Tax Arbitration Law. In intra-Community treaty disputes, a taxpayer may request the Netherlands to enter into a MAP and, if necessary, subsequently an arbitration procedure. The scope of this law includes both transfer pricing cases and interpretation cases. The Tax Arbitration Law applies to disputes arising in financial years beginning on or after 1 January 2018 for which the complaint is filed on or after 1 July 2019 (unless agreed otherwise by the states).

10.5 Existing Use of Recent International and EU Legal Instruments

The Dutch State Secretary of Finance provided information on the use of arbitration to settle tax disputes by the Netherlands on 21 September 2020. This information provides that no arbitration proceedings have ever been initiated between the Netherlands and another treaty country. A dispute is usually settled in the MAP prior to arbitration. There are, however, a number of long-running MAPs (under the EU Arbitration Convention and under DTTs that provide for arbitration), in which the Netherlands is, in principle, open to setting up an arbitration panel to reach a solution for the taxpayer(s) concerned as quickly as possible.

10.6 New Procedures for New Developments under Pillar One and Two

The Pillar One blueprint includes innovative dispute resolution mechanisms (including arbitration and mediation) with respect to disputes that may occur as a result of applying the new allocation rules (including the so-called Amount A). The new procedures under Pillar One are still pending and are subject to political consensus among countries. If the rules are implemented it remains to be seen whether they will result in interpretative differences between various jurisdictions, potentially resulting in more arbitration cases.

10.7 Publication of Decisions

The Tax Arbitration Law requires that arbitration cases will have to be published. Under double tax treaties, the rules differ as to whether or not to publish arbitration outcomes. The confidentiality of the proceedings is, however, generally considered paramount, therefore an interested party can often indicate that it wants the arbitration decision to be anonymous. As a result, an anonymised summary instead of the entire final decision may be published.

10.8 Most Common Legal Instruments to Settle Tax Disputes

As indicated in **10.2 Types of Matters that Can Be Submitted to Arbitration**, no arbitration case has yet been submitted. Disputes are generally settled in the MAP prior to arbitration.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

The exact details of the arbitration procedure, deadlines, selection of arbitrators, allocation of costs, award and so on will depend on the instrument under which arbitration is applied. In general, the rules prescribe that the taxpayer requests the establishment of an arbitration panel and that the states appoint an arbitrator and a representative.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

The administrative appeal procedure is initiated by lodging an objection against a tax assessment or against any other decision of the DTA to which an objection can be lodged. The DTA does not charge costs for handling the objection of the taxpayer. A taxpayer can request a reimbursement for costs incurred in relation to its administrative appeal, which request is granted only if certain conditions are met; eg, the DTA makes a culpable mistake and revisits its earlier decision. The reimbursement of costs is generally around EUR269 (2022) but may be higher depending on the complexity of the case at hand.

11.2 Judicial Court Fees

If the DTA rules against the taxpayer in the administrative appeal, the taxpayer may decide to file for appeal. If so, the taxpayer has to pay court registry fees at the start of the proceedings, the

amount of which varies depending, inter alia, on whether the taxpayer is an individual or a legal entity and the characteristics of the case.

For individuals, the court registry fee for district court tax litigation in first instance amounts to EUR184 (2022) if the appeal relates to dividend withholding tax, VAT, excise duties, taxation of passenger cars and motorcycles, consumption tax on non-alcoholic beverages, environmental taxes or customs law. In all other cases, the court registry fee for individuals amounts to EUR50 (2022). For legal entities, the court registry fee for district court tax litigation in first instance amounts to EUR365 (2022) irrespective of the taxes to which the case relates.

At the court of appeal for tax litigation, the court registry fee for individuals amounts to EUR274 (2022) if the appeal relates to dividend withholding tax, VAT, excise duties, taxation of passenger cars and motorcycles, consumption tax on non-alcoholic beverages, environmental taxes and customs law. In all other cases, the court registry fee amounts to EUR136 (2022). For legal entities, the court registry fee for tax litigation at the court of appeal amounts to EUR548 (2022) irrespective of the taxes to which the case relates.

The court registry fees at the Dutch Supreme Court are the same as the court registry fees for tax litigation at the court of appeal (see above). All court registry fees have to be paid up front.

11.3 Indemnities

If the court rules against the DTA or the Dutch State Secretary of the Ministry of Finance in tax litigation before the Dutch Supreme Court, they have to repay the amount of the court registry fee to the taxpayer. The court may also order the DTA (or the State Secretary) to reimburse the taxpayer's legal costs. In addition, in certain specific situations – and only if the taxpayer files a claim to that extent – a court may order the DTA

to pay damages to the taxpayer, which could, for instance, be the case if the taxpayer suffers damages as a result of a wrongful act, omission or decision of the DTA.

11.4 Costs of ADR

Mediation may be an efficient option (including in terms of cost) for taxpayers to resolve their tax disputes with the DTA (depending also on whether the taxpayer engages legal advisers, etc). The costs for mediation mainly comprise of the fees of the mediator, the amount of which typically depends on the time spent.

Apart from the legal fees a taxpayer may incur in the process of negotiating a settlement with the DTA or obtaining advance clearance from the DTA in the form of an APA/ATR settlement agreement, there are no costs associated with these two ways of resolving tax disputes or disagreements with the DTA.

12. STATISTICS

12.1 Pending Tax Court Cases

Each year approximately 27,500 tax cases are brought before the Court of First Appeal. In 2021 there was a minor decrease in tax cases compared to 2020. In the 2021 numbers, an 83% increase in the number of cases brought before the Court of Appeal compared to 2020 stands out. This increase is partly due to a large increase in the number of cases that were filed regarding the Dutch Private Motor Vehicle and Motorcycle Tax Act 1992.

The expectation is that the number of tax cases will begin to increase in the coming years due to the changed international tax environment following the BEPS project and the implementation of the EU initiatives against tax avoidance. These developments will likely prompt more active enforcement by the DTA.

12.2 Cases Relating to Different Taxes

No such data is available.

12.3 Parties Succeeding in Litigation

No such data is available.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The BEPS project and the implementation of the EU regulations countering tax avoidance give the DTA new instruments to tackle tax avoidance and contest the tax positions of taxpayers. In addition, under the principal purpose test of the MLI, taxpayers may be denied treaty benefits. Furthermore, tax authorities around the world are increasingly sharing more and more information on taxpayers. In addition, taxpayers and their intermediaries active in the EU are now subject to a mandatory disclosure obligation in respect of potentially aggressive cross-border tax-planning arrangements based on DAC6, which was adopted on 25 May 2018 and came into effect (in the Netherlands) on 1 January 2021. The mandatory disclosure rules in principle apply to intermediaries. In certain specific cases, however, the mandatory disclosure rules apply to, or shift to, the relevant taxpayer. This may for instance be the case when there is attorney-client privilege or when there is no intermediary involved with respect to the cross-border potentially aggressive tax planning arrangement(s). Tax authorities within the EU will share the information received on the basis of the directive.

Taxpayers should consider developing tax risk-management policies, procedures and processes in this changing tax environment. Taxpayers need to be proactive to prevent and manage tax disputes and disagreements with the DTA. Taxpayers without a comprehensive and sound approach on detecting potential tax risks and

the management thereof are likely to be more vulnerable to the scrutiny of the tax authorities.

It nevertheless may be inevitable that tax disputes and disagreements with the DTA arise. As a result of the changing global tax environment, taxpayers are likely to be confronted with tax audits and tax disputes by the DTA more frequently. In these cases, it generally helps if the taxpayer already has a good understanding of the various mechanisms available to the taxpayer to resolve the tax dispute/disagreement and of the pros and cons thereof (eg, mediation and litigation).

In addition, it generally helps if the taxpayer has historically had, and continues to have, an open and good relationship with the DTA. This increases the taxpayer's chances of settling the tax dispute/disagreement in the early stages.

Stibbe handles complex legal challenges both locally and cross-border from its main offices in Amsterdam, Brussels and Luxembourg, together with its branch offices in London and New York. By understanding the commercial objectives of clients, their position in the market and their sector or industry, Stibbe can render suitable and effective advice. From an international perspective, it works closely with other top-tier firms on cross-border matters in various juris-

dictions. These relationships are non-exclusive, enabling Stibbe to assemble tailor-made integrated teams of lawyers with the best expertise and contacts for each specific project. This guarantees efficient co-ordination on cross-border transactions throughout a multitude of legal areas, irrespective of their nature or complexity. The authors would like to thank Tirza Cramwinckel for her assistance with the article.

AUTHORS



Reinout de Boer is a partner in Stibbe's Amsterdam tax practice group and he specialises in domestic and international taxation with an emphasis on M&A, private equity transactions and corporate reorganisations. He heads the Dutch tax controversy practice of Stibbe and advises in a wide range of (international) tax litigation cases.



Michael Molenaars is head of Stibbe's tax practice group. His specialisms include domestic and international taxation with an emphasis on M&A and private equity transactions, corporate reorganisations and investment fund structures. Michael guides large multinational companies, financial institutions and private equity firms through every stage of technically complex issues, including contentious issues. He is also a frequent speaker on international tax issues and has co-authored several books and articles on international taxation.



Rogier van der Struijk

specialises in international corporate taxation of Dutch and foreign multinationals, advising clients on complex matters such as tax-efficient structuring of

investments and divestments. He has experience in various industries – such as financial services – advising clients on the tax aspects of large cross-border investments. Furthermore, he is experienced in tax controversy work, including (tax) litigation, and is a senior member of Stibbe’s tax controversy practice with a specific focus on cases before the Supreme Court. He is a member of the Dutch Bar association and the Dutch Association of Tax Advisers, and a deputy judge in the tax chamber of the Arnhem district court.



Mieke Lavreysen

specialises in domestic and international corporate taxation of Dutch and foreign multinationals. Furthermore, she is a junior member of Stibbe’s tax

controversy practice. Mieke holds master’s degrees from the University of Chicago Law School (LLM, 2019) and from Radboud University (Dutch corporate law LLM, 2018 and Dutch tax law LLM, 2018). Mieke is a member of the Dutch Bar association and a prospective member of the Dutch Association of Tax Advisers.

Stibbe

Beethovenplein 10
1077 WM Amsterdam
P.O. Box 75640
1070 AP Amsterdam
The Netherlands

Tel: +31 20 546 06 06
Fax: +31 20 546 01 23
Email: amsterdam@stibbe.com
Web: www.stibbe.com

Stibbe

Law and Practice

Contributed by:

Geoffrey Clews and Sam Davies

Old South British Chambers see p.464



CONTENTS

1. Tax Controversies	p.443	5.3 Judges and Decisions in Tax Appeals	p.452
1.1 Tax Controversies in this Jurisdiction	p.443	6. Alternative Dispute Resolution (ADR) Mechanisms	p.452
1.2 Causes of Tax Controversies	p.443	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.452
1.3 Avoidance of Tax Controversies	p.443	6.2 Settlement of Tax Disputes by Means of ADR	p.452
1.4 Efforts to Combat Tax Avoidance	p.443	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.452
1.5 Additional Tax Assessments	p.444	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.452
2. Tax Audits	p.444	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.453
2.1 Main Rules Determining Tax Audits	p.444	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.453
2.2 Initiation and Duration of a Tax Audit	p.445	7. Administrative and Criminal Tax Offences	p.453
2.3 Location and Procedure of Tax Audits	p.445	7.1 Interaction of Tax Assessments with Tax Infringements	p.453
2.4 Areas of Special Attention in Tax Audits	p.445	7.2 Relationship between Administrative and Criminal Processes	p.454
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.446	7.3 Initiation of Administrative Processes and Criminal Cases	p.454
2.6 Strategic Points for Consideration during Tax Audits	p.446	7.4 Stages of Administrative Processes and Criminal Cases	p.454
3. Administrative Litigation	p.447	7.5 Possibility of Fine Reductions	p.455
3.1 Administrative Claim Phase	p.447	7.6 Possibility of Agreements to Prevent Trial	p.455
3.2 Deadline for Administrative Claims	p.447	7.7 Appeals against Criminal Tax Decisions	p.456
4. Judicial Litigation: First Instance	p.448	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.456
4.1 Initiation of Judicial Tax Litigation	p.448	8. Cross-Border Tax Disputes	p.456
4.2 Procedure of Judicial Tax Litigation	p.449	8.1 Mechanisms to Deal with Double Taxation	p.456
4.3 Relevance of Evidence in Judicial Tax Litigation	p.450	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.457
4.4 Burden of Proof in Judicial Tax Litigation	p.450		
4.5 Strategic Options in Judicial Tax Litigation	p.450		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.451		
5. Judicial Litigation: Appeals	p.451		
5.1 System for Appealing Judicial Tax Litigation	p.451		
5.2 Stages in the Tax Appeal Procedure	p.451		

8.3	Challenges to International Transfer Pricing Adjustments	p.457	10.5	Existing Use of Recent International and EU Legal Instruments	p.459
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.458	10.6	New Procedures for New Developments under Pillar One and Two	p.459
8.5	Litigation Relating to Cross-Border Situations	p.458	10.7	Publication of Decisions	p.460
9. State Aid Disputes		p.459	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.460
9.1	State Aid Disputes Involving Taxes	p.459	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.460
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.459	11. Costs/Fees		p.460
9.3	Challenges by Taxpayers	p.459	11.1	Costs/Fees Relating to Administrative Litigation	p.460
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.459	11.2	Judicial Court Fees	p.460
10. International Tax Arbitration Options and Procedures		p.459	11.3	Indemnities	p.461
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.459	11.4	Costs of ADR	p.461
10.2	Types of Matters that Can Be Submitted to Arbitration	p.459	12. Statistics		p.461
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.459	12.1	Pending Tax Court Cases	p.461
10.4	Implementation of the EU Directive on Arbitration	p.459	12.2	Cases Relating to Different Taxes	p.462
			12.3	Parties Succeeding in Litigation	p.462
			13. Strategies		p.462
			13.1	Strategic Guidelines in Tax Controversies	p.462

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

New Zealand has a self-assessment tax system. Taxpayers who derive income from which tax is not fully deducted at source file an annual return of their income and tax liability to Inland Revenue/ *Te Tare Take* (IR). Most tax controversies arise when IR disputes the position returned by a taxpayer, usually as a result of some anomaly detected by audit. However, tax controversies can also be initiated by the taxpayer, when a taxpayer wishes to adjust an earlier tax position or disclose previously undeclared income.

Tax controversies can also arise from administrative decisions, such as registration for goods and services tax (GST), the equivalent of VAT, or refusal of financial relief. Inquiries by IR, investigations and audits can all give rise to controversy because of IR's wide powers.

1.2 Causes of Tax Controversies

For most New Zealand taxpayers, tax is collected unobtrusively on their behalf. A "Pay As You Earn" (PAYE) withholding system ensures that employed taxpayers correctly pay tax on wages and salaries, because it is withheld by their employers. Similarly, some contractor payments and all bank interest income are subject to tax withholding.

GST is included in the price for most purchases, and levies are included in fuel prices. This results in a system where correct compliance is straightforward and automatic for most taxpayers. Most tax controversy arises in relation to taxes whose collection relies on voluntary compliance by taxpayers, especially company and business taxpayers. Controversy arises from IR action to identify potential tax risks including risk reviews, audits and investigations.

1.3 Avoidance of Tax Controversies

The statutory tax disputes process, which is summarised in **3. Administrative Litigation**, exists both to reduce the instances of tax controversy and to facilitate resolution when tax controversy does arise. IR undertakes risk reviews in which it will often invite voluntary disclosure of tax discrepancies with the promise of reduced penalties to avoid or mitigate controversy.

1.4 Efforts to Combat Tax Avoidance

New Zealand has embraced BEPS initiatives enthusiastically. It has adopted the updated OECD model tax convention and signed the multilateral convention (MLI). It has also legislated an all-encompassing approach to prevent multinationals from aggressively reducing their New Zealand tax liability. From 1 July 2018, new laws introduced a permanent establishment anti-avoidance rule, strengthened the transfer pricing and thin-capitalisation rules, introduced new rules to tax hybrid and branch mismatch arrangements, and increased IR's already broad information gathering powers.

Restricted transfer-pricing rules for inbound party-related debt were also introduced, departing from the arm's-length principle in favour of prescriptive interest rate rules aimed at preventing a "BEPS risk". The Government is considering introducing a digital services tax aimed at multinational providers of digital platforms in New Zealand, although the approach will likely be shaped by OECD policy and international consensus.

It is too early to say how BEPS initiatives will affect tax controversy. However, it is widely accepted that the legislation is complex and likely to lead to an increase in compliance issues and costs. Its complexities may well offer avenues for challenge. However, since being enacted there has been little activity by IR specifically applying these reforms. That is largely because

for much of the last two years, IR has been pre-occupied with administering important element of the government's COVID-19 response.

1.5 Additional Tax Assessments

In most cases, a taxpayer does not need to pay a tax reassessment before being able to challenge it, although if a taxpayer is unsuccessful in a challenge, late payment penalties and interest will continue to be charged until payment. Where there is a risk of eventual non-payment, IR can require some or all of the tax to be paid. In some extreme cases, IR can apply to freeze assets pending the disposition of a pre-assessment dispute or a challenge. Before being able to challenge a default assessment (ie, an assessment raised in the absence of a tax return), both the relevant return and a notice of proposed adjustment must be filed to provide a threshold explanation of the taxpayer's position.

Criminal law consequences can arise from non-payment of tax. Civil disputes are normally suspended pending the outcome of criminal proceedings to preserve fair trial rights. In these proceedings, whether or not tax has been paid (albeit late) is an important factor in sentencing upon conviction. Criminal proceedings often, therefore, prompt payment even if civil liability has yet to be fully determined. If tax evasion charges are laid, that can adversely affect the extent to which IR can compromise over civil tax debt.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

IR applies its investigation resources carefully. Those resources are extensive, and IR's forensic capabilities have been upgraded very substantially over a period of six years in which a new system called START (simplified tax and revenue technology) has been launched.

In theory, IR may audit any taxpayer subject to a time bar. In reality, however, most taxpayers are never audited – primarily because of the efficiency of the PAYE, withholding and GST collection mechanisms. Structurally, IR focuses on three taxpayer categories: individuals, small to medium-sized enterprises and significant enterprises or businesses.

IR uses increasingly sophisticated diagnostic tools to identify taxpayers for audit in each category, together with information from third parties such as banks and the oft-quoted anonymous “tip-off”. Public records, social media, business filings and advertising all contribute to “tax intelligence”. A poor compliance or payment history can increase the likelihood of an audit, and certain taxpayers and industries that are considered “high risk” because of their relative ease of suppressing income may be targeted more often.

These include businesses trading significantly in cash, such as tradespeople, taxpayers trading in land, and taxpayers with overseas bank accounts. IR may also audit taxpayers in a particular geographic area. As an example, businesses in certain agricultural and horticultural regions may become targets because of the prevalence of tax evasion amongst certain work groups with which the businesses may operate.

High net worth individuals and significant enterprises are a perennial target of IR. For these taxpayers, risk reviews and audit are more likely to be prompted by unusually complex structures, unorthodox financing transactions, uncertainty over compliance by controlled foreign companies and foreign trust structures, transfer pricing or BEPS issues. IR has initiated a controversial survey of high net worth individuals' effective tax rates with a view to future tax policy changes.

2.2 Initiation and Duration of a Tax Audit

IR does not need to give notice of an audit in order to require taxpayers to supply records. For example, IR officers can make unannounced visits to check payroll and GST records. Audits are often preceded by a “risk review”, where IR requests information to review, with a view to assessing the risk of non-compliance. If a risk is detected, the taxpayer will be notified that an audit will commence. The formal notification of the commencement of an audit is an important step in relation to possible discounts from civil penalties that are available for voluntary disclosures.

The length of audit depends on the issues and tax types involved, the records to be reviewed, the complexity of the taxpayer’s affairs, the quality of the taxpayer’s records and the co-operation of the taxpayer. Complicated audits may run for several years.

There is no time limit for initiating an audit, but a time bar on IR’s ability to increase a taxpayer’s liability means that an audit must be started and concluded in a timely way. Usually, IR can only increase an assessment within four years of the end of the income year, or other tax period, in which the relevant tax return was filed. Thus, if an income tax return is filed in the year to March 2022 for the income year ended March 2021, an assessment increasing the liability for 2021 cannot normally be made after 31 March 2026. That time bar can be lifted in the case of fraudulent or wilfully misleading returns, or if a particular type or source of income was not originally declared.

If the time bar is lifted, there is legally no time limit on IR’s ability to reassess, but administratively IR will not normally reassess for more than ten years. The four-year time bar is generally considered to be positive for taxpayers and IR as it offers certainty for when an assessment

will be considered final, but it can also drive an audit to a conclusion when IR wants to prevent an income tax year “falling out” of time, and that can be disadvantageous. Because of this, a process of time bar waiver is available to taxpayers.

2.3 Location and Procedure of Tax Audits

As more taxpayers move to exclusively digital record-keeping, off-site audits have become more common. Taxpayers are often asked to provide digital information (including computer hard drives) as part of an initial information request. When IR makes unannounced visits to obtain records, computer hard drives are routinely copied, subject to steps being taken to protect material that could be subject to claims of legal professional privilege or tax advice non-disclosure (a parallel protection for accountants’ tax advice). The interrogation of such information, assisted by audit software, allows IR to target later information requests.

While this shift to digital audits is underway, many audits are still carried out by exchange of paper documents. Sometimes, IR will still review information at a taxpayer’s premises for ease of communication and accessibility of documentation. The questioning of taxpayers may occur voluntarily or compulsorily, with different legal consequences applying in each case. Compulsory interviews will normally occur on IR premises and under oath.

2.4 Areas of Special Attention in Tax Audits

Threshold administrative requirements apply to some aspects of IR’s audit inquiries. For example, a private dwelling may not be entered without a court-issued warrant, and removal of records while IR has access to any premises also requires a warrant. These processes are subject to general law governing search, seizure and surveillance in New Zealand. Tax auditors

must take special care over these matters, and they are also prime considerations for advisers assisting taxpayers under audit. Rights of silence, privilege and tax advice non-disclosure must be respected by IR and, again, are a focus.

IR will usually start by reviewing accounting records, contracts, invoices and bank accounts. IR often contacts third parties, such as accountants, banks, suppliers and employees, if it needs further information. It is worth noting that private activities and information are not “off limits” in an audit. IR may review private activities and records to substantiate a taxpayer’s correct tax position. In most cases, auditors place importance on meeting taxpayers, including company officers, face to face. This begins as an opportunity to understand the way in which the subject business operates and who is responsible for tax compliance. Such face-to-face dealings can be extensive, though many taxpayers prefer to limit “exposure” to IR by working through their tax agents or advisers.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

NZ has committed to the OECD’s Automatic Exchange of Information (AEOI) regime, and the Common Reporting Standard (CRS) came into effect in NZ on 1 July 2017. Affected banks and other financial institutions were expected to identify foreign tax residents and report their financial account information for the initial reporting period ending 31 March 2018, due to IR by 30 June 2018.

The first exchange of information between the revenue authorities from reportable jurisdictions occurred on 30 September 2018. The new cross-border exchanges of information increased audit activity. IR has issued a number of risk review letters as a result of being advised that a New

Zealand tax resident has an account overseas. These have led to voluntary disclosures, to pre-empt audits and reduce associated penalties. This process is ongoing.

2.6 Strategic Points for Consideration during Tax Audits

The following 12 points summarise some key considerations during a tax audit in New Zealand:

- have a clear understanding of IR’s authority, delegations, warrants, and actions during the inquiry and ensure that IR does only what it is permitted to do by law, and nothing more;
- control the scope and timing of any investigation, and limit information and topics to be strictly within this scope;
- limit IR access to business personnel;
- control the information flow to IR, co-ordinate a “single source” of information, and oversee all exchanges;
- consider the worth of voluntary disclosure, even at the risk of prosecution (some disclosures will lead to non-prosecution and some will not);
- remember that the burden of proof is on the taxpayer – assertion is not evidence;
- special rules apply to proof of offshore payments;
- consistent with client interests, build trust and confidence with the IR team;
- keep open avenues to escalate problems that cannot be addressed with the auditors;
- manage the risk of IR approaching others to the detriment of the taxpayer;
- identify weaknesses in the taxpayer’s case and plan whether and when to compromise these; and
- critically assess the credibility of the individuals involved in the taxpayer’s case.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

If a tax issue cannot be resolved informally, it is dealt with under a prescribed statutory tax disputes process. This can loosely be called the “administrative phase”. Except for certain cases, IR cannot make a new tax assessment until the disputes process has substantially been carried out. This process is designed to refine tax disputes, identify issues, disclose facts and ensure communication between the taxpayer and IR. The aim is to resolve disputes without litigation if possible, but if litigation is necessary, to avoid either side being ambushed.

The tax disputes process can be initiated by either the taxpayer or IR and is largely the same, regardless of who starts it. If the tax disputes process does not resolve the issue, the affected taxpayer may litigate the resulting assessment. The process is mandatory in that a taxpayer may not challenge an assessment unless the parties have engaged in the disputes process, at least to the point where their respective positions have been established to a minimum extent.

The tax disputes process follows prescribed steps. Either party will issue a notice of proposed adjustment (NOPA) outlining proposed adjustments to a tax position and detailed factual and legal reasons for them. The other party then has an opportunity to respond with a notice of response (NOR). When the parties disagree, this initial exchange is followed by a conference, often facilitated by a senior IR officer not connected with the case. If the taxpayer opts out of the conference stage (with the permission of IR), or the conference does not reach a satisfactory resolution, then IR will issue a disclosure notice and a statement of position (SOP) to the taxpayer. The SOP outlines the facts, documentary

evidence and law that supports IR’s position. The taxpayer supplies a responding SOP.

The disclosure notice triggers a statutory limitation on the issues and the propositions of law that can be contested in any subsequent judicial litigation. Because the taxpayer bears the burden of proving its case, it is crucial at this stage that all appropriate facts, evidence and legal arguments are put forward by it. In most cases, SOPs exchanged by the parties are then referred to IR’s disputes review unit (DRU) for adjudication. Though part of IR, the DRU is independent of IR’s investigators and must decide whether or not the position advanced by the investigators is correct. Should the DRU decide in the taxpayer’s favour, the matter is closed. However, if the DRU upholds IR’s position, the taxpayer may challenge a resulting assessment in the Taxation Review Authority (TRA) or the High Court, discussed further at **4. Judicial Litigation: First Instance**. The imposition of penalties in respect of any assessment is discussed in **7. Administrative and Criminal Tax Offences**.

3.2 Deadline for Administrative Claims

Although there are strict deadlines as part of the tax disputes process, there is no time limit for it to conclude, apart from the statutory four-year time bar for tax reassessments. The disputes process takes about 635 days to complete on average, not including the initial information requests and investigation. A brief summary of the key time periods for the tax disputes process follows, but exceptions and variations are numerous and very fact-dependent. Many of the timeframes referred to below are administrative targets set by IR. Statutory timeframes apply to the exchange of formal notices and statements of position.

Initiating a Dispute

If IR is initiating the tax disputes process, it will usually alert a taxpayer that a NOPA will

be issued about five days beforehand, and will confirm receipt about ten days after it has been sent. The taxpayer will be required to file their responding NOR within two months of the NOPA's issue. IR will confirm if the taxpayer intends to file a NOR about two weeks before the response period expires. If IR considers that exceptional circumstances have prevented the taxpayer from responding in time, then it can deem the response to have been received "in time" and has a month to issue a determination to that effect or decline to do so. If out of time, the taxpayer is deemed to have accepted IR's NOPA. The taxpayer's NOR is otherwise assigned to an officer within about five working days of receipt, and receipt of the NOR is acknowledged within ten. Within a month, IR will advise the taxpayer if the NOR is accepted, rejected, or still being considered. Acceptance at this stage would finalise the tax disputes process and an amended assessment can be issued if the agreed position requires it.

Rejection or Consideration

If the NOR is rejected or under consideration, IR can invite the taxpayer to participate in a conference, and to have that facilitated by a senior IR officer independent of the case officers. The taxpayer usually responds to this invitation within two weeks, though on more complicated matters this can take substantially longer. The taxpayer has the right to request to opt out of the tax disputes process and proceed straight to litigation by way of a tax challenge within two weeks of the end of the conference phase. IR has three months to decide if it will allow the request to bypass the tax disputes process and proceed directly to litigation. If the taxpayer accepts the invitation to a conference, IR will come back within about two weeks to confirm the structure of the meeting and when it will occur. The conference phase usually takes about three months.

Disclosure Notice

If the conference phase is unsuccessful, IR will usually issue a disclosure notice within three months, and its SOP (although there is no requirement for it to do this within any timeframe). The taxpayer must issue their responding SOP within two months of receiving IR's SOP; the applicable timeframes can be extended if the circumstances justifying the taxpayer's delay are sufficiently "exceptional". Exceptional circumstances are usually outside of the taxpayer's control. Failure by a taxpayer to issue a responding SOP within time, without an extension, will result in deemed acceptance of IR's SOP.

If the SOP is received in time from the taxpayer, IR has two months to provide an addendum to its SOP. The taxpayer can request to add further information to their SOP, at IR's discretion. Within one month of the addendum, IR will usually determine if the matter will be further escalated to the DRU. The materials to be sent to the adjudicator will be agreed with the taxpayer; if no agreement is reached after ten days, IR will supply the materials to the DRU. Importantly, the DRU considers matters only "on the papers" and will not independently assess witness credibility.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

If IR and the taxpayer cannot reach agreement through the tax disputes process, judicial tax litigation "challenge" proceedings can be commenced by the taxpayer within two months of the relevant tax assessment being confirmed. There is a right of challenge against most decisions of IR following the tax disputes process. However, a taxpayer cannot challenge an assessment without first completing at least part of the tax disputes process. As outlined at **3. Administrative Litigation**, an opt-out request can be made

within two weeks of the conference phase ending, so that a challenge can be commenced without completing the disputes process.

On rare occasions, a taxpayer may seek judicial review if IR has reached a decision or exercised a discretion based on irrelevant considerations or without taking relevant considerations into account. Judicial review can also be available where a matter cannot be subject to a tax challenge. Review must be brought in the High Court, as it is beyond the TRA's jurisdiction. The TRA and the Court generally require a procedural claim to be brought alongside any substantive tax challenge, to avoid the risk of taxpayers artificially "gaming" the system to delay a substantive decision on tax liability.

The TRA and the High Court (each called a "hearing authority" for tax purposes) are the first judicial forums available to a taxpayer wishing to contest the outcome of the tax disputes process. The TRA is a tribunal that hears only tax challenges. Its proceedings are not open to the public, and published decisions have all identifying details removed. In the past, TRAs have been District Court Judges, although the appointee need not be one and the current TRA is an experienced tax barrister. The TRA can receive any evidence it considers may assist in its decision, even if such evidence would not be admissible in the High Court. Costs cannot generally be awarded against an unsuccessful litigant in the TRA. The cost of litigating in the TRA can be less than in the High Court, though that is not always so.

The High Court is not a specialist tax court but is the forum in which all significant and/or complex litigation should be heard at first instance. The High Court is not obliged to deal confidentially with tax matters and generally the principle of open justice prevails. In this Court, costs are routinely awarded against the unsuccessful party.

Both hearing authorities have all of the powers, duties, functions and discretions of IR when hearing and determining a tax challenge. Although advocates must adhere to the usual rules of evidence, in both forums a taxpayer may appear for themselves, often with considerable assistance from the Bench.

4.2 Procedure of Judicial Tax Litigation

Judicial tax litigation follows the same procedure as other civil claims. The timetable for a hearing in either the TRA or the High Court is set by the Judge, usually in accordance with a proposal by the parties. Written briefs of evidence are filed with the court and served on the opposing party in advance of a hearing to outline the evidence in chief, and bundles comprising documentary evidence and legal authorities are usually agreed by the parties. Most hearings continue to be paper-based, but electronic document management is being introduced in the High Court and is already more prevalent in the appellate courts.

Very briefly summarised, the steps for first instance tax litigation are as follows. (The language reflects the High Court but similar procedures apply in the TRA.)

A notice of proceedings, with a statement of claim and key documents from the tax disputes process is submitted to the Court by the taxpayer, who is plaintiff in the proceedings, and is served on IR as defendant. The statement of claim outlines the general nature of the challenge, including a brief factual background (usually by reference to the dispute documents already exchanged between the parties), and concludes with the remedy sought.

IR files a statement of defence, responding to the taxpayer's case. Once these statements are with the Court, a timetable is set as part of standard case management. This can extend to the full range of interlocutory steps, including the

pleading of particulars, orders for discovery and interrogatories. The parties then collate and file evidence. Written summaries of the evidence in chief to be given by witnesses, together with any documentary exhibits, are submitted by each party to the Court. Expert witnesses usually file a technical report supporting their findings. Special rules apply to their evidence.

At the hearing, following an opening statement from the taxpayer, evidence at the trial is presented orally, with briefs of evidence usually being read into the record by the witnesses under oath, including references to exhibited supporting documents. It is not unusual for briefs or summaries of evidence to be supplemented by further evidence in chief, led orally. This is followed by cross-examination and re-examination. The same pattern then follows for IR. Closing statements presented to the Judge signal the end of the trial. The Judge will normally take time to deliberate, sometimes in the order of months, before a detailed written decision is issued.

4.3 Relevance of Evidence in Judicial Tax Litigation

As noted in **4.2 Procedure of Judicial Tax Litigation**, evidence in chief must be provided in a written brief to the courts and the other party in advance of the hearing. These are read into the record during the trial, and documentary evidence is produced by way of exhibit. This evidence is crucial for presenting a party's argument or rebuttal, and is usually the only opportunity to produce the evidence on which the taxpayer relies. In tax proceedings the onus of proof lies with the taxpayer-disputant, so the production of evidence sufficient to discharge that onus is vital.

In complex tax avoidance cases, it is not unusual for the Court to receive a great deal of evidence, including expert evidence on matters such as valuation, business orthodoxy, commercial out-

comes and rationale. All necessary evidence should be produced at first instance because the opportunities to introduce further evidence on appeal are very limited.

In some cases, it is possible to agree statements of evidence and to have them admitted without contest. This is not usual and occurs only when the matter is essentially an argument of law.

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof in civil tax matters rests with the taxpayer (except for certain civil penalties outlined below, where it rests with IR), to establish their case on the balance of probabilities. The burden of proof in criminal matters rests with the prosecution, which must prove its case beyond reasonable doubt.

4.5 Strategic Options in Judicial Tax Litigation

As with every kind of complex civil proceeding, there are myriad strategic matters to consider in preparing for and conducting tax litigation. The following paragraphs are not exhaustive.

Choice of forum – it is the taxpayer's choice to commence a tax challenge in the TRA or the High Court. The relevant factors have been canvassed.

What does success “look like?” This will shape the way litigation is undertaken, particularly if a negotiated outcome is preferred.

Preparation and presentation of witnesses – crucial when the burden lies with the taxpayer. Do not assume the taxpayer knows anything or, if they do, that they know how to explain it!

Expert witnesses – in a small country, the catchment for some witnesses is small and their evidence well known. Care is required and expert

testimony from outside New Zealand may be needed. Be careful not to have experts usurp the court's role.

No surprises litigation means exactly that – do not try to ambush with unseen documents or evidence. The system is designed to exclude this, so this type of strategy will count against the side that tries it.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

New Zealand follows an English common-law litigation tradition. Precedent is important. When considering an international tax matter, a Court will consider international jurisprudence, doctrine and commentary. However, the persuasiveness of such material can vary. Decisions of foreign courts are rarely directly relevant to NZ tax litigation, although analogies can often be made. Australian tax cases are often considered persuasive, depending on the status of the court, because Australia and New Zealand have overlapping areas of tax law and a similar colonial legal history. Similarly, UK and Canadian case law is often considered persuasive by the courts, depending on the subject at hand. An advocate must carefully consider the relevance of international case law in tax litigation, particularly if it relates to “classic” issues such as the revenue/capital distinction.

Double taxation agreements (DTAs) are part of New Zealand's domestic law and have an overriding effect on it. As a result, if domestic law and a DTA conflict, the DTA takes precedence. New Zealand courts will usually consider OECD commentary when interpreting DTAs, as New Zealand DTAs are based on the OECD model commentary.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

A decision of the TRA can be appealed to the High Court. A decision of the High Court can be appealed to the Court of Appeal, and then, with leave, to the Supreme Court. The Supreme Court is New Zealand's final appellate court.

An appeal of a TRA decision to the High Court will only lie if the amount of tax involved is greater than NZD2,000, the net loss is at least NZD4,000, or the appeal relates to questions of law only. Otherwise, TRA decisions are final. An appeal to the High Court must be commenced within one month of the disputed TRA decision.

An appeal from the High Court to the Court of Appeal can be on a question of fact and/or law. Either party can appeal from the High Court to the Court of Appeal as of right, but the Court of Appeal seldom receives new evidence, or takes up a point of law not previously raised. An appeal must normally be brought within 20 working days of the appealed decision.

An appeal to the Supreme Court requires leave. The Supreme Court will only hear matters of general commercial significance, or general or public importance. If leave to appeal is declined, the Court of Appeal's decision is final. The Supreme Court seems disinclined to regard many tax appeals as meeting the threshold for leave to appeal, although one significant avoidance case has leave and is awaiting hearing.

5.2 Stages in the Tax Appeal Procedure

The appeal procedure follows the general appeal process already summarised, with some deviation for interlocutory matters. An intended appellant must file a notice of appeal, specifying the findings of fact and rulings being appealed. The

appellant then collates a case on appeal, comprising all the material before the lower court. Both the appellant and respondent then file a synopsis of their submissions. Further evidence can be supplied in exceptional circumstances – namely, if something that substantially changes the correct application of the law has arisen since the lower court heard the case.

In most cases an appeal is by way of a rehearing. That does not mean, however, that the case is actually reheard. Instead, the appellate court undertakes a full review of the record of evidence and submissions relating to the case and arrives at a fresh determination of the matter. One downside of this system is that judges in the appellate court will not necessarily be able to assess the credibility of witnesses and instead rely on written transcripts of evidence.

5.3 Judges and Decisions in Tax Appeals

At first instance, civil tax cases are heard by a single judge in the High Court or by a single TRA. Appeals to the High Court from the TRA are heard by a single High Court Judge. Criminal tax cases are often heard by a single judge in the District Court, though more serious criminal tax matters may be heard before a Judge and jury. In the Court of Appeal, the bench usually consists of panels of three to five judges, often with two High Court Judges seconded to support a Court of Appeal Judge. If the Court of Appeal is being asked to overturn one of its own judgments or is dealing with a particularly precedential matter, a bench of five judges can be requested. In the Supreme Court, a full bench of five judges considers all matters.

The allocation of judges to a matter is usually in the hands of the executive judge in each court or the relevant Head of Bench, and will take into account the overall capacity of the Court and the capacity of the individual judges. There are no

specialist tax judges in the High Court, Court of Appeal or Supreme Court, although one sitting Supreme Court Judge practised as a tax partner in a major law firm some 20 years ago.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

The disputes process, specifically the conference phase described in **3.1 Administrative Claim Phase**, is closest to arbitration, mediation and other alternative tax dispute mechanisms. New Zealand does not have any other alternative dispute resolution regime covering tax matters. This has been criticised by some tax commentators. However, New Zealand does have a comprehensive binding ruling system to avoid the need to take a tax position that IR could contest; see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**.

6.2 Settlement of Tax Disputes by Means of ADR

New Zealand does not have an alternative dispute resolution regime covering tax matters.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

New Zealand does not have an alternative dispute resolution regime covering tax matters.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Any taxpayer can apply for a binding ruling, seeking IR's confirmation that the taxpayer's interpretation of tax law applicable to a specified actual or contemplated transaction is correct. However, this is an expensive and time-con-

suming process, requiring in-depth analysis of tax law. As a result, IR recommends using a tax professional. Therefore, most binding rulings are sought for complicated matters with substantial sums in issue. A binding ruling is binding on IR and, therefore, it is crucial that the facts and law of the situation are very clearly explained in the ruling application and followed to avoid a later reversal. IR is not bound by a ruling if the facts of the arrangement as implemented materially differ from those in the ruling, or if there has been an omission or misrepresentation by the applicant, or if assumptions prove to be incorrect or a stated condition is not complied with. While IR must otherwise comply with a binding ruling, the taxpayer can dispense with it at any time.

Because of the barriers to obtaining binding rulings, IR introduced “short-process rulings”. Short process rulings have been available since 1 October 2019. Taxpayers with an annual gross income of NZD20 million or less can apply for a short process ruling. The query must relate to less than NZD1 million of tax, and to only one type of tax. At the time of writing (April 2022), a short-process ruling costs NZD2,000 and takes about six weeks from submission to IR to the ruling being issued. For small and medium sized businesses, which short-process rulings target, short-process rulings offer certainty without the cost of the binding ruling process.

6.5 Further Particulars Concerning Tax ADR Mechanisms

New Zealand does not have an alternative dispute resolution regime covering tax matters.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

New Zealand does not have an alternative dispute resolution regime covering tax matters.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Any breach of a tax obligation can lead to a civil penalty and criminal liability, or both.

Civil Penalties

A tax default will usually result in late payment penalties (LPP) and short-fall penalties (SFP). In the case of employer-related tax deductions that have not been made, IR may notify special “non-payment” incremental penalties which are capped at 150% of the unpaid sum. Additionally, use of money interest (UOMI) applies, but this is expressly not a penalty under statute.

SFPs are a one-off charge calculated as a percentage of the tax shortfall according to the perceived culpability of the taxpayer’s default. Not every default attracts a penalty but, in practice, most do. SFPs range between 20% and 150% of the tax shortfall to which they relate. SFPs are assessed after an investigation has been completed and are subject to internal “consistency” oversight by IR. They can be disputed and challenged in the same way as substantive tax.

Criminal Penalties

Criminal charges can be laid by IR alongside civil tax proceedings, although criminal proceedings will normally take priority, to avoid civil proceedings compromising a taxpayer’s fair trial rights.

Penalties arise in three categories of tax offending: absolute liability offences, knowledge offences and offences of or similar to tax evasion.

Absolute liability offences relate to basic expectations of compliance and are sanctioned by fine. Knowledge offences occur when a person knows of a tax obligation and fails to meet it.

These offences are more serious and have a graduated fine regime. They can also attract a sentence of up to five years' imprisonment. Evasion of similar offending is the most serious class and occurs when an act or omission occurs knowingly, but also with the intent to evade assessment or payment of taxes. While these offences share the upper limit of imprisonment for knowledge offences, they are often charged under the Crimes Act, where potentially longer prison terms can be imposed.

Sentences for tax offending are imposed under comprehensive laws designed to apply a scale of sanctions from financial punishments at the lowest level, through non-custodial community work, community and home detention, to a term of imprisonment for serious offending. Company officers can be criminally liable as parties to any tax offence committed by their company.

7.2 Relationship between Administrative and Criminal Processes

The civil tax disputes process can run concurrently with a criminal process. However, to protect fair trial rights, the Court of Appeal has strongly indicated that a civil dispute or proceedings should not be conducted ahead of criminal proceedings. That approach has recently been confirmed in a case where criminal proceedings were vacated because IR's civil procedures had compromised the criminal defence. In practice, therefore, IR will usually stay the disputes process and any related civil proceedings, often after the NOPA and NOR have been exchanged, to first complete criminal proceedings. That may change because the exchange of any notices in a civil dispute could conceivably compromise a criminal defence. Typically, IR resumes civil processes once the criminal matter has been disposed of, including the consideration of shortfall penalties which, if not imposed before prosecution, may be imposed in addition to criminal sanctions.

7.3 Initiation of Administrative Processes and Criminal Cases

The civil tax disputes process can lead to the imposition of civil penalties by way of SFPs and/or result in criminal charges being laid, though the timing of each can be an issue as noted in **7.2 Relationship between Administrative and Criminal Processes**. The decision whether or not to prosecute is taken seriously within IR and is made against relatively well-publicised prosecution guidelines issued by both the Solicitor General and IR. The way the SFP regime and criminal offence provisions work together can lead to anomalies.

As noted in **7.1 Interaction of Tax Assessments with Tax Infringements**, if IR first imposes an SFP, it may not later choose to prosecute the taxpayer for the same default. However, if that taxpayer is first prosecuted, then a SFP can still be imposed even if the taxpayer has been acquitted in the criminal prosecution. Time bars do not normally apply to the imposition of SFPs, so the option to follow criminal proceedings with a civil penalty is usually available. Although IR asserts this is seldom done, the authors' experience is that it occurs enough to be concerning.

7.4 Stages of Administrative Processes and Criminal Cases

A civil penalty will usually be proposed by IR, using the tax disputes process. It does not need to be resolved at the same time as a proposed substantive tax liability. The taxpayer can oppose the proposed imposition of the penalty through the tax disputes process and by a tax challenge in the TRA or the High Court.

Criminal charges are usually laid in and dealt with by the District Court. The TRA does not have a criminal jurisdiction. Once the charges are laid, the usual criminal process follows, under which the prosecution adduces evidence, which the defence tests.

The prosecution carries the burden of proving any tax offence beyond reasonable doubt, and the taxpayer is not obliged to give evidence. In reality, if there is a contest over the extent of a tax liability in criminal proceedings (usually a matter for sentencing), that will be resolved in a disputed-facts hearing. To establish criminal liability, IR does not normally have to show the precise and correct liability or the precise sum evaded; it only needs to show that the taxpayer's position was wrong and that this was taken with the requisite knowledge and intent.

7.5 Possibility of Fine Reductions

While an upfront payment of tax will not result in a reduction of penalties other than LPP, SFP can be reduced by statutory reductions for prior good behaviour and voluntary disclosures. Voluntary disclosures can be either "pre-notification", if made before IR notifies the taxpayer of an audit, or "post-notification", if made after an audit has been notified but before investigation has commenced. A pre-notification disclosure came with an assurance of non-prosecution until March 2019.

IR has amended its position on non-prosecution, stating that future disclosures of serious, evasive or fraudulent behaviour may still be prosecuted in extremely rare circumstances. The effect of this new policy has yet to be tested. The new approach means that in serious cases of evasion the disclosure process has to be carefully managed. A pre-notification disclosure qualifies for a 100% reduction of lower level SFPs, and a 75% reduction for all higher penalties. For post-notification disclosures, a flat 40% deduction is given for all SFPs.

Further reductions are available if a taxpayer can show that financial hardship would arise from continued collection of outstanding tax or penalties. This includes illness, or if the taxpayer would not be able to meet minimum liv-

ing standards, according to normal community standards of cost and quality. IR has tabulated the expected costs of minimum living expenses, against which applicants can judge their likelihood of success should they make a claim of serious hardship. SFPs levied for evasion or similar default cannot be written off other than in the taxpayer's bankruptcy or liquidation. The impact of this on negotiations for settlement of civil tax liability can be serious.

While IR can write off interest, UOMI is very rarely reduced as it is intended to compensate IR for the loss of opportunity created by the late payment.

Where tax has been assessed and is also the subject of criminal charges, payment of at least the core tax in question is an important factor in sentencing for the criminal offence. Although several factors will be relevant, reparation of evaded tax can often be the difference between a custodial and a non-custodial sentence being imposed.

7.6 Possibility of Agreements to Prevent Trial

Mitigating submissions are often made to IR as it considers whether or not to prosecute a taxpayer. As noted, that decision is made according to well-publicised guidelines to which submissions must be directed. Once the decision to prosecute has been made by IR or in serious cases by the Crown, payment of tax penalties and interest is not sufficient in itself to prevent a trial.

The Supreme Court has made it clear that a payment to procure non-prosecution is void as against public policy. It is still possible to seek the withdrawal of a prosecution, once commenced, but there must be supporting grounds other than the payment of tax. These will usually be grounds that were not adequately considered at

the time the original decision was made. Though charges will not often be withdrawn completely, it is not unusual for them to be replaced with lesser charges to reach an agreed disposition of the case consistent with a prudent use of IR and court resources.

7.7 Appeals against Criminal Tax Decisions

The appeals process for criminal trials follows the same steps as those outlined in **5. Judicial Litigation: Appeals**; however, criminal matters are usually first heard in the District Court and can then be appealed to the High Court. An appeal in the High Court is by way of a rehearing and can result in a different decision. An appeal may be against conviction or sentence or both.

Sentencing appeals are unlikely to be successful unless an appellant can establish that the sentence was manifestly excessive, or that material new information has come to light since the first instance trial. As judges have significant discretion when making sentencing decisions, appeals are allowed only in cases where it is clear that the court at first instance has made an error.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Tax avoidance and transfer pricing are not criminal offences under New Zealand law, but tax defaults can in both cases be subject to a civil SFP. The concept of tax avoidance only engages if the relevant position otherwise meets the requirements of tax law. It is normally too difficult to establish the necessary element of dishonesty for transfer pricing to give rise to an offence.

A taxpayer found to be in breach of the general anti-avoidance rule (GAAR) or a specific anti-avoidance rule (SAAR) or transfer-pricing rules will therefore not face criminal charges but could challenge IR's assessment of a SFP through the

tax disputes process and challenge proceedings.

A promoter of a tax avoidance arrangement can be liable for special penalties, imposed if an abusive tax position has been offered, sold, issued or promoted to ten or more persons in a tax year. This penalty is the sum of all tax shortfalls resulting from the promotion of the abusive tax position.

There is an ongoing debate regarding whether something done that is so obviously tax avoidance that it will inevitably be set aside is done dishonestly so as to attract criminal sanction. That has yet to be resolved.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

A taxpayer in New Zealand can initiate the domestic tax disputes process concurrently with an application to the competent authority under the relevant DTA, to engage the mutual agreement procedure (MAP). The MAP sets out how New Zealand's competent authority will liaise with the competent authority of another affected tax jurisdiction to determine the correct application of the DTA to the taxpayer. Alternatively, IR can initiate this process with another contracting state to resolve foreseeable issues of interpretation.

If the domestic tax disputes process results in a court decision, the New Zealand competent authority is bound by this decision, and must defend and explain the NZ position to other affected tax authorities.

Arbitration is available to New Zealand taxpayers when the applicable DTA contains the current

model Article 25(5). The only New Zealand DTAs with an arbitration clause are with Australia and Japan.

New Zealand has accepted the arbitration article in the OECD's MLI. The MLI introduces arbitration clauses if the corresponding countries have also adopted the relevant arbitration article. If the competent authorities cannot reach an agreement within two years, the taxpayer can request arbitration. However, if the model Article 25(5) is not present in the applicable DTA, the taxpayer can still apply for arbitration, granted at the discretion of the tax authorities involved.

Because of the complexities often involved, most taxpayers facing the prospect of double taxation as the result of IR action in New Zealand will try to have IR engage with an affected overseas tax authority sooner rather than later.

It is too early to assess how the measures adopted under the MLI will affect New Zealand practice concerning double taxation. While the EU Tax Disputes Directive is an interesting backdrop to the issue, it has no direct influence or impact on New Zealand practice.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Until recently, New Zealand's DTAs and its GAAR appeared to conflict. DTAs may override domestic law. The GAAR voids for tax purposes any arrangement with a "more than incidental purpose" of obtaining a tax benefit. IR considered a DTA to not override the GAAR, or an applicable SAAR, so both can apply to an international tax dispute. Following recent amendments, the GAAR may now expressly apply to override relief that would otherwise be available under a DTA. This does not align with the Australian, UK or Canadian approach, as these countries specifically legislate to allow DTAs to override their GAARs.

New Zealand has opted for the principal purpose test (PPT) in Article 7(1) of the MLI as the mechanism for countering treaty abuse. However, most commentators and practitioners consider that the PPT is likely to have a similar effect to the GAAR. Accordingly, adopting the PPT is unlikely to have a major impact in practice. The GAAR is likely to remain the focus of the New Zealand Courts.

8.3 Challenges to International Transfer Pricing Adjustments

New Zealand's transfer-pricing rules are enacted in domestic law. The recent extension of these rules following the OECD's BEPS initiatives is briefly discussed in **1.4 Efforts to Combat Tax Avoidance**. These would apply to an international transfer pricing adjustment challenge, and must be interpreted in light of the OECD's transfer pricing guidelines, although they do not directly apply.

Transfer-pricing issues are not often litigated because most taxpayers prefer to resolve such issues between jurisdictions without resorting to litigation.

To illustrate this, IR noted in its 2021 annual report that a key focus area has been monitoring the effectiveness of measures to target base erosion and profit shifting by multinationals operating in New Zealand. IR noted that its monitoring focused on 248 organisations, selected on the basis of their high risk to NZ's tax base. IR observed a significant curtailing of aggressive tax planning, including a major reduction in the levels of non-resident associated party debt. For example, IR monitored 37 multinationals with high debt levels and found their non-resident associated party debt fell by NZD377 million in the 2019 tax year, following a similar decline in 2018.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Unilateral advanced pricing agreements (APAs) are obtained using the binding ruling regime (see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**). Bilateral APAs are issued following the relevant DTA's MAP article. IR increasingly favours APAs for businesses dealing in intangibles, where the correct tax treatment could otherwise be contested.

The process for completing an APA involves a pre-application, which involves a short, written proposal outlining the factual background and the suggested transfer-pricing arrangement. This is usually followed by a brief meeting between the taxpayer and IR to discuss the proposal. The APA request is then formalised and submitted to IR for review.

IR requests that an APA application should include the full functional analysis of the transfer-pricing arrangement, in addition to an analysis of the key profit drivers and value added, the choice of methodology, comparable arrangements and copies of inter-company agreements. Upon completion of the review, IR will arrange to meet with the taxpayer – or the international authority in the case of a bilateral APA – to reach an agreed position.

Once a taxpayer has become party to an APA, they must submit annual compliance reports to IR, including financial statements reconciled with the transfer-pricing methodology, and confirmation that the taxpayer is complying with the agreement and that none of the critical assumptions have been breached. This full process usually takes six months for unilateral APAs, or bilateral APAs between New Zealand and Australia. Bilateral APAs take much longer to negotiate with other jurisdictions, and for this reason uni-

lateral APAs are usually favoured by taxpayers, unless there is a risk of double taxation.

The APA programme is long standing. According to IR's 2021 annual report, 46% of taxpayers that have an agreement have been in this programme for more than ten years, and 22% for more than 15 years. As at 30 June 2021, 76 taxpayers had active agreements with IR, representing tax assured of approximately NZD290 million a year.

8.5 Litigation Relating to Cross-Border Situations

IR investigation actively covers a number of cross-border situations, but these do not always lead to litigation. Investigations routinely examine withholding tax obligations in relation to off-shore lending, status and liability as the result of the existence of a permanent establishment and the basis on which goods and services provided to a New Zealand entity have been priced by an associate.

For the most part, cross-border tax-related litigation has been prompted by international information requests and has tested the scope and application of the mutual assistance provisions of DTAs. Recent litigation undertaken by the authors has also tested how DTA concessions such as tax-sparing relate to New Zealand's controlled foreign corporation rules and how income source apportionment rules apply between countries.

Outside these areas, APAs and binding rulings mitigate the need for complex and expensive tax litigation. However, practical barriers to these processes mean taxpayers continue to take positions without assurance.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

This issue is not relevant to New Zealand, a non-EU jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

This issue is not relevant to New Zealand, a non-EU jurisdiction.

9.3 Challenges by Taxpayers

This issue is not relevant to New Zealand, a non-EU jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

This issue is not relevant to New Zealand, a non-EU jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

New Zealand signed that MLI when it opened for signature in June 2017, and was one of the first countries to ratify it. New Zealand's approach has been to adopt as many MLI provisions as possible, and it adopted Part VI. That adoption was subject to two reservations relating to MAP cases either already decided by a court or tribunal, or decided after a referral to arbitration but before an arbitration panel renders its decision.

Arbitration clauses exist in New Zealand's DTAs with Australia and Japan.

10.2 Types of Matters that Can Be Submitted to Arbitration

The scope of possible arbitration under the New Zealand/Australia DTA extends to issues of fact and any other issues that are agreed between the governments by exchange of notes. In the case of Japan, the scope covers any issue that is unresolved under the MAP, unless a court or tribunal has pronounced upon it. Where the MLI procedures apply, the only limitation is by way of the reservations notified as part of the ratification process, covered at **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

New Zealand does not have an alternative dispute resolution regime covering tax matters.

10.4 Implementation of the EU Directive on Arbitration

New Zealand is not an EU member state. While New Zealand has adopted the MLI with its arbitration provisions, it is too early to determine if there is any change in trend relating to the arbitration of international tax issues beyond the MAP.

10.5 Existing Use of Recent International and EU Legal Instruments

There are no published reports of recent international and EU legal instruments being used to settle tax disputes involving New Zealand tax authorities or tax resident parties.

10.6 New Procedures for New Developments under Pillar One and Two

Pillars 1 and 2 were endorsed by NZ along with over 130 countries in October 2021. The NZ government has not, however, decided finally whether to adopt either Pillar and has not ruled out adopting a digital services tax. An issues

paper has recently been issued seeking submissions on whether and how NZ ought to adopt the so called “GloBE” tax rules under Pillar 2. Submissions had not closed at the time this chapter was finalised (May 2022).

Despite not having yet been adopted, some high-level observations are possible. Pillar 2 is likely to be of most impact because it will require tax on profits in any country where a qualifying multinational operates to be at least 15%. That might seem low compared with NZ’s corporate tax rate of 28%, but the minimum rate is applied to accounting profit which could include capital gains which are not normally taxed. NZ multinationals which are caught, and subsidiaries of global multinationals operating locally, cannot assume that the headline 28% corporate tax rate will obviate the Pillar 2 rules, which might require further tax to be paid on NZ income.

In much the same way as arbitration between states can compromise the position of local taxpayers, the instruments designed to mitigate controversy in relation to the BEPS Pillars could well supervene on the local tax position of an affected taxpayer. However, the impact may not arise in NZ. If a top-up of tax is required, it may well arise outside NZ in a country where the taxpayer is doing business and less than the minimum tax is paid. All things being equal, tax paid overseas should be creditable in NZ, although it is not clear that tax paid to the NZ government under the Pillar 2 rules would give rise to domestic imputation credits.

10.7 Publication of Decisions

The standard provision of the MLI relating to arbitration provides for the arbitral decision to be provided only to the competent authorities engaged in the proceedings. Affected New Zealand taxpayers can expect to receive, from the New Zealand competent authority, at least a redacted copy of the decision that conveys as

much as possible of the rationale for the result. A taxpayer dissatisfied with the decision of the competent authority as to what will be released may seek judicial review, but the courts will be reluctant to interfere with IR’s view of its treaty obligations.

10.8 Most Common Legal Instruments to Settle Tax Disputes

The present experience in New Zealand is that international tax issues are or have been resolved using the network of DTAs, combined with domestic law, prior to the adoption of the MLI. That is simply a reflection of the infrequency with which these matters come to the fore and the time that it takes for the necessary procedures to be undertaken. No doubt the DTAs, as affected by the adopted MLI, will play a greater part over time.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Taxpayers wishing to initiate international tax procedures will typically seek professional advice and representation before doing so. Legal input for IR is normally from in-house legal professionals or from the Crown Law Office/*Te Tari Ture o te Karauna* (CLO).

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

Apart from professional fees, there are no administrative or filing costs involved in pursuing a tax dispute as outlined in **3. Administrative Litigation**.

11.2 Judicial Court Fees

The administrative and filing costs for the TRA are outlined in its regulations. At the time of writ-

ing, the cost of filing an initiating document was NZD410.

The administrative and filing costs for the High Court are outlined in that court's regulations. At the time of writing, the cost of filing an initiating document was NZD1,350, though only NZD540 for an appeal or judicial review. Filing a statement of claim costs NZD110. Hearing fees (essentially daily Court fees applicable after the first day of hearing) are also charged, and must be met by the taxpayer plaintiff.

The administrative and filing costs for the Court of Appeal are similarly set by regulation. At the time of writing, the cost of filing notice of an appeal was NZD1,100. Daily hearing fees also apply, and are borne by the appellant.

The administrative and filing costs for the Supreme Court are also set by regulation. At the time of writing, the cost of filing for leave to appeal was NZD1,100. Scheduling a hearing date and the first day's hearing costs NZD1,000, with each additional half day costing NZD500.

Failure to pay fees that are charged by the courts can lead to fixtures being vacated and in extreme cases proceedings being terminated.

11.3 Indemnities

Except in proceedings in the TRA, an unsuccessful party must usually pay at least part of the other party's legal costs. These are usually set by the Court, according to the stages of litigation and bands of complexity.

If a baseless claim is advanced, indemnity costs may apply, but these seldom if ever arise in tax cases where the IR position will be addressed on cogent grounds. The TRA may award costs against a party for bad conduct in the proceedings.

IR does not usually litigate without being confident of its case. In its 2021 reporting year, IR won 83.3% of litigated cases. This success rate has been fairly constant over recent years. It is therefore very uncommon for a taxpayer to be awarded indemnity costs. IR has successfully made indemnity cost claims against some taxpayers.

11.4 Costs of ADR

Save for elements of the tax disputes process (chiefly the facilitated conference stage), there are no tax-related ADR mechanisms in New Zealand. It is possible to mitigate the chance of a dispute arising by seeking an advance ruling or a short-process ruling, but that process can be time-consuming and expensive (see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**).

12. STATISTICS

12.1 Pending Tax Court Cases

Although IR is very active in auditing taxpayers, not many cases are litigated. According to the legal publisher Wolters Kluwerat, at the time of writing (May 2022), there were only six tax appeals pending: three from the TRA and three from the High Court or the Court of Appeal. Anecdotally, the "pipeline" of civil tax cases is not long. The CLO tax team is not over-burdened and the TRA has so little work at the moment that its future has been debated. This is one of the reasons why the TRA is no longer a sitting District Court Judge, whose services were required in that overburdened Court. There is an important tax avoidance case pending in the Supreme Court dealing with an international corporate refinancing (leave to appeal was given in June 2021), but other cases have not advanced, perhaps because of decisions made by both IR and taxpayers because of COVID-19.

As to criminal cases, it is not possible to identify criminal prosecution numbers until they have been concluded and reported. In its 2021 annual report, IR confirmed that it had completed 50 serious prosecutions to 30 June 2021 and that a further 97 live tax prosecutions were before the courts at that date.

12.2 Cases Relating to Different Taxes

The number of civil tax cases initiated and completed annually is not publicly reported. A brief review of a leading database suggests that in the year to June 2020 there were some 26 tax-related decisions reported from the High Court and more senior courts. Though in the past more cases have dealt with GST than other taxes, that is not the current trend. The spread between tax types is fairly even.

Sums at stake in the higher court matters range from several hundreds of thousands of New Zealand dollars to many millions, however smaller sums were often at issue in administrative matters. High Court criminal appeals as to conviction and/or sentence are more numerous but are not easily collated.

In the prior year, 2019, the Court of Appeal considered ten matters, five of which were procedural applications. The remaining cases dealt with complex technical questions of law. The Supreme Court heard and refused two tax-related applications for leave to appeal.

In the same year, the TRA heard six cases. Four dealt with a technical legal question and two with procedural matters.

Since 2020 there has been a noticeable fall in the number of tax cases coming to hearing. The authors have noted that the level of face-to-face IR audit activity has also slowed somewhat, although IR noted in its 2021 annual report that

it had closed in that year 16,140 audit cases, down only 3% on the year before.

There is no publicly available information about criminal cases in the District Court. However, IR has stated that in the year to June 2021 it completed 50 prosecutions for serious tax-related offending, which would have been heard in the District Court.

12.3 Parties Succeeding in Litigation

In the year to June 2021, IR reportedly won 83.3% of the cases it litigated. This success rate has been fairly steady over recent years. It reflects the impact of the disputes process, both in terms of ensuring that only cases that require litigation find their way to the courts, and in the sense that the costs of a dispute often leave a taxpayer struggling to resource litigation even for a worthy case.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The following guidelines are unlikely to be exclusive to New Zealand, and neither will they be exhaustive of the matters to be considered in advising and representing parties engaged in tax controversy.

Know your opponent. Understand IR's structure and personnel, its administrative practices and requirements. Know where in the organisation to take a matter if intervention is required. Know when to allow IR latitude and when to insist that it abides strictly by its practices.

Need for justification to settle. If IR is to settle a case, it must have justification in law. That requires knowledge of technical tax law but also a clear understanding of administrative law and

the scope and limits of IR's care and management of taxes.

Keep an audit focused. Try to keep an audit as focused as possible as to tax types and periods. Meet deadlines as much as possible and give IR no reason to expand its audit.

Know your client's weak points. Understand the taxpayer's strengths and weaknesses that will become apparent during investigation and interview. Manage the process of interview carefully to avoid unwanted concessions and incrimination.

Otherwise, follow the audit strategies summarised in **2.6 Strategic Points for Consideration** During Tax Audits.

Invest in the early stages of the tax dispute process. Do not leave it too late to raise arguments and present evidence; entrenched views may later be harder to change.

Build trust and confidence with IR on behalf of the taxpayer client. Without it, everything will be more difficult. Impress on the client the importance of realistic engagement if a matter is to be resolved.

Identify early on who will tell the taxpayer's "story". Prepare them by obtaining working briefs of evidence once the issues have become clear. This can be useful both in the disputes process and in preparing litigation. As perceptions of the dispute or case change, check back with potential witnesses and refine what they will say. Check, cross-check and test against documentary evidence what is said by potential witnesses.

Engage forensic accounting and other expert assistance at an early stage. Use it to test both IR's position and that being asserted by the taxpayer, to be sure that the consequences and implications of both are understood. Make sure that accounting and other advisers understand their job. Agree what assumptions, if any, can be made.

Know your Bench. If the matter is to be litigated, know your Judge. Establish what prior tax knowledge they have. Research their tax "attitudes". Reflect that in the preparation of evidence and argument. Factor in an element of institutional support for IR's position.

Strive for simplicity in messaging. Develop a theme and theory for the case, consistent with the facts. Distil complex facts and arguments to summaries that are better understood by a Court, but do not lose the "total picture".

Old South British Chambers is a specialist set of barristers' chambers in Auckland, New Zealand, dealing with all aspects of tax controversy. Its team represents clients against Inland Revenue in tax investigations, disputes and litigation. It has particular expertise in international tax controversy, including managing cross-border investigations and inter-jurisdictional requests for information, and the interpretation and application of double tax treaties, having litigated these matters in the superior courts of

New Zealand and the Cook Islands. It is also highly experienced in managing complex domestic tax investigations with offshore components and defending serious tax fraud. The OSBC team routinely works with tax specialists in other professions to add an advocacy edge to its dealings with Revenue. Outside New Zealand, it is skilled in the tax, international company and trust regimes of the Cook Islands. The OSBC team is headed by senior barrister Geoffrey Clews.

AUTHORS



Geoffrey Clews is a leader at the New Zealand Tax Bar, whose practice covers all aspects of tax controversy. He advises taxpayers on domestic and international revenue

investigations, and during the sometimes difficult statutory tax disputes process. He litigates civil tax issues, and defends criminal tax charges at trial and appellate levels. Geoffrey has contributed to five international texts, and has acted as national tax reporter to the ABA and IBA. He is a long-standing member of IFA and the New Zealand Law Society Taxation Committee, and is a Teaching Fellow in tax controversy at the University of Auckland Law School.



Sam Davies worked in tax firms in New Zealand and the UK before joining Old South British Chambers. In London, he worked with Deloitte and Pinsent Masons on high-profile

tax disputes such as the Marks & Spencer and Icebreaker cases before returning to New Zealand to specialise in tax controversy. Sam has acted as counsel with Geoffrey Clews in matters before the New Zealand and Cook Islands courts, and closely assists Geoffrey in all aspects of his work. He is a member of the New Zealand branch of IFA.

Old South British Chambers

Level 3, 3-13 Shortland Street
P O Box 1993, Shortland Street
Auckland 1140
New Zealand

Tel: +64 9 307 3993
Fax: +64 9 307 3996
Email: geoff.clews@taxcounsel.co.nz
Web: www.taxcounsel.co.nz



GEOFFREY CLEWS
BARRISTER
SPECIALIST TAX & TRUSTS COUNSEL

Law and Practice

Contributed by:

Thor Leegaard and Pål-Martin Schreiner
KPMG Law Advokatfirma AS see p.482



CONTENTS

1. Tax Controversies	p.467	5.3 Judges and Decisions in Tax Appeals	p.474
1.1 Tax Controversies in this Jurisdiction	p.467	6. Alternative Dispute Resolution (ADR) Mechanisms	p.474
1.2 Causes of Tax Controversies	p.467	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.474
1.3 Avoidance of Tax Controversies	p.467	6.2 Settlement of Tax Disputes by Means of ADR	p.474
1.4 Efforts to Combat Tax Avoidance	p.467	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.474
1.5 Additional Tax Assessments	p.468	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.474
2. Tax Audits	p.468	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.475
2.1 Main Rules Determining Tax Audits	p.468	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.475
2.2 Initiation and Duration of a Tax Audit	p.468	7. Administrative and Criminal Tax Offences	p.475
2.3 Location and Procedure of Tax Audits	p.469	7.1 Interaction of Tax Assessments with Tax Infringements	p.475
2.4 Areas of Special Attention in Tax Audits	p.469	7.2 Relationship between Administrative and Criminal Processes	p.475
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.469	7.3 Initiation of Administrative Processes and Criminal Cases	p.476
2.6 Strategic Points for Consideration during Tax Audits	p.469	7.4 Stages of Administrative Processes and Criminal Cases	p.476
3. Administrative Litigation	p.469	7.5 Possibility of Fine Reductions	p.476
3.1 Administrative Claim Phase	p.469	7.6 Possibility of Agreements to Prevent Trial	p.476
3.2 Deadline for Administrative Claims	p.470	7.7 Appeals against Criminal Tax Decisions	p.477
4. Judicial Litigation: First Instance	p.471	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.477
4.1 Initiation of Judicial Tax Litigation	p.471	8. Cross-Border Tax Disputes	p.477
4.2 Procedure of Judicial Tax Litigation	p.471	8.1 Mechanisms to Deal with Double Taxation	p.477
4.3 Relevance of Evidence in Judicial Tax Litigation	p.471	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.477
4.4 Burden of Proof in Judicial Tax Litigation	p.471		
4.5 Strategic Options in Judicial Tax Litigation	p.472		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.472		
5. Judicial Litigation: Appeals	p.472		
5.1 System for Appealing Judicial Tax Litigation	p.472		
5.2 Stages in the Tax Appeal Procedure	p.473		

8.3	Challenges to International Transfer Pricing Adjustments	p.477	10.5	Existing Use of Recent International and EU Legal Instruments	p.479
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.477	10.6	New Procedures for New Developments under Pillar One and Two	p.479
8.5	Litigation Relating to Cross-Border Situations	p.478	10.7	Publication of Decisions	p.479
9.	State Aid Disputes	p.478	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.479
9.1	State Aid Disputes Involving Taxes	p.478	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.479
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.478	11.	Costs/Fees	p.480
9.3	Challenges by Taxpayers	p.478	11.1	Costs/Fees Relating to Administrative Litigation	p.480
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.478	11.2	Judicial Court Fees	p.480
10.	International Tax Arbitration Options and Procedures	p.478	11.3	Indemnities	p.480
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.478	11.4	Costs of ADR	p.480
10.2	Types of Matters that Can Be Submitted to Arbitration	p.479	12.	Statistics	p.480
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.479	12.1	Pending Tax Court Cases	p.480
10.4	Implementation of the EU Directive on Arbitration	p.479	12.2	Cases Relating to Different Taxes	p.480
			12.3	Parties Succeeding in Litigation	p.480
			13.	Strategies	p.481
			13.1	Strategic Guidelines in Tax Controversies	p.481

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

A tax controversy may commence either through an announced audit or through correspondence with the tax authorities.

The tax authorities can perform unannounced audits. This is, however, uncommon and typically reserved for criminal cases.

1.2 Causes of Tax Controversies

While the tax authorities may audit all types of taxes and duties, a significant proportion of tax controversies concerns:

- corporate tax;
- individual income tax;
- value added tax;
- petroleum tax; and
- the application of penalty taxes due to insufficient tax return disclosures.

Some matters frequently raised are (non-exhaustive):

- deduction of financing expenses;
- tax and VAT treatment of share transaction costs;
- permanent establishment;
- transfer pricing;
- GAAR;
- application of dividend tax exemption;
- undeclared work; and
- employee travel costs and fringe benefits.

There is no general de minimis value threshold for initiating a tax audit and income adjustments proposed by the tax authorities can on occasion be relatively minor. That being said, the tax authorities tend to prioritise cases where the monetary value is significant. This is in particular true for the specialised offices working with

larger entities and the office covering entities encompassed by the petroleum tax regime.

1.3 Avoidance of Tax Controversies

Taxpayers may request an advance ruling for intended transactions and other dealings, subject to certain material limitations. Significantly, an application cannot concern tax treaty interpretations, liability to tax in Norway, transfer pricing, valuations or tax residency of entities.

Advance rulings are binding for the tax authorities for three years after the year the ruling was issued, and provided the taxpayer's acts are in accordance with the facts presented to the tax authorities. Advance rulings may be appealed to the Tax Appeal Board.

Although the tax authorities are under no obligation to respond, it is also possible to request a statement from the tax authorities or from the Ministry of Finance, for instances on the interpretation or application of a specific tax provision. The tax authorities will, in some cases, also give a view on a specific case, for instance concerning tax treaty matters or valuation methods. While such statements are not binding for the tax authorities, experience is that taxpayers in most cases can rely on the tax office to act consistent with the stated view.

In 2015, the tax authorities established a centralised team dealing with advance pricing arrangements under Articles 7 and 9 of the OECD Model Convention. Although Norway does not formally have legislation providing for advance pricing arrangements, the tax authorities will adhere to the negotiated results.

1.4 Efforts to Combat Tax Avoidance

Norway has taken an active role in the OECD BEPS project, and continues to take an active approach to its effect on domestic legislation. This has resulted in a number of changes, such

as extending the earnings stripping rules to cover interest paid on debt to unrelated parties and the implementation of further anti-hybrid rules.

Effective 1 July 2021, Norway has implemented a limited domestic withholding tax on interest and royalties paid to related entities in low tax jurisdictions. From 1 October 2021, a similar withholding tax on lease payments for certain fixed assets (vessels, rigs, planes, etc) was also implemented.

The Ministry of Finance is also considering the introduction of DAC6-type reporting obligations. However there has been no development on this since a discussion paper was issued in December 2019.

Norway has also committed to introducing the OECD two-pillar global minimum corporate tax, with expected introduction in 2023. In short, the rules introduce a global minimum corporate tax rate set at 15%. The minimum tax will apply to multinational enterprises with revenue above EUR750 million.

1.5 Additional Tax Assessments

Following a decision by the tax office, when a claim for payment of outstanding tax is issued, it must be paid within three weeks. It may be possible to agree a postponement of the payment, subject to security and late payment interest.

Tax penalties are only payable when the deadline for appeal is passed or when the case is finally decided either by the Tax Appeal Board or in court.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The tax authorities do not publish which entities or individuals are targeted for audit and there are

no specific guidelines or policies publicly available.

It tends to be that companies with extraordinary transactions and/or restructurings are more frequently audited. Transfer pricing and withholding tax matters are also regularly audited.

The tax authorities will often prioritise a specific industry or a specific type of case. Additionally, companies in industries with a high degree of undeclared work and labour law violations are also frequently targeted. A change of law could also trigger special attention to a specific matter.

Entities that fall into the purview of the Central Office for Taxation of Large Entities or the Petroleum Tax Office will be audited regularly. Large upstream petroleum companies can generally expect to be audited annually.

2.2 Initiation and Duration of a Tax Audit

The statute of limitation for reassessment for tax and VAT is five years after the relevant financial year. If the taxpayer has intentionally, or due to gross negligence, provided incorrect or insufficient information in its tax returns/VAT returns, the statute of limitations is extended to ten years.

A formal notice of reassessment interrupts the statute of limitations. Once the tax office issues a notice of reassessment, tax audits do not need to be resolved within the period specified in the statute of limitations.

Provided the matter is not time barred, the tax authorities are generally free to initiate an audit of any and all tax matters. A tax audit may, depending on the complexity of the matter, be resolved quickly or could potentially last for several years.

Once a tax audit has been initiated and a formal notice has been issued, the tax office is generally

under no obligation to resolve a matter within a specific deadline. The tax authorities may nonetheless be restricted from making adjustments in the taxpayer's disfavour if there is an extended period of inactivity from the tax authorities.

2.3 Location and Procedure of Tax Audits

During the audit, the tax authorities may either be at the taxpayers' premises or work from the tax authority's offices. The tax authorities will generally accept electronic data. They may request electronic access to the company's accounting systems. It is also not uncommon for the tax authorities to request interviews with personnel.

2.4 Areas of Special Attention in Tax Audits

During a tax audit, the taxpayer is generally obligated to co-operate and to allow access to relevant information. The tax authorities may also collect information from other parties and from other sources.

Evidence dating from, and documentation produced during, the period under review would generally be emphasised by the tax authorities.

See **1.2 Causes of Tax Controversies** for a non-exhaustive overview of the issues to which the tax office may give special attention during an audit.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Norway has, in recent years, entered into a number of exchange of information treaties. This comes in addition to a vast pre-existing tax treaty network that already includes information exchange clauses. Furthermore, Norway has joined the OECD Convention on Mutual Administrative Assistance in Tax Matters and entered

into an agreement on administrative co-operation, combating fraud and recovery of claims in the field of value added tax with the European Union.

There are no published official statistics on the number of audits or exchanges of information with other jurisdictions.

There has been increased attention from the tax authorities on international tax matters and the use of information obtained through cross border exchanges.

2.6 Strategic Points for Consideration during Tax Audits

During audits, it is important for the taxpayer to manage the process and ensure that information requests are recorded. It is also prudent to ask the tax authorities to clarify the tax matters under investigation and, if possible, to present their positions.

It is critical to consider requests for information properly. Correspondence with lawyers is generally privileged. There is also no obligation to disclose written tax considerations prepared by the taxpayer or external parties. It may be used as evidence if the taxpayer has consented to sharing such correspondence.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase Audit Phase

A notice from the tax authorities normally initiates a tax audit. While this details the scope of the audit, it does not restrict the tax authorities from investigating other issues.

Often, an initial meeting will take place between representatives of the taxpayer and the tax

authorities. This will be followed by a data collecting phase, where the tax authorities will request the information required to prepare a reasoned decision. This could include review of documentation as well as conducting interviews with relevant personnel.

Once the tax authorities conclude they have sufficient data, they will issue a draft audit report. The taxpayer will be allowed to correct factual inaccuracies and may submit additional evidence.

The final report is, in most cases, accompanied by an updated notice of reassessment. The taxpayer is given the opportunity to contradict the final report and is allowed to make additional submissions in fact and in law.

Before a final administrative decision can be made, the taxpayer has the right to review and comment on a draft version of the decision. The draft should be reasoned and should include a statement of relevant facts and present the tax authorities' legal arguments.

Appeals Phase

A decision by the tax office may either be appealed to the Tax Appeal Board or brought directly before the courts.

Administrative appeals are sent to the tax office that prepared the reassessment. If the tax authorities agree with the taxpayer, they may accept the appeal and cancel the reassessment. Where the tax authorities disagree with the taxpayer, they may provide comments to the Tax Appeal Board.

Once lodged, the appeal is handled by the Tax Appeal Board secretariat, which prepares a draft decision for the Board. The taxpayer is entitled to a copy of the comments from the tax office, and also to review and comment on the draft

from the secretariat. The secretariat may request additional information and has, in some cases, allowed the taxpayer to present its view in physical or virtual meetings.

The Tax Appeal Board has full jurisdiction and can try all parts of the case, including new evidence. This includes considering issues not raised by the taxpayer. The Tax Appeal Board is not bound by the assertion of facts or the legal arguments made by either the tax office or the taxpayer.

3.2 Deadline for Administrative Claims

A decision by the tax office may either be appealed to the Tax Appeal Board or be brought before the courts. The tax authorities may decide that a lawsuit cannot be filed before an appeal has been heard by the Tax Appeal Board.

Appeals must be made within six weeks of the date a decision reached the taxpayer. However, extensions, when requested, are typically granted. A lawsuit must be filed within six months.

In the choice between an administrative appeal or a lawsuit, it is important to consider whether additional evidence is required and appropriate submissions have been made in the administrative process. Taxpayers are, to a certain degree, prevented from presenting new evidence in court, to the extent that they could reasonably be expected to have been presented during the administrative process. If the tax authorities have presented additional evidence, the taxpayer may be allowed to counter this new evidence. These principles are governed by case law, and can be complex to navigate.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

The Norwegian court system does not include separate administrative tax courts. Cases concerning administrative tax matters are heard by the ordinary courts.

On initiating a judicial tax litigation, the claimant – in most cases the taxpayer – will lodge a written appeal bringing the case for the district court. The appeal should broadly include the claim made, the factual and legal grounds for the claim and what evidence will be presented by the claimant. The initial appeal can be supplemented through subsequent submissions to the court.

The tax authorities may appeal a decision reached by the Tax Appeals Board through a juridical litigation.

4.2 Procedure of Judicial Tax Litigation

Norway is divided into court districts, consisting of one or more municipalities. The district courts are the courts of first instance.

Court hearings are decided based on oral evidence and arguments presented by the parties involved. The courts are not limited to testing the legal reasoning in the decision from the tax office, but may apply the law freely (within the boundaries of the arguments made by the parties). One limitation is that it cannot test a different transaction or factual situation.

The courts will, as a rule, not assess the tax authorities' discretionary assessment (eg, pricing or valuations), unless the discretionary assessment is contrary to the evidence presented or regarded as arbitrary or grossly unreasonable.

Court hearings are conducted in three phases:

- presentation of the case and relevant written evidence;
- testimonies from both parties and from witnesses called by the parties are heard – expert witnesses will, where relevant, also be heard during this phase; and
- closing arguments.

Following closing arguments, the court hearings are concluded. A written judgment is prepared by the judge and served to the parties. This judgment may be appealed to the court of appeal, see **5.1 System for Appealing Judicial Tax Litigation**.

4.3 Relevance of Evidence in Judicial Tax Litigation

Both documentary and witness evidence is relevant for civil tax litigation processes.

The main rule is that documentary evidence should be made available in the submissions to the court and presented in the initial phase of the court hearing. As a result of a contradictory proceeding, the parties have the opportunity to contradict documentary evidence during testimonies.

Any additional evidence should be presented during administrative proceedings and taxpayers are, to some extent, prevented from presenting new evidence during court hearings. If the tax authorities have presented additional evidence, the taxpayer may be allowed to counter this new evidence.

4.4 Burden of Proof in Judicial Tax Litigation

In civil tax litigation, the tax authorities have the burden of proof. However, if the tax authorities put forward evidence, the burden of proof may shift to the taxpayer.

In criminal tax litigation, the burden of proof lies with the tax authorities.

4.5 Strategic Options in Judicial Tax Litigation

In a civil tax litigation, the court will, together with the parties, agree on the process in the initial preparatory phase. The court will generally allow the parties to adequately prepare for the court hearings. This means that the parties during the court hearings will be allowed to present relevant evidence and to assert its legal arguments. The process will allow for the parties to make strategic decisions, including the possibility of settling the case out of court if an agreement can be reached with the other party. The tax authorities are, in this regard, allowed to negotiate with the taxpayer and settle out of court during the court proceedings.

As addressed in **4.3 Relevance of Evidence in Judicial Tax Litigation**, taxpayers are, to some extent, prevented from presenting new evidence during court hearings. It is therefore crucial to ensure that relevant documentary evidence is presented during the administrative phase.

A claim for payment of the outstanding tax will generally be due following a decision from the tax authorities.

Expert reports or expert witnesses are commonly used in civil tax litigations, particularly to support tax valuations and transfer pricing assessments. A convincing expert witnesses is generally a useful tool for a taxpayer during court hearings.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Judgments by the Supreme Court are considered as precedents. The Supreme Court may set aside a precedent. There have been past exam-

ples of the Supreme Court setting aside past judgments on tax matters.

While Norway is not an EU member state, decisions made by the Court of Justice of the European Union (CJEU) are relevant for the application of the EEA agreement, to the extent the articles of the EEA agreement correspond to the articles of the EU agreement interpreted by the CJEU.

Other international court tax judgments have, in some cases, been heard by the courts, for instance if the judgments concern the interpretations of tax treaty articles.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The courts of appeal are the courts of second instance, hearing appeals against judgments in the district courts. Judgments from the district courts must be lodged within one month after the judgment was served. Leave of appeal is required for cases where the disputed amount is less than NOK250,000. The court may refuse an appeal if it finds that it is evident that it cannot succeed.

The Supreme Court is the highest court in Norway. Its decisions are final and cannot be appealed. However, the European Court of Human Rights may try the Supreme Court's application of the European Convention on Human Rights.

An appeal to the Supreme Court requires leave. This requires that the appeal concerns questions that are also of interest to other cases, or that there are other significant reasons for requesting a judgment from the Court. There is no guarantee that leave is granted, even if the disputed

amounts are material. The Supreme Court may return the matter to the Court of Appeal for new hearing.

It is, in principle, possible to make an appeal over a judgment from the district court directly to the Supreme Court. This requires leave from the Court and applies only in exceptional cases concerning cases of public importance and where a quick judgment from the Supreme Court is required.

An advisory opinion from the EFTA Court of Justice may also be requested in matters concerning EEA law. Such requests may be made at all stages of the appeals procedure by the relevant court and the Tax Appeal Board.

5.2 Stages in the Tax Appeal Procedure

Court of Appeals

As mentioned above, the judgment from the district court must be appealed within one month after the judgment was served. The appellant issues a notice of appeal to the District Court. This is then served to the appellee, which should file a defence reply within a deadline of normally three weeks. The case is then transferred to the Court of Appeal.

The Court of Appeal will then decide whether there are grounds for rejecting the appeal. The Court of Appeal will also contact the parties to plan the further proceedings. This includes scheduling the oral appeal hearing, but also agreeing on, inter alia, whether mediation should take place and the deadline for written pleadings prior to the oral appeal hearing. The law requires as the main rule that an oral appeal hearing is scheduled to take place within six months from the appeal. Due to requests from the lawyers or limited resources at the court, this is not always possible.

During the subsequent trial preparations, the parties will often file multiple written pleadings to the court, presenting new evidence and arguments. This could potentially necessitate court rulings deciding whether the parties are prevented from presenting new evidence at this stage of the case.

Proceedings

The oral appeal hearing follows the same procedure as for the District Court, see **4.2 Procedure of Judicial Tax Litigation**. Following closing arguments, the court proceedings are concluded. A final written judgment is prepared by the judges and served to the parties.

Supreme Court

The Court of Appeal judgment must be appealed within one month after the judgment is served. The Appeals Committee of the Supreme Court, consisting of three judges, will decide whether leave shall be granted. Typically three to five tax cases are granted leave each year.

Similar to preparations at the District Court and Court of Appeals, the parties will be contacted in order to plan the further proceedings, including the scheduling of the oral appeal hearing.

The oral appeal hearing differs from the oral hearings as the District Court and Court of Appeal as only written evidence (and expert testimonies) can be presented for the Supreme Court. Each party may address the court twice.

In the first address, the parties will present both the written evidence and the arguments. The parties' second address shall be limited to the issues raised by the opposite party. The court proceedings are then concluded. A final written judgment is prepared by the judges and served to the parties.

5.3 Judges and Decisions in Tax Appeals

The appointed judges decide and write the judgments themselves for the Norwegian courts.

For the district courts, tax cases are generally held before a single professional judge. Either side can in principle demand two lay judges be seated as well. In tax cases, the appeals court will consist of three judicial judges.

Cases before the Supreme Court are normally heard by five judges, but the court can decide to hear the case with 11 judges or in plenary session.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

One of the main purposes of the dispute act for civil procedures is to promote dispute resolution by mediation. Generally, cases must be heard before the conciliation board before they can be brought before the District Court. This does not apply to tax disputes, as the government is always party to such cases, the matter not being of a private law nature.

Parties to tax disputes must expect the district court judge to promote mediation during the case preparations, as this is the normal proceeding in all cases. However, no mediation will take place unless all parties consent. Due to the nature of tax disputes, these cases are rarely resolved by mediation.

The government is generally restricted from agreeing to solutions that are not consistent with the law (in the government's view). Cases where the facts are disputed rather than the legal

reasoning are therefore slightly more likely to be resolved by mediation; ie, cases concerning transfer pricing.

Dispute resolution through arbitration is not an alternative in Norwegian tax disputes.

6.2 Settlement of Tax Disputes by Means of ADR

If the parties reach an agreement in a judicial mediation, the settlement may be concluded as an in-court settlement. This will be a publicly available document. Alternatively, the parties can disrupt the judicial mediation procedure at this point and formalise the agreement in an out-of-court settlement. These are not publicly available. Non-judicial mediations are resolved in out-of-court settlements.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

As discussed in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**, tax disputes are rarely settled by mediation. Tax assessments where the case relies on legal reasoning rather than an assessment of the facts are, in general, even more unlikely to be settled by mediation. This would also include penalties.

Interest due resulting from a tax assessment would not be part of the settlement for direct tax purposes. Such interest is not part of the appealed tax office or Tax Appeal Board decision, but merely results in a new tax statement being issued based on the tax assessment decision.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Taxpayers may request an advance ruling for intended transactions and other dealings, subject to certain material limitations. Significantly, an application cannot concern tax treaty inter-

pretations, liability to tax in Norway, transfer pricing, valuations or tax residency of entities.

Advance rulings are binding for the tax authorities for three years after the year the ruling was issued, and provided the taxpayer's acts are in accordance with the facts presented to the tax authorities. Advance rulings may be appealed to the Tax Appeal Board.

6.5 Further Particulars Concerning Tax ADR Mechanisms

If a lawsuit is not filed within six months from the tax office or Tax Appeal Board decision, the decision is final and it is not possible to appeal. Formal mediation is therefore conducted as part of court proceedings.

The parties should not settle a dispute by agreement if not satisfied with the result, as the settlement would be legally binding. However, both out-of-court and in-court settlements may be declared invalid or amended by a judgment pursuant to the rules for invalidity and amendment of contracts.

For in-court settlements, the lawsuit must be brought within six months of the date the party became aware, or ought to have obtained knowledge, of the alleged grounds for invalidity. The outer timeframe is ten years from the settlement.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

As transfer pricing cases rely heavily on facts, the government may be more willing to settle such cases by mediation. A transfer pricing dispute in one residency does, however, trigger a double tax relief procedure in the other jurisdiction concerned.

A prerequisite for reaching an agreement with the competent authority of the other jurisdiction, for the avoidance of double taxation, is that the

competent authority is convinced that the settlement is in line with the arm's-length principle. This should be kept in mind by the parties when assessing if and on what terms the dispute should be resolved by settlement.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

The general rate of tax penalties is 20% (of the additional tax), and may be imposed if the taxpayer has failed to provide correct and complete information.

Penalties may be increased to 40% or 60% if the failure to provide information is deliberate or grossly negligent. In disputes over penalties, the courts can try all aspects of the decision of the tax authorities.

As penalty tax is considered as punishment, the imposition of penalty taxes will limit the prosecuting authority's right to also apply criminal liability. The tax authorities may administratively impose penalty tax. A penalty tax appeal to the courts is treated as a civil court matter.

Criminal liability can be applied under the Penal Code if the taxpayer has failed to provide correct and complete information. This is generally reserved for severe cases. Criminal liability under the Penal Code is a criminal law matter and can only be imposed by the courts (the prosecuting authority may in certain cases issue fines).

7.2 Relationship between Administrative and Criminal Processes

No administrative or criminal sanctions can be imposed if the taxpayer has acted in accordance with the tax legislation.

For administrative sanctions, the underlying tax matter will generally be addressed at the same time as the underlying tax matter.

A criminal tax matter does not address the underlying tax matter, only the tax offence. Pre-judicial assessment of the tax matter may, however, be required as a violation of tax legislation is a prerequisite for criminal sanctions under the Penal Code.

7.3 Initiation of Administrative Processes and Criminal Cases

The tax authorities would normally initiate penalty taxes parallel to the additional tax assessment, with both claims being decided in the same written decision. Depending on the specific facts, it is not unusual for the notice for penalty tax to be issued at a later stage than the notice for the additional tax assessment. This is because the tax authorities would refrain from sending notice of penalty tax until it is sufficiently clear that there will be an additional tax assessment.

The tax authorities could alternatively wait until the additional tax assessment is decided before the penalty tax procedure is initiated. The statute of limitation is the same for penalty taxes as for the tax issue it concerns.

Penalty taxes would in most cases be the tax authorities' preferred action. Criminal proceedings for the same action would then be prevented. It is understood that if the taxpayer is given notice of penalty tax, but no decision is made, the tax authorities are not prevented from initiating criminal proceedings. Equally, if criminal proceedings are initiated but later dropped, penalty taxes could still be imposed.

7.4 Stages of Administrative Processes and Criminal Cases

Administrative penalty tax is decided by the tax authorities. A decision may be appealed to the

Tax Appeal Board and, if the appeal is unsuccessful, it may be appealed to the courts.

While penalty tax is regarded as a criminal punishment under the European Convention on Human Rights, giving the taxpayer rights as if they have been criminally indicted, penalty taxes are decided as a civil court matter under domestic law.

Where a taxpayer is indicted under the Penal Code, the case is a criminal court matter. A criminal tax matter does not address the underlying tax matter, only the tax offence. However, pre-judicial assessment of the tax matter may be required as a violation of tax legislation is a prerequisite for criminal sanctions under the Penal Code.

7.5 Possibility of Fine Reductions

There are no negotiations in criminal cases and plea bargains are not available under Norwegian criminal law.

Reduced sanctions may nonetheless be granted during court proceedings where the taxpayer provides a full confession. A taxpayer may also prevent court proceedings by accepting a fine by the prosecuting authority.

7.6 Possibility of Agreements to Prevent Trial

A taxpayer may prevent court proceedings by accepting a fine by the prosecuting authority, see **7.5 Possibility of Fine Reductions**.

Payments of taxes assessed will not prevent a criminal proceeding. See **1.5 Additional Tax Assessments** concerning the obligation to pay taxes assessed once a decision has been issued.

7.7 Appeals against Criminal Tax Decisions

A judgment from the district court may be appealed to the court of appeal. An appeal must be lodged within two weeks of being served to the taxpayer. The appeal court can consider the district court's application of law and factual assertions.

The appeal court's judgment may be appealed to the Supreme Court. An appeal to the Supreme Court requires leave. The Supreme Court may only consider the appeal court's application of law.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Transactions and operations challenged under transfer pricing rules or anti-avoidance standards may be subject to administrative and criminal sanctions, provided the conditions for such sanctions are met.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Judicial domestic litigation continues to be relatively common in Norway. In accordance with statistics produced by the tax authorities in their 2021 annual report, there were 51 new appeals lodged in 2021, 28 tax and VAT cases were concluded through a final judgment and five cases were withdrawn by the taxpayer and two by the tax authorities.

In 2015, the tax authorities established a centralised team dealing with advance pricing agreements (APAs) and mutual agreement procedures (MAPs) under Articles 7 and 9 of the OECD Model Convention. Nonetheless, the number of cases being handled through these mecha-

nisms remains relatively modest in an international context. In accordance with data provided by the Norwegian tax authorities in their 2021 annual transfer pricing report, the tax authorities concluded 17 MAP cases and two APAs in 2020. The effects of the available tax dispute mechanisms measures adopted under the OECD MLI have so far been limited.

While an EEA member state, Norway has not adopted the EU Tax Disputes Directive.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The Norwegian GAAR and SAAR applies to cross-border situations, but only to the extent the application does not go beyond Norway's taxing rights under a bilateral tax treaty.

There is no current practice concerning the application of the PPT introduced by the MLI. Although difficult to predict, it would be expected that the tax authorities would look to challenge pass-through and treaty shopping arrangements where there is limited substance.

8.3 Challenges to International Transfer Pricing Adjustments

It is common in Norway to bring transfer pricing challenges through domestic litigations and there have been a number of Supreme Court decisions on transfer pricing.

As addressed in **8.1 Mechanisms to Deal with Double Taxation**, there is a centralised office working with double tax treaty mechanisms and a number of cases are annually processed.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Unilateral advance pricing agreements are not available for Norwegian taxpayers.

Although Norway does not formally have legislation providing for bilateral APAs, taxpayers may in practice enter into negotiations for such agreements. While less prevalent than in Norway's neighbouring countries, APAs are not uncommon.

8.5 Litigation Relating to Cross-Border Situations

Norway has extensive court practice on several cross-border situations and in particular concerning permanent establishments, income allocation and transfer pricing. This is partly because of the extensive activity on the Norwegian Continental Shelf, both with regard to foreign entities with temporary activity there or related to upstream petroleum companies taxed under the 78% petroleum tax regime.

The current trend is that litigation activity will continue to be high in these areas.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

While Norway is not a member of the EU, the EU state aid restrictions apply under the European Economic Area (EEA) agreement. Under the agreement, tax reliefs and other beneficial taxation may be considered as state aid where the recipient gains an advantage on a selective basis.

To have individual concerns addressed, complainants have the option of bringing cases of potentially unlawful aid before the national courts. Such complaints are, in the authors' experience however, rare.

More general state aid complaints may be brought to the EFTA Surveillance Authority (ESA), which monitors EEA members' compliance with the EEA agreement, including the state aid rules.

A formal complaint may be lodged by any interested party, including competitors and trade associations. As an example, an environmental political party recently lodged an (unsuccessful) complaint to ESA against a COVID-19 tax relief package granted to Norwegian-based oil companies, arguing that that the measure constituted unlawful state aid.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

In cases where ESA concludes that unlawful or incompatible fiscal state aid has been granted, ESA will issue a decision requiring the state to enact necessary measures to ensure repayment of the unlawful state aid, including interest. This will follow normal payment enforcement procedures.

9.3 Challenges by Taxpayers

Challenges against state aid recovery have mainly concerned indirect taxes. A typical practical example concerns whether cultural events, such as concerts, are VAT exempted or whether they are considered VAT-liable commercial activities.

9.4 Refunds Invoking Extra-Contractual Civil Liability

There are no cases in Norway of refunds, following subsequent litigation against the state, invoking extra-contractual civil liability.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Norway has decided not to apply part VI of the MLI to the Covered Tax Agreements. In a recent white paper, the government stated that Norway, as a starting point, is moving to include arbitra-

tion provisions in its tax treaties. This has been implemented in the recent tax treaties with the Netherlands, the UK and Switzerland. However, the government's view is that arbitration should be assessed in light of other provisions of the tax treaty, and that this is best done in bilateral negotiations.

10.2 Types of Matters that Can Be Submitted to Arbitration

See **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**.

For the recently adopted arbitration provisions in Norway's tax treaties with the Netherlands and the UK, all issues that remain unresolved after two years can be submitted to arbitration, only if they have not already been decided by a court or other administrative tribunal in either state.

The tax treaty with Switzerland restricts arbitration in cases concerning issues relating to hard-to-value intangibles. Cases involving abusive transactions with the view of obtaining unintended benefits under the provisions of the Convention, and to which domestic anti-abuse rules apply, are also exempt from arbitration. Other than this, all issues that remain unresolved three years from the submission of the case to the competent authority can be submitted to arbitration.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This is not applicable in Norway.

10.4 Implementation of the EU Directive on Arbitration

Norway has, in recent tax treaties, agreed that issues that remain unresolved after two years can be submitted to arbitration.

10.5 Existing Use of Recent International and EU Legal Instruments

This is not applicable in Norway.

10.6 New Procedures for New Developments under Pillar One and Two

Although much is still unclear as to how the rules will be implemented in practice, Norway has committed to introducing Pillar One and Pillar Two, with expected introduction in 2023; see **1.4 Efforts to Combat Tax Avoidance**.

It is expected that the instruments to mitigate tax controversies and the tax certainty procedures may require some time to settle in order to effectively prevent and resolve disputes.

10.7 Publication of Decisions

Tax treaty decisions are generally not published.

10.8 Most Common Legal Instruments to Settle Tax Disputes

There have been few, if any, international tax court cases concerning tax treaty application.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

The arbitration process may vary under differing tax treaties. The details concerning the arbitration process under the tax treaty with the UK and the Netherlands are not published. Under the treaty with Switzerland, the arbitration panel shall consist of three individual arbitrators with expertise and experience in international tax matters. The competent authorities of each contracting state appoint one arbitrator. These then appoint the third arbitrator, who will function as Chair. The Chair shall not be a national or resident of either contracting state.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

No fees are payable for the administrative appeals to the tax office and to the Tax Appeal Board. There is no formal administrative litigation.

11.2 Judicial Court Fees

For litigations before the District Court, a number of court fees (one court fee equals NOK1,199) will incur, depending on, inter alia, the number of days the main hearing is scheduled for. The minimum fee is a total of five court fees, which equals NOK5,995. However, should the case be dismissed or cancelled, the fee will be reduced.

The minimum fee before the Court of Appeal and the Supreme Court is, as a rule, 24 court fees, equalling NOK28,776, with additional court fees depending on the number of days for oral appeal hearings.

The party filing the case or appeal is responsible for the fee, with the lawyer having joint and several liability. The fees are not due until the closing of the proceedings. The court might decide that the losing party covers the cost.

11.3 Indemnities

If the court decides that the initial additional tax assessment is null and void, the taxpayer would generally be entitled to full compensation from the government for necessary legal costs concerning the court proceedings.

The taxpayer would also be entitled to compensation for necessary legal costs related to the tax authorities' procedure with the additional tax assessment. Such claim must be sent to the tax authorities, which then decides on the compensation.

11.4 Costs of ADR

The cost of alternative dispute resolution by settlement will depend on at which stage of the court proceedings the case is settled. A settlement more than four weeks prior to the oral hearing will result in a total fee of NOK2,398 at either court. A settlement less than four weeks prior to the oral hearing will result in a total fee of NOK2,398 before the City Court and NOK14,388 before the Court of Appeal and the Supreme Court. If the case is settled during the hearings, the full fee will be reduced by half. Note that if a mediator is appointed in a non-judicial mediation, the parties will in equal share be responsible for remunerating the mediator.

12. STATISTICS

12.1 Pending Tax Court Cases

The number of pending tax cases is not publicly available. The tax authorities' 2019 annual report stated there were 59 new court appeals lodged in 2019, 35 direct tax and VAT cases were concluded through final judgment and one case was withdrawn by the taxpayer.

12.2 Cases Relating to Different Taxes

In 2019, out of 35 total concluded court cases, 29 concerned direct taxes and seven concerned VAT; see **12.1 Pending Tax Court Cases**.

12.3 Parties Succeeding in Litigation

In accordance with the tax authorities' 2019 annual report, the tax office won 86% of the direct tax court cases concluded in 2019. For VAT, the tax authorities' success rate was 100%. The tax authorities' success rate in 2019 appears to be somewhat higher than the norm.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Administrative Phase

During audits, it is important for the taxpayer to manage the process and ensure that information requests are recorded. It is also prudent to ask the tax authorities to clarify the tax matters under investigation and, if possible, to present their positions.

It is prudent to consider requests for information properly. Correspondence with lawyers is generally privileged. There is also no obligation to disclose written tax considerations prepared by the taxpayer or external parties. It may be used as evidence if the taxpayer has consented to sharing such correspondence.

Taxpayers are, to some extent, prevented from presenting new evidence during court hearings. It is therefore important to ensure that the relevant documentary evidence is presented during the administrative phase.

KPMG Law Advokatfirma AS is a full-service tax practice and a leading Norwegian law firm within international and domestic corporate tax and personnel tax, transfer pricing, VAT and indirect taxes, company and business law, and EU/EEA tax-related matters in addition to litigation and administrative appeal processes. KPMG Law Advokatfirma AS has clients ranging from large international groups to medium-sized and small businesses, including family-owned, private equity-owned and listed enterprises. The

firm leverages the vast knowledge, skills and experience across its global network of firms to help clients identify and address their most complex business problems with confidence. Through the experience and knowledge of the firm's professionals and client work, it has built extensive insights into many industries and sectors, especially upstream petroleum, drilling, offshore oil services, real estate, power and utilities, IT/technology, financial sector, seafood and private equity.

AUTHORS



Thor Leegaard is a partner at KPMG Law Advokatfirma AS and part of the corporate tax department and covers all areas of international and corporate tax law as well as European law

issues connected to taxation. Thor has extensive M&A experience, and has successfully managed significant tax and transfer pricing controversies with the tax authorities. He has litigation experience both from Norwegian courts and the EFTA Court of Justice. He is a member of the Norwegian Bar Association.



Pål-Martin Schreiner advises on international and domestic corporate tax matters. He has significant corporate tax experience, including experience acting as a Big Four tax lawyer

for over ten years. He provides tax planning advice and tax dispute assistance. Recent advisory work has also covered tonnage tax, transfer pricing and corporate structuring. He is also a key member of KPMG's M&A tax group, and assists on a number of domestic and international transactions in a variety of industries. He is a member of the Norwegian Bar Association.

KPMG Law Advokatfirma AS

Sørkedalsveien 6
P.O. Box 7000 Majorstuen
NO-0306 Oslo
Norway

Tel: +47 406 34526
Email: pal.schreiner@kpmg.no
Web: www.kpmg.no



PHILIPPINES

Law and Practice

Contributed by:

Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales
and Hailin DG. Quintos

SyCip Salazar Hernandez & Gatmaitan see p.503



CONTENTS

1. Tax Controversies	p.485	5.3	Judges and Decisions in Tax Appeals	p.494
1.1 Tax Controversies in this Jurisdiction	p.485	6. Alternative Dispute Resolution (ADR) Mechanisms	p.494	
1.2 Causes of Tax Controversies	p.485	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.494	
1.3 Avoidance of Tax Controversies	p.486	6.2 Settlement of Tax Disputes by Means of ADR	p.494	
1.4 Efforts to Combat Tax Avoidance	p.486	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.494	
1.5 Additional Tax Assessments	p.486	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.495	
2. Tax Audits	p.487	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.495	
2.1 Main Rules Determining Tax Audits	p.487	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.495	
2.2 Initiation and Duration of a Tax Audit	p.487	7. Administrative and Criminal Tax Offences	p.496	
2.3 Location and Procedure of Tax Audits	p.487	7.1 Interaction of Tax Assessments with Tax Infringements	p.496	
2.4 Areas of Special Attention in Tax Audits	p.488	7.2 Relationship between Administrative and Criminal Processes	p.496	
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.488	7.3 Initiation of Administrative Processes and Criminal Cases	p.496	
2.6 Strategic Points for Consideration during Tax Audits	p.488	7.4 Stages of Administrative Processes and Criminal Cases	p.496	
3. Administrative Litigation	p.489	7.5 Possibility of Fine Reductions	p.496	
3.1 Administrative Claim Phase	p.489	7.6 Possibility of Agreements to Prevent Trial	p.497	
3.2 Deadline for Administrative Claims	p.490	7.7 Appeals against Criminal Tax Decisions	p.497	
4. Judicial Litigation: First Instance	p.490	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.497	
4.1 Initiation of Judicial Tax Litigation	p.490	8. Cross-Border Tax Disputes	p.498	
4.2 Procedure of Judicial Tax Litigation	p.490	8.1 Mechanisms to Deal with Double Taxation	p.498	
4.3 Relevance of Evidence in Judicial Tax Litigation	p.491	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.498	
4.4 Burden of Proof in Judicial Tax Litigation	p.491			
4.5 Strategic Options in Judicial Tax Litigation	p.492			
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.492			
5. Judicial Litigation: Appeals	p.493			
5.1 System for Appealing Judicial Tax Litigation	p.493			
5.2 Stages in the Tax Appeal Procedure	p.493			

PHILIPPINES CONTENTS

8.3	Challenges to International Transfer Pricing Adjustments	p.498	10.5	Existing Use of Recent International and EU Legal Instruments	p.500
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.498	10.6	New Procedures for New Developments under Pillar One and Two	p.500
8.5	Litigation Relating to Cross-Border Situations	p.498	10.7	Publication of Decisions	p.500
9.	State Aid Disputes	p.499	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.501
9.1	State Aid Disputes Involving Taxes	p.499	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.501
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.499	11.	Costs/Fees	p.501
9.3	Challenges by Taxpayers	p.499	11.1	Costs/Fees Relating to Administrative Litigation	p.501
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.499	11.2	Judicial Court Fees	p.501
10.	International Tax Arbitration Options and Procedures	p.499	11.3	Indemnities	p.501
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.499	11.4	Costs of ADR	p.501
10.2	Types of Matters that Can Be Submitted to Arbitration	p.499	12.	Statistics	p.501
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.500	12.1	Pending Tax Court Cases	p.501
10.4	Implementation of the EU Directive on Arbitration	p.500	12.2	Cases Relating to Different Taxes	p.501
			12.3	Parties Succeeding in Litigation	p.502
			13.	Strategies	p.502
			13.1	Strategic Guidelines in Tax Controversies	p.502

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

The Philippines practises self-assessment, wherein the taxpayer determines the tax liability, files the tax returns and pays the taxes due. Proper tax administration, however, cannot rely on voluntary compliance alone. Thus, several measures are in place to facilitate the taxpayer's compliance with the tax laws, such as the extensive investigatory powers granted to tax authorities. To check the correctness of taxes remitted to the government, tax authorities are authorised to examine the taxpayer's returns and related documents.

Tax controversies in the Philippines are generally the result of regular tax audits/investigations conducted by the:

- Bureau of Internal Revenue (BIR) for national taxes under the National Internal Revenue Code of 1997, as amended (Tax Code);
- Bureau of Customs (BOC) for tariff and customs duties; and
- local government units (LGUs) for local taxes, which include local business taxes and real property taxes (RPT).

A tax controversy arises when the authorities issue an assessment for tax deficiencies and the taxpayer disputes that assessment.

Tax controversies may also arise from the following:

- premature issuance of warrants that authorise the BIR to attach the taxpayer's real and personal properties, even if the tax assessment is not yet final;
- assessments for customs duties and taxes arising from the tariff classification and valuation of imported products;

- claims for refund by the taxpayer involving erroneously or illegally collected taxes, excess creditable taxes withheld, and excess unutilised input taxes;
- requests for a ruling on the tax implications of a certain transaction (eg, tax treaty relief applications (TTRAs) and requests for tax-free exchange rulings);
- court decisions, which finally resolve and confirm the taxability of certain transactions – these may lead to tax audits of taxpayers with similar transactions, or of those belonging to the same industry or industries where such transactions are common;
- complaints, confidential information filed by informers, or referrals from other government agencies, which may result in the investigation and prosecution of criminal tax cases under the BIR's Run After Tax Evaders (RATE) programme; and
- petitions filed by taxpayers to assail the validity of a tax statute, local tax ordinance of LGUs or regulations issued by the BIR or BOC.

1.2 Causes of Tax Controversies

Generally, tax controversies arise from all types of taxes.

For national taxes, most tax controversies involve corporate income tax, withholding tax and value-added tax (VAT). This is due mainly to the taxpayer's poor tax compliance system and inadequate documentation or lack of supporting records. Deficiency assessments on corporate income tax usually come from conflicting interpretations of law or tax regulations or differing tax positions on a complex transaction. Withholding tax deficiencies are commonly due to differences of opinion on the applicable withholding tax rates and discrepancies over the amount of certain expenses reported in the financial statements or tax returns as against the alphabetical list of income payees (which con-

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hailin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

tains the amounts paid to these payees and the taxes withheld). VAT controversies normally arise from non-compliance with the proper invoicing requirements for VAT zero-rated sales.

For local taxes, the typical tax controversy involves RPT, where there is a dispute over the property classification and assessment level. Some LGUs also continue to impose local taxes on export-oriented companies and other companies entitled to tax incentives.

1.3 Avoidance of Tax Controversies

A controversy involving national taxes is usually mitigated by securing a confirmatory ruling from the BIR regarding the tax implications of a transaction.

The other ways to mitigate tax controversies include:

- seeking tax advice or an opinion on a transaction, especially when it involves a novel tax issue, difficult interpretation of tax laws or conflicting positions due to its complexity;
- engaging an external advisor to conduct tax due diligence; and
- maintaining a robust tax compliance system, such that the books of accounts are in order, the supporting documents are intact, tax returns are properly recorded and timely filed, and all taxes are fully accounted for.

1.4 Efforts to Combat Tax Avoidance

The Philippines has not fully adopted the Organisation for Economic Co-operation and Development (OECD)'s Base Erosion and Profit Shifting (BEPS) Recommendations, nor the European Union (EU)'s recent measures to combat tax avoidance.

1.5 Additional Tax Assessments

When the BIR assesses a taxpayer for tax deficiencies, it will issue a final assessment notice/

formal letter of demand (FAN/FLD), requiring the taxpayer to pay the assessed taxes within 30 days from the date of that demand. If the taxpayer agrees, it can immediately pay the assessed taxes. However, if the taxpayer disagrees with the assessment, the taxpayer must file a protest within 30 days from receipt of the demand. The protest must contain the taxpayer's factual and legal bases for disputing the tax assessment, together with supporting documents. The taxpayer is not required to pay the amount of deficient taxes due while the tax assessment is under protest. However, interest on the tax deficiency tax will continue to accumulate until the full amount of tax is paid.

Generally, the CIR's decision or inaction on the protest may be elevated to the Court of Tax Appeals (CTA) without payment of the disputed tax. Nonetheless, the BIR may still enforce collection against the taxpayer, unless collection is suspended by the CTA.

The rule is different in the case of RPT (a local tax). Under the Local Government Code, the taxpayer must pay the RPT due before filing a protest.

Under the Customs Modernisation and Tariff Act (CMTA), the BOC shall assess the duties and taxes on imported goods. If this assessment is disputed by the importer, it shall be completed upon either final readjustment based on the tariff ruling in the case of a classification dispute, or the final resolution of the protest case involving valuation, rules of origin, and other customs issues. In the absence of fraud and when the goods have been finally assessed and released, the assessment shall be conclusive three years from the date of final payment of duties and taxes, or upon completion of the post-clearance audit. Decisions of the BOC Commissioner may be appealed to the CTA.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Revenue Memorandum Order (RMO) No 19-2015, as amended by RMO No 64-2016, prescribes the procedures to be observed during a tax audit. It classifies those that are subject to tax audits as follows:

- mandatory cases including claims for tax refund, tax clearance and estate tax returns;
- priority taxpayers or industries such as taxpayers with zero-rated sales, taxpayers enjoying tax exemptions/incentives and those whose compliance is below the established benchmark rate; and
- other priority audits identified by the BIR.

RMO No 19-2015 also provides that taxpayers who have not been audited but have been in operation for more than three years are subject to a mandatory tax audit. Meanwhile, those that have been subject to a tax audit for two successive taxable years will no longer be subject to tax audit, unless there is a presumption of a tax fraud (ie, understatement of sales or income, or overstatement of expenses/deductions by at least 30%).

2.2 Initiation and Duration of a Tax Audit

Under the Tax Code, the BIR has the authority to assess internal revenue taxes within three years after the last day prescribed by law for the filing of the return or the actual date of filing, whichever is later. In exceptional cases (ie, false or fraudulent return with intent to evade tax or failure to file a return), the BIR may assess the taxpayer at any time within ten years after discovery of the falsity, fraud or omission.

The law does not limit the duration of the tax audit, as long as it is conducted within the three-year prescriptive period. However, RMO No

19-2015 requires the BIR examiners to strictly comply with the prescribed periods for completion of their audits and submission of reports. BIR examiners are given an internal deadline of 180 days (for non-large taxpayers) or 240 days (for large taxpayers) from the issuance of the letter of authority (LOA) to submit their report.

Generally, tax audits do not suspend the prescriptive period. Under the Tax Code, only the following instances suspend the running of the prescriptive period:

- when the BIR is prohibited from making the assessment and for 60 days thereafter;
- when the taxpayer requests a reinvestigation which is granted by the CIR;
- when the taxpayer cannot be located at the address given in the tax return filed, upon which a tax is being assessed or collected; and
- when the taxpayer is out of the Philippines.

The prescriptive period is also suspended when the taxpayer agrees, in writing, to waive such period.

Meanwhile, the BOC may conduct an audit examination, inspection, verification, and investigation of records pertaining to any goods declaration for the purpose of ascertaining the correctness of that goods declaration and determining the liability of the importer for duties, taxes and other charges, including any fine or penalty, within three years from the final payment date of duties and taxes or customs clearance.

2.3 Location and Procedure of Tax Audits

Generally, tax audits are conducted in the business premises of the taxpayer during business hours. The BIR examiners usually request copies of tax returns, invoices and official receipts, journal vouchers, ledgers and other accounting

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hailin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

books and records. Tax returns, invoices and official receipts are based on printed documents, while books of accounts and accounting records can be made available electronically or in a spreadsheet format.

2.4 Areas of Special Attention in Tax Audits

Tax auditors should check the authority of the assigned BIR examiners and the validity of the LOA issued to the taxpayer. A taxpayer may validly refuse a request for examination by any revenue officer not mentioned in the LOA. Tax auditors must ensure that the BIR examiners' power to conduct the tax audit has not lapsed or does not go beyond the scope of the LOA.

In terms of documentation, the BIR typically examines the completeness and timeliness of a taxpayer's filings and reporting obligations. Furthermore, it is likely that the BIR will compare the financial statements, tax returns and other documents to spot discrepancies between the amounts reported or disclosed (eg, sales in the financial statements as opposed to sales reported in the alphabetical list). The discrepancies noted will become the basis of any tax deficiency assessment.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The prevalence of rules concerning cross-border exchanges of information and mutual assistance between tax authorities has contributed to an increase, though not a significant one yet, in tax audits in the Philippines.

Republic Act No 10021, or the Exchange of Information on Tax Matters Act, allows the exchange of information by the BIR on tax matters according to internationally agreed tax standards. Under the law, the CIR is authorised to inquire

into the bank deposits and other related information of taxpayers held by financial institutions, and to respond to a request from a foreign tax authority, pursuant to a tax treaty to which the Philippines is a party. Furthermore, income tax returns of the taxpayer, who is the subject of a request for exchange of information by a foreign tax authority, shall be open to inspection, upon the order of the President of the Philippines.

We have not experienced, or are not aware of, any joint tax audits conducted by the BIR with the tax authority of another state.

2.6 Strategic Points for Consideration during Tax Audits

Familiarity with the Tax Treatments of Accounts and Transactions

Taxpayers should be familiar with the tax treatment of all their material accounts, entries and transactions. It would be helpful if these tax treatments were documented through company policies or supported by the opinion of a tax expert.

Prepare Tax Documents and Other Supporting Documents in Advance

In tax audits, the tax authorities will request all relevant tax returns, accounting records and other documents. Since the BIR usually requests the same set of documents, the taxpayer can prepare the documents for a given year in anticipation of a tax audit. Having the complete documents in order not only gives the impression that the taxpayer is prima facie compliant with all its tax filings and tax reporting obligations, but also facilitates the conduct of the audit. It is also helpful if the taxpayer can provide a reconciliation of the usual discrepancies the BIR examiners note in their findings. Accordingly, the taxpayer can easily explain the reason for any discrepancies thereby preventing the discrepancy from giving rise to a deficiency assessment.

Designate a Contact Person for the Tax Authorities

To ensure a smooth audit, the taxpayer should designate a responsible employee to co-ordinate with the tax authorities on their document requests and to handle the overall conduct of the tax audit.

Engage an External Tax Advisor

It is prudent to engage an external tax advisor to handle the tax audit who can help prepare the factual and legal arguments and ensure that the rights of the taxpayer are adequately protected. An external advisor may also be consulted on major legal issues and possible questions from the tax examiner during the audit.

3. ADMINISTRATIVE LITIGATION**3.1 Administrative Claim Phase**

When attempting to refute or protest an assessment by the tax authorities, the administrative phase is mandatory and must be concluded before proceeding to the judicial phase.

Letter of Authority (LOA)

The issuance of an LOA signifies the start of a tax assessment. The LOA is issued to authorise a BIR examiner to conduct a tax audit. It must specify the type of taxes that will be examined and the taxable year subject of the audit.

Tax Audit Proper

After the issuance of the LOA, the BIR examiners can request and examine the tax returns, books of accounts and accounting records, official receipts, invoices, and other relevant documents necessary for the tax audit.

Notice of Discrepancy (NOD)

Revenue Regulations (RR) No 22-20, dated 15 September 2020, provides for the preparation

and issuance of an NOD. Upon audit, the BIR examiners will submit their initial report containing findings of discrepancies. Based on the report, the taxpayer shall be informed in writing of the discrepancies for the discussion of discrepancy (Discussion).

The taxpayer may present its side and explain the discrepancy during the Discussion, which must not extend beyond 30 days from receipt of the NOD. The taxpayer must also submit all the necessary supporting documents within the 30-day period. Failure by the taxpayer to appear without prior notice is tantamount to a waiver of its right to a Discussion. If the taxpayer does not agree with the BIR's findings, or if the BIR finds that the taxpayer is still liable for tax deficiencies, the case will be endorsed for issuance of a Preliminary Assessment Notice within 10 days from the conclusion of the Discussion.

Preliminary Assessment Notice (PAN)

The PAN contains the proposed deficiency tax assessment along with its factual and legal bases. The taxpayer may file a reply to the PAN within 15 days from receipt, containing the taxpayer's factual and legal bases in disputing the PAN, and supporting documents.

Final Assessment Notice and Formal Letter of Demand (FAN/FLD)

The BIR will review the taxpayer's reply to the PAN. If the BIR does not accept, fully or partially, the explanation of the taxpayer, it will issue the FAN/FLD, which must be done within the three-year prescriptive period, and in exceptional cases, within ten years. Otherwise, the BIR's right to assess will be barred by prescription. Usually, the FAN/FLD is only a reiteration of the findings in the PAN with adjustments on the amount of interest.

If the taxpayer does not agree with the BIR's findings, it must file a protest within 30 days

from receipt of the FAN/FLD. A protest may be in the form of a request for reconsideration or for reinvestigation. In the case of a request for reinvestigation, the taxpayer must submit additional supporting documents within 60 days from the date of filing of the protest. If the taxpayer does not file a protest, the assessment becomes final and executory.

Final Decision on Disputed Assessment (FDDA)

Based on the arguments in the protest and the supporting documents, the BIR will decide whether to grant or deny (in whole or in part) the protest, which decision will be embodied in an FDDA. The taxpayer may appeal the FDDA administratively through a motion for reconsideration before the CIR, or judicially through an appeal before the CTA.

Administrative Claim Phase in BOC

Depending on the issue involved (eg, refund, abandonment, valuation rules or origin issues), decisions of the Port Office, or of the BOC Commissioner, may be appealed administratively and/or judicially within the corresponding period prescribed under the CMTA and its implementing rules.

3.2 Deadline for Administrative Claims

There is no mandatory deadline given to the tax authorities to decide a protest lodged by a taxpayer.

For national taxes, the CIR is given 180 days from receipt or, in the case of a request for reinvestigation, from receipt of the supporting documents to decide on the protest. If a decision is received during this period, the taxpayer has 30 days from receipt of the BIR's decision within which to appeal to the CTA.

However, in the case of inaction on the part of the CIR, the taxpayer has the option to file an

appeal before the CTA within 30 days from the lapse of the 180-day period or to wait for the CIR's decision and then appeal it within 30 days from receipt of that decision.

Different periods are provided in the case of (i) refunds of national taxes and (ii) protests against, and refunds of, local taxes.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is initiated by filing a petition for review (Petition) with the CTA to appeal the:

- CIR's decision or inaction on disputed assessments involving national internal revenue taxes;
- BOC Commissioner's decision in cases involving liability for customs duties; or
- Central Board of Assessment Appeals (CBAA)'s decision in the exercise of its appellate jurisdiction over cases involving the RPT assessments originally decided by the provincial or city board of assessment appeals.

Judicial tax litigation may also be initiated by filing a complaint before the regional trial courts (RTC) in respect of local taxes originally decided by the local treasurer of the respective LGUs.

4.2 Procedure of Judicial Tax Litigation

The CTA adopted certain provisions under the 2019 Amendments to the 1997 Rules of Civil Procedure, pursuant to CTA En Banc Resolution No 9-2020. Other provisions that were not specifically adopted shall apply supplementarily.

After the filing of a Petition and payment of docket fees, summons will be served to the respondent (eg, the BIR), requiring it to file an

answer within 30 calendar days after service of the summons, which period may be extended for another 30 days. The answer must include all of the claims or defences, legal bases, and grounds for dismissal of the Petition (if any).

After the BIR files an answer, the case will be set for pre-trial not later than 60 days from the filing of the last responsive pleading. The parties must submit their respective pre-trial briefs at least three calendar days before the pre-trial.

During the pre-trial conference (PTC), the parties, through counsel, may stipulate on facts, determine the issues to be resolved and identify the evidence to be presented during trial. After the PTC, the CTA will issue a pre-trial order reciting the matters covered during the PTC. The order shall bind the parties, limit the trial to matters not disposed of and control the course of the trial, unless modified by the CTA to prevent injustice.

Thereafter, trial hearings will be conducted by the CTA for the presentation of the parties' respective evidence. Upon the completion of the trial hearings, the CTA will direct the parties to file their respective memoranda, which summarise the parties' claims, arguments and defences. The CTA Division will decide on the issues based on the evidence presented during trial.

4.3 Relevance of Evidence in Judicial Tax Litigation

Testimonial and documentary evidence are important considering that judicial claims before the CTA are litigated *de novo* and decided based on what has been presented and formally offered by the parties (and admitted by the CTA) during the trial.

The documents or exhibits to be presented, their purpose, and the numbers and names of witnesses, are identified as early as during the PTC. However, testamentary and documentary

evidence will still need to be presented and marked before the CTA during the course of the trial hearings.

The testimonies of the witnesses will be presented pursuant to the Judicial Affidavit Rule. The judicial affidavit contains the testimony of the witness in a question-and-answer format and is submitted in lieu of the direct testimony of the witness.

Under the CTA En Banc Resolution No 9-2020, the taxpayer must submit all its evidence (eg, judicial affidavits and documentary evidence) upon filing of the Petition with the CTA. This is a significant change from the previous practice, wherein evidence was submitted only during the course of the PTC. Nevertheless, the parties may still introduce evidence, which was not submitted together with the Petition, by submitting a judicial affidavit (JA) containing the testimony of the witness and attaching the documentary evidence cited in the JA at least five days before the PTC.

4.4 Burden of Proof in Judicial Tax Litigation

In tax controversies, tax assessments are presumed to be correct and made in good faith. Thus, in order to rebut this presumption and avoid a decision in favour of the tax authority, the taxpayer must prove that the assessment has no legal or factual basis. Similarly, the claimant must prove all the elements required for a tax refund since refunds are construed strictly against the claimant and in favour of the state. In criminal tax litigation, the government is required to prove the accused's guilt beyond reasonable doubt.

4.5 Strategic Options in Judicial Tax Litigation

Timing to Produce Documents

Under the Revised Rules of the CTA, all pieces of evidence, including the judicial affidavits of witnesses, must be submitted upon filing of the Petition or answer with the CTA.

Evidence

In cases where the dispute involves mostly factual issues, it is important for the taxpayer to determine, as early as possible, the quantity and quality of evidence that is available or that can be produced to support its position. Note that judicial claims are decided based on what has been presented and formally offered by the parties during the trial, and while the allegations by the taxpayer may be factually correct, mere allegations without proof cannot be given weight by the courts, unless they can be subject to judicial notice.

Legal Arguments

Tax disputes normally arise from conflicting interpretations of a legal provision. Thus, it is critical for the taxpayer and its external tax advisor, who may or may not be the litigating lawyer, to conduct comprehensive research to determine the probability of obtaining a favourable ruling.

Possibility of Settlement

The current CTA rules provide for referral to mediation and entering into a compromise agreement if both parties are willing to settle the case out of court. The taxpayer, in determining whether to settle, must evaluate not only the strength of its arguments, but also practical considerations such as litigation costs, length of time before a case can be decided by the courts, what potential benefit it may gain should the case be decided in its favour and whether an early settlement outweighs all the costs already incurred.

Expert Reports

A party who desires to introduce voluminous documents or long accounts into evidence must, with the CTA's prior approval, refer the voluminous documents to an independent Certified Public Accountant (ICPA) who will review, as a court-appointed commissioner, the source documents or other financial records, and render a summary report to the CTA.

It is also possible to obtain testimony from an expert on certain issues that have an impact on the tax treatment (eg, an accountant on the question of whether an item is a deductible expense or a capital expenditure).

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Court decisions are based primarily on tax laws and regulations. Judicial decisions applying or interpreting the laws form a part of the legal system of the Philippines. However, only decisions of the Supreme Court establish jurisprudence and are binding on all other courts. However, since the Tax Code originated in US tax law, older decisions of US courts in tax cases are, although not binding, persuasive.

In cases where there is no established precedent, or where the case involves international tax issues, the local courts may find foreign jurisprudence and international guidelines (eg, those of the OECD) persuasive in the interpretation of tax treaties, including the concepts and terms therein, and in the resolution of the tax issue at hand. However, these foreign authorities, while persuasive and carrying some weight, are not binding on local courts.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The judicial phase of tax litigation consists of several levels of review.

A taxpayer may seek judicial relief if its protest was denied, whether fully or partially, by the CIR. Upon issuance of the FDDA, the taxpayer may opt to appeal administratively to the CIR or to elevate its appeal to the CTA, through filing a Petition.

The CTA is a highly specialised court that reviews cases involving tax issues. There are two levels of review at the CTA: the CTA Divisions and the CTA En Banc.

The appealed decision of the CIR will be tried and resolved by the CTA Division. In the case of an unfavourable ruling, the taxpayer may file a motion for reconsideration (MR) or a motion for new trial (MNT) before the same CTA Division. The resolution of the CTA Division on the MR or MNT may be appealed through a Petition with the CTA En Banc. Lastly, the decision of the CTA En Banc may be appealed to the Supreme Court through a Petition for Review on Certiorari.

For local taxes originally decided by the local treasurer of the respective LGUs, an appeal of the local treasurer's decision may be made through filing a complaint before the RTC having jurisdiction over the taxpayer's place of business.

Cases involving RPT go through the Local Board of Assessment Appeals and the CBAA before they are appealed to the CTA En Banc.

5.2 Stages in the Tax Appeal Procedure Petition for Review (CTA Division)

For cases under the exclusive appellate jurisdiction of the CTA, such as decisions of the CIR involving disputed assessments, the taxpayer files an appeal by filing a Petition before the CTA. The Petition must be filed within 30 days from receipt of the FDDA or denial by the CIR of the taxpayer's motion for reconsideration.

The CTA Division will then hear and resolve the case based on the issues presented and evidence submitted by the parties.

Motion for Reconsideration or New Trial (CTA Division)

Once a decision is promulgated, an aggrieved party may file an MR or MNT before the same CTA Division. Otherwise, the decision of the CTA Division becomes final and executory.

The CTA Division may grant or deny, whether fully or partially, the MR or MNT based on the merits and the arguments of the parties.

Petition for Review (CTA En Banc)

The resolution of the CTA Division on the MR or MNT may be appealed by filing a Petition with the CTA En Banc within 15 days from receipt of the resolution. Otherwise, the resolution of the CTA Division becomes final and executory.

The CTA En Banc may sustain, reverse or modify the decision of the CTA Division. The aggrieved party may file an MR of the decision before the CTA En Banc within 15 days from receipt of the adverse decision. If no MR is filed before the CTA En Banc, the decision shall become final and executory.

Petition for Review on Certiorari (Supreme Court)

The aggrieved party may appeal the decision of the CTA En Banc to the Supreme Court by fil-

ing a Petition for Review on Certiorari within 30 days from receipt of the decision. The aggrieved party may file an MR of the decision before the Supreme Court within 15 days from receipt of the adverse decision. Upon finality of the decision by the Supreme Court, the tax assessment becomes final and executory.

5.3 Judges and Decisions in Tax Appeals

Court of Tax Appeals

The CTA is composed of a Presiding Justice and eight Associate Justices appointed by the President of the Philippines. The CTA may sit En Banc, or in three Divisions comprised of three justices each, including the Presiding Justice, who shall be the Chairman of the First Division.

Cases in Divisions are heard and decided upon by three CTA justices sitting as one body. The attendance of at least two CTA justices is necessary to constitute a quorum, and the affirmative votes of at least two CTA justices are required for the rendition of a decision or resolution.

Cases in CTA En Banc are decided by the eight Associate Justices and the Presiding Justice sitting as one body. The attendance of at least five justices constitutes a quorum, and the affirmative votes of at least five justices shall be necessary for the rendition of a decision or resolution. If a majority vote is not reached, the petition or motion shall be dismissed or denied.

Supreme Court

The Philippine Supreme Court is composed of a Chief Justice and 14 Associate Justices, who are appointed by the President of the Philippines. The Supreme Court may sit En Banc or in one of its three divisions composed of five members each.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Under the CTA guidelines, the CTA may refer cases to mediation. However, not all cases may be referred to mediation (eg, criminal tax cases and those cases where there is already a final and executory decision).

6.2 Settlement of Tax Disputes by Means of ADR

The parties will be required to appear before a mediator to determine their willingness to enter into mediation. If one party objects, the mediation proceedings will be terminated and the CTA proceedings will continue.

If both parties are willing to enter into mediation, they will be asked to execute an agreement to mediate and proceed with mediation before a mediator. The parties have 30 days, extendible for another 30 days, to reach a compromise agreement. A successful mediation may result in either a full compromise, which would terminate the CTA proceedings, or a partial compromise, in which case CTA proceedings on the remaining issues would continue.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Mediation allows the party and the BIR to enter into a settlement which may entail a reduction of the amount of tax assessed, including any surcharge, interest and penalties. In mediation, the BIR is still bound by substantive law, particularly Section 204 of the Tax Code, which provides for a compromise settlement of 40% or 10% of the basic tax assessed based on doubtful validity of the assessment or financial incapacity, respectively. In the latter case, the taxpayer is required to prove its financial incapacity through support-

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hallin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

ing facts and documents. A settlement offer less than the prescribed minimum rates would still be subject to the approval of the evaluation board composed of the CIR and the four deputy commissioners.

Aside from the court-annexed mediation, the BIR assessment may be settled by compromise or abatement. Under the Tax Code, the CIR may compromise over the payment of taxes when:

- reasonable doubt exists as to the validity of the claim against the taxpayer; or
- the financial position of the taxpayer demonstrates a clear inability to pay the assessed tax.

In cases of financial incapacity, the minimum compromise rate is equivalent to 10% of the basic assessed tax, while for all other cases, the minimum compromise rate is 40%.

The CIR may also abate or cancel the entire amount or portion of unpaid tax liability if the assessment is excessive or if the administration costs involved are not justified by the collection of the amount due.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

A revocation, modification or reversal of a BIR ruling shall not be given retroactive application if it will prejudice the taxpayer. In this sense, confirmatory tax rulings issued by the tax authority are binding against the BIR, but only in relation to the taxpayer who originally applied for that ruling, the specific transaction involved, and the taxes that were the subject of the ruling. Moreover, since the ruling is issued by the BIR based on facts represented by the taxpayer, if the BIR finds, upon investigation, that the facts represented are different from the actual ones,

the ruling will be considered void and will not be binding against the BIR.

6.5 Further Particulars Concerning Tax ADR Mechanisms

In addition to the details discussed in **6.2 Settlement of Tax Disputes by Means of ADR**, the following cases cannot be referred to mediation:

- where the jurisdiction of the CTA, BIR, BOC, Secretary of Finance, Secretary of Trade and Industry, or Secretary of Agriculture is in issue;
- where there is a pending application for a temporary restraining order or preliminary injunction for the suspension of collection of taxes;
- cases arising from criminal offences within the jurisdiction of the CTA Division or En Banc;
- the RTC's decisions/resolutions/orders in tax collection cases involving final and executory assessments;
- the RTC's decisions/resolutions/orders in local tax cases;
- the CBAA's decisions over cases involving the assessment and taxation of real property; and
- civil cases involving tax assessments that are final and executory.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

As the BIR has only recently issued the transfer pricing (TP) audit guidelines, it has not yet strictly implemented such guidelines during a tax audit.

The TP regulations provide that the BIR and the taxpayer may enter into an advance pricing agreement (APA) to determine in advance an appropriate set of criteria for the determination of the transfer prices of controlled transactions over a fixed period. The APA aims to reduce the risk of TP examination and double taxation. However, the APA is not a mandatory require-

ment, and is undertaken purely on a voluntary basis on the part of the taxpayer.

Recently, the BIR issued RR No 19-20, which requires the affected taxpayers to submit the new BIR Form No 1709 or Information Return on Related Party Transactions. In December 2020, the BIR issued RR No 34-20, amending RR No 19-20, which prescribes the guidelines and procedures for the submission of BIR Form No 1709, TP documentation and other supporting documents.

As of writing, the BIR has not yet issued separate guidelines on the application of APAs.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Failure to pay the correct taxes will not only result in an assessment for basic deficiency taxes but also in the imposition of civil penalties. Civil penalties include a 25% surcharge (50% in cases of wilful neglect to file the return or in cases where a false or fraudulent is wilfully made) and interest on the unpaid amount of tax at the rate of double the legal rate of interest.

Non-payment of taxes does not automatically give rise to a criminal offence, unless the circumstances of non-payment (eg, it is attended by fraud) constitute a separate criminal offence.

7.2 Relationship between Administrative and Criminal Processes

When a criminal action is instituted, the civil action for collection of taxes (eg, tax evasion) is automatically instituted in that criminal action. However, an assessment (or a determination that taxes have not been paid) is not necessary before a criminal case may be instituted, and

a collection or an assessment case does not automatically mean that a tax offence has been committed.

7.3 Initiation of Administrative Processes and Criminal Cases

Based on the findings in a regular tax audit, third-party information or other sources, a taxpayer may be the subject of a preliminary investigation for violation of the Tax Code before the Department of Justice (DOJ), which is the initial step in a criminal tax case.

Pursuant to the RATE programme, the BIR is mandated to investigate criminal violations of the Tax Code and assist in the prosecution of criminal cases. RATE is a joint programme of the BIR and the DOJ to investigate, prosecute and convict tax evaders.

7.4 Stages of Administrative Processes and Criminal Cases

Criminal tax cases are initially filed with the DOJ for determination of the existence of probable cause in a preliminary investigation. Upon a finding of the existence of probable cause, the case will be filed either at the RTC or the CTA, depending on the amount involved.

The RTC has original jurisdiction over criminal offences arising from violations of the Tax Code and other laws administered by the BIR or BOC, where the principal amount of taxes and fees claimed, exclusive of charges and penalties, is less than PHP1 million (approximately USD20,000) or where there is no specified amount claimed. The CTA has original jurisdiction over criminal tax cases when the amount claimed is at least PHP1 million.

7.5 Possibility of Fine Reductions

Upfront payment of the additional tax assessment does not result in the reduction of potential fines applicable to the tax offence. Furthermore,

under the Tax Code, the payment of the tax due shall not constitute a valid defence in any prosecution for violations of the Tax Code.

7.6 Possibility of Agreements to Prevent Trial

Payment of the assessed tax does not prevent or stop a criminal tax trial. Criminal cases already filed in court and those involving tax fraud may not be compromised.

During the administrative phase of the tax assessment, compromise penalties are imposed and collected by the BIR against the taxpayer, in lieu of criminal prosecution for violations committed by the taxpayer (see **6.3 Agreements to Reduce Tax Assessments, Interest or Penalties**). However, certain violations, such as tax evasion and declarations under penalties of perjury, may not be compromised.

7.7 Appeals against Criminal Tax Decisions

Rule 9 of the CTA rules sets out the following procedures for appeals.

Notice of Appeal

An appeal to the CTA En Banc in criminal cases decided by the RTC in the exercise of its original jurisdiction shall be made by filing a notice of appeal within 15 days from receipt of a copy of the decision or final order with the court which rendered the final judgment or order appealed from and by serving a copy upon the adverse party.

Petition for Review

An appeal to the CTA En Banc in criminal cases decided by the CTA Division shall be taken by filing a Petition within 15 days from receipt of the decision or resolution appealed from. The CTA may, for good cause, extend the time for filing of the Petition for an additional period not exceeding 15 days.

An appeal to the CTA En Banc in criminal cases decided by the RTC in the exercise of their appellate jurisdiction shall be taken by filing a Petition within 15 days from receipt of the decision/final order appealed from.

Petition for Review on Certiorari

An appeal to the Supreme Court in criminal cases decided by the CTA En Banc shall be made by filing a Petition within 15 days from receipt of the decision or resolution appealed from. The Supreme Court may, for justifiable reasons, grant an extension of 30 days within which to file the petition.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Neither a general anti-abuse rule (GAAR) nor a specific anti-avoidance rule (SAAR) has been adopted in the Philippines.

In one case involving TP issues, in which the BIR imputed interest on an interest-free loan, the Supreme Court ruled that the BIR's power to allocate gross income does not include the power to impute "theoretical interest" because there must be actual or, at the very least, probable receipt or realisation by the taxpayer of the income that is being allocated. The Supreme Court also recognised that interest cannot be imposed unless expressly stipulated in writing.

Currently, the Philippines still adheres to the distinction between tax evasion and tax avoidance with the latter generally being considered to be acceptable. However, there are specific rules in the Tax Code which seek to prevent tax avoidance practices, such as the substantial change of ownership in connection with net operating loss carryover and limitation on interest expenses. Furthermore, Section 50 of the Tax Code allows the CIR to allocate income and deductions between controlled entities.

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hailin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

If the BIR has assessed additional taxes in a cross-border transaction resulting in double taxation, taxpayers typically resort to domestic litigation (as opposed to availing themselves of the mechanisms under the double tax treaty) to appeal the administrative decision.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) has not been adopted in the Philippines. As of now, the Philippines has double taxation agreements (DTA) with 43 countries. None of these have an arbitration clause, relying, instead, on a mutual agreement procedure (MAP). A MAP is a means through which tax administrations of contracting parties consult to resolve disputes regarding the application of double tax conventions. This procedure can be used to eliminate double taxation that could arise from a TP adjustment.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Neither a GAAR nor a SAAR has been adopted in the Philippines. Moreover, the Philippines has not yet signed nor ratified the MLI.

8.3 Challenges to International Transfer Pricing Adjustments

The lack of uniform regulations in TP adjustments poses a challenge to both taxpayers and the tax authorities in addressing issues regarding international TP. Consequently, the decisions of tax authorities are made on a case-by-case basis. Although the BIR has not yet issued detailed APA regulations, an APA would be expected to address disputes on TP concerns.

As of this writing, international TP adjustments have not been challenged before local tax courts, although there are local tax cases in the CTA wherein TP has been raised as an issue or TP principles and guidelines have been used by the BIR as a tool to make an assessment against taxpayers and determine the deficiency taxes due.

8.4 Unilateral/Bilateral Advance Pricing Agreements

The TP regulations provide for an APA, which a taxpayer may enter into on a voluntary basis in order to reduce the risk of a TP audit and double taxation. The APA may be either unilateral (an agreement between the taxpayer and the BIR) or bilateral/multilateral (an agreement among the taxpayer, the BIR and one or more countries).

As of this writing, however, the BIR has yet to issue detailed guidelines on APAs.

8.5 Litigation Relating to Cross-Border Situations

Withholding taxes and permanent establishment are common issues relating to cross-border transactions. Another common issue is the documentary stamp tax implications of transactions that have both local and international elements (eg, an offshore loan contract with a security agreement that has onshore property as collateral, and vice versa).

As the BIR is yet to issue detailed TP guidelines and the Philippines has pending tax reform measures on tax avoidance, we anticipate that TP and taxation of the digital economy will be major sources of tax controversies involving cross-border transactions in the coming years.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

No information is available in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

No information is available in this jurisdiction.

9.3 Challenges by Taxpayers

No information is available in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

No information is available in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

The MLI has not been adopted in the Philippines. The Philippines' DTAs do not provide an arbitration clause but only a MAP (see **8.1 Mechanisms to Deal with Double Taxation**).

10.2 Types of Matters that Can Be Submitted to Arbitration

DTAs existing in the Philippines make use of the MAP to resolve matters arising from double taxation. However, these DTAs do not specifically provide a procedure for arbitration and those matters which can be subject to arbitration. Moreover, the MLI has not been adopted in the Philippines.

Generally, a taxpayer who believes that they have been subject to double taxation may raise their concerns with the tax authority (ie, the BIR, through the International Tax Affairs Division (ITAD)) to resolve the conflict. According to

the DTAs, the BIR should endeavour to resolve the case by mutual agreement with the competent authority of the other contracting state, to avoid taxation which is not in accordance with the DTA.

Tax Treaty Relief Applications

RMO No 14-2021, as clarified by Revenue Memorandum Circular (RMC) No 77-2021, provides the procedure for tax treaty relief applications (TTRAs). Under these issuances, all income items derived by non-residents entitled to tax treaty relief shall be confirmed by the BIR through the filing of (i) a request for confirmation (RFC) by the withholding agent, or (ii) a tax treaty relief application (TTRA) by the non-resident taxpayer together with an application for refund of excess taxes withheld. RMC No 77-2021 lists documentary items for each income item subject to the RFC or TTRA.

When the treaty rate for a certain income payment has been used or applied as the withholding tax rate, the withholding tax agent must file with the BIR ITAD an RFC on the propriety of the withholding tax used or applied. The RFC may be filed at any time after the payment of withholding tax but no later than the last day of the fourth month following the close of each taxable year.

Under RMO 14-2021 the withholding agent or income payor may rely on the submitted Application Form for Treaty Purposes, Tax Residency Certificate duly issued by the foreign tax authority, and the relevant provision of the applicable tax treaty on whether to apply the tax treaty rate or exemption when withholding income payments made to a non-resident taxpayer.

Notwithstanding the foregoing, however, the RFC may still be denied. Thus, until the RFC is granted, there is a risk that the local withholding tax agent will be assessed for tax deficiencies

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hailin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

plus penalties. RMO 14-2021 provides that the local withholding agent bears the liability for tax deficiencies.

On the other hand, if the regular withholding tax rate applied at the income payments, the non-resident taxpayer may file a TTRA with the ITAD, at any time after the receipt of income, if it wants to get a refund. The refund claim may be filed independently of, or simultaneously with, the TTRA. However, it must be filed within two years from payment of taxes.

The BIR has also issued RMO No 46-2020, which requires the filing of a request for a confirmatory ruling for a taxpayer to avail itself of the 15% reduced rate (down from the regular 25% final withholding tax rate effective as of 1 January 2021, pursuant to a recent amendment in the Tax Code which became effective last 11 April 2021) under the tax sparing provision of the Tax Code.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Neither baseball arbitration (or final offer arbitration) nor the independent opinion procedure are specifically adopted in the Philippines. The rules on arbitration which, in general, prevail in the Philippines require that a fair and reasonable award be rendered by the arbitrator on the dispute of the parties.

10.4 Implementation of the EU Directive on Arbitration

The OECD countries have taken measures to broaden the modes of settling disputes, including international tax arbitration.

In the Philippines, although tax arbitration is unusual as taxpayers prefer domestic resolutions, the most recent case which was subject of international arbitration was the USD1.1 billion

Malampaya tax dispute between Shell Philippines Exploration B.V. (SPEX) and the Philippine government before the International Chamber of Commerce (ICC) in Singapore. In 2019, the ICC resolved the case in favour of SPEX and against the Philippine government.

10.5 Existing Use of Recent International and EU Legal Instruments

The Philippines has not yet adopted the MLI which provides for a tax arbitration procedure. Thus, the MAP laid down in the DTAs and relevant issuances of the tax authorities are the main instruments used in the Philippines.

10.6 New Procedures for New Developments under Pillar One and Two

While the Philippines has been making significant progress in its readiness to join the Inclusive Framework on BEPS, it has not yet fully adopted the same. Thus, it is not anticipated that BEPS Pillars One and Two will take effect in the jurisdiction.

The Philippine Congress has proposed several bills to address the tax challenges stemming from the digitalisation of the economy and to impose taxes on certain digital transactions; however, as of the time of writing (May 2022), none of these bills have been enacted into law.

10.7 Publication of Decisions

Under the DTAs, a taxpayer may present their case or tax imposition, which is not in accordance with the DTA, to the competent authority (ie, the BIR) of the said state of which they are a resident. Rulings of the BIR on issues of international tax raised by a certain taxpayer are published on its official website for guidance to other taxpayers. Although not binding on courts, BIR rulings may be given persuasive effect by domestic courts.

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hallin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

10.8 Most Common Legal Instruments to Settle Tax Disputes

In settling international tax disputes, reference to the DTAs signed by the Philippines must be made. These DTAs provide for a MAP where the contracting states may engage into discussions on the issue of double taxation. They may communicate directly with each other for the purpose of reaching an agreement and to discuss special cases not provided for in the DTAs.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Independent professionals or lawyers can be hired by either the taxpayer or the state to initiate international arbitration. As in the recent Malampaya tax arbitration dispute (see **10.4 Implementation of the EU Directive on Arbitration**), in which SPEX hired an independent law firm to pursue its case.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

There is no filing fee for tax cases at the administrative level.

11.2 Judicial Court Fees

The filing fee for instituting a case before the CTA Division is between 0.67% and 1.5% of the amount of the disputed assessment, in addition to other nominal fees.

These fees are collected from the taxpayer upon filing of a Petition and are considered as sunk costs which cannot be refunded, regardless of the outcome of the case. Nominal fees will also be paid upon the filing of an appeal with the CTA En Banc and the Supreme Court.

There are also filing fees for tax-related cases filed before other courts or agencies such as the RTC and the CBAA. These filing fees are paid upon the filing of the case.

Payment of filing fees are mandatory and jurisdictional.

11.3 Indemnities

The filing fees to litigate before the CTA, and other costs incurred in connection with the tax litigation (professional or attorney's fees, out of pocket expenses, etc) are for the taxpayer's own account, and considered as sunk costs that cannot be recovered or reimbursed.

11.4 Costs of ADR

The mediation fee consists of a basic mediation fee in the amount of PHP2,500 (approximately USD50) and an additional mediation fee of PHP5,000 to PHP50,000 (approximately USD100 to USD1,000), depending on the sum in dispute.

12. STATISTICS

12.1 Pending Tax Court Cases

There is currently no available data on the number of cases that are pending before the CTA.

The latest available annual report containing the statistics on case disposition was published in 2016. Accordingly, in 2016, the CTA attained a disposal rate (or ratio of case output over case input) of 23% and a clearance rate (or ratio of case output over cases filed) of 72%.

12.2 Cases Relating to Different Taxes

There is no readily available data regarding the number of cases initiated and terminated every year relating to different taxes.

In tax criminal cases, the CTA has published statistics regarding the number of cases initiated and resolved every year. The latest report in 2018 provides that out of the 38 criminal tax cases initiated and filed before the CTA, only seven cases were decided or resolved during the same year.

12.3 Parties Succeeding in Litigation

There is currently no available data regarding which party succeeds in litigation.

In the latest available annual report, published in 2016, it was reported that the CTA awarded, in favour of the litigants, a total of PHP28.9 billion.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Cost-Benefit Analysis

The taxpayer must evaluate whether pursuing a certain remedy would actually be beneficial, or more costly – in terms of money, time and effort – than simply paying.

Filing an appeal before the courts entails costs, including filing fees, legal fees, cost of engaging legal counsel and a tax expert, out-of-pocket expenses and other incidental fees. These costs are over and above the potential tax liabilities that the taxpayer may pay if the decision turns out to be unfavourable. Furthermore, the interest on tax deficiencies continues to run while the case is pending (unlike in tax refund cases wherein the government is not obliged to pay interest if the taxpayer is entitled to a refund). Therefore, if the taxpayer loses, it can end up with a hefty tax bill. Aside from monetary costs, court litigation also involves time and effort.

Timeline

In general, when seeking judicial relief, it will take years before the case can be resolved with finality. If the taxpayer does not obtain a favourable judgment, the interest on the deficient taxes continues to accumulate while the case is pending. This goes together with the cost-benefit analysis to be conducted by the taxpayer in deciding which course of action to pursue.

It is generally better to settle the deficient taxes at the audit stage if the claim is indefensible or, even if it is defensible, if the cost of litigation exceeds the proposed assessment.

Strength of the Case

During the course of the tax audit, and before seeking judicial relief, the taxpayer must evaluate the legal and factual bases of its case. The taxpayer must not only provide legal arguments, it should also be able to substantiate these arguments with facts based on documents or the testimonies of witnesses. While the taxpayer's position may be legally sound and correct, there is always a risk that the taxpayer may lose the case for failure to present sufficient evidence to warrant a favourable ruling.

Possibility of Settlement

The taxpayer may also wish to consider exploring settlement. A mediation and compromise settlement may sometimes be a win-win situation for both parties, not only financially, but also with regard to the speedy disposition and termination of the case.

Contributed by: Russel L. Rodriguez, Ronald Mark C. Lleno, Mark Xavier D. Oyales and Hallin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan

SyCip Salazar Hernandez & Gatmaitan (SyCipLaw) is a full-service law firm and one of the largest in the Philippines. The firm's tax department consists of 26 lawyers (14 partners, one of counsel, one special counsel and ten associates), a third of whom are certified public accountants, and is headed by Ms Carina C. Laforteza, who is a partner and a certified public accountant. SyCipLaw's tax department provides the entire range of tax services, from

advising on, and structuring, the tax aspects of corporate transactions to administrative and judicial litigation in relation to tax refunds and defending clients against assessments for national and local taxes and customs duties, including in respect of safeguarding measures cases before the Department of Trade and Industry and the Tariff Commission. The firm also assists its corporate clients in obtaining rulings and with compliance requirements.

AUTHORS



Russel L. Rodriguez is a partner at SyCipLaw. He specialises in taxation, litigation, and employment law. Mr Rodriguez is also an expert in customs and maritime law. His

tax work covers various practice areas, from disputing tax assessments at the Bureau of Internal Revenue, the Bureau of Customs, the Court of Tax Appeals and the Supreme Court; to tax structuring in relation to transfer of employees and applications for preferential duty rates under treaties and trade agreements signed by the Philippines. He has handled a broad range of cases involving real property tax, customs duties, tariff classifications, and seizure and detention.



Ronald Mark C. Lleno is a partner at SyCipLaw who specialises in litigation, including tax and employment law litigation. He is an experienced litigator, which enables him to

assist clients in tax assessment matters from the administrative to the judicial level. Mr Lleno litigates tax cases before the Bureau of Internal Revenue and all levels of the Philippine judiciary, including the Regional Trial Courts, the Court of Tax Appeals and the Supreme Court. He also handles criminal tax investigations and cases against corporate officers and directors before the Department of Justice and real property tax cases before the Central Board of Assessment Appeals.

PHILIPPINES LAW AND PRACTICE

Contributed by: Russel L. Rodriguez, Ronald Mark C. Llano, Mark Xavier D. Oyales and Hailin DG. Quintos, SyCip Salazar Hernandez & Gatmaitan



Mark Xavier D. Oyales is a senior associate at SyCipLaw. He is a tax lawyer and is part of the firm's various corporate practice groups. He handles complex corporate transactions

involving infrastructure, aviation finance, retail and M&A. He assists clients in availing themselves of tax treaty benefits and of tax incentives from the Philippine Economic Zone Authority. He has advised on tax structuring for foreign investments and acquisitions. He handles cases involving deficiency tax assessments with the Court of Tax Appeals and the Supreme Court and also assists in real property tax cases filed with the Local Board and Assessment Appeals.



Hailin DG. Quintos is a senior associate at SyCipLaw and is a certified public accountant. She is a tax lawyer and has worked on the tax aspects of acquisitions and corporate

restructuring. She has assisted clients in their applications for tax treaty relief and for tax exemptions, and registrations with the Philippine Economic Zone Authority. She also represents clients in disputed tax assessments, including those involving real property taxes, at the administrative level and at the appellate level, before the Court of Tax Appeals and the Supreme Court. Her practice also includes foreign investments, M&A, restructuring and corporate housekeeping.

SyCip Salazar Hernandez & Gatmaitan

SyCipLaw Center
105 Paseo de Roxas
Makati City 1226
Metro Manila
Philippines

Tel: +632 8982 3500
Fax: +632 8817 3570
Email: sshg@syciplaw.com
Web: www.syciplaw.com

The logo for SyCip Salazar Hernandez & Gatmaitan, featuring the firm's name in a serif font with horizontal lines above and below the text.

SYCIP
SALAZAR
& HERNANDEZ
GATMAITAN

Law and Practice

Contributed by:

*Sławomir Łuczak, Karolina Gotfryd and Ewelina Calczyńska
Sołtysiński Kawecki & Szlęzak see p.524*



CONTENTS

1. Tax Controversies	p.507	5.3 Judges and Decisions in Tax Appeals	p.513
1.1 Tax Controversies in this Jurisdiction	p.507	6. Alternative Dispute Resolution (ADR) Mechanisms	p.514
1.2 Causes of Tax Controversies	p.507	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.514
1.3 Avoidance of Tax Controversies	p.507	6.2 Settlement of Tax Disputes by Means of ADR	p.514
1.4 Efforts to Combat Tax Avoidance	p.508	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.514
1.5 Additional Tax Assessments	p.508	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.514
2. Tax Audits	p.509	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.515
2.1 Main Rules Determining Tax Audits	p.509	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.515
2.2 Initiation and Duration of a Tax Audit	p.509	7. Administrative and Criminal Tax Offences	p.515
2.3 Location and Procedure of Tax Audits	p.509	7.1 Interaction of Tax Assessments with Tax Infringements	p.515
2.4 Areas of Special Attention in Tax Audits	p.510	7.2 Relationship between Administrative and Criminal Processes	p.516
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.510	7.3 Initiation of Administrative Processes and Criminal Cases	p.516
2.6 Strategic Points for Consideration during Tax Audits	p.510	7.4 Stages of Administrative Processes and Criminal Cases	p.516
3. Administrative Litigation	p.510	7.5 Possibility of Fine Reductions	p.517
3.1 Administrative Claim Phase	p.510	7.6 Possibility of Agreements to Prevent Trial	p.517
3.2 Deadline for Administrative Claims	p.511	7.7 Appeals against Criminal Tax Decisions	p.517
4. Judicial Litigation: First Instance	p.511	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.518
4.1 Initiation of Judicial Tax Litigation	p.511	8. Cross-Border Tax Disputes	p.518
4.2 Procedure of Judicial Tax Litigation	p.511	8.1 Mechanisms to Deal with Double Taxation	p.518
4.3 Relevance of Evidence in Judicial Tax Litigation	p.512	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.518
4.4 Burden of Proof in Judicial Tax Litigation	p.512		
4.5 Strategic Options in Judicial Tax Litigation	p.512		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.513		
5. Judicial Litigation: Appeals	p.513		
5.1 System for Appealing Judicial Tax Litigation	p.513		
5.2 Stages in the Tax Appeal Procedure	p.513		

8.3	Challenges to International Transfer Pricing Adjustments	p.518	10.5	Existing Use of Recent International and EU Legal Instruments	p.520
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.518	10.6	New Procedures for New Developments under Pillar One and Two	p.520
8.5	Litigation Relating to Cross-Border Situations	p.519	10.7	Publication of Decisions	p.521
9.	State Aid Disputes	p.519	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.521
9.1	State Aid Disputes Involving Taxes	p.519	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.521
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.519	11.	Costs/Fees	p.521
9.3	Challenges by Taxpayers	p.520	11.1	Costs/Fees Relating to Administrative Litigation	p.521
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.520	11.2	Judicial Court Fees	p.521
10.	International Tax Arbitration Options and Procedures	p.520	11.3	Indemnities	p.522
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.520	11.4	Costs of ADR	p.522
10.2	Types of Matters that Can Be Submitted to Arbitration	p.520	12.	Statistics	p.522
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.520	12.1	Pending Tax Court Cases	p.522
10.4	Implementation of the EU Directive on Arbitration	p.520	12.2	Cases Relating to Different Taxes	p.522
			12.3	Parties Succeeding in Litigation	p.523
			13.	Strategies	p.523
			13.1	Strategic Guidelines in Tax Controversies	p.523

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In Poland, tax controversies arise in various ways. Generally, they are detected during tax audits, tax proceedings, and customs and tax audits conducted by the tax authorities. Tax controversies also usually arise because of submitting tax returns late or failing to submit a tax return. It should be added that tax controversies of an individual taxpayer may arise due to:

- information provided by another tax authority (including foreign tax authorities); or
- information appearing in internal systems to which the tax authorities have access.

1.2 Causes of Tax Controversies

Generally, value added tax (VAT), corporate income tax (CIT), and personal income tax (PIT) give rise to most tax controversies in Poland.

According to the Polish Ministry of Finance, from January to November 2021, the National Fiscal Administration conducted:

- 11,912 tax audits – the value of tax evasion was PLN2.17 billion;
- 2,485 customs and tax audits – the value of tax evasion was PLN5.04 billion; and
- 2,271,427 tax checks – the value of tax evasion was PLN3.99 billion.

The Polish tax system is affected by a high level of variability. Almost a third of all tax regulations are changed during the calendar year. The most frequent changes of legislation occur in the acts regarding PIT, CIT, and VAT. Hence, most tax controversies arise regarding these taxes. Since their introduction in the 1990s, the PIT, CIT, and VAT acts have been amended hundreds of times.

1.3 Avoidance of Tax Controversies

Tax law in Poland is complex and is subject to constant change. To avoid tax controversy, the taxpayer should implement internal procedures to minimise tax risk, including verifying business partners before doing business. It is important for taxpayers to constantly monitor changes in tax legislation.

Non-binding Tax Information from the National Tax and Customs Information Office

If a taxpayer has doubts regarding the proper application of tax laws and tax and customs information, it is possible to contact the National Tax and Customs Information Office by telephone to obtain free information related to the taxpayer's tax obligations. However, the information provided by the National Tax and Customs Information Office is not binding on the taxpayer.

Binding Tax Ruling

Moreover, taxpayers may also apply for a binding tax ruling on whether any planned or actual taxpayer actions, arrangements, or transactions comply with Polish tax law.

If a tax ruling is issued, tax authorities may not challenge the tax settlements of a taxpayer following the letter of the ruling. Confirmation of a taxpayer's standpoint protects a taxpayer from criminal liability and from the obligation to pay interest on tax arrears in cases where the tax authority changes its point of view on that particular matter.

Further, the biggest advantage of an individual tax ruling is that it may protect a taxpayer from paying tax in circumstances where the taxable event has not already taken place.

It is possible to appeal to the Provincial Administrative Court if the tax ruling is unfavourable to the taxpayer.

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Calczyńska, Sołtysiński Kawecki & Szlęzak

An application for a tax ruling may be submitted jointly by two or more taxpayers participating in the same transactions or events.

The tax authority should issue an individual tax ruling without undue delay, but no later than within three months. Currently, the provisions of the acts introduced due to COVID-19 have extended this deadline to six months.

A Protective Opinion under GAAR

The taxpayer has a right to apply for a protective opinion which confirms that there is no danger of GAAR's application regarding a planned transaction, action, or arrangement. The fee for obtaining such an opinion is much more costly than for obtaining an individual tax ruling (a tax ruling costs PLN40, a protective opinion PLN20,000).

Binding Rate Information

From 1 November 2019, it has been possible to apply to the Director of the National Revenue Information System for Binding Rate Information which confirms the correctness of the applied VAT rate. Binding Rate Information has been applicable since 1 July 2020 when the VAT matrix regulations entered into force.

1.4 Efforts to Combat Tax Avoidance

Poland has already implemented various OECD BEPS recommendations to combat tax avoidance, eg, CFC rules, CbCR rules, new TP documentation rules, limitation on the deductibility of interest, IP/Innovation Box, and MDR notification.

The Polish tax administration's activities aim to combat tax fraud. Poland is firmly focused on eliminating the remaining loopholes in the Polish tax system by amending existing provisions and introducing various regulations, eg, exit tax or stricter rules for controlled foreign companies (CFC), new requirements for transfer pricing documentation, or reporting tax schemes

(Mandatory Disclosure Rules – MDR). These measures are taken to prevent tax base erosion and profit shifting, aggressive tax optimisation, indirect tax fraud, and tax leakages caused by all the above.

It is worth adding that the Polish tax administration is now more focused on TP issues than in the past by challenging the arm's-length character of the transaction. Tax authorities are increasingly identifying harmful tax schemes in the activities of large multinational corporations in connection with the obligations imposed by the MDR legislation.

In this regard, the BEPS recommendations do have a substantial impact on the Polish government's tax policies and have led to increasing numbers of tax controversies in Poland.

1.5 Additional Tax Assessments

In Polish tax law, the final decision issued by a second-instance tax authority is an enforceable decision. This means that, as a rule, the taxpayer must pay the tax liability resulting from the decision, together with interest. If the tax liability is not settled, executive proceedings may be initiated against the taxpayer. A taxpayer may avoid executive proceedings by filing the following to the court:

- an application to suspend the enforcement of a decision;
- a request to defer the payment of a tax liability and interest until the case is finally resolved; or
- a request for tax liability and interest to be paid in instalments.

To obtain a deferment of payment/be permitted to pay in instalments, the taxpayer's interest or the public interest must be proved. This relief is granted as *de minimis aid*.

In any event, it is possible to appeal to a Provincial Administrative Court against the final decision issued. A taxpayer is not obliged to pay or guarantee the tax assessed to be able to lodge an administrative claim.

Criminal Filing Made against the Taxpayer

In connection with initiating tax proceedings against a taxpayer, criminal and fiscal proceedings may also be initiated at the same time.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Tax authorities may verify if a taxpayer has properly applied tax law. In Poland, there are no clear criteria given by the tax authorities that cause a tax audit to be initiated. As a rule, the tax authorities are free to decide whether to initiate a tax audit.

2.2 Initiation and Duration of a Tax Audit

A tax audit is initiated to check whether the taxpayer is complying with its obligations under Polish tax law.

The tax authorities are obliged to notify a taxpayer that a tax audit has been planned. The tax audit is initiated no earlier than after seven days and no later than after 30 days from the date of the delivery of the notice on the intention to initiate the tax audit. If the tax audit is not initiated within 30 days of the date of the notice, a new notice is required to initiate the tax audit. In certain circumstances, a tax audit may be conducted without prior notification (eg, where a fiscal or commercial offence has been committed).

The tax audit must be conducted within the period indicated in the authorisation (ie, a document authorising the tax authority to initiate a tax audit). Under the Business Act, the duration

of all audits of a business entity conducted during a single calendar year may not exceed the following:

- micro-enterprises – 12 business days;
- small enterprises – 18 business days;
- medium-sized enterprises – 24 business days; and
- large enterprises – 48 business days.

The taxpayer must be notified of any failures to complete the tax audit within the period specified in the authorisation.

Tax liability becomes time-barred after five years, counting from the end of the calendar year in which the deadline for payment of the tax expired. Commencing a tax audit does not suspend or interrupt the limitation period of a tax liability.

2.3 Location and Procedure of Tax Audits

Tax audits may occur in the tax authority's headquarters or on the taxpayer's premises. Most often, a tax audit is conducted at the audited taxpayer's registered office or another location where the business activity is performed, or at locations where documents are stored. Therefore, the audited taxpayer should be present while a tax audit is conducted.

Tax audits are based mainly on printed documents, but they may also be based on data made available electronically.

The audited taxpayer has the right to actively take part in the tax audit. In particular, the taxpayer may submit clarifications, present evidence, or demand that certain documents be considered or witnesses heard. The audited taxpayer should co-operate with the tax authority to allow it to perform its task effectively (eg,

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Calczyńska, Sołtysiński Kawecki & Szlęzak

provide access to documentation and necessary clarifications).

2.4 Areas of Special Attention in Tax Audits

Areas and matters for the tax auditors' special attention are various and depend on which tax is verified. During the tax audit, the tax authorities may verify accounting documents, invoices, and other documents. The tax authorities may extensively verify the taxpayer's compliance with tax legislation.

In particular, the tax authorities very carefully examine all types of reorganisation and restructuring operations in which they see taxpayers recognising beneficial tax effects and unjustified tax savings.

Transactions between related parties are also verified very carefully.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

At this point, it is difficult to assess whether the provisions on cross-border exchanges of information and mutual assistance between tax authorities have resulted in an increase in the number of tax audits in Poland. The Ministry of Finance has not yet published such data.

However, it is certain that international administrative co-operation may have led to an increase in the number of tax audits due to the flow of data or other information between foreign tax authorities.

A Polish tax authority may request information from a foreign tax authority and vice versa. As a result, foreign and Polish tax authorities may assist each other; this may lead to an increase in the number of tax audits.

Recently, the Polish tax authorities have co-operated with foreign tax authorities, especially in the area of VAT carousel proceedings. For a tax audit, the Polish tax authorities very often apply to a foreign tax authority with a request for information (SCAC information) regarding a foreign counterparty of a Polish company.

2.6 Strategic Points for Consideration during Tax Audits

During a tax audit, the taxpayer should co-operate with the tax authorities. In particular, the taxpayer should submit the requested documents, provide evidence, make statements, respond to summons from the authority, and participate in the inspection activities. An unjustified refusal to provide the requested documents or attempts to complicate or delay the audit may constitute a violation of that obligation.

It is advisable for the taxpayer to co-operate with the auditors, to clarify their arguments, prove the content of their documentation and declarations, and generally supply to the auditor all the information that is needed to ascertain the facts relevant for taxation.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

In most cases, tax proceedings are initiated by the tax authority when a tax audit reveals irregularities on the side of the taxpayer (eg, tax arrears, undisclosed income, or an improper tax return). Tax proceedings may also be initiated upon a taxpayer's application. There are two stages involved in tax proceedings: generally, in the first instance, the tax authority is the head of the tax office; and in the next instance (the higher instance), the tax authority is the director of the tax administration chamber.

Every tax decision made in the first instance of proceedings may be appealed and heard at the higher instance (mostly by the director of the tax chamber). To appeal a tax decision, the appeal must be submitted within 14 days of the date of the delivery of the decision. A decision is final if a taxpayer does not file an appeal within this time period, and the tax proceedings are then complete.

In cases where an appeal is submitted to the higher instance, the higher instance tax authority will settle the case, and its decision will be final and enforceable. The appeal authority may:

- accept the taxpayer's appeal and issue a new decision;
- revoke the decision of the first instance and refer the case for reconsideration;
- uphold the decision of the authority of first instance; or
- declare the appeal inadmissible.

As a general rule, an appellate body may not issue a decision to the disadvantage of an appealing party unless the decision of the first-instance body grossly violates the law or the public interest.

That final decision may be challenged by lodging a complaint to the Provincial Administrative Court.

3.2 Deadline for Administrative Claims

A case on appeal should be disposed of no later than two months from the date of receipt of the appeal by the appellate authority. The tax authority is obliged to notify the party of each case not settled on time, giving reasons for missing the deadline and indicating a new deadline to settle the case. The taxpayer does not have the right to lodge a reminder to the higher chamber if the case is not settled on time by the appeal body.

However, a taxpayer may file a complaint against the inaction of the tax authorities or the excessive length of the procedure with the Provincial Administrative Court if the case is not settled within the time limit.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Complaints against decisions and rulings (and other administrative acts) should be lodged within 30 days of the decision to the Provincial Administrative Court via the tax authority that issued the decision or ruling in the last instance. The 30-day period begins to run from the day following the day on which the taxpayer received the decision. A complaint to the court should be filed via the authority which issued the contested decision.

The right to lodge a complaint to the Provincial Administrative Court is available to any person who has a legal interest in the proceedings, eg, a public prosecutor, ombudsman, or societal organisations (mostly non-governmental organisations), within the scope of their statutory activities and in matters concerning the legal interests of other persons, if the organisation has participated in administrative proceedings. Taxpayers may represent themselves in the Provincial Administrative Court. Alternatively, they may be represented by a professional representative, eg, an attorney-at-law, an attorney, or a tax adviser.

4.2 Procedure of Judicial Tax Litigation

When a complaint is lodged, the administrative authority must turn it over to the court with the relevant files and prepare a response within 30 days of the date the complaint was lodged. The authority analyses the possibility of granting the complaint as a whole (a "self-inspection procedure"). The complaint is not particularly formal-

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

ised since it must only meet the requirements of a letter in the court proceedings.

The Provincial Administrative Court first examines the formal and legal correctness of the complaint. The complaint will be rejected when the court finds that there are formal obstacles preventing it from hearing the case. When the court finds no formal or legal deficiencies in the complaint, it will examine it. The court may:

- dismiss the complaint;
- overturn a decision in full or in part; or
- confirm the invalidity of a decision in whole or in part.

The Provincial Administrative Court rules within the limits of the case but is not bound by the claims or statements stated in the complaint or the legal grounds raised by the party (ie, a taxpayer or a tax authority).

Consequently, the court will independently assess the correctness of the tax authority's action or decision and assess the tax authority's compliance with the law. Generally, an administrative court may not alter a decision or rule on merit (ie, issue a decision instead of the tax authority) but it may instruct a tax authority to re-examine a case.

Often the ruling is issued at the first hearing. The administrative court hears cases based on the file of documents provided by the public authority.

4.3 Relevance of Evidence in Judicial Tax Litigation

The administrative court examines the case based on the case files (documents) presented by the tax authorities. Witnesses are not heard before the administrative court and neither are expert witnesses consulted (such evidence, if it was necessary to resolve the case, should

have been provided during the administrative proceedings by the tax authorities, and if it was not provided, the decision of the court is likely to be overturned). However, the court may take supplementary evidence from documents if it is necessary to clarify significant doubts and will not unduly prolong the proceedings in the case.

4.4 Burden of Proof in Judicial Tax Litigation

As Polish tax proceedings follow the principles of an official investigation, there are no statutory provisions regarding the burden of proof. This obligation results from the principle of objective truth adopted in administrative proceedings which obliges the authority to exhaustively collect and consider all the evidence, whereby it undertakes, ex officio or at the request of a party, all actions necessary to clarify the exact state of the facts and to resolve the case. That means that the tax authorities must prove all facts and circumstances necessary to justify a tax claim against the taxpayer. The taxpayer, on the other hand, is required to present their position and provide substantiated evidence against the facts presented by the tax authorities.

In a criminal tax procedure, it is always the state that is required to prove the illegality of a taxpayer's action.

4.5 Strategic Options in Judicial Tax Litigation

The strategy pursued must be adapted to each individual case, and there are no general guidelines suitable for every case. The court decides the case based on the evidence gathered by the tax authorities during the tax proceedings (all the evidence should be presented during the tax proceedings). Legal arguments may be presented during the judicial case.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

In addition to domestic case law, Polish courts take into consideration case law from the European Court of Justice and the European Court of Human Rights. International guidelines, eg, the OECD Transfer Pricing Guidelines or the OECD Model Tax Convention, are usually followed by the tax authorities and may also be used as grounds to support argumentation in tax court proceedings.

- a violation of substantial law owing to an erroneous interpretation or incorrect application of law; or
- a breach of procedural regulations.

if that infringement may have seriously affected the outcome of a particular case. The cassation appeal may not be based on any irregularity in the proceedings but only on the infringements that may possibly affect the content of the decision.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The structure of administrative courts in Poland consists of two levels: Provincial Administrative Courts as courts of lower instance and the Supreme Administrative Court as the court of higher instance. There are 16 administrative courts of lower instance, and one Supreme Administrative Court which has its seat in Warsaw.

A judgment of the Provincial Administrative Court may be challenged by a complaint to the Supreme Administrative Court (signed by an attorney, an attorney-at-law, or a tax adviser). Leave to appeal does not depend on the value of the case or on the nature of the controversy.

5.2 Stages in the Tax Appeal Procedure

A cassation appeal is lodged via the Provincial Administrative Court that issued the judgment within 30 days of being served the judgment together with a justification. The cassation appeal may only be based on strictly defined grounds, namely:

The counterparty (who has not filed the cassation appeal) may file a written response to the cassation appeal within 14 days of being served the cassation complaint.

If the complaint fulfils the requirements, the hearing before the Supreme Administrative Court cassation appeal is scheduled. However, obtaining a hearing date may take up to two-and-a-half years from submitting the cassation appeal.

5.3 Judges and Decisions in Tax Appeals

In the first instance and in cassation proceedings, the case is decided by a panel of three judges, one of which is a reporting judge. The administrative court sits with a single judge in a closed session.

A judge may be excluded from the court hearing by law, at the judge's own request, or by a party's request.

Judges are selected randomly by the chairperson of the judicial division.

When the case is referred back to the court for reconsideration, the chairperson of the judicial division orders that the panel of the court will be determined by drawing lots.

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

The Provincial Administrative Court collegium, on the motion of the court president, assigns judges and court referees to judicial departments and determines the detailed rules for assigning cases to judges and entrusting court referees.

Generally, supervision of the Provincial Administrative Court is performed by the president of the Supreme Administrative Court, vice-presidents, and other judges and employees of this court, as well as by presidents of Provincial Administrative Courts, vice-presidents, and division presidents of these courts.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Alternative dispute resolution is not widely used in disputes between taxpayers and the tax authorities. There are no general provisions pertaining to the mutual agreement procedure (MAP) in the Polish Tax Ordinance Act. The MAP is present only within bilateral tax treaties between countries.

Polish law on proceedings before administrative courts provides only one specific procedure in proceedings before the administrative courts: mediation. Mediation is allowed only when an appeal has been filed with the administrative court, and may be conducted at the request of a complainant or the authority. It is also possible that mediation is initiated *ex officio*. The deadline for filing a request for mediation is the date of the hearing. As a rule, mediation should be conducted during a single court session. If the mediation ends in failure and the parties fail to agree on a common position, the case will be resolved through the standard procedure (ie, it will be referred to a hearing).

When a dispute is effectively settled at mediation, there are two possible outcomes: the court proceedings are discontinued because of the withdrawal of the appeal, or the mediation arrangements may provide an obligation for the administrative authority to verify its decision.

The administrative authority is free to choose how it will proceed within the scope of the performance of the mediation. Therefore, a complainant has no influence on the application of such arrangements. Nevertheless, it is possible to file an appeal to a Provincial Administrative Court against the act or measures taken by the authority as a result of the mediation within 30 days.

However, mediation is not a widely used mechanism in the administrative judiciary.

6.2 Settlement of Tax Disputes by Means of ADR

As previously stated, there are no domestic ADR mechanisms available in Poland.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

No agreement may be reached outside the scope of an administrative complaint procedure or litigation.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

The taxpayer is entitled to obtain:

- a tax ruling; and
- binding tax rate information.

There is also an investment agreement which is reserved for investors who plan or have started an investment within the territory of the Republic of Poland worth PLN100 million (PLN50 million starting from 2025).

Tax Ruling

A tax ruling presents the tax authorities' standpoint of the application of a tax law (a specific article) to a situation presented by a taxpayer. A taxpayer may file a motion to issue such a ruling (individual tax ruling), or the Ministry of Finance may issue a general tax ruling applicable to all taxpayers.

A tax ruling is binding upon the tax authorities but not on a taxpayer. In other words, as a rule, tax authorities may not challenge the tax settlements of a taxpayer that is following the letter of the ruling. Confirmation of a taxpayer's standpoint protects a taxpayer from criminal liability and from the obligation to pay interest on tax arrears in cases where the tax authority changes its point of view on that particular matter.

From 2019, the tax authorities may revoke individual tax rulings obtained in the past if they aimed to circumvent the law or if they allowed optimisation measures to be taken in an artificial way or without economic justification and, in consequence, allowed the taxpayer to obtain a tax advantage. This means that, in many cases, the obtained individual tax rulings will no longer grant protection to those taxpayers. Moreover, the subject of the request for interpretation may not be the provisions to prevent tax avoidance which relate, inter alia, to: GAAR; abuse of law in VAT; conduct of actual activity (CFC); measures limiting contractual benefits; specific anti-abuse rules (SAARs), etc.

If the taxpayer obtains an unfavourable tax ruling, it may appeal to the Provincial Administrative Court.

Binding Tax Rate Information

From 1 November 2019, it is possible to apply to the Director of the National Revenue Information System for Binding Rate Information (BRI) which confirms the correctness of the applied VAT rate.

The BRI has been applicable since 1 July 2020 when the VAT matrix regulations entered into force. The BRI grants taxpayers tax and penal-fiscal protection if the correctness of the applied VAT rate is challenged during a potential tax audit or tax proceedings.

6.5 Further Particulars Concerning Tax ADR Mechanisms

As previously stated, there are no domestic ADR mechanisms available in Poland.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

There is no ADR mechanism specifically for transfer pricing that is different from those described in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

In the Polish tax law system, a taxpayer may be subject to both criminal and administrative liabilities at the same time. However, the procedures and principles under which liability is determined take place under different procedures. Criminal penalties are imposed solely by the criminal divisions of the common courts, whereas administrative tax penalties are imposed by the tax authorities.

Administrative penalties in Polish tax law are not legally defined in any legal act. The prerequisites for being sanctioned with administrative penalties are determined in tax law acts. However, the legal basis for proceedings is the Polish Tax Ordinance Act. Polish tax law recognises many examples of administrative penalties, eg, higher (sanction) tax rates or an additional tax obligation.

For tax offences, the relevant prerequisites and elements are determined in the Penal and Fiscal Code. Procedure and execution are based on the Criminal Procedure Code and on the Enforcement of Penalties Code, respectively. The initiation of the preparatory procedure is conditional upon a justified suspicion that a tax offence has been committed. The pre-trial proceedings are conducted mostly by the fiscal authorities.

Criminal penalties for fiscal offences are imposed by courts only. Administrative courts play no role in determining the criminal liability for tax offences.

Criminal (penal-fiscal) proceedings are separate from tax proceedings. Hence, the issuance of a tax assessment decision does not automatically mean that penal-fiscal proceedings will be initiated.

7.2 Relationship between Administrative and Criminal Processes

Criminal (penal-fiscal) proceedings take place independently of tax proceedings. In penal-fiscal proceedings, the provisions of the Polish Tax Ordinance Act are not applicable, but those of the Penal and Fiscal Code and the Criminal Procedure Code are. Therefore, it is not for the tax authorities within the tax proceedings or the administrative courts to assess whether a fiscal offence has been committed.

Penal-fiscal proceedings may be suspended in a situation where, due to a pending tax procedure, tax inspection, or pending procedure before tax or customs authorities, or administrative courts, the conduct of such proceedings is significantly impeded. This means that the authority is not obliged to suspend it. In practice, if penal-fiscal proceedings are already initiated during tax proceedings, the prosecuting authority suspends these proceedings. Tax case files are of great importance in a criminal case as they usually

constitute the majority of evidence based on which the fiscal penal proceedings are conducted.

7.3 Initiation of Administrative Processes and Criminal Cases

The tax authorities, after tracing the irregularities within the tax proceedings, are obliged to apply administrative sanctions (if such is provided by the law) in the dimension prescribed in a tax regulation. Administrative penalties are imposed within the same proceedings in which the tax authority has determined the tax liability.

Regarding criminal (penal-fiscal) litigation, the initiation of the preparatory procedure is conditional upon a justified suspicion that a tax offence has been committed. The competent authority that initiates and conducts the preliminary investigation is generally the tax office. The perpetrator has the position of a suspect within the preparatory procedure and the defendant within the court procedures (main hearing).

As criminal proceedings are separate from tax proceedings, the administrative infringement process (tax procedure) may not evolve into a criminal tax case. However, “regular” tax audits may lead to the initiation of fiscal criminal proceedings, and therefore potentially to conducting further fiscal criminal audits, ie, these proceedings may run in parallel.

7.4 Stages of Administrative Processes and Criminal Cases

Tax Administrative Cases

Administrative penalties are imposed in tax proceedings regulated in the Polish Tax Ordinance Act. There are two stages involved in tax proceedings. The decision imposing a tax liability/administrative sanction may be appealed to the higher tax authority. Then, the final tax decision may be challenged by appeal to the Provincial Administrative Court. Next, the judgment of

the Provincial Administrative Court may be the object of an extraordinary appeal to the Supreme Administrative Court.

Criminal Tax Cases

The competent authority to initiate and conduct the preparatory proceedings is generally the tax office. The indictment is approved and filed by the public prosecutor. Criminal penalties for fiscal offences are imposed by courts only. The competent courts for hearing criminal law cases are the common courts: the District Courts, Provincial Courts, and Courts of Appeal. The Supreme Court examines cassations (extraordinary appeals). Criminal cases are led by the criminal divisions of the aforementioned courts. The Provincial Administrative Courts and Supreme Administrative Court play no role in determining criminal liability for fiscal crimes.

7.5 Possibility of Fine Reductions

Tax liability (including the additional tax assessment) is not deductible from the fine applicable to the corresponding fiscal offence.

However, the penal-fiscal procedure provides for the use of various consensual instruments encouraging the co-operation of the suspect/defendant with the authorities and offering them various advantages in return.

Among these instruments is a voluntary disclosure letter (self-disclosure) under the Penal and Fiscal Code which is a declaration on committing a prohibited act. Due to the voluntary disclosure letter, a taxpayer may avoid the negative consequences of negligence if the tax authority has no knowledge of the committed offence. One of the conditions for using the voluntary disclosure letter is the payment in full of the amount due within the time limit set by the competent tax authority.

Furthermore, the court may refrain from imposing a penalty if, prior to commencing proceed-

ings for a fiscal misdemeanour consisting of a persistent failure to pay tax on time, the due tax has been paid in full to the competent tax authority.

Payment of the amount due in full within the prescribed period is also part of other consensual instruments in penal-fiscal proceedings, eg, the voluntary submission to criminal liability.

7.6 Possibility of Agreements to Prevent Trial

In criminal law, only courts impose penalties. Therefore, it is not possible to enter into an agreement with the tax authority conducting the preparatory proceedings without a court ruling.

The Penal and Fiscal Code provides for the institution of a conviction without a trial. This measure consists of an agreement between a suspect and a public prosecutor or an authority conducting preparatory proceedings on the penalty or penalty measure that would be imposed by the court. The submission of an appropriate request is conditioned by the undoubted circumstances of having committed a prohibited act, and that the perpetrator's conduct indicates that the objectives of the proceedings will be achieved. The conviction without a trial is enclosed with the indictment.

The above form of completion of the proceedings shortens their duration. Furthermore, thanks to a conviction without a trial, the perpetrator may be treated more leniently. However, it is still the court that decides on the penalty.

7.7 Appeals against Criminal Tax Decisions

The first-instance judgment may be appealed to the Provincial Court or Appeal Court. The time limit for the appeal is 14 days running from the date the judgment is served with the statement of reasons.

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

A cassation appeal may be filed against a final judgment to the Supreme Court. The time limit to file a cassation appeal by the parties is 30 days from the date on which the judgment with the statement of reasons was served.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Under the Polish Tax Ordinance Act, when issuing a decision with the application of the measures limiting contractual benefits, SAARs, incorrect withholding tax (WHT) statements, or transfer pricing regulations, the tax authority determines the additional tax liability corresponding to a fraction of the tax advantage found in the proceedings (ie, in the range of 10% to 80% of the tax benefit). The additional tax liability is applied automatically within the standard tax procedures.

The above additional tax liability does not apply to an individual who is liable for a fiscal offence for the same act.

By evading tax, the taxpayer is exposed to criminal or penal liability for failing to pay the tax which they were obliged to pay. The circumstances of each case involving the application of GAAR, SAAR, transfer pricing rules, or anti-avoidance rules are analysed in terms of whether there is a justified suspicion that a tax offence has been committed; this is a prerequisite to initiating preparatory proceedings. Therefore, in situations of this type, the competent authority always verifies whether the conditions for initiating penal-fiscal proceedings have occurred.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Whether cross-border double taxation is remedied by means of domestic litigation or an available mechanism under the respective double taxation treaty, if any, will depend entirely on the specifics of the case at hand.

MLI or EU Tax Disputes Directive solutions have not yet emerged in practice, but are expected to become a more common option for how to resolve international tax disputes in the future.

8.2 Application of GAAR/SAAR to Cross-Border Situations

GAARs or SAARs have become commonly used in Poland, though mostly in domestic situations.

As for the principal purpose test (PPT) introduced with the MLI, this is yet to enter into force for many of the major Polish double tax treaties and it remains to be seen how it will affect the way Polish tax authorities combat BEPS in cross-border situations.

8.3 Challenges to International Transfer Pricing Adjustments

There is no official data available in this respect. However, transfer pricing adjustments are most-ly challenged under domestic litigation.

8.4 Unilateral/Bilateral Advance Pricing Agreements

In Poland, APA may be concluded since 2006; however, due to lengthy/protracted proceedings and a negligible percentage of entities that finally received a positive decision, this instrument quickly became understood as very hard to get, and as such, is unpopular. Indeed, by the end of 2016, only 39 unilateral agreements in total were signed. However, due to legislative chang-

es in the area of TP in 2019, we can observe an increase in the popularity of and interest in APA. In 2021, there were 96 unilateral and five bilateral APAs concluded.

Applying for an APA is a long process as the whole procedure requires collecting all the necessary documentation, preparing a comprehensive application, and presenting the proper justification of the transaction conditions applied. Usually, an exchange of additional correspondence and information is also required, as well as the incurring of a relatively high fee. The application is submitted to the relevant department, usually after a prior meeting at the Ministry of Finance (but this is not formally necessary). After filing an application, affiliated entities are expected to present a methodology for determining the transfer price to the tax administration.

8.5 Litigation Relating to Cross-Border Situations

Although there is no official data available, the highest rates of cross-border tax litigation cover transfer pricing and withholding tax. Litigation also involves PE&FE assessments, or the supply chain of goods involved in VAT fraudulent activities.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

As Polish law provides for certain state aid regarding taxes, especially during the COVID-19 pandemic (eg, allowing one to file an application to pay tax in instalments or to redeem the interest on tax due), there is no official record of disputes in this regard.

However, as an example of a high-end state aid dispute involving taxes, we should mention the ruling from 2021 of the Grand Chamber of the CJEU on the so-called trade tax in Poland.

Revenue exceeding a certain ceiling was to be taxed. According to the European Commission, the new tax introduced by Poland constituted an illegal aid measure for some entrepreneurs, hitting larger entities, often of foreign origin. The CJEU disagreed with such reasoning. The EU court emphasised that such a progressive taxation system may constitute prohibited state aid in a situation where it favours certain entrepreneurs or groups of entrepreneurs. However, in this case, the CJEU stated that the Commission, which is obliged to prove the existence of prohibited state aid, failed to prove the existence of such a selective advantage. It was wrong for the Commission to take as its point of reference an “ideal” system in which Polish vendors pay the same tax irrespective of the amount of revenue they receive.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

In accordance with the provisions of Council Regulation (EU) No 2015/1589 of 13 July 2015 laying down detailed rules for the application of Article 108 of the Treaty on the Functioning of the European Union (referred to as the Aid Regulation), if it is confirmed that an unauthorised aid measure has been applied, the European Commission issues a decision ordering the recovery of the aid received, with interest due from the date of payment of the aid until the date of its actual recovery. The beneficiary may appeal against the Commission decision to the CJEU. Obtaining undue state aid or using the aid received in a manner inconsistent with its intended use which puts public finances at risk also constitutes a fiscal offence.

Also, if the European Commission considers that Poland has unlawfully granted state aid in the form of tax advantages, it will give a reasoned opinion on the matter after giving the country the opportunity to submit its comments. In the meantime, the Commission may apply interim

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

measures during the procedure, eg, a suspension injunction or a recovery injunction.

If Poland does not comply with the opinion within the time limit laid down by the Commission, the latter may decide to refer the case to the CJEU. The Council of the European Union may take a decision in a specific situation concerning the verification of state aid if a member state so requests.

9.3 Challenges by Taxpayers

Over the past year, Polish taxpayers have not raised this issue in court cases. However, in 2020, an interesting case on the controversial tax treatment of wind farms in Poland for 2017 came before the Supreme Administrative Court. The Court, relying on the CJEU's interpretation, indicated that even granting unlawful public aid (not notified to the European Commission) by a member state does not entitle the victim of such aid to demand that the aid be extended to it. The possible illegality of a tax exemption, in light of the provisions in the area of state aid, does not affect the legality of the tax itself in such a way that enterprises obliged to pay the tax may not plead before the national court that the exemption granted is unlawful to avoid its payment or obtain its refund.

9.4 Refunds Invoking Extra-Contractual Civil Liability

The Polish Tax Ordinance Act consists of an independent institution of the State Treasury's liability for damages for issuing an unlawful tax decision.

Unfortunately, in practice, the State Treasury's liability for damages is extremely difficult to prove before Polish courts. This is illustrated by the fact that, in 2020, total compensation awarded amounted to PLN210,000 (around EUR45,000) with 159 cases pending.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Poland did not opt to apply Part VI of the MLI.

10.2 Types of Matters that Can Be Submitted to Arbitration

As mentioned previously, the arbitration solutions have not yet been recognised by the Polish authorities. Therefore, there is no policy regarding this issue and the related solutions indicated in the MLI.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Due to not implementing the provisions of Part VI of the MLI, these instruments are not applicable in tax disputes in Poland.

10.4 Implementation of the EU Directive on Arbitration

The assumptions of the Directive on tax dispute resolution mechanisms in the European Union were implemented in Poland in 2019. One of the most significant measures introduced into Polish jurisdiction is the Procedure for resolving disputes concerning double taxation between European Union member states (DRM).

10.5 Existing Use of Recent International and EU Legal Instruments

The MLI and the EU Arbitration Directive are very recent and no reliable information is available yet.

10.6 New Procedures for New Developments under Pillar One and Two

It should be noted that Poland was one of the countries that, on 1 July 2021, issued a joint

statement on the desire to develop new common principles of taxation, including places of income taxation and a global minimum tax. Recent changes in Polish tax law also indicate a high interest in the presented assumptions. At this stage, it is also difficult to say whether BEPS objectives will be effective regarding the domestic tax system.

10.7 Publication of Decisions

Because Poland has decided not to apply the provisions of the MLI concerning arbitration regarding the DTT, such decisions are not published.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Currently, international tax disputes are still generally settled under mutual agreement procedures or, more commonly, under domestic procedure rules in a litigation procedure between taxpayers and the state.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Due to the overall complexity of international tax law matters subject to arbitration proceedings, it is generally highly advisable for taxpayers to obtain professional legal advice (either from an attorney, attorney-at-law, or tax adviser).

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

There is a distinction between administrative fees and costs in tax proceedings. As a rule, the tax authorities do not have influence on the fees to be charged; they are most often determined under the Act of 16 November 2006 on stamp duty. Conversely, costs in tax proceedings are

fixed by the authorities based on the expenditure incurred in connection with the conduct of the proceedings.

In principle, the costs of administrative proceedings (also tax proceedings) are the responsibility of the tax authority conducting the proceedings to the extent that it fulfils its statutory obligations, eg, to conduct evidence proceedings as part of the ongoing administrative proceedings. As a rule, the costs of proceedings before the tax authorities are incurred by the State Treasury, voivodeship, county or district. This leads to the conclusion that these costs will not apply to a controlled taxpayer (during a tax audit or investigative proceedings). These concern, in particular:

- travel expenses and other receivables of witnesses;
- expert and translator costs;
- costs of inspections; and
- costs of delivering official letters.

A taxpayer, on the other hand, may be charged with the costs of administrative proceedings that result from the taxpayer's fault or are incurred in their interest or at their request.

The Polish tax authorities do not charge administrative fees for lodging an appeal.

11.2 Judicial Court Fees

In principle, court proceedings involve costs. Court costs include fees (an entrance fee) and expenses (eg, translation expenses). The court costs must be paid by the taxpayer party who has filed a complaint for which the fees are due or expenses incurred. If the due fee is not paid, the court requests payment within one week. Otherwise, the case will be dismissed. The amount of the fee is based on a percentage of the amount in dispute (this may range from PLN100 to PLN100,000) or, in some cases, the

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Calczyńska, Sołtysiński Kawecki & Szlęzak

amount is provided for as a fixed fee (this may range from PLN100 to PLN10,000).

The entrance fee for a cassation complaint amounts to half of the complaint entrance fee; however, not less than PLN100.

The costs of the proceedings (fees, expenses, and attorney's fees) are borne by the party that loses the proceedings. This means that there is an obligation (and this is stated in the judgment) that the losing side will reimburse the costs previously advanced by the winning party at the end of the proceedings.

11.3 Indemnities

The provisions of the Polish Tax Ordinance Act, within the scope of liability for damages, refer to the provisions of civil law. Hence, it is possible to seek compensation for damage caused in civil proceedings.

Additionally, the taxpayer will receive a refund of tax already paid and may claim interest.

11.4 Costs of ADR

If a taxpayer opts for mediation before the administrative court, the costs are usually lower than during traditional judicial litigation.

The costs of remuneration and the reimbursement of expenses incurred in conducting the mediation should be paid by the parties.

According to the Ordinance of the Minister of Internal Affairs and Administration of 2 June 2017 on the amount of the mediator's remuneration and reimbursable expenses in the proceedings before the administrative court in cases in which the subject matter of the appeal is a pecuniary sum, the mediator's remuneration is 1% of the value of the subject matter of the appeal, but not less than PLN150 and not more than PLN2,000 for the entire mediation proceedings.

The regulation also specifies the fixed amounts of the mediator's remuneration in other cases.

12. STATISTICS

12.1 Pending Tax Court Cases

In the Supreme Administrative Court, according to the data provided for 2021, there are 13,393 tax cases remaining to be heard for the next period. In addition, further cases are received for cognisance on an ongoing basis.

More detailed statistics have not been published.

12.2 Cases Relating to Different Taxes

In 2021, the Supreme Administrative Court received 26,778 cassation complaints (of which the Finance Chamber received 9,194) and 128 complaints regarding the resumption of proceedings, of which:

- 2,185 concerned VAT;
- 2,002 concerned real estate tax;
- 1,037 concerned PIT;
- 1,001 concerned the execution of pecuniary benefits;
- 618 concerned the tax liability of third parties or tax reliefs;
- 449 concerned CIT;
- 436 concerned excise duties;
- 402 concerned transfer tax; and
- 175 concerned inheritance and donation tax.

Among the cassation complaints registered in 2021, complaints against individual interpretations issued by the Minister of Finance, WHT opinions, and Binding Rate Information accounted for 11,120 cases.

Statistics on the value of cases before the Supreme Administrative Court have not been published.

12.3 Parties Succeeding in Litigation

In 2021, at a public hearing, the Supreme Administrative Court set aside the judgment of the court of first instance in 114 cases and referred the cases back to it, and in 220 cases set aside the judgment of the court of first instance and recognised the complaint. In turn, at closed sessions in 2021, in 867 cases, the Supreme Administrative Court set aside the judgment of the court of first instance and referred the cases back to it, and in 1,644 cases set aside the judgment of the court of first instance and recognised the complaint.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

During a tax dispute, there are many strategic options and decisions to be taken. Each case deserves its own strategy, preparation, and analysis.

It is of pivotal importance to retain a professional counsel to review and summarise the facts and to prepare legal arguments. Also, it should be remembered that new facts and evidence may only be brought forward while the case is pending with the tax authorities.

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

Sołtysiński Kawecki & Szlęzak is an independent Polish law firm with a team of over 170 lawyers, offering legal services to businesses from Poland and abroad. SK&S has over 30 years of experience in providing comprehensive advisory services in all aspects of tax law, in the following areas: new technologies and the digital economy, taxation of personal income, merger and acquisition transactions and business and capital restructuring, tax proceedings, financial transactions, regulatory issues, com-

pliance, VAT, excise tax and customs duties, private clients and international taxation. It is committed to the continuing professional development of its experts. This, combined with an interdisciplinary nature and the high quality of its services, enables it to advise clients on even the most difficult tax issues that pose significant challenges, as well as both legal and business risks. It offers strategic advice and finds solutions to even the most novel and complex tax problems.

AUTHORS



Sławomir Łuczak has been an attorney-at-law and a partner in the tax practice of Sołtysiński Kawecki & Szlęzak since 2007. He specialises in tax, customs and foreign exchange law. He

has broad experience in international tax law and in representing clients in tax and customs matters before tax and customs authorities and administrative courts. He advises on tax matters in restructuring and consolidation projects, and currently also leads the Private Clients practice. He is a member of the International Fiscal Association (IFA), and Association Européenne d'Etudes Juridiques et Fiscales (AEEJF). He is involved in the work of the Union Internationale des Avocats (UIA) in its two groups: the Tax Law Commission and Family Law Commission. Sławomir has been repeatedly recognised as a leading tax professional in Poland by trade and law publications.



Karolina Gotfryd is an associate and attorney-at-law. She joined the Sołtysiński Kawecki & Szlęzak team in 2018, after gaining experience in tax teams at international law

firms in Warsaw and London. Karolina specialises in tax and enforcement proceedings before tax authorities and administrative courts, as well as in tax and legal consultancy related to M&A transactions, including restructuring and international tax structuring. She advises clients on various aspects of their activity in Poland, including day-to-day business, implementing schemes of succession in family businesses, and on the creation of optimal structures to ensure the security of wealth succession using offshore private foundations and trusts. She is a member of the International Fiscal Association.

*Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska,
Sołtysiński Kawecki & Szlęzak*



Ewelina Całczyńska is an associate and provides comprehensive advice on tax law, including issues such as VAT, CIT, PIT (particularly in international transactions), and

real estate tax. Her advice covers tax compliance, tax planning, conducting and supervising tax audits, and implementation of tax reliefs (such as R&D relief). She has provided tax advice in numerous transactions on the real estate and financial markets.

Sołtysiński Kawecki & Szlęzak

Jasna 26
00-054 Warsaw
Poland

Tel: +48 22 608 70 00
Fax: +48 22 608 70 70
Email: office@skslegal.pl
Web: www.skslegal.pl



Trends and Developments

Contributed by:

*Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska
Sołtysiński Kawecki & Szlęzak see p.530*

COVID-19 Pandemic Regulatory Framework

The COVID-19 pandemic resulted in a number of permanent and temporary changes to tax law, including the following.

- The deadline for filing PIT and CIT tax returns has been postponed once.
- The deadlines for filing MDR tax schemes have been suspended. The suspension of domestic tax schemes continues.
- The deadline to apply the residence certificate has been extended. If the 12-month deadline for the residency certificate were to expire during the COVID-19 pandemic, then Polish withholding taxpayers may take the certificate into account for the duration of the pandemic and for two months after its cancellation.

From 2020 onwards, due to the current epidemic situation caused by COVID-19, the courts have temporarily suspended their activities, which has further increased the delays in the disposal of cases by the courts. Currently, parts of court hearings are being held in closed sessions or in hearings conducted online.

Trend of Tax Litigation Cases

In Poland, value added tax (VAT) has given rise to more tax litigation cases.

Based on published statistics by the Supreme Administrative Court for 2021, the Court received 26,778 cassation complaints (of which the Finance Chamber received 9,194) and 128 complaints regarding the resumption of proceedings, of which:

- 2,185 concerned VAT;
- 2,002 concerned real estate tax;
- 1,037 concerned PIT;
- 1,001 concerned the execution of pecuniary benefits;
- 618 concerned the tax liability of third parties or tax reliefs;
- 449 concerned CIT;
- 436 concerned excise duties;
- 402 concerned transfer tax; and
- 175 concerned inheritance and donation tax.

Among the cassation complaints registered in 2021, complaints against individual interpretations issued by the Minister of Finance, WHT opinions, and Binding Rate Information accounted for 11,120 cases.

Tax Developments and Trends

EPS and MLI

Poland has already implemented a number of the OECD BEPS recommendations, such as:

- CFC rules;
- CbCR rules;
- new transfer pricing documentation rules;
- limitation on deductibility of interest;
- IP/Innovation Box.

On 7 June 2017, Poland signed the Multilateral Instrument to Modify Bilateral Tax Treaties (MLI), as stipulated in BEPS Action 15, which entered into force in Poland on 1 July 2018.

From 1 January 2019, the MLI is applicable to withholding taxes in respect of double tax treaties with Austria, Australia, France, Israel, Japan,

Lithuania, New Zealand, Serbia, Slovakia, Slovenia and the United Kingdom.

From 1 January 2020, the MLI is applicable to withholding taxes in respect of double tax treaties with India, Belgium, Norway, Ukraine, Canada, Iceland and Denmark.

From 1 January 2021, the MLI is applicable to withholding taxes in respect of double tax treaties with Russia, Latvia, Qatar, Saudi Arabia, Cyprus, Portugal, Indonesia, Czech Republic, Korea, Kazakhstan, Bosnia and Herzegovina, Albania, Jordan, and Egypt.

As for other taxes (including taxes on income from employment), since 1 January 2019, the MLI was only applicable for double tax treaties with Austria and Slovenia. Since then, the MLI has become applicable for double tax treaties with other countries.

Given the fact that the MLI has been recently signed, it may take some time to conclude the final scope of double tax treaties and the scope of their amendments. At this time, it is too early to see or to predict the effectiveness of the aforementioned measures.

It should be noted that in 2019 Poland introduced the obligation to report tax schemes, which is the result of the implementation of the Polish tax law BEPS Action 12 and Council Directive (EU) 2018/822 regarding the mandatory disclosure rules for cross-border transactions. Polish Mandatory Disclosure Rules (MDRs) are applicable to those who develop tax planning schemes, supporting and making them available to enterprises in their implementation (eg, tax advisers, attorneys-at-law, employees of financial institutions). The MDRs apply to both cross-border and domestic transactions. The main reason for introducing MDRs is to discour-

age taxpayers and their advisers from using tax planning schemes.

Other BEPS implementation measures have progressed at an EU level through the first and second EU Anti-Tax Avoidance Directive (ATAD). On 1 January 2019, Poland introduced a new exit tax and modified GAAR provisions.

The Polish Deal – tax revolution in Poland from 2022

In 1 January 2022 a number of significant changes in tax law came into force, notably the so-called “Polish Deal”, in the areas discussed below.

PIT

- An increase in the tax-free amount to PLN30,000. All persons whose income is subject to taxation according to the tax scale benefit from this free amount.
- Regulations that raise the income threshold from which a higher 32% PIT rate is applied to PLN120,000. Income up to PLN120,000 is subject to 17% PIT.
- Changes in the scope of health contributions. For taxpayers conducting a business activity, the amount of health insurance contribution is determined in a new way.
 - (a) For those settling with a 19% flat tax, the contribution is 4.9% of income.
 - (b) For people settling with a lump-sum tax, the contribution is determined by three thresholds based on 60%, 100%, and 180% of the average monthly salary.
 - (c) In other cases, a 9% health insurance contribution applies.
 - (d) The proposed regulations do not allow health insurance premiums to be deducted from PIT. The change affects, inter alia, employees, contractors, and other persons with income taxed according to the 17–32% scale.
 - (e) The lack of the possibility to deduct the

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

health insurance premium from PIT results in a decrease in net remuneration in many cases. The effects of this change are felt most strongly by persons who receive income from sources other than employment contracts, and employees whose annual salaries exceed PLN133,692.

- (f) Employees whose annual salary does not exceed PLN133,692 are able to take advantage of an additional relief, the “middle class relief”, which compensates for the lack of the possibility to deduct health contributions. The “middle class relief” is planned to be abolished by 1 July 2022.
- From 1 January 2022, a new tax relief is now applicable. People who have been foreign tax residents for at least three years and who decide to move their residence to Poland and acquire the status of a Polish tax resident gain the possibility to apply the tax exemption for four years. The previous foreign residence needs to be confirmed by foreign tax residency certificates or other evidence documenting the residence for tax purposes. The exemption applies to income from employment relationships, contracts of mandate and business activities, up to an amount not exceeding PLN85,528 per year.
- A foreign income lump-sum for taxpayers with above-average levels of assets (“high net-worth individuals”). This is a new Polish regulation with a new form of flat-rate taxation on foreign income for persons who decide to transfer their tax residence to Poland. As a result of choosing this form of taxation, foreign income will be taxed with a fixed lump-sum tax regardless of the amount of foreign income.
- Individuals who have been foreign tax residents for at least five of the six years preceding the year in which they acquired the status of a Polish tax resident, and who decide to move their place of residence to Poland, are to gain the possibility of applying a lump-sum

tax on foreign income for a period of ten tax years. Its amount, irrespective of the level of income, would be no more than PLN200,000 annually.

- One of the conditions for applying the flat rate is to incur, in Poland, expenditures for economic growth, the development of science and education, the protection of cultural heritage, or the promotion of physical culture in the amount of at least PLN100,000 a year on average. Closest family members of a taxpayer taking advantage of the flat rate, understood as being a spouse or minors, will also be able to benefit from this solution. The flat rate on their foreign income would be lower by half and would amount to PLN100,000 annually.

CIT

- Regarding transfer pricing, the amendments concerning, inter alia, a statement on the local transfer pricing documentation and arm’s length pricing will include an additional element: a statement that the local transfer pricing documentation has been drawn up in conformity with the actual circumstances.
- A new regulation in the Penal Fiscal Code will impose sanctions on anyone who, contrary to the obligation, fails to draw up the Transfer Pricing Local file, fails to attach thereto the Transfer Pricing Master file, or has drawn up any such documentation contrary to the actual circumstances. The sanction will be a fine of up to PLN28 million (in 2022), ie, the highest fine provided for in the Penal Fiscal Code.
- A new WHT regime, the amendments for which concern, inter alia:
 - (a) limiting the scope of application of the WHT refund to passive revenues that paid to related entities;
 - (b) changes to the definition of a beneficial owner;
 - (c) opinions on the application of prefer-

- ences could be issued on the basis of provisions of double tax treaties;
- (d) broadening the scope of cases in which a copy of the residence certificate may be used.
- Changes in the scope of Estonian CIT. Estonian CIT may also be applied by limited partnerships and limited joint-stock partnerships. There has been a reduction from 15% to 10% of the tax base in the case of small taxpayers and taxpayers starting a business, and a reduction from 25% to 20% in the case of other taxpayers. The provision that indicated the upper revenue limit for taxpayers taxed with Estonian CIT at PLN100 million has been repealed. The provision that obliged taxpayers to maintain capital expenditures or salary expenditures at a certain level has also been repealed.
 - New minimum income tax. The new tax covers entities subject to CIT whose share of income in revenues (other than from capital gains) will be less than 1%, or which will incur a loss for a given tax year from a source of income other than capital gains. The minimum income tax rate is 10%.
 - A new tax regime for holding companies.
 - New tax reliefs, inter alia:
 - (a) tax relief for companies that incur test production costs (prototype allowance) or increase revenue from sales of products (growth-promoting allowance); and
 - (b) tax relief for companies that invest in robotics.
 - The new possibility of simultaneously applying R&D relief and an IP Box.

POLAND TRENDS AND DEVELOPMENTS

Contributed by: Sławomir Łuczak, Karolina Gotfryd and Ewelina Całczyńska, Sołtysiński Kawecki & Szlęzak

Sołtysiński Kawecki & Szlęzak is an independent Polish law firm with a team of over 170 lawyers, offering legal services to businesses from Poland and abroad. SK&S has over 30 years of experience in providing comprehensive advisory services in all aspects of tax law, in the following areas: new technologies and the digital economy, taxation of personal income, merger and acquisition transactions and business and capital restructuring, tax proceedings, financial transactions, regulatory issues, com-

pliance, VAT, excise tax and customs duties, private clients and international taxation. It is committed to the continuing professional development of its experts. This, combined with an interdisciplinary nature and the high quality of its services, enables it to advise clients on even the most difficult tax issues that pose significant challenges, as well as both legal and business risks. It offers strategic advice and finds solutions to even the most novel and complex tax problems.

AUTHORS



Sławomir Łuczak has been an attorney-at-law and a partner in the tax practice of Sołtysiński Kawecki & Szlęzak since 2007. He specialises in tax, customs and foreign exchange law. He

has broad experience in international tax law and in representing clients in tax and customs matters before tax and customs authorities and administrative courts. He advises on tax matters in restructuring and consolidation projects, and currently also leads the Private Clients practice. He is a member of the International Fiscal Association (IFA), and the Association Européenne d'Etudes Juridiques et Fiscales (AEEJF). He is involved in the work of the Union Internationale des Avocats (UIA) in its two groups: the Tax Law Commission and Family Law Commission. Sławomir has been repeatedly recognised as a leading tax professional in Poland by trade and law publications.



Karolina Gotfryd is an associate and attorney-at-law. She joined the Sołtysiński Kawecki & Szlęzak team in 2018, after gaining experience in tax teams at international law

firms in Warsaw and London. Karolina specialises in tax and enforcement proceedings before tax authorities and administrative courts, as well as in tax and legal consultancy related to M&A transactions, including restructuring and international tax structuring. She advises clients on various aspects of their activity in Poland, including day-to-day business, implementing schemes of succession in family businesses, and on the creation of optimal structures to ensure the security of wealth succession using offshore private foundations and trusts. She is a member of the International Fiscal Association.



Ewelina Całczyńska is an associate and provides comprehensive advice on tax law, including issues such as VAT, CIT, PIT (particularly in international transactions), and

real estate tax. Her advice covers tax compliance, tax planning, conducting and supervising tax audits, and implementation of tax reliefs (such as R&D relief). She has provided tax advice in numerous transactions on the real estate and financial markets.

Sołtysiński Kawecki & Szlęzak

Jasna 26
00-054 Warsaw
Poland

Tel: +48 22 608 70 00
Fax: +48 22 608 70 70
Email: office@skslegal.pl
Web: www.skslegal.pl



Law and Practice

Contributed by:

Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema
Morais Leitão, Galvão Teles, Soares da Silva & Associados see p.560



CONTENTS

1. Tax Controversies	p.535	5.3 Judges and Decisions in Tax Appeals	p.545
1.1 Tax Controversies in this Jurisdiction	p.535	6. Alternative Dispute Resolution (ADR) Mechanisms	p.546
1.2 Causes of Tax Controversies	p.535	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.546
1.3 Avoidance of Tax Controversies	p.535	6.2 Settlement of Tax Disputes by Means of ADR	p.546
1.4 Efforts to Combat Tax Avoidance	p.535	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.546
1.5 Additional Tax Assessments	p.536	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.547
2. Tax Audits	p.536	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.547
2.1 Main Rules Determining Tax Audits	p.536	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.547
2.2 Initiation and Duration of a Tax Audit	p.537	7. Administrative and Criminal Tax Offences	p.547
2.3 Location and Procedure of Tax Audits	p.538	7.1 Interaction of Tax Assessments with Tax Infringements	p.547
2.4 Areas of Special Attention in Tax Audits	p.539	7.2 Relationship between Administrative and Criminal Processes	p.548
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.540	7.3 Initiation of Administrative Processes and Criminal Cases	p.548
2.6 Strategic Points for Consideration during Tax Audits	p.540	7.4 Stages of Administrative Processes and Criminal Cases	p.549
3. Administrative Litigation	p.541	7.5 Possibility of Fine Reductions	p.550
3.1 Administrative Claim Phase	p.541	7.6 Possibility of Agreements to Prevent Trial	p.550
3.2 Deadline for Administrative Claims	p.542	7.7 Appeals against Criminal Tax Decisions	p.550
4. Judicial Litigation: First Instance	p.542	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.551
4.1 Initiation of Judicial Tax Litigation	p.542	8. Cross-Border Tax Disputes	p.551
4.2 Procedure of Judicial Tax Litigation	p.542	8.1 Mechanisms to Deal with Double Taxation	p.551
4.3 Relevance of Evidence in Judicial Tax Litigation	p.543	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.552
4.4 Burden of Proof in Judicial Tax Litigation	p.544		
4.5 Strategic Options in Judicial Tax Litigation	p.544		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.544		
5. Judicial Litigation: Appeals	p.545		
5.1 System for Appealing Judicial Tax Litigation	p.545		
5.2 Stages in the Tax Appeal Procedure	p.545		

PORTUGAL CONTENTS

8.3	Challenges to International Transfer Pricing Adjustments	p.552	10.5	Existing Use of Recent International and EU Legal Instruments	p.555
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.552	10.6	New Procedures for New Developments under Pillar One and Two	p.555
8.5	Litigation Relating to Cross-Border Situations	p.553	10.7	Publication of Decisions	p.555
9. State Aid Disputes		p.553	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.556
9.1	State Aid Disputes Involving Taxes	p.553	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.556
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.554	11. Costs/Fees		p.556
9.3	Challenges by Taxpayers	p.554	11.1	Costs/Fees Relating to Administrative Litigation	p.556
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.554	11.2	Judicial Court Fees	p.556
10. International Tax Arbitration Options and Procedures		p.554	11.3	Indemnities	p.556
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.554	11.4	Costs of ADR	p.557
10.2	Types of Matters that Can Be Submitted to Arbitration	p.555	12. Statistics		p.557
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.555	12.1	Pending Tax Court Cases	p.557
10.4	Implementation of the EU Directive on Arbitration	p.555	12.2	Cases Relating to Different Taxes	p.558
			12.3	Parties Succeeding in Litigation	p.559
			13. Strategies		p.559
			13.1	Strategic Guidelines in Tax Controversies	p.559

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Most tax controversies have their origin in a tax assessment, which may be made by the tax authorities (as is the case with personal income tax and with the tax on the acquisition of immovable property, based on information disclosed by taxpayers) or directly by taxpayers (as is generally the case with corporate income tax (CIT) and value-added tax (VAT)).

Tax controversies may arise for numerous reasons, although in most cases they arise because of an alleged illegality identified by the tax authorities during administrative tax audits that lead to additional tax assessments.

1.2 Causes of Tax Controversies

Most tax controversies arise from corporate income tax disputes, in particular regarding the non-recognition of certain costs for CIT purposes by the tax authorities.

Nonetheless, there are some pending cases related to more cutting-edge topics, such as controlled foreign corporations (CFCs), transfer pricing and the general anti-avoidance rule (GAAR).

Additionally, considering that recent years have seen the creation of sectoral taxes (eg, on banking, pharmaceuticals or the energy industry) that generate very high assessments, such taxes have given rise to a significant number of tax disputes.

1.3 Avoidance of Tax Controversies

Binding Rulings

Taxpayers may request binding rulings from the tax authorities regarding the application of law to certain facts.

Through such binding rulings taxpayers may, for instance, request advance clearance on the tax and legal qualification of certain highly complex transactions.

At the request of the taxpayer, and where duly justified, the binding ruling may be provided urgently within 75 days, as long as the taxpayer presents a proposal for the tax treatment considered applicable. A fee ranging between EUR2,550 and EUR25,500 is payable by the taxpayer to the tax authorities in such cases.

If the tax authorities recognise the urgency of the matter and the binding ruling is not issued within 75 days, it is considered that the tax authorities agree with the proposal of the tax treatment presented by the taxpayer.

Non-urgent binding rulings are free of charge and should be given within 150 days after the submission of the request. This deadline is considered merely indicative.

Advance Pricing Agreements

Another way to mitigate tax controversies, considering that in recent years the number of transfer pricing disputes has grown significantly, is to enter into an advance pricing agreement (APA) with the tax authorities. Such agreements may be unilateral, bilateral or multilateral.

APAs give legal certainty to taxpayers when conducting transactions with related entities (including parent companies, subsidiaries or associated companies, branches and other permanent establishments) provided that taxpayers comply with the terms and conditions of the APAs in question.

1.4 Efforts to Combat Tax Avoidance

Over the years Portugal has already put in place a number of measures to combat tax avoidance; these include:

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

- rules preventing the tax deductibility of payments to entities located in low-tax jurisdictions;
- interest barrier rules;
- CFC rules;
- exit tax rules; and
- the last set of rules (the GAAR and its procedural provisions) that allow the tax authorities to recharacterise operations as purely fictional.

Anti-Tax Avoidance Directives

Nonetheless, in May 2019 the Portuguese Parliament formally (partially) implemented the Anti-Tax Avoidance Directives I and II into Portuguese Law.

Through this legislation the Portuguese tax system adopts the common solutions defined in the context of the EU, in line with the conclusions of the final reports of the G20 and the OECD project on the erosion of the tax base and the artificial shifting of profits (BEPS) to ensure that co-ordinated measures are implemented to discourage tax avoidance practices more effectively; to ensure fair and effective taxation; and to protect tax systems, at a global level, against aggressive fiscal planning.

This legislation includes amendments to the CIT Code and to the GAAR and its procedural provisions, currently provided for in the General Tax Law and the Tax Procedure and Process Code.

1.5 Additional Tax Assessments

The taxpayer may challenge an additional tax assessment through an administrative, a judicial or an arbitration claim.

Tax disputes may involve both an administrative and a judicial or arbitration phase; they can start and finish as an administrative or a judicial or arbitration process, but they can also start as an administrative process that evolves into a judi-

cial or arbitration one if the taxpayer is not satisfied with the final decision of the tax authorities.

Neither of these claims, by itself, suspends the foreclosure file. As a rule, the taxpayer must also pay the tax assessed or render a guarantee to suspend the foreclosure file while the claim is being heard; and if the taxpayer is not successful with the administrative, judicial or arbitration award and the latter becomes *res judicata*, the foreclosure file is immediately activated and enforced.

In the case of disputes related to additional tax assessments made by the tax authorities, the taxpayer will also be notified of an infraction procedure. Notwithstanding the possibility of immediately paying the administrative penalty or challenging the decision that determined the administrative penalty on its own merits, the law provides that this process may remain suspended until a final decision is reached in the tax dispute concerning the legality of the tax assessment. Usually, taxpayers opt for the latter alternative because the infraction file will be closed if they win the tax dispute.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Primarily, tax audits follow the general National Plan for tax and customs audits (the so-called PNAITA) that is approved every year by the government. The National Plan defines the programme of action, the criteria to be used and the taxpayers to be audited and establishes the targets to be achieved by the different tax services.

However, other tax audits may also be initiated during the year and the Plan should allocate specific human and material resources to tax audits not previously established. Although the National Plan is confidential, the tax and customs authori-

ties must disclose the general criteria defined to select taxpayers and other entities that will be subject to a tax audit.

Tax audits may, therefore, be initiated following:

- the National Plan for tax and customs audits;
- European or international (eg, OECD) guidelines that tax authorities decide to enforce;
- the application of randomised methods for the selection of taxpayers;
- specific denunciations lodged before the tax authorities; and
- the verification of abnormal behaviour or parameters that do not follow from the ordinary patterns expected of a specific activity or wealth situation.

Heavily Audited Individuals and Companies

Moreover, specific taxpayers are permanently on the radar of the Portuguese tax authorities, in particular large companies and high net worth individuals (HNWI).

Under the current regulations, these entities are accompanied by a special large taxpayers' unit (LTU) that targets such entities using the following criteria.

- HNWI – individuals with:
 - (a) income above EUR750,000 in a specific year;
 - (b) ownership, directly or indirectly, of wealth (including assets and rights) worth more than EUR5 million;
 - (c) a lifestyle commensurate with the above-mentioned income or wealth and/or possession of the related accoutrements; or
 - (d) the existence of a legal or economic relationship with HNWI or with companies or entities that are followed by the LTU.
- Large companies – if:
 - (a) they are entities supervised by the Central Bank or by the Insurance and Pensions

Funds Authority (with the exception of those that carry out the activity of insurance distribution), or which are collective investment undertakings under the supervision of the Portuguese Securities Market Commission, or if they are entities with a turnover, or total income, in the case of holding companies, exceeding EUR1.2 billion or, in the case of an entity belonging to a group of companies subject to the CbC report, exceeding EUR2.1 billion;

- (b) they have in force an advance pricing agreement on transfer pricing matters;
- (c) they have a total tax bill in excess of EUR20 million per year;
- (d) they are companies that are considered relevant despite not meeting the above-mentioned criteria because of their relationship with entities that do meet the criteria; or
- (e) they make up part of a tax group for corporate income tax purposes and any of the companies meet the above-mentioned criteria.

Strategic Plan to Combat Tax and Customs Fraud and Evasion

The government also prepares and releases a triennial Strategic Plan to Combat Tax and Customs Fraud and Evasion (the current one concerns the period 2020–22, and presents an annual report to Parliament, setting out the relevant actions that were put in place to achieve those goals and presenting statistics on different subjects under analysis).

2.2 Initiation and Duration of a Tax Audit

As a rule, a tax audit may be initiated within the statute of limitations period, which in principle corresponds to a four-year period following the taxable event. If a criminal proceeding related to the tax audit is initiated within that period,

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

the statute of limitations is extended and the tax authorities may make a tax assessment until the end of the year following the date on which that proceeding is closed, or a final decision becomes *res judicata*.

Usually a tax audit that takes place in the taxpayer's premises should be concluded in a six-month period but, in specific circumstances, that period may be extended for two additional periods of three months each. The tax audit suspends the statute of limitations period during those six months.

When a mistake that may trigger an additional tax assessment was evidenced in the tax return, the statute of limitations period decreases to three years. On the contrary, the statute of limitations period increases to 12 years in two other situations; precisely when the tax authorities may encounter more difficulties in making additional tax assessments, as follows:

- when the tax event, not reported to the tax authorities in due time, is connected with low-tax jurisdictions, as foreseen in the blacklist approved by the Minister of Finance; or
- when the tax event is connected with bank accounts (cash or securities) opened with a non-EU financial institution or branches located outside the EU and those accounts are not mentioned in the tax returns presented by taxpayers.

2.3 Location and Procedure of Tax Audits

The audits may occur in the tax authorities' headquarters or the taxpayer's premises. The latter inspection is the so-called external audit and usually occurs in the taxpayer's head office or other location where the accounting ledgers are maintained; all this information (eg, inventory, assets, VAT registers, any other types of records) is currently kept on computers, but physical

documents on paper still exist (eg, invoices). In addition, the board of directors' minutes and general shareholders' meeting minutes are also provided in physical books. The tax authorities may also ask to see any specific elements or documents and may make special visits to the taxpayers' offices, namely, to verify if the records are duly updated and/or to see inventory, etc.

The tax authorities can only make one external audit related to the same tax or year of a specific taxpayer, unless a specific grounded decision is adopted by the head of the tax services, namely invoking new facts.

Under their rights and powers, the tax authorities may:

- ask for all types of elements and documents that reveal the taxpayer's situation;
- proceed with a physical inventory, including the identification and evaluation of assets;
- analyse and test all computer data and electronic archives either to check compliance matters (eg, tax return compliance or tax payments), tax accounts and tax reporting, specific operations (eg, mergers, divisions) or specific matters such as transfer pricing, tax-consolidation rules of a group or specific payments abroad, in particular to low-tax jurisdictions;
- send specific questionnaires to taxpayers or obtain specific oral statements from them;
- obtain information from other taxpayers that relate to the specific taxpayer subject to the tax audit;
- collect information from other tax authorities under the EU directives, bilateral tax treaties or any other international treaties or "arrangements"; and
- in addition to all financial documentation (including invoices, receipts, credit or debit notes, banking information), also ask to see reports prepared by the taxpayer's account-

ants, auditors or lawyers, although confidentiality rules may apply and prevent them from being revealed in specific cases.

As a rule, the tax authorities should make their requests in writing and, if not made under an audit within the taxpayer's premises, through a registered letter, allowing the taxpayer to obtain and prepare its answers. Thus, the rule is to give advance notice that they are initiating a tax audit in the taxpayer's premises (with a minimum period of five days) to provide time to reply to a specific questionnaire.

Taxpayers are often accompanied by their legal and tax advisers during the tax inspections and, in the case of companies, they should also appoint a representative who accompanies the tax auditor within the company's premises.

2.4 Areas of Special Attention in Tax Audits

Tax audits can be general or specific. The former generally cover all types of taxes, although the most common audits only cover income taxes, VAT, real estate taxes or stamp duty. They may also be very specific, covering one of the taxes above-mentioned or any other.

General tax audits are usually designed to verify the global position of a specific taxpayer, whereas specific tax audits are commonly launched to verify a particular aspect within a sector or activity (eg, to verify whether and how financial institutions are dealing with a specific stamp duty or VAT issue).

Usually the tax authorities review the company's accounts and review its financial accounting compliance and tax obligations. Depending on the type of tax audit (a general or a specific one), the tax authorities may ask to examine:

- samples of sale and purchase invoices to verify if they comply with VAT and corporate income tax regulations;
- the information contained in different types of documents, reports and statements to verify if results are consistent;
- the transfer pricing documentation and the intra-group transactions, including the relationships between the company and associated companies and/or permanent establishments;
- formalities observed in specific operations (eg, neutral mergers, divisions, transfer of assets or exchange of shares, the transfer of a head office);
- transactions concluded with entities located in low-tax jurisdictions and, in particular, payments made to them;
- the consolidated tax return and the different returns presented by all the companies belonging to a specific group as well as the formalities that those companies are, or are not, observing;
- payments abroad and all matters related to the proper application of withholding taxes;
- intra-community VAT operations or VAT deductions, or financial operations made by financial institutions often subject to stamp duties; and
- customs matters (often related to the qualification of items).

Both formal requirements and substantive issues constitute top priorities for the tax authorities and litigation often arises because the tax authorities consider that taxpayers have failed to observe formal requirements in order to benefit from a specific tax regime (eg, a neutral merger operation, the consolidation tax regime or a waiver of a withholding tax), or reach the conclusion that a specific operation or a sequence of operations cannot produce the tax result intended by the taxpayer, either considering a specific violation

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

of a substantive tax rule or invoking a specific or the general anti-avoidance rule.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Cross-border exchanges of information and mutual assistance between tax authorities have been increasing tendencies over the years, although the numbers, in some areas, are not yet very significant.

The Portuguese tax authorities' Report of Activities released in 2021, and referring to 2020, evidences the following number of requests for mutual assistance (MA) in the areas of customs/excises.

- Customs areas – three Portuguese requests for MA from other states, 78 where Portugal was a recipient of requests from other states, 81 in total.
- Excises – One Portuguese request for MA from other states, eight where Portugal was a recipient of requests from other states, nine in total.
- Naples Convention II – 12 Portuguese requests for MA from other states, 26 where Portugal was a recipient of requests from other states, 38 in total.
- Total – 16 Portuguese requests for MA from other states, 112 where Portugal was a recipient of requests from other states, 128 in total.

Moreover, in relation to the co-operation between the Portuguese tax authorities and the EC – mainly the Directorate-General for Taxation and Customs Union (DG TAXUD) and the European Anti-Fraud Office (OLAF) – in 2020, according to the Portuguese tax authorities' Report of Activities (released in 2021 and referring to 2020), Portugal received a total of 1,845 forms of information of significant risks that required

specific analysis and treatment, and 51 specific indications of fraud and serious irregularities detected by OLAF.

The cross-border exchanges of information in relation to income taxes in 2020 may be summarised as follows.

- Requests – 229 received, 317 sent.
- Spontaneous – 65 received, 61 sent.
- Automatic – 1,615,193 received, 2,697,365 sent.

In 2017, under VAT EU Regulation No 904/2010, concerning administrative co-operation and the fight against VAT fraud – through the Central Liaison Office (CLO), participation in the Eurofisc network and participation in Multilateral Controls – 1,417 files were initiated concerning the exchange of information, at the request of member states. Of these, 483 files originated in requests from other tax authorities and 958 in requests made by the Portuguese tax authorities.

The exchange of information between the tax authorities of different member states and their mutual assistance is obviously influencing the growth of tax audits as well as the sophistication and the level of information that the Portuguese tax authorities currently have in relation to taxpayers that do business abroad and/or have cross-border connections.

2.6 Strategic Points for Consideration during Tax Audits

In general, it is important to take the following steps before and during a tax audit.

- To prepare the right and proper documentation to release to the tax inspector and to be able to explain it, including all the relevant facts related to that documentation.

- To know beforehand the legal and formal requirements that the tax authorities and the taxpayer should observe during the tax audit in relation to all relevant aspects (scope, duration, timetables, obligation to provide documents, how to reply to questionnaires, how and when to require deadline extensions, etc).
- To evaluate the tax contingencies at an early stage and to verify whether it is better to regularise the situation immediately (without penalties or with less penalties) or how it might be possible to mitigate and reduce adverse tax and other consequences (eg, infringement or even criminal penalties).
- To be assisted by a tax lawyer before the tax inspection is initiated and during its course.
- To provide documentation and clarifications to the tax audit accurately.
- To decide what to say (or not to say) after receiving the tax audit draft, considering that, as a rule, the tax authorities will have the possibility to review it before issuing their final report.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

There are situations where an administrative claim is mandatory before initiating a judicial phase, namely in situations of self-assessment, withholding taxes, payments on account of the final tax due or custom duties, when the claim is related to the origin, classification or customs value of the product.

However, in situations of additional tax assessment, the administrative claim phase is always optional.

The administrative claim should be presented in the local tax office of the area where the tax-

payer is domiciled, or where the tax assessment took place, or of the location of the assets; it also can be sent electronically through the tax authorities' website. Although the administrative claim should be presented in the local tax office, it should be decided by the regional tax directorate (in Portugal the tax authorities are formed by the central services, regional tax directorates and local tax offices). The deadline for the presentation of the claim is 120 days, counted from the first day inclusive following the termination of the deadline to pay the additional assessment, which should be around 30 days after the assessment is made. If the additional tax assessment does not give rise to an obligation to pay a certain amount of tax (for instance, the taxpayer had tax losses and the result of the additional tax assessment was a reduction of the available tax losses), the 120-day deadline to present the administrative claim should be counted from the notification of the assessment.

The procedure of the administrative claim, up to the final decision, is determined by law to be simple and without formalities. In this regard it is worth mentioning that, as a rule, in the administrative phase of tax litigation there are no costs or fees due to the administration, but the proof is limited to the documentation made available and only exceptionally will the tax authorities decide to hear witnesses. Moreover, this phase (as well as the eventual subsequent judicial phase) does not, by itself, suspend the enforcement and collection of the tax assessed, which means that to avoid the seizure of assets, the taxpayer should pay the assessment or present a guarantee to the tax authorities (exceptionally, it can be released from this duty, namely if the taxpayer is able to demonstrate economic hardship or that the presentation of the guarantee will cause irreparable damage). Finally, if the tax authorities intend to dismiss the administrative claim, they should notify the taxpayer, allowing them to react to the projected dismissal within

a deadline of between 15 and 25 days. In their final decision, the tax authorities should take into consideration the reasons invoked by the taxpayer and the grounds on which they were rejected.

3.2 Deadline for Administrative Claims

Notwithstanding specific deadlines that may apply to specific administrative procedures or claims, the main rule stipulates that any tax procedure (including, therefore, an administrative claim) shall be decided within four months.

The consequence of the tax authorities not complying with this deadline is that the taxpayer may presume that the claim was tacitly denied for the purposes of appealing against that tacit negative decision. The practical effect of this rule is to allow speeding up of litigation; ie, instead of waiting *sine diem* for a decision from the tax authorities, the taxpayer may presume that the appeal was dismissed at the end of the four-month period and appeal to court against that tacit negative decision.

Taxpayers frequently use this rule in a strategic move because (i) they try to convince tax authorities at the administrative level first, and (ii) the deadlines to lodge administrative claims terminate after the deadlines to go directly to court. Accordingly, it is relatively common to see taxpayers presenting an administrative claim and, at the end of the fourth month, appealing to a court assuming the tacit denial of the claim. Instead of going to court, taxpayers can also make a hierarchical appeal against the tacit negative decision and, on the express or tacit negative decision of the hierarchical appeal, subsequently go to court.

Otherwise – ie, if the tax authorities manage to decide the appeal in the said timeframe – taxpayers can also go to court against an express denial of the administrative appeal.

However, whilst the deadline to lodge a judicial claim is 90 days after the notification of the denial of the administrative claim or after the tacit negative decision of such claim, the deadline to present the hierarchical appeal is 30 days counting from the same events. According to the law, hierarchical appeals should be decided within 60 days; however, this deadline is considered merely indicative and it is frequently not complied with. Taxpayers may consider that a tacit negative decision has occurred at the end of the 60-day term for the purpose of reacting against that negative decision.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation is initiated with the presentation of the claim in writing to the court of first instance. The claim may be sent by mail or by electronic means through the dedicated website of the tax (and administrative) courts. The claims can be presented directly by taxpayers, except if the value of the claim exceeds EUR10,000, in which case it is mandatory to appoint a lawyer registered with the Portuguese Bar Association. The claim has to be presented in articles, identify the act contested, and expose the circumstances of fact and the law that ground the final request. Moreover, the value of the claim shall also be indicated. Finally, the petitioners shall indicate their witnesses, other means of proof they wish to use and, in an annexe to the claim, the petitioners shall attach the documentary evidence at their disposal.

4.2 Procedure of Judicial Tax Litigation

After the presentation of the claim, the court attributes a number to the case and the process is distributed to a judge who notifies the tax authorities of the need to contest the claim within three months. The tax authorities are rep-

resented in court by a specific body called *Representantes da Fazenda Pública*, whose function is to represent the tax authorities in the thousands of files pending in the courts.

Although contestation is not mandatory, the tax authorities normally contest within the said deadline. Within the deadline available to contest the claim, the tax authorities shall also gather the information available related with the process (the administrative file) and present it to the court.

If there is a partial revocation of the act, the tax authorities shall, within three days, notify the taxpayers to confirm, within ten days, if they want to continue with the judicial claim.

If the act is totally revoked, the tax authorities shall contact the person representing the tax authorities in court to promote the termination of the judicial claim.

After the response of the tax authorities to the taxpayer's petition and if the litigation is related to a strictly legal matter, the judge may decide upon the claim immediately after it has passed through the Public Prosecutor in the court.

If witnesses shall be heard or other forms of proof shall be presented, such as inspections or expert hearings, the judge shall notify the parties of the relevant date to produce those forms. The number of witnesses to be heard in relation to each fact shall not exceed three and the maximum number of witnesses allowed is ten. The hearing shall occur in court and the testimonials shall be duly recorded. If witnesses are resident in an area not covered by the territorial jurisdiction of the court, they may be present in the court of the area where they live and be heard and interrogated through videoconference. The claimant as well as the person representing the

tax authorities may directly interrogate the witnesses.

Once the presentation of proof is terminated, the judge shall notify the parties to produce their final written allegations with a minimum deadline of ten days, which shall not exceed 30 days.

Finally, before the decision, the claim shall be presented to the Public Prosecutor in the court who may pronounce on the matters under discussion. The Public Prosecutor's opinion is not binding upon the judge.

4.3 Relevance of Evidence in Judicial Tax Litigation

In principle, the proof must be presented (in the case of documentation or witnesses) or requested (in the case of inspections or expert witness) immediately with the presentation of the claim in writing to the court of first instance. Exceptionally, mainly if it is demonstrable that it was not possible to present or request the proof earlier, it is possible to present or request such proof afterwards.

Although it is not stated as such in the law, there is a clear preference for documentary evidence in tax litigation in comparison with witness testimony or other types of proof. If there are no witnesses to be heard – and in a considerable number of cases there are not – the entire case from its beginning to its termination will occur without any personal contact between the parties and the judge as all the contact is in writing.

If witnesses are to be heard and questioned by the judge and the parties, it is up to the judge to schedule a hearing after the tax authorities have presented their answer to the taxpayer's petition. Both the taxpayer and the tax authorities can request the hearing of witnesses. Usually, in the tax authorities' case, their witnesses will be their agents. Witnesses are first questioned

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

by the judge, then by the party that has requested their hearing and they can be subsequently cross-examined by the other party.

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof is with the party that invokes a certain fact to be proved. As a rule, the tax authorities invoke and should prove their claims in the audit report, therefore grounding the tax assessment, and it is for the taxpayer to challenge such views and refute those proofs in the administrative or judicial claim.

In criminal tax litigation, the burden of proof rests with the Public Prosecutor.

4.5 Strategic Options in Judicial Tax Litigation

Evidence

From a strategic perspective – and taking into consideration the limitations established by the law of the process as well as the fundamental *audi alteram partem* principle – it is advisable, as a rule, for all the evidence to be presented or requested at the beginning, as well as all the legal arguments.

Settlement

The possibility of settlement, namely through an agreement whereby both the taxpayer and the tax authorities would retract part of what they are claiming, is not possible. Among other motives this is due to the fact that the law clearly states that the tax authorities' credit (ie, the amount of tax) is not at their disposal.

Paying Upfront

The option to pay or not to pay the tax while the dispute is pending is mainly a financial issue that the taxpayer has to weigh. In favour of paying the tax one can essentially invoke that, on the one hand, this is reflected on the company's financial accounts and, on the other hand, if it

wins the case, in principle it will be entitled to interest, currently at the rate of 4% per year. Taking into account the interest rate offered by banks operating in Portugal, it can be quite advantageous from a financial perspective to opt to pay the tax and then receive back the tax paid with interest. If the taxpayer opts not to pay the tax, it will have to constitute a guarantee to the benefit of the tax authorities. In considering this option the taxpayer has to weigh the fact that the guarantee has costs, firstly a tax cost related to stamp duty due on guarantees and then variable costs depending on the type of guarantee chosen (eg, bank commissions or notary costs). Moreover, in connection with this option, the taxpayer should also consider that while the case is pending, interest will continue to be computed and will be due if the taxpayer loses the case. On the other hand, if the taxpayer wins the case, as a rule, it is possible to recover this cost.

Finally, the taxpayer can also opt to pay the tax in instalments. Depending on the amount due, payment in instalments, to be accepted by the tax authorities, may oblige the presentation of a guarantee.

Expert Reports

The presentation of expert reports or professors' opinions is also something to consider. Their use will depend on the type of case. If the file includes complex non-legal matters, expert reports may be relevant to help the judge to understand the situation. In the case of complex legal matters, opinions from scholars may also be worth considering. Although these reports and opinions are not binding on the judge, they are usually taken into consideration.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

In litigation related to international tax matters, it is common for the courts to take into account relevant jurisprudence (mainly from the ECJ) and

international guidelines (mainly the different versions of the commentaries to the OECD Model Tax Convention or to the OECD Transfer Pricing Guidelines).

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

There are two appellate courts, the Administrative Central Court (ACC) North and the ACC South, and one Administrative Supreme Court (ASC).

The ACC South is situated in Lisbon and essentially covers the southern area of the country, and the ACC North is situated in Porto and covers the northern area of the country. The ASC is also located in Lisbon and covers the entire country.

Whoever loses the case at first instance – the taxpayer or the tax authorities – or both in the event that both parties lose part of the case, may take the case to the ACCs in the event of a disagreement over the facts and the law decided at first instance, or to the ASC in the event of a disagreement exclusively based on matters of law.

The appeal is only precluded if the value of the case (in cases challenging tax assessments, the amount of tax in litigation) is lower than EUR5,000.

From the decision of the ACCs or of the ASC, the taxpayer or the tax authorities may in exceptional cases still lodge a second appeal to the ASC based on a contradiction of a previous judgment or go to the Constitutional Court in cases where there is a constitutional issue at stake.

If there are uncertainties as to whether a tax assessment violates EU law, the final-instance court shall file a request for a preliminary ruling to the Court of Justice of the European Union. In contrast to the final-instance court, the courts of first instance are not obliged to file such a request and the occasions on which such courts have opted to request a preliminary ruling voluntarily are scarce.

5.2 Stages in the Tax Appeal Procedure

The appeal is launched in the court of first instance within 30 days of a final decision and shall include the appellant's statements. If the appeal is admitted by the court of first instance (it is only precluded if the value of the case is lower than EUR5,000), the other party will then have 30 days to submit its response. The appeal then goes to the ACCs or the ASC, where it will await a decision. Where the purpose of the appeal is to review recorded evidence, the above-mentioned deadlines are increased by ten days each.

5.3 Judges and Decisions in Tax Appeals

The ACCs and the ASC each have one chamber for tax law appeals and actions, and another chamber that deals only with administrative law appeals and actions.

The decisions of the appellate courts are rendered by the majority decision of a panel of three judges. The judges are appointed by the court randomly. If there is no unanimity, the dissenting judge may publish their reasons for the dissenting vote.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Portugal adopted an arbitration regime to settle tax disputes as an alternative dispute resolution (ADR) mechanism in 2011. Tax arbitration courts (TACs) were created to solve domestic tax disputes regardless of whether they involve domestic, EU or international tax law.

TACs must decide the cases based on the written law, being expressly prohibited from resorting to equity. In a nutshell, TACs should decide tax cases based on the same legal framework available to judicial tax courts.

According to this regime, the tax authorities are bound by arbitration decisions for almost all types of tax disputes with a value of up to EUR10 million.

Mediation has not yet been established, although several proposals exist to create a specific regime in some areas.

Moreover, at the international level and where tax disputes involve the relationships between states, tax arbitration becomes the ultimate resort to settle those disputes.

6.2 Settlement of Tax Disputes by Means of ADR

Under the arbitration regime, disputes are settled by TACs that can be constituted by a single arbitrator (usually for controversies of low value – up to EUR60,000) or a panel of three arbitrators (cases up to EUR10 million).

The linchpin of the tax arbitration project was deciding how the judges would be chosen/

appointed by the parties involved or by a third party.

Provided the disputed amount exceeds EUR60,000, or the taxpayer chooses to appoint an arbitrator, the arbitration court is formed by a panel of three arbiters. Otherwise, the case will be settled by way of a decision of a single arbiter. The majority of cases are decided by a single arbitrator appointed by the Ethics Committee of the Centre for Administrative Arbitration (CAA).

Cases are initiated by a specific request filed electronically to CAA, which also indicates whether the taxpayer intends to appoint a specific arbitrator. Cases must be settled in a period of six months following the creation of the TAC, which nevertheless may be extended for a further six-month period.

TACs receive the written arguments of both parties (first taxpayers, usually contesting a tax assessment grounded in an audit report, and then the tax authorities) and analyse the merits of the claim, hear witnesses and eventually the parties or experts, and they decide in writing.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Under the arbitration system it is not possible to reach an agreement to reduce the tax assessment, the interest due or the penalties that may eventually be applied.

However, in an earlier phase (usually during the tax audit), it is possible to regularise situations to reduce the interest due and/or the penalties that may potentially apply.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Advance rulings with binding effect may be requested from the tax authorities. See also **1.3 Avoidance of Tax Controversies**.

6.5 Further Particulars Concerning Tax ADR Mechanisms

TACs

According to the current arbitration regime, cases may be submitted to TACs as follows.

- As a rule, TACs have the jurisdiction to decide on the legality or illegality of the most common tax acts or decisions.
- All cases with a value up to EUR10 million may be submitted.
- The TAC has a period of six months, eventually renewable by another six months, to provide its final decision.
- Usually, there is no possibility to appeal against a TAC decision, the absence of an appeal in respect of TAC decisions is one of the principal characteristics of the model; there are, however, a few exceptions that contribute to ensuring the harmonisation of court decisions and guaranteeing taxpayers rights at the highest level:
 - (a) an appeal to the ASC whenever the TAC decision conflicts with a previous decision issued by another TAC, the ACC or the ASC, provided the same fundamental point of law is at issue; or
 - (b) an appeal to the Constitutional Court whenever the TAC's decision denies the application of a provision based on its being unconstitutional or applies a provision the unconstitutionality of which was raised during the proceedings.

TACs are formed by one or three arbitrators.

- The panel of three arbitrators may be chosen by the CAA, otherwise each party chooses an arbitrator, and both choose the president.
- Although precedence is not a binding rule, a previous decision on a specific matter of law may prove to be extremely important.
- Decisions must be based strictly on law.

MLI

The OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), signed on 17 June 2017, was ratified in November 2019, and, on 28 February 2020, Portugal deposited its instrument of ratification before the OECD. The MLI entered into force in Portugal on 1 June 2020.

Under one of the many optional clauses foreseen in the MLI, Portugal opted to apply the arbitration clause to settle international tax disputes; this option and the transposition of the EU Arbitration Directive (ie, Directive (EU) 2017/1852 of 10 October 2017), which is even more relevant in practice, mean that arbitration will be allowed to settle this type of dispute in the near future.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

In specific areas (eg, transfer pricing) or situations (eg, when the tax authorities calculate income through indirect methods), agreements between the parties (taxpayers and tax authorities) may be signed. See also **1.3 Avoidance of Tax Controversies**.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Additional tax assessments typically result from internal or external tax audit procedures con-

ducted by the Portuguese tax authorities. Within the context of such tax inspection procedures, the tax authorities not only evaluate whether the taxpayer has made a correct assessment of the tax paid and whether the taxpayer has paid the full amount of taxes due, but also ascertain if the mistakes eventually detected correspond to tax infringements/crimes.

Therefore, the tax inspection's final report already contains (i) an assessment regarding possible inaccuracies regarding the taxes paid and the taxes and interest due, and (ii) an assessment respecting any tax infringements that may derive from the mistakes/significant crimes committed by taxpayers.

In these circumstances and because both assessments are made at the same time, typically, additional tax assessments and tax infringement processes begin "side by side".

However, the tax authorities may initiate an administrative tax offence process whenever there is suspicion that an administrative tax offence has taken place and independently from a tax inspection procedure, and whatever the situation is under the tax assessment perspective. The same applies to the Public Prosecutor's Office regarding tax crimes.

If an administrative tax offence is detected, the tax authorities are competent to initiate an administrative tax offence procedure on their own. In the event of a possible tax crime being detected, the tax authorities must inform the Public Prosecutor's Office and pass on all the information gathered during the inspection procedure.

7.2 Relationship between Administrative and Criminal Processes

The administrative process in which the additional tax assessment is being challenged and

the tax administrative offence or criminal process regarding the facts that gave rise to such additional tax assessment run in parallel. They are, therefore, independent from one another.

However, when an administrative process, in which the additional tax assessment is being challenged, is pending and the qualification of the facts under dispute as a tax infringement depends on the decision of that administrative process – which determines whether the additional tax assessment was legally issued and if the tax assessed is due – the tax-infringement process (whether an administrative offence or a criminal one) must be suspended until a final decision on the administrative process is adopted and becomes *res judicata*.

7.3 Initiation of Administrative Processes and Criminal Cases

As described above (see **7.1 Interaction of Tax Assessments with Tax Infringements**), an administrative or a criminal tax offence proceeding is initiated by the tax authorities in any case in which they become aware or suspect that an administrative tax offence or that a tax crime may have taken place. Commonly this awareness arises within the context of tax audit procedures.

The same facts may simultaneously support an indictment in an administrative tax offence proceeding and an indictment in a criminal proceeding. When this happens, the facts are prosecuted as a crime.

If, for some reason, the same facts have given rise to an administrative tax offence proceeding and a criminal one, the first one is extinguished as soon as the defendant is notified of the criminal indictment.

There are far more cases of administrative tax offences, considering that all types of mistakes

originate in a file and usually the application of a fine (*coima*). However, tax criminal law has been aggravated in the last decade and the tax and social security authorities are using criminal sanctions far more often than in the past.

7.4 Stages of Administrative Processes and Criminal Cases

Administrative Tax Offence Proceedings

The administrative tax offence proceedings may be divided into two main stages: the administrative stage and the judicial stage. In the first stage, the tax authorities have broad powers to investigate and to issue a formal bill of indictment against the taxpayer, if it is concluded at the end of an investigation that there are sufficient grounds and evidence to indicate that a tax offence has been committed. Normally the grounds that give rise to additional tax assessments are the ones used by the tax authorities to issue such a bill of indictment.

Subsequently, the defendant may present its defence before the tax authorities.

Thereafter the tax authorities will issue their final decision; if a conviction is rendered at that moment, that decision may be judicially challenged by the defendant. Such judicial appeal marks the beginning of the judicial stage and has suspensive effect: therefore, the decision reached by the tax authorities at that point will neither become final nor immediately enforceable.

The judicial decision rendered by the first-instance court may still be appealed to the appellate courts if the first-instance court confirms the conviction previously rendered by the tax authorities.

Only the decision rendered by that appellate court would, in principle, be final and fully enforceable, except if constitutional issues are

involved and an extraordinary appeal (also with suspensive effect) is presented to the Constitutional Court.

The Administrative and Tax Courts are the competent courts to decide on tax administrative processes.

Criminal Tax Offence Proceedings

Criminal tax proceedings usually consist of four main stages: an investigation stage, a pre-trial stage (that may or may not occur), a trial stage and an appeal (see **7.7 Appeals against Criminal Tax Decisions**).

The investigation stage, which is conducted by the Public Prosecutor's Office, has the purpose of gathering all the relevant information and evidence regarding the tax criminal offence allegedly committed. This stage typically ends with a decision of indictment or with a decision to close the investigation. Under certain circumstances, this stage may also give rise to a decision of provisional suspension of the tax criminal proceedings, where the defendants agree to comply with a number of injunctions for a period, after which time the investigation may be closed with no further action, or proceed, if the injunctions are not complied with.

The pre-trial stage is not compulsory. It may take place if requested by the defendant, as regards facts based upon which the Public Prosecutor submitted a bill of indictment.

The pre-trial stage represents a number of preliminary judicial acts that the investigating judge intends to perform and, compulsorily, involve a preliminary hearing, oral and adversarial in character, during which the Public Prosecutor, the defendant and their defence counsel may participate. It ends with a decision to arraign, with the case proceeding to the trial stage, or with a

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

decision not to pursue the case, which brings an end to the proceedings.

In the trial stage, all evidence gathered by the Public Prosecutor's Office and all evidence gathered by the defendants is brought to the first-instance court to be discussed and analysed. This stage ends with the court issuing a decision, which is, in principle, appealable (see **7.7 Appeals against Criminal Tax Decisions**).

The Criminal Courts are the competent courts to decide on tax criminal offences.

7.5 Possibility of Fine Reductions

Portuguese law provides for some situations in which the taxpayers may benefit from fine waives or reductions.

Taxpayers may benefit from a fine waive if they have not been convicted by a final decision within an administrative tax offence or tax crime proceeding, nor benefited from exemption or payment of a reduced fine.

The fine waive automatically applies to situations in which (i) it is not the non-payment of taxes that is being discussed; and (ii) the taxpayer has, in the meantime, fulfilled the tax obligations that gave rise to the tax infraction.

If the fine is paid at the taxpayer's request, they will benefit from a reduction of the fine, which can range from 12.5% of the minimum applicable fine up to 50% of the minimum applicable fine, depending on the stage of the administrative tax offence proceedings.

If the defendant pays the fine before the administrative tax offence proceedings or tax inspection begins, the minimum applicable fine will always be imposed.

When the taxpayer pays the fine after one of those occurrences but before the deadline to be heard within a tax inspection, the penalty shall be reduced to 50% of the applicable fine.

The 50% reduced fine may also be applied at the request of the taxpayer before the deadline for presenting their defence within an administrative tax offence proceeding if they confess their responsibility for the infraction and regularise their tax situation.

7.6 Possibility of Agreements to Prevent Trial

Portuguese law does not allow a defendant to enter a plea bargain. Normally, plea bargains represent agreements between defendants and the Public Prosecutor's office whereby the defendant agrees to plead guilty and pays the tax assessed plus interest and penalties in exchange for a reduced sentence and avoiding trial.

There are no other procedures for the early resolution of criminal law offences before trial.

However, if the criminal process refers to a crime for which criminal law allows no sentence, the Public Prosecutor's Office may decide to close the case without further action (ie, no indictment and no trial) after consulting the tax authorities and with the agreement of the investigating judge.

7.7 Appeals against Criminal Tax Decisions

The judicial decision rendered by the first-instance court is appealable, as a rule, to an appellate court and has suspensive effect in the case of conviction; therefore, the decision reached by the first-instance court at that point will neither become final nor immediately enforceable.

In some exceptional cases, first-instance court decisions are appealable to the Supreme Court.

To appeal against a criminal court decision, the defendant must submit a written application declaring their intention to file an appeal, together with a written appeal statement. The written application must be submitted to the court of first instance, but it will be considered by the second-instance court. The appeal must be submitted within 30 days after the notification of the decision issued by the first-instance court.

If constitutional issues are involved, an extraordinary appeal (also with suspensive effect) may still be presented to the Constitutional Court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a rule, transactions and operations that have been challenged in Portugal under the GAAR, specific anti-avoidance rules (SAAR), transfer pricing rules or anti-avoidance rules gave rise to administrative tax cases in the same terms as all other tax facts (see **7.1 Interaction of Tax Assessments with Tax Infringements**); this firm is not aware of criminal cases involving these type of operations, but one cannot exclude such a possibility if the facts were to show the existence of *dolus* with the evident intent of not paying the due taxes.

Therefore, in principle there are no particular procedures to address these matters.

The largest disputes involving such matters (in terms of the amounts involved, the number of defendants or their public notoriety) produce, however, a great deal of media attention and public pressure to obtain convictions (which do not necessarily occur).

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In situations of double taxation due to additional tax assessments or tax adjustments in cross-border situations, it is common to use domestic litigation, which does not mean that the mutual agreement procedure is not used – either as an alternative to, or together with, judicial litigation. According to the OECD statistics, 39 cases related to Portugal started in 2020 and 19 were terminated in the same year, and the total number of cases pending at the end of 2020 was 86.

With regard specifically to cases concerning transfer pricing, according to the same source, 14 cases started in 2020 and five were terminated in the same year, and the total number of cases pending at the end of 2020 was 42.

The Arbitration Directive and the MLI

In September 2019, Portugal published Law No120/2019, of September 19th, which implemented the EU Arbitration Directive, and “lays down rules on a mechanism to resolve disputes between member states when those disputes arise from the interpretation and application of agreements and conventions that provide for the elimination of double taxation of income and, where applicable, capital. It also lays down the rights and obligations of the affected persons when such disputes arise”.

Being so recent, there are still no data or statistics available on its use, although it is likely to assume an important part in cross-border double taxation disputes in the future. It is also not yet possible to determine the effects that the MLI measures will produce in practice; it seems that it will take some time before a proper and reliable evaluation can be made.

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

8.2 Application of GAAR/SAAR to Cross-Border Situations

With the publication of the 2003 update to the OECD Model Convention, Portugal introduced an observation on the Commentaries to Article 1 stating that the application of GAAR or SAAR could not prevail if they were in conflict with treaty provisions due to the rules of the hierarchy of laws in the Portuguese legal system, according to which double tax treaties prevail over domestic law regardless of whether the latter rules were enacted before or after the former ones. This observation was later eliminated in the 2010 update of the OECD Model Convention.

After the elimination of this observation, Portugal started to negotiate treaties allowing the application of domestic anti-abuse provisions. Specifically, with regard to the application of the GAAR, taking into account that it may allow the tax authorities discretionarily to recharacterise the facts and operations that occurred as facts or operations of an equivalent economic result, it is argued that it can be against the double tax treaty as it may alter the taxing powers of the contracting states. However, to the best of the authors' knowledge, this has never been challenged successfully in court.

Times are changing, however. The MLI introduces more anti-abuse rules and includes the principal purpose test (PPT) in all Conventions signed by Portugal. Moreover, Portugal has accepted the principle that tax treaties generally do not limit the right to tax residents of a state to that state, unless this is expressly excluded by the treaty ("saving clause"), which is intended to clarify that SAARs such as CFC rules might be compatible with the Convention.

This evolution and other international trends justify taxpayers being particularly cautious in cross-border transactions whenever benefiting from tax treaty measures, although they should

not feel deterred by these new rules. In practice, it is likely that the PPT will not have a significantly different effect than the GAAR.

8.3 Challenges to International Transfer Pricing Adjustments

Portuguese tax law allows for correlative adjustments. Although these adjustments can be promoted by the tax authorities in the context of double tax treaties that foresee such a possibility, they should be generally promoted by taxpayers since it is in their best interest to avoid the double taxation originating in the transfer pricing correction made to an associated company in another state. According to the law, the taxpayer shall present, to the tax authorities, a request to make the correlative adjustment. This request has to be presented within the deadline foreseen in the mutual agreement procedure (MAP) of the relevant double tax treaty. If the tax authorities agree with the adjustment made in the other state, the correlative adjustment shall be made within 120 days after the agreement obtained with the tax authorities of the other state.

There is no information available on the number of such adjustments that have been made by the tax authorities or challenged by taxpayers.

The only information available is that 14 transfer pricing cases under the MAP were initiated in 2020 and five were terminated in the same year, and the total number of cases pending at the end of 2020 was 42.

See **8.2 Application of GAAR/SAAR to Cross-Border Situations** for discussion of the effect of the MLI on cross-border tax disputes.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Whilst detailed rules on transfer pricing have been provided for in the law since 2001, APAs were only introduced in 2008. In the early years,

taxpayers were reluctant to initiate APAs, but things have changed in recent years, when they have become more widespread to mitigate controversies and litigation in transfer pricing matters. It is expected that if the number of APAs does not grow, more tax controversies on transfer pricing matters will arise. Although APAs take some time and involve a complex administrative procedure, more and more taxpayers intend to enter into this type of agreement.

The procedure to sign an APA starts with the request presented by the taxpayer to the tax authorities. In the event that taxpayers want to include operations with associated enterprises resident in countries with which Portugal has entered into double tax conventions, they can request that the APA is bilateral or multilateral, in which case the request will be presented to the other(s) tax authorities under the MAP. The agreement reached between the tax authorities is notified to the taxpayer, to obtain its confirmation on the acceptance of such agreement. The request shall:

- contain a proposal of the methods chosen by the taxpayer;
- identify the period and operations covered;
- contain the signature of all the entities that are to be bound by the agreement;
- contain a declaration stating that the taxpayer will co-operate with the tax authorities and will not invoke any commercial or professional secrecy; and
- supply all the necessary elements so that the automatic exchange of information between the tax authorities can be put in place.

8.5 Litigation Relating to Cross-Border Situations

Taking into account the case law produced by the higher courts, the cases related to cross-border situations that generate the most litigation are those related to withholding taxes. How-

ever, transfer pricing and residency matters are increasingly attracting the attention of the tax authorities and several relevant court cases in this domain have recently been initiated or/and decided.

To mitigate this situation, taxpayers should have internal compliance rules that allow them to control these cases. Moreover, they should verify, with particular attention, the different formalities and criteria that the implementation of EU rules and the double tax treaty requires. Particular attention should be paid to facts, documentation, compliance rules and procedures that might prevent or reduce tax contingencies.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

Portugal has a sound relationship with the European Commission in state aid matters, and aims to comply with the applicable European Union Treaty provisions and implementing regulations, soft law and the *acquis communautaire* of the European Courts and of the European Commission addressed to Portugal.

The majority of cases concern atypical private enforcement cases, including legal actions against taxes, and parafiscal charges and actions by customers of the alleged aid beneficiary. State aid rules were invoked to challenge parafiscal charges imposed on the claimants by the state, based on the argument that the proceeds from those charges were used to finance illegal state aid, or that an exemption from the charge constituted illegal state aid.

For example, there have been numerous legal actions lodged by undertakings active in the wine sector against their obligation to pay a parafiscal charge for the promotion of wine (a system that had been conditionally approved

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

under state aid rules by European Commission Decision No 2011/6/EU).

In the past, there have been Commission investigations into Portuguese tax schemes for supposedly illegal state aid elements. In 2002, for instance, the Commission adopted a decision ruling that Portugal was using an illegal tax regime in Azores (State Aid C 35/2002 (Ex NN 10/2010)). Portugal appealed to the ECJ (Case C-88/03) but was unsuccessful.

More recently, in a decision dated 4 December 2020, the Commission declared certain situations related to corporate and other tax exemptions for companies active in Madeira to be illegal and incompatible state aid and ordered Portugal to recover the amounts from the beneficiaries (Case SA.21259 – Portugal, Zona Franca da Madeira, Regime III).

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

There is not a particular legal regime that is used in these matters. Depending on the particular situation, the Portuguese tax authorities request the recovery of specific state aid as they consider appropriate. Sometimes the recovery is carried out by the Portuguese tax authorities according to the usual procedures used for the request of an additional tax assessment. This leads taxpayers to try to challenge such tax assessments.

9.3 Challenges by Taxpayers

As mentioned in **9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid**, there have been instances of taxpayers challenging requests or additional tax assessments. However, in the past, the tax authorities and the courts have maintained that taxpayers cannot challenge such requests as a typical additional tax assessment. This is on the grounds that such requests were mere executive decisions following an EU decision, the lat-

ter being the sole one to be challenged in court. In another words, it has been said that taxpayers may challenge the European Commission decisions but if they do not react against them them (in the European instances), they cannot attack the enforcement measures taken by the national authorities, either administratively or judicially.

It is obviously very important to ascertain what is really considered illegal or incompatible with the European law; ie, was the legal regime put forward by the state not authorised or forbidden? Conversely, if the taxpayer applied the law but did not respect the European Commission terms and conditions for such aid, they might be obliged to refund the illegal state aid received. However, if the controversy is based on facts (ie, to determine whether the taxpayer fulfilled the criteria required), domestic courts would probably have a different view on their competence to settle the dispute.

9.4 Refunds Invoking Extra-Contractual Civil Liability

There are cases pending on this object although no positive decisions seem to have been made yet.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Portugal opted to apply part VI of the MLI.

As a result, an arbitration clause was included in 18 double tax treaties (DTTs). These tax treaties include 12 EU member states (Austria, Belgium, Denmark, Slovenia, Spain, France, Greece, the Netherlands, Ireland, Italy, Luxembourg and Malta) and six states that do not belong to the

EU (Andorra, Barbados, Canada, Singapore, the United Kingdom and Switzerland).

Before the signature of the MLI and the modifications introduced by these options, Portugal only had one DTT with an arbitration clause inserted in the MAP regime (ie, the DTT signed with Japan – Article 24). Portugal opted not to apply part VI of the MLI in respect of this DTT.

10.2 Types of Matters that Can Be Submitted to Arbitration

Portugal reserved the right only to apply arbitration in matters related to Articles 5, 7 and 9 of the OECD Model Convention, declining to apply it in cases:

- where no effective double taxation occurs;
- of fraud or any other tax crime;
- that deal with the GAAR or SAAR, including tax treaty anti-abuse rules; or
- that should be dealt with by the EU Arbitration Directive or the Arbitration Convention.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Portugal reserved the right not to apply the default “final offer” arbitration procedure (“baseball arbitration”), opting instead to apply the “independent opinion” model. Although no official justification was made public, this option seems to be consistent with the position adopted by Portugal in the Arbitration Convention.

Apart from this, one should stress that the sole DTT with an arbitration clause (ie, the DTT signed with Japan) does not provide for a specific mode of arbitration.

10.4 Implementation of the EU Directive on Arbitration

The EU Arbitration Directive (ie, Directive (EU) 2017/1852 of 10 October 2017) has been trans-

posed into Portuguese law. Considering the countries covered by the arbitration clause (see **10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)**) and the fact that Portugal declined to apply the MLI arbitration procedure if the case might be dealt with by the EU Arbitration Directive or the Arbitration Convention, it seems that the latter instruments will be more relevant in practice than the MLI. Moreover, the matters that may be challenged under an arbitration procedure are much broader in the EU Arbitration Directive than in the MLI.

10.5 Existing Use of Recent International and EU Legal Instruments

The MLI and the EU Arbitration Directive are very recent and no reliable information is available yet.

10.6 New Procedures for New Developments under Pillar One and Two

Portugal has supported the implementation of Pillars One and Two during the last years. Thus, it is expected that provided the projects go ahead, Portugal will be one of the states involved under the rules that will be approved at international level (eg, through conventions or Directives).

For the time being, no Portuguese rules or drafts exist dealing with the envisaged rules to prevent and/or settle tax disputes as indicated in Blueprint One or related to Blueprint Two. However, Portugal has already ratified the MLI and adopted the domestic rules necessary to transpose the EU Arbitration Directive to settle tax disputes.

10.7 Publication of Decisions

Decisions in international arbitration proceedings are generally not published. Portugal has opted to apply the confidentiality obligation foreseen in the MLI (Article 23.º Nos 4 and 5). However, the EU Directive 2017/1852 and the

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

Portuguese law that implemented it establish the possibility of publication of the final decision if all parties agree, or at least the publication of a summary according to an EU standard form.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Currently international tax disputes are still generally settled under the mutual agreement procedures or, more commonly, in accordance with domestic procedure rules in a litigation procedure between taxpayers and the State.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

As a rule, taxpayers involve lawyers/barristers in the early stages of a dispute in order to better deal with a potential contingency, many times even before a dispute has emerged. On the other side, it is rare for the State to hire independent professionals in tax disputes. The complexity and paramount importance of these matters suggests that both parties gain from being well assisted and equipped from the start.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

As a rule, litigating at the administrative level (by filing an administrative claim to the Portuguese tax authorities) has no associated fees, but the latter may apply a 5% fee if that claim does not seem to be sufficiently grounded.

11.2 Judicial Court Fees

The tax litigation process involves the payment of fees that vary between EUR102 and EUR3,060 according to the value of the claim, between EUR51 and EUR1,530 in the case of appeals and according to the value of the appeal, and

between EUR204 and EUR6,120 in cases classified by the courts as particularly complex.

Where the value of the claim exceeds EUR500,000, the legal fee is not fixed but variable between EUR2,040 and EUR3,060, between EUR1,020 and EUR1,530 in the case of an appeal, or between EUR4,080 and EUR6,120 in the case of files classified by the courts as particularly complex.

The court may decide not to impose this extra fee.

In general terms, taxpayers must pay the above-mentioned fees in advance (it is the cost of their initiative to litigate), except for variable value legal fees. In these cases, only the minimum fee is paid in advance, the balance is paid at the end of the case.

The tax authorities are excused from the advance payment of legal fees, which means they will only be notified to pay fees at the end of the case.

Each party is responsible for the payment of the legal fees to the court: the court is always paid for its intervention. However, the winning party may request a refund of the amounts paid in all instances of litigation from the party that lost.

11.3 Indemnities

There are two possible situations to address regarding the possibility of requesting an indemnity if the disputed additional tax assessment is considered absolutely void and/or null.

Where the additional tax assessment has been paid, the taxpayer will be entitled to a full refund of the tax and interest unduly paid, plus an amount of indemnity interest of 4% per year calculated on the value of that tax and interest unduly paid.

If the additional tax assessment has not been paid and the taxpayer has prevented a tax enforcement procedure from seizing their assets, by providing a bank guarantee or equivalent to suspend such procedure while the additional tax assessment is in dispute, the taxpayer may request an indemnity related to the costs borne to maintain that guarantee.

The guarantee must have been maintained for at least three years for the taxpayer to be entitled to an indemnity, unless the additional tax assessment resulted from an error on the part of the tax authorities.

11.4 Costs of ADR

Tax litigation in the TAC involves the payment of fees that vary between EUR306 and EUR4,896 according to the value of the claim. Where the value of the claim exceeds EUR275,000, an extra legal fee is due, equal to EUR306 for each additional EUR25,000 or fraction thereof.

Half of the fees due are paid with the initial request for the constitution of the TAC and the other half are due before the point that the arbitration decision is issued (no decisions are issued without the correspondent fees being entirely paid for).

Where the arbitrators are appointed by the parties, the fees payable by the taxpayer vary between EUR6,000 for arbitration proceedings with a value up to EUR60,000 and a maximum of EUR120,000 for proceedings between EUR7.5 million and EUR10 million.

In the latter case, arbitration fees are entirely borne by the taxpayer and must be totally paid before the filing of the initial request for the constitution of the TAC.

12. STATISTICS

12.1 Pending Tax Court Cases

First Instance

The following statistics show the number of tax court cases pending in the first instance, indicating the average number of cases attributed to a judge of first instance.

Register of tax court cases (first instance) and their status (2020 and 2018)

- Pending Cases (31/12/2020): 39,912.
- Total number of first-instance judges (31/12/2020): 123.
- Average number of cases per judge (2020): 325.

Source: based on information published by the *Conselho Superior dos Tribunais Administrativos e Fiscais* in November 2021.

The statistics show that tax judges are still being allocated a significant number of cases despite efforts have been made to reduce the number of pending cases with the recruitment of special teams for this purpose.

Appeal

The following two sets of statistics reflect the number of cases pending in the second-instance courts and the ASC. There was also a decrease in the level of appeal litigation.

Register of tax cases at the ACC (second instance) and their status (2019 and 2020)

- Pending cases (31/12/2019) – north area/ Porto: 2,726; south area/Lisbon: 2,887; total: 5,613.
- Pending cases (31/12/2020) – north area/ Porto: 2,807; south area/Lisbon: 3,066; total: 5,873.

Source: based on information published online by the *Conselho Superior dos Tribunais Admin-*

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

Administrativos e Fiscais and the Direção-Geral da Política da Justiça in November 2021.

Register of tax cases at the ASC (final instance) and their status (2019 and 2020)

- Pending cases (31/12/2019): tax plenary: 3; tax section: 940; section customs 212; total 1,155.
- Pending cases (31/12/2020): tax plenary: 3; tax section: 741; section customs: 196; total: 940.

Source: based on information published by the *Conselho Superior dos Tribunais Administrativos e Fiscais*, the *Direção-Geral da Política da Justiça* and the Administrative Supreme Court in November 2021.

Arbitration

As for tax arbitration, since 2011, 4,300 cases were initiated and, up to 31 December 2018, 3,809 cases were terminated, hence 491 were pending on 1 January 2019.

12.2 Cases Relating to Different Taxes

Tax Litigation by Region

The following statistics show the number of tax court cases, in the different regions of Portugal, initiated and terminated in 2020 in the first instance, although there is no information regarding their value or the taxes to which they relate.

- Almada: 2,803 cases initiated; 3,025 cases finalised; 2,117 pending cases.
- Aveiro: 3,242 cases initiated; 3,486 cases finalised; 2,632 pending cases.
- Beja: 284 cases initiated; 1,490 cases finalised; 522 pending cases.
- Braga: 5,585 cases initiated; 5,769 cases finalised; 4,137 pending cases.
- Castelo Branco: 278 cases initiated; 385 cases finalised; 1,246 pending cases.

- Coimbra: 338 cases initiated; 472 cases finalised; 1,253 pending cases.
- Funchal: 186 cases initiated; 222 cases finalised; 506 pending cases.
- Leiria: 4,175 cases initiated; 4,482 cases finalised; 3,352 pending cases.
- Lisbon: 14,498 cases initiated; 14,822 cases finalised; 12,340 pending cases.
- Loulé: 390 cases initiated; 363 cases finalised; 973 pending cases.
- Mirandela: 261 cases initiated; 256 cases finalised; 404 pending cases.
- Penafiel: 546 cases initiated; 785 cases finalised; 1,109 pending cases.
- Ponta Delgada: 51 cases initiated; 109 cases finalised; 57 pending cases.
- Porto: 7,823 cases initiated; 8,011 cases finalised; 5,245 pending cases.
- Sintra: 4,442 cases initiated; 4,915 cases finalised; 3,613 pending cases.
- Viseu: 302 cases initiated; 314 cases finalised; 753 pending cases.
- Total cases: 44,664 cases initiated; 48,906 cases finalised; 40,259 pending cases.

Source: based on information published by the *Conselho Superior dos Tribunais Administrativos e Fiscais and the Direção-Geral da Política da Justiça* in October 2021.

Tax Litigation Subjects

Regarding the different taxes and according to the 2019 data, most cases were related to CIT (34%), personal income tax (18.1%) and VAT (16.2%). Property tax was discussed in 12.8% of the cases and stamp duty and property transfer tax were discussed in 6.4% each. Vehicle tax gave rise to 3.6% of the cases.

Arbitration

As for arbitration, the number of cases initiated every year increased until 2014, peaking at 850 new cases, and then decreased slightly until 2017, when it started increasing again. In 2015

there were 789 new cases, in 2016 there were 772 new cases, in 2017 there were 693 cases, in 2018 there were 709 new cases and in 2019 there were 718 new cases.

Finally, in accordance with the 2017 data, in arbitration most cases had a value of up to EUR60,000 (62%), 20.8% of cases had a value between EUR60,000 and EUR275,000, 5.8% had a value of EUR275,000 up to EUR500,000, 5.4% had a value between EUR500,000 and EUR1 million, and only 6% had a value higher than EUR1 million.

12.3 Parties Succeeding in Litigation

According to the OECD statistics (compiled with tax litigation data reported to 2015), around 40% of tax court cases are decided in favour of the Portuguese tax administration.

These results do not seem different to those achieved in arbitration, according to the Administrative Arbitration Centre, using statistics from 2017.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Throughout the course of a tax controversy there are many strategic options and decisions to be taken. In spite of each case deserving its own strategic consideration, preparation and analysis, there are general guidelines that should guide, or be considered by, taxpayers along the path. Below are some of the most relevant issues.

- Usually the factual pattern is of paramount importance – to know all the facts related to the case, to scrutinise all the documents and the relevant business matters around them (including all the business reasons for a specific transaction or behaviour), may prove crucial in changing a prima facie approach that could lead to the wrong result.
- Legal aspects are also decisive on many occasions, such as:
 - (a) the formalities to be observed throughout the course of the process (as at an earlier stage, during the tax audit);
 - (b) the analysis of the burden of proof;
 - (c) different possible interpretations of legal provisions; and
 - (d) the proper use of all possible forms of evidence to prove alleged facts (documents, witnesses, experts, etc) or better illustrate a question of law (an option).
- Therefore, to be assisted by a tax lawyer from an early stage to help to understand the controversy, the strong and weak points of a case and the way forward, evaluating all the facts and the legal possible outcomes is a game changer.
- Taxpayers should also consider which form is best suited for pursuing the tax dispute, either administratively, judicially or through arbitration (including the possibility to refer questions to the ECJ); this must be evaluated at an early stage, together with the eventual interplay of options (pursuing an option and subsequently an alternative or alternatives, if necessary).

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

Morais Leitão, Galvão Teles, Soares da Silva & Associados (Morais Leitão) is a leading full-service law firm in Portugal, with a solid background and decades of experience. Widely recognised, Morais Leitão is a reference in several branches and sectors of the law at national and international level. The firm's reputation amongst both peers and clients stems from the excellence of the legal services provided. Morais Leitão's work is characterised by its unique technical expertise, combined with a distinc-

tive approach and cutting-edge solutions that often challenge some of the most conventional practices. With a team comprising over 250 lawyers at its clients' disposal, Morais Leitão is headquartered in Lisbon and has additional offices in Porto and Funchal. Due to its network of associations and alliances with local firms and the creation of the Morais Leitão Legal Circle in 2010, the firm can also offer support through offices in Angola (ALC Advogados) and Mozambique (HRA Advogados).

AUTHORS



Francisco de Sousa da Câmara is a senior partner at Morais Leitão who has headed the tax teams in Lisbon and Madeira for more than two decades. He specialises in

complex tax litigation involving domestic and international tax issues, and focuses on handling files before all types of courts. He is also a CAA-recognised arbitrator. Francisco advises high net worth individuals and family office businesses and structures. He has been involved in drafting tax legislation, including the General Tax Law, the Tax Procedure and Process Code, and a project for a wealth tax reform. Francisco regularly contributes to a range of tax-focused publications, both in Portugal and internationally.



Bruno Santiago is a partner at Morais Leitão who specialises in tax law, with a focus on domestic and international taxation, both in consulting and in dispute resolution. He

co-ordinates dedicated teams advising clients on cross-border transactions and transfer pricing, taking advantage of his knowledge of Angolan and Mozambican taxation. Bruno is also very active in the area of tax disputes and arbitration, covering income taxes, value-added tax, property taxes as well as stamp duty on financial operations; and in administrative, judicial and penalties proceedings. Bruno represents clients from sectors including financial services, oil and gas, energy, real estate and construction, media and advertising, and pharmaceuticals, as well as private clients.



Inês Salema is a senior associate at Morais Leitão who practises in the area of domestic and international taxation, both in dispute resolution and in consulting. She has a strong

focus on tax litigation (administrative and judicial procedures), across a wide range of issues, but with an emphasis on local, regulatory and port charges. Inês works in the field of tax consultation on various matters, including the taxation of individuals in an employment context (taxation of fringe benefits, stock options and compensation for termination of employment contracts). She has also been actively working on the taxation of fortuitous gains, from both an individual and a business perspective.

Morais Leitão, Galvão Teles, Soares da Silva & Associados

Rua Castilho 165
1070-050 Lisbon
Portugal

Tel: +351 21 381 74 00
Fax: +351 21 381 74 99
Email: mlgtslisboa@mlgts.pt
Web: www.mlgts.pt



Trends and Developments

Contributed by:

Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema

Morais Leitão, Galvão Teles, Soares da Silva & Associados see p.568

Introduction

Usually, in the last quarter of each year, the Portuguese government presents its annual budget for the following year to be approved by the Parliament. Last year, however, the government lacked the necessary majority in Parliament to approve its proposal of budget for 2022 which led Portugal to new general elections that occurred at the end of January 2022. For this reason, the budget for 2022 is to be approved only by mid-2022 with the expected consequence of a certain slowing down of economic activity during the period.

Following the old rule *if you can't beat them, join them*, Portugal has adapted to the new reality of living with the virus and the extraordinary measures created during the worst days of the pandemic (lockdowns, moratoriums, suspension of deadlines, etc) are now a thing of the past.

But even as the country is leaving behind the social, economic and health crisis created by the novel coronavirus, it is witnessing the emergence of a new humanitarian crisis in Ukraine with millions of refugees searching for a safe haven in other countries and facing the prospect of new economic turmoil due to the increase in the prices of oil and gas and a sharp increase in inflation to levels that haven't been seen for decades in the majority of EU member states. Inflation, sometimes known as the hidden tax, may lead to an increase in tax revenues (namely the tax collected on transactions) and will also lead to additional pressure for wage increases that, in their turn, could lead to an inflationary spiral if not properly dealt with.

This chapter will present brief summaries of selected jurisprudence recently produced by the Portuguese courts in matters that are of interest to an international audience wishing to do business, or having a substantial presence, in Portugal, as well as highlighting other recent trends and developments in the field of tax controversy.

Banking Sector Contribution from Branches of Foreign Banks Operating in Portugal

The Banking Sector Contribution (CBS) is a "ring-fencing" tax on banking sector entities, imposed from 2011 onwards, and aims to protect the economy from the systemic risk of the banking sector, similarly to the contributions under Directive 2014/59/EU, of 15 May 2014.

In 2016, the Portuguese bank levy was extended to cover Portuguese branches of banks domiciled in other EU member states, which have been contested in court by the vast majority of the relevant taxpayers. In the last years Portuguese arbitral and judicial courts have been issuing contradictory decisions, although the majority of the decisions were rendered in favour of the taxpayer, following legal reasoning according to which the bank levy on such Portuguese branches of foreign banks was imposed in violation of EU law.

The key taxpayer argument referred to discrimination in breach of EU Law between the CBS taxable base for resident banks or subsidiaries of non-resident banks vis-a-vis the taxable base for branches of non-resident banks. In fact, the CBS regime enables resident banks and subsidiaries to deduct, from their CBS base, liability

items comprising own funds and equity registered in their accounts. Branches of non-resident banks do not have this deduction available to them. Firstly, because the legal nature of a resident bank allows for its accounts to register share capital, where a branch does not have this specific type of accounting register. In this regard, the Portuguese tax authorities have issued guidelines stating that the free capital of a branch does not qualify for the eligible CBS deduction to the base.

To the best of the authors' knowledge there are several appeals pending before the Tax Courts of Appeal and it is possible that the matter will be referred to the ECJ for a preliminary ruling.

Exemption of Stamp Duty on Loans between Banks and Portuguese Holding Companies (SGPS)

In recent years, several inconsistent decisions have been issued by the Portuguese arbitration courts regarding an exemption from stamp duty which is applicable on the funding, interest and commissions charged and/or guarantees granted between financial institutions.

The contradiction in these decisions centres on the question of whether or not a SGPS (ie, a Portuguese holding company) qualifies as a "financial institution". At this date (May 2022), the count has reached ten favourable and eight negative decisions for taxpayers. Some negative decisions state that a SGPS cannot be considered a financial institution if it is not under the regulatory supervision of the Portuguese Banking Supervision Authority. Taking into account this dissidence in judicial guidelines, the Supreme Administrative Court, in an attempt to unify jurisprudence and to avoid further contradictory decisions, has referred the matter for a preliminary ruling from the ECJ on the question whether a holding company domiciled and regulated under the specific legislation of Portugal

falls under the concept of a financial institution contained in Directive 2013/36/EU and EU Regulation No 575/2013.

Transfer Pricing

During 2022, a notable case concerned a decision served by the Court of Appeals on transfer pricing matters. The case referred to the sale of a *lavaría*, a mining operation facility used to treat zinc extracted from a mine, under a mining concession. The sale was part of a wider deal executed between two different economic groups which included, among other items, the sale of the shares of the concessionary company, the sale of credits and the sale of the *lavaría* to said concessionaire.

The Portuguese tax authorities reviewed the transaction and corrected the selling price (EUR1) under transfer pricing rules. This decision was then upheld by a first instance court and by the Court of Appeals. The tax courts were impressed by the price and the previous value and evaluation of the asset, but the decision served by the latter was based on very controversial grounds which, if kept, may have a significant impact on the market.

On one hand, the Court of Appeals has considered that – although the entire deal was executed between two separate economic groups and that, by the time the sale of the *lavaría* was executed, no special relations existed between the seller (a company belonging to the selling group) and the buyer (the concessionaire) – the transaction should be subject to transfer pricing rules because the price was negotiated and agreed when the seller and buyer belonged to the same economic group. In addition, the court has found that an evaluation made within the context of a previous transaction regarding the *lavaría* carried out between the same parties, when they were indeed associated companies, was a valid comparable uncontrolled price.

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

Given the grounds of the decision and the importance that transfer pricing rules have in the day-to-day reality of business life, a special appeal has been lodged before the Supreme Court to overturn the Court of Appeals decision. The appeal is currently pending.

Taxation of Renewables: Property Tax on Wind Turbines and Solar Plants

As a result of nearly ten years of litigation in which the Portuguese Supreme Administrative Court has consistently decided that wind turbines cannot be considered as property for tax purposes, meaning that they shall not be subject to the annual municipal property tax due from the owners of real property, new internal instructions were issued to reformulate the interpretation of the law defended by the tax authorities in order to allow the promoters of wind farms and solar plants to be subject to the mentioned municipal property tax.

Thus, through Circular No 2/2021, the tax authorities have adjusted their understanding in line with the unfavourable decisions of the case law, while changing the interpretation of what they consider to fit the definition of property for tax purposes, clarifying that wind farms and solar plants satisfy the requirements underlying this definition – as opposed to the individual wind turbines – and referring the methods to be used to value such properties for municipal property tax purposes.

Although these new instructions contain relevant clarifications regarding the way in which the tax authorities will act with regard to the procedures for registering, assessing and taxing wind farms and solar power plants for municipal property tax purposes, it is not certain that the promoters will agree to or accept such an interpretation of the law. Since the tax authorities have already started notifying the promoters to register their wind farms and solar plants, it is expected that

a new wave of litigation around this subject will arise.

Application of Double Tax Treaties

The gratuitous attribution of assets to a company resident in Portugal generates an increase in equity of that company that is subject to corporate income tax under domestic rules. Based on this rule, the tax authorities have made a corporate tax assessment of a company resident in Malta that had received a property located in Portugal through a gratuitous supply (*prestação acessória*) made by its parent company resident in Portugal. According to the tax authorities the company resident in Malta had obtained a profit subject to tax in Portugal under either Article 6 or 7 of the Double Tax Treaty (DTT) in force between Malta and Portugal. The arbitration court ruled against the tax authorities, finding that Article 6 should not apply since the income did not arise from the exploitation of immovable property and that Article 7 should not apply because the company resident in Malta did not have a permanent establishment in Portugal. The court was, however, of the opinion that Article 21 of the DTT should apply and consequently Portugal had no competence to tax such income.

Taxation of Foreign Investment Funds in Breach of EU Law

Several decisions of the arbitration courts have been issued in the past year upholding the arguments presented by funds incorporated in other EU member states arguing that Portuguese law is in breach of the free movement of capital when it subjects to withholding tax the payment of dividends made by companies resident in Portugal to such funds, whereas it exempts from withholding tax such payments made to funds incorporated according to Portuguese law.

Exemption of Capital Gains on the Sale of Shares in Foreign Companies Obtained by Individuals under the NHR Regime

In a very innovative case issued in March 2022, the Portuguese Tax Arbitration Court decided in favour of an American individual taxpayer in a case concerning the application of the non-habitual resident (NHR) exemption to capital gains arising from the disposal of foreign shareholdings and participation units of investment funds. According to this regime, capital gains from the sale of shares in companies resident abroad are exempt of personal income tax in Portugal if those capital gains may be taxed in the source state according to the Double Tax Treaty in force with that state (which normally may not be taxed in the source state since the competence to tax such gains under double tax treaties belongs exclusively to the residence state).

The individual, tax resident in Portugal under the NHR regime, realised capital gains on the sale of French and US securities, and paid US tax on such income. The Portuguese tax authorities considered that the gains should be taxed at the rate of 28%, whilst the taxpayer deemed they should benefit from the NHR exemption aimed at avoiding double taxation. Taking into account the savings clause included in the Portugal-USA Double Tax Treaty, which foresees that, in certain cases, the USA may tax its citizens as if the treaty had not come into effect, the Tax arbitration court decided that the gains were potentially subject to tax in the USA, and thus could benefit from the NHR exemption applicable to capital gains.

Capital Gains on the Sale of Immovable Property Located in Portugal Obtained by Non-resident Individuals

The Portuguese personal income tax regime applicable to capital gains made on the transfer of real estate contains an clear discrimination

between resident and non-resident individuals, according to which residents are subject to taxation only on 50% of those capital gains at the general progressive tax rates (ranging between 14.5% and 48%) while non-residents are subject to taxation on 100% of the capital gains at the flat rate of 28% (except if such non-resident is deemed resident for tax purposes in another EU member state, in which case the non-resident taxpayer can choose to be subject to the taxation regime applicable to tax residents).

Therefore, whilst non-residents are subject to an effective tax rate of 28%, the effective taxation applicable to tax residents, as a rule, does not exceed 24%. This fact has led to more than a decade of tax disputes between non-resident taxpayers and the Portuguese tax authorities, under which both national courts and the ECJ have stated, without a shadow of a doubt, that this tax regime should be deemed contrary to the free movement of capital either in a scenario where the capital gain is made by a non-resident having their tax residence in another EU member state or where such non-resident has their tax residence in a third country.

According to the latest information available, the Portuguese tax authorities are finally recognising the understanding assumed by the several Court decisions issued within this scope in the administrative and judicial procedures currently pending regarding this matter. Nevertheless, so far, no amendment of the tax law has been approved in order to duly comply with the relevant jurisprudence and conclude this tax controversy once and for all.

Matters where Litigation May Increase

The above-mentioned cases are mere examples that illustrate the type of issues that the near future may bring – at an amplified scale – in terms of post-pandemic litigation, now with all the most sophisticated tools brought forward by

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Moraes Leitão, Galvão Teles, Soares da Silva & Associados

BEPS, the Anti-Tax Avoidance Directives (ATAD) I and II, the Multilateral Convention to Implement Tax Treaty Related Matters to Prevent BEPS (MLI), the Common Reporting Standard (CRS), DAC 5, etc.

Taking into account the incorporation of this unparalleled number of international legal instruments, it will be interesting to see how the courts will protect taxpayers' rights in situations of abuse or wrong application by the tax authorities of these new mechanisms.

The targeted taxpayers will probably check whether those measures offend ordinary or constitutional domestic rules, or EU or international agreements, and if they consider that they do, they will fight for their rights.

GAAR

The past year has seen a growing trend for the tax authorities to deviate from their duty of making tax assessments and instead moving the discussion on the existence of a tax liability into the criminal area, and with this shift surreptitiously coercing taxpayers to pay and not contest the tax authorities' findings. Due to the existence of specialised courts in Portugal for criminal matters as well as for tax matters this trend, if not timely overturned, could ultimately result in the denial of a fair trial since taxpayers will be denied of the right to their case being judged by a tax tribunal.

DAC 6

The Portuguese Ombudsman (at the demand of the Portuguese Bar Association) presented in the last quarter of 2021 in the Constitutional Court a request to scrutinise the constitutionality of some norms of Law 26/2020, of 21 July 2021, which implements Council Directive 2018/822, of 25 May 2018 amending Council Directive 2011/16/Eu, of 15 February 2011 as regards the mandatory automatic exchange of information

in the field of taxation in relation to reportable cross-border arrangements (commonly known as DAC 6). The request was grounded on a potential violation of the principle of proportionality, the right to a fair trial, the right to privacy and attorney-client professional privilege, all principles and rights protected by the Portuguese Constitution. A decision from the Constitutional Court is expected in late 2022.

Foreclosures

During the early stages of the pandemic the government established measures that allowed for moratoriums on the payment of interest (and in some cases capital and interest) to the banks by companies and individuals in difficult circumstances due to COVID-19. Now that this extraordinary measure has been shut down, it is expected that foreclosures files will grow because some taxpayers will have the added difficulty of complying with their ordinary obligations, including taxes. This may lead to an increase in the number of tax foreclosures.

Final Notes

Portugal, as an EU and OECD member state, is at the forefront of the international measures that are being implemented as a consequence of BEPS. The implementation of the two pillars that are being developed at the OECD level is eagerly awaited. The Portuguese authorities are better equipped with technical means and supplied with much more information than in the past. BEPS initiatives will continue to make an important contribution to the monitoring of large companies and HNWIs as well as the interaction of different tax systems in cross-border situations.

Clearly, the best strategy for taxpayers is to anticipate and be prepared for the audits that will soon come, by reviewing their most recent operations and any possible weaknesses in order to better identify and mitigate the tax risks – collecting data and arguments that will sus-

*Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema,
Morais Leitão, Galvão Teles, Soares da Silva & Associados*

tain positions. This is crucial to avoid potential litigation and, if this is not possible, it may be key to initiating the successful challenge of an additional tax assessment.

PORTUGAL TRENDS AND DEVELOPMENTS

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados

Morais Leitão, Galvão Teles, Soares da Silva & Associados (Morais Leitão) is a leading full-service law firm in Portugal, with a solid background and decades of experience. Widely recognised, Morais Leitão is a reference in several branches and sectors of the law at national and international level. The firm's reputation amongst both peers and clients stems from the excellence of the legal services provided. Morais Leitão's work is characterised by its unique technical expertise, combined with a distinc-

tive approach and cutting-edge solutions that often challenge some of the most conventional practices. With a team comprising over 250 lawyers at its clients' disposal, Morais Leitão is headquartered in Lisbon and has additional offices in Porto and Funchal. Due to its network of associations and alliances with local firms and the creation of the Morais Leitão Legal Circle in 2010, the firm can also offer support through offices in Angola (ALC Advogados) and Mozambique (HRA Advogados).

AUTHORS



Francisco de Sousa da Câmara is a senior partner at Morais Leitão who has headed the tax teams in Lisbon and Madeira for more than two decades. He specialises in

complex tax litigation involving domestic and international tax issues, and focuses on handling files before all types of courts. He is also a CAA-recognised arbitrator. Francisco advises high net worth individuals and family office businesses and structures. He has been involved in drafting tax legislation, including the General Tax Law, the Tax Procedure and Process Code, and a project for a wealth tax reform. Francisco regularly contributes to a range of tax-focused publications, both in Portugal and internationally.



Bruno Santiago is a partner at Morais Leitão who specialises in tax law, with a focus on domestic and international taxation, both in consulting and in dispute resolution. He

co-ordinates dedicated teams advising clients on cross-border transactions and transfer pricing, taking advantage of his knowledge of Angolan and Mozambican taxation. Bruno is also very active in the area of tax disputes and arbitration, covering income taxes, value-added tax, property taxes as well as stamp duty on financial operations; and in administrative, judicial and penalties proceedings. Bruno represents clients from sectors including financial services, oil and gas, energy, real estate and construction, media and advertising, and pharmaceuticals, as well as private clients.

Contributed by: Francisco de Sousa da Câmara, Bruno Santiago and Inês Salema, Morais Leitão, Galvão Teles, Soares da Silva & Associados



Inês Salema is a senior associate at Morais Leitão who practises in the area of domestic and international taxation, both in dispute resolution and in consulting. She has a strong

focus on tax litigation (administrative and judicial procedures), across a wide range of issues, but with an emphasis on local, regulatory and port charges. Inês works in the field of tax consultation on various matters, including the taxation of individuals in an employment context (taxation of fringe benefits, stock options and compensation for termination of employment contracts). She has also been actively working on the taxation of fortuitous gains, from both an individual and a business perspective.

Morais Leitão, Galvão Teles, Soares da Silva & Associados

Rua Castilho 165
1070-050 Lisbon
Portugal

Tel: +351 21 381 74 00
Fax: +351 21 381 74 99
Email: mlgtslisboa@mlgts.pt
Web: www.mlgts.pt



Law and Practice

Contributed by:

Alexandru Cristea, Ramona Chițu, Cristian Velcu and
Narcisa Ichim

Țuca Zbârcea & Asociații Tax see p.586



CONTENTS

1. Tax Controversies	p.573	5.3 Judges and Decisions in Tax Appeals	p.577
1.1 Tax Controversies in this Jurisdiction	p.573	6. Alternative Dispute Resolution (ADR) Mechanisms	p.577
1.2 Causes of Tax Controversies	p.573	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.577
1.3 Avoidance of Tax Controversies	p.573	6.2 Settlement of Tax Disputes by Means of ADR	p.578
1.4 Efforts to Combat Tax Avoidance	p.573	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.578
1.5 Additional Tax Assessments	p.573	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.578
2. Tax Audits	p.573	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.578
2.1 Main Rules Determining Tax Audits	p.573	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.578
2.2 Initiation and Duration of a Tax Audit	p.574	7. Administrative and Criminal Tax Offences	p.578
2.3 Location and Procedure of Tax Audits	p.574	7.1 Interaction of Tax Assessments with Tax Infringements	p.578
2.4 Areas of Special Attention in Tax Audits	p.574	7.2 Relationship between Administrative and Criminal Processes	p.578
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.575	7.3 Initiation of Administrative Processes and Criminal Cases	p.579
2.6 Strategic Points for Consideration during Tax Audits	p.575	7.4 Stages of Administrative Processes and Criminal Cases	p.579
3. Administrative Litigation	p.575	7.5 Possibility of Fine Reductions	p.579
3.1 Administrative Claim Phase	p.575	7.6 Possibility of Agreements to Prevent Trial	p.579
3.2 Deadline for Administrative Claims	p.575	7.7 Appeals against Criminal Tax Decisions	p.580
4. Judicial Litigation: First Instance	p.576	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.580
4.1 Initiation of Judicial Tax Litigation	p.576	8. Cross-Border Tax Disputes	p.580
4.2 Procedure of Judicial Tax Litigation	p.576	8.1 Mechanisms to Deal with Double Taxation	p.580
4.3 Relevance of Evidence in Judicial Tax Litigation	p.576	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.580
4.4 Burden of Proof in Judicial Tax Litigation	p.576		
4.5 Strategic Options in Judicial Tax Litigation	p.577		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.577		
5. Judicial Litigation: Appeals	p.577		
5.1 System for Appealing Judicial Tax Litigation	p.577		
5.2 Stages in the Tax Appeal Procedure	p.577		

8.3	Challenges to International Transfer Pricing Adjustments	p.580	10.5	Existing Use of Recent International and EU Legal Instruments	p.583
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.580	10.6	New Procedures for New Developments under Pillar One and Two	p.583
8.5	Litigation Relating to Cross-Border Situations	p.581	10.7	Publication of Decisions	p.583
9.	State Aid Disputes	p.581	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.583
9.1	State Aid Disputes Involving Taxes	p.581	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.583
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.581	11.	Costs/Fees	p.584
9.3	Challenges by Taxpayers	p.582	11.1	Costs/Fees Relating to Administrative Litigation	p.584
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.582	11.2	Judicial Court Fees	p.584
10.	International Tax Arbitration Options and Procedures	p.583	11.3	Indemnities	p.584
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.583	11.4	Costs of ADR	p.584
10.2	Types of Matters that Can Be Submitted to Arbitration	p.583	12.	Statistics	p.584
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.583	12.1	Pending Tax Court Cases	p.584
10.4	Implementation of the EU Directive on Arbitration	p.583	12.2	Cases Relating to Different Taxes	p.584
			12.3	Parties Succeeding in Litigation	p.584
			13.	Strategies	p.584
			13.1	Strategic Guidelines in Tax Controversies	p.584

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In Romania, tax controversies arise as a result of tax assessments derived from tax audits conducted by the Romanian Tax Authorities (RTA). There is no possibility for taxpayers to challenge their own tax returns.

1.2 Causes of Tax Controversies

Tax controversies arise in relation to all Romanian tax obligations; however, the more frequent ones are the value added tax (VAT) and the corporate income tax (CIT, including transfer pricing). These are also the areas which involve the most significant values in terms of tax obligations assessed by the RTA following their audits. During recent years, the matters which gave rise to most tax controversies are as follows:

- the value of intra-group transactions (especially with related non-resident entities), from a transfer pricing perspective;
- the deductibility (both CIT and VAT) in relation to the expenses incurred with services received from related non-resident entities;
- the deductibility (both CIT and VAT) in relation to the expenses incurred from Romanian taxpayers who have failed to pay their tax obligations;
- various VAT issues in relation to real estate transactions (eg, imposing VAT on sales, imposing VAT adjustment on the initial deduction, etc);
- tax issues in relation to various promotional/marketing structures (eg, the granting of gift tickets assimilated to salary income, etc).

1.3 Avoidance of Tax Controversies

Tax controversy can be mitigated by trying to reduce, to the extent possible, the red flags which usually draw the attention of the RTA, such as the following:

- the existence of years with tax losses;
- a profitability level below the average for the respective industry/type of activity together with the existence of transactions with related parties;
- submitting multiple rectifying tax statements and/or with high value differences;
- the existence of reporting differences regarding the value of the transactions declared in relation to business partners (VIES reporting for intra-community transactions with goods/services and equivalent reporting for transactions subject to Romanian VAT).

Other ways of mitigating potential tax controversy include obtaining tax advice prior to performing new transactions of significant value, obtaining tax binding rulings or non-binding opinions from the RTA, etc.

1.4 Efforts to Combat Tax Avoidance

Currently, it is difficult to estimate the impact of the BEPS recommendations and other recent EU measures to combat tax avoidance regarding the number of tax controversies in Romania.

1.5 Additional Tax Assessments

Additional tax assessments give rise to an obligation to pay the amount of tax assessed within a period of 20–30 days. There are some procedural means available for postponing this payment obligation: either by submitting a bank guarantee letter, or by starting a court action against the RTA stating that their assessment is not legally grounded, and that the payment of the respective amount is significantly disturbing the business of the taxpayer.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

There are multiple reasons that can trigger a tax audit of the RTA, including:

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax

- that the taxpayer has not been audited in the last five years and the previous tax audit led to tax assessments;
- the existence of years with tax losses;
- a profitability level below the average for the respective industry/type of activity together with the existence of transactions with related parties;
- submitting multiple rectifying tax statements and/or with high value differences;
- the existence of reporting differences regarding the value of transactions declared in relation to business partners (VIES reporting for intra-community transactions with goods/services and equivalent reporting for transactions subject to Romanian VAT);
- various target industries/activities (eg, during recent years there was an increased number of tax audits for transportation companies, distributors of medicines, trading companies, etc).

2.2 Initiation and Duration of a Tax Audit

There are different types of tax audits, as follows.

- A regular tax audit (which can cover a single tax or multiple taxes) is announced within 30 days prior to its commencement and can last up to six months, depending on the size of the taxpayer. In practice, the RTA can extend this period up to double this amount without breaching legal provisions, and by even more than that by suspending the tax audit for specific periods.
- Unannounced tax audits, which are limited in extent and scope and can last up to 30 days. There is no pre-announcement, and usually these are used to identify tax risk areas and could lead to a subsequent regular tax audit. Tax assessment cannot be imposed by the RTA at the end of such audits.
- A recent type of tax audit is the “documentary check”: this represents a very brief audit

of a specific situation and can lead to a tax assessment on the respective topic.

The regular tax statute of limitation is five years, and can be extended to ten years in the case of tax criminal offences. The expiry of this period can prevent the assessment of additional tax obligations.

The relevant moment for the statute of limitation is the beginning of the tax audit. If the tax audit is started within the statute of limitation period, it doesn't matter when it will end.

2.3 Location and Procedure of Tax Audits

The location of the tax audits can differ based on the size of the taxpayer and the duration of the audit: for small taxpayers and short tax audits, they can be conducted at the premises of the RTA. Otherwise, the premises of the taxpayer are used. The special circumstances of the last two years have increased the occurrence of transmitting data to the RTA through electronic means. Moreover, the current implementation of SAF-T reporting is likely to increase this during the coming years.

2.4 Areas of Special Attention in Tax Audits

The usual areas of interest for tax inspectors during their tax audits include the following:

- the reasons that led to tax losses;
- the compliance with the transfer pricing rules for the transactions with related parties;
- the existence of missing stocks/inventories;
- the existence of promotional schemes;
- the deductibility of services expenses (with special attention given towards intra-group services);
- the applicability of VAT exemption (especially for intra-community supplies of goods);

- withholding tax applicability on income derived from Romania by non-residents.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Information exchanges and tax verification procedures have increased between the RTA and other tax authorities. During recent years, we have assisted our clients in an increasing number of brief tax audits which have originated from requests received by the RTA from tax authorities in other jurisdictions.

In addition, the RTA are initiating such cross-border checks more often, an aspect which is visible in the tax audits which they are conducting at the level of Romanian taxpayers.

2.6 Strategic Points for Consideration during Tax Audits

The recent practice of the RTA during tax audits has shown that in most cases taxpayers can avoid the risk of being imposed with additional tax obligations if the following conditions are cumulatively met:

- there are no clear tax issues in place;
- they proactively communicate with the tax inspectors during the tax audit;
- the involvement of tax advisors, which is recommended in most situations;
- all the known risk areas determined by the practice of the RTA are carefully addressed in due time.

In addition, taxpayers should proactively use any information/documents (eg, relevant jurisprudence) stipulating their position immediately after identifying that the tax inspectors have spotted a potential risk area.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

After receiving a tax assessment, the administrative claim phase is mandatory before initiating the judicial phase.

The tax appeal must be submitted by the taxpayer within a maximum of 45 days following the date when the tax assessment was communicated by the RTA. Filing an administrative appeal cannot put the taxpayer in a worse position as compared to the tax assessment issued by the RTA.

The taxpayer can also request a formal meeting with the RTA to discuss its tax appeal.

Tax appeals are currently resolved at the level of the Ministry of Finance.

If the answer to the appeal is negative, the taxpayer has an extraordinary means of challenging such a decision, in addition to the regular court action. This is based on a request for revision of the decision and can be justified by various reasons, such as new decisions of the Court of Justice of the European Union, new decisions of the Romanian High Court of Cassation and Justice, etc.

3.2 Deadline for Administrative Claims

There is no specific deadline provided by legislation for providing an answer to a tax appeal. The general deadline for the tax authorities to answer the requests of the taxpayer is 45 days.

If the answer to the tax appeal is not received within six months following its submission, the taxpayer has the legal right to lodge a court claim to force the tax authorities to provide an answer.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

The decision on the tax appeal can be challenged in court by the taxpayer. The case shall be brought before the county court or the court of appeal where the taxpayer has its registered place of business, depending on the value of the disputed amount (amounts exceeding RON3 million change the competence to higher courts, ie, the court of appeal as first instance).

The legal action must be lodged within six months from the date when the taxpayer has received the answer to the appeal, and requires the payment of a fixed-fee stamp tax.

The payment of tax liabilities before bringing the case to court may not hinder the chances of the taxpayer to obtain a favourable court decision. Usually, taxpayers prefer to pay the principal additional tax obligations to stop the accrual of further late payment interest and penalties.

4.2 Procedure of Judicial Tax Litigation

Tax cases before the courts are organised under a two-tier judgment system.

In the first-instance procedure, the taxpayer presents the reasons for which the tax decision has been issued in breach of the procedural or substantial provisions of the tax law. The legal action of the taxpayer must also include the evidence that maintains its arguments, and the proposed new pieces of evidence which must be approved by the court. The court is entitled to propose new evidence, as well.

The RTA responds with a statement of defence, usually confirming the initial arguments of the tax inspectors. The parties may be represented before the court by a lawyer during the entire procedure, including before the judicial experts

that may be appointed by the first-instance court.

The law does not provide a maximum duration for the first-instance procedure, which may fluctuate depending on the pieces of evidence received by the court.

The taxpayer or the RTA may appeal the decision of the first-instance court. The appellant must follow the strict legal reasons for which the first-instance decision may be subject to appeal. The decision of the second-instance court is final.

4.3 Relevance of Evidence in Judicial Tax Litigation

The evidence proposed by the parties should be related to the statements made in the legal action/statement of defence. Depending on the tax issue, the written evidence may be accompanied by expert evidence. The taxpayer may also prepare and present an off-court expert report as evidence, such an approach being useful in the probable situation where the court does not approve on-court expert evidence.

Before the court, the oral examination of witnesses rarely occurs in practice.

The judge is entitled to assess the weight of the evidence that is presented by the parties. If the judge considers that only the interpretation of tax law is needed, additional evidence may be rejected.

4.4 Burden of Proof in Judicial Tax Litigation

As a rule, the burden of proof remains with the party making a statement, which is the taxpayer. The burden may be shifted depending on the matter of the tax dispute and the facts that need to be proven. The taxpayer may ask the court to order the submission of written evidence held by the RTA or by third parties.

4.5 Strategic Options in Judicial Tax Litigation

Strategic options are not provided by law, and their applicability depends on a case-by-case analysis. Such options include asking a tax expert or a technical expert, referring preliminary questions to the Court of Justice of the European Union, etc.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The courts consider the OECD guidelines related to transfer pricing and the OECD Model Convention, these documents serving as a legal basis under the Romanian Fiscal Code.

The courts also observe CJEU and ECHR case law, and may refer cases to the CJEU with preliminary questions.

The jurisprudence of local Romanian courts on similar cases is not binding.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

A taxpayer or the RTA may appeal the decision of the first-instance court to a higher court. The cases judged in the first stage by the county courts are handled in the second stage by the courts of appeal. For cases with disputed tax amounts exceeding RON3 million, the first instance is the court of appeal, and the appeal is further judged by the High Court of Cassation and Justice located in Bucharest.

The appeal against the decision of the first court must be based on the limited reasons provided by the Romanian Civil Procedure Code, such as the breach of substantial or procedural law or the absence of the rationale of the first court.

The Romanian Civil Procedure Code also provides extraordinary appeals which may be admissible only on the basis of strict limited legal conditions (eg, lack of competence of the courts, existence of contradictory decisions issued by the courts in relation to the same matter, issuance of relevant ECHR/Constitutional Court decisions).

5.2 Stages in the Tax Appeal Procedure

The procedure before the second-instance court is similar to the procedure before the first-instance court (referred to in section **4.2 Procedure of Judicial Tax Litigation**). The interested party files the appeal, and the other party responds through a statement of defence.

In the appeal stage, the parties may present only written evidence, as other types of proof are not admissible.

The court can declare the appeal as founded or unfounded. In case the appeal is approved, the case may be returned once to the first-instance court for a retrial.

5.3 Judges and Decisions in Tax Appeals

In the first-instance court, the tax case is decided by a single judge, irrespective of the court or the complexity of the case. In the appeal stage, the tax case is decided by three judges. The judges are randomly allocated to the respective cases by the courts.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

In Romania there are no ADR mechanisms available to solve tax litigations. There is only a spe-

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax

cific mediation procedure which can facilitate the postponement of the payment of additional tax obligations.

6.2 Settlement of Tax Disputes by Means of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

In Romania, no mechanisms that can generate an agreement (to reduce the tax assessment, the interest due or the penalties) are available. There are amnesty periods that have been introduced through new legislation, allowing the waiver of interest and penalties subject to the fulfilment of certain criteria by the taxpayers.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Legislation provides for a specific procedure of obtaining binding tax rulings. Obtaining such a ruling involves securing the tax treatment for the respective situation. In recent years, the issuance of binding rulings has been significantly delayed by the RTA.

During the term of an advance pricing agreement (APA), provided that the taxpayer files annual reports containing data regarding the application of the APA, and the terms of the APA are complied with by the taxpayer, the Romanian tax authorities should not request the Local Transfer Pricing file for the transactions covered by the APA, and no transfer pricing adjustments should be imposed.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

A criminal case can be opened either ex officio by the criminal prosecution bodies, or following the notification of any person, including the notification of the RTA, when it considers that there are elements that outline a criminal activity and the intention of the taxpayer to evade the payment of taxes, and not just negligence. Thus, the mere non-payment of taxes, or non-payment in full when the taxpayer acts in good faith or in error, does not automatically constitute an offence.

7.2 Relationship between Administrative and Criminal Processes

Assuming that there is an administrative procedure, as well as a criminal procedure in progress regarding the same factual situation, the RTA do not usually suspend the procedure regarding the issuance of administrative acts imposing additional tax amounts to be paid.

To the extent that the taxpayer challenges the acts issued by the RTA, the latter has the possibility to suspend the procedure for resolving the tax appeal until the resolution of the criminal case, issuing a decision in this regard – a decision which can be challenged before administrative and fiscal courts.

The tax amounts are not necessarily relevant from the perspective of generating/removing criminal liability, but are important for individualising punishments, pronounced solutions,

or applying causes of impunity in case those amounts are paid.

7.3 Initiation of Administrative Processes and Criminal Cases

Usually, the RTA notify the criminal prosecution bodies when they consider that there are elements from which a conduct described by the criminal law and a criminal intent follow, ie, the intent of the taxpayer to evade the payment of tax obligations by certain actions/omissions.

The existence of an administrative procedure does not automatically imply the formulation of a criminal complaint, just as the existence of a criminal procedure does not automatically require the initiation of an administrative procedure (if it has not already been initiated), given that the prosecution may be opened ex officio or at the notification of any person, and not only of the fiscal bodies.

7.4 Stages of Administrative Processes and Criminal Cases

The criminal process consists of three phases, as follows.

- The prosecution phase, conducted by a prosecutor, where evidence is gathered to prove the existence/non-existence of the offences and of the responsible persons.
- The preliminary chamber phase, led by a preliminary chamber judge, who verifies the legality and fidelity of the prosecution and administration of evidence by the prosecutor. The preliminary chamber takes place in two stages: merits and challenge before a higher court.
- The trial phase, conducted by a panel of judges, where the merits of the allegations are verified. The trial takes place in two stages: merits and appeal (ordinary appeal).

There are also extraordinary appeals which can be formulated against the decisions on appeal, such as the appeal in annulment, review or appeal in cassation.

7.5 Possibility of Fine Reductions

The payment of the additional tax amounts may have an effect on the criminal proceedings, depending on the amounts at stake.

If the damages do not exceed EUR100,000 and are paid in full during the criminal prosecution or trial, the court may apply the punishment of a criminal fine (having also the possibility to impose a prison sentence).

If the damages do not exceed EUR50,000 and are paid in full during the criminal prosecution or trial, the court must impose a criminal fine (not having the possibility to impose a sentence to prison).

In any case, the payment of the damages can be relevant from the perspective of the individualisation of the punishments by the court, usually as a factor in reducing the sentence.

7.6 Possibility of Agreements to Prevent Trial

Currently, if the damages from tax evasion do not exceed the value of EUR100,000 in the equivalent of the national currency, and even if during the criminal prosecution or the trial until a final judgment is pronounced this amount increases by 20% (to which are added the interests and penalties), the deed is not punishable.

Prior to 18 December 2021, the cause of impunity was applicable regardless of the amount of damage from tax evasion, the previous legal provisions still being applicable to ongoing criminal proceedings concerning acts committed prior to this date.

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax

7.7 Appeals against Criminal Tax Decisions

An appeal may be formulated against a judgment in a criminal case pronounced by a court regarding a tax evasion offence within ten days from the communication of the judgement, which shall be judged by the court of appeal in whose district the court is located (as a first-instance court).

Extraordinary appeals may be brought only against final judgments pronounced on appeal (in principle, only after the exhaustion of remedies of the appeal).

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

In principle, in such cases, civil/fiscal liability is incidental, but initiation of a criminal investigation (subsequent or in parallel) is not excluded, as such situations are found in practice. However, the prosecutor usually examines elements specific to a criminal prosecution (material actions which are intended, intentionally, to evade the payment of tax obligations), and not a mere non-compliance with tax law.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In case a double taxation situation occurs due to a tax adjustment performed by the RTA, both domestic litigation to challenge the position of the RTA and the available mechanism under the double tax treaty (eg, the mutual agreement procedure) are used. The option will very much depend on the specifics of the case at hand.

The MLI and the EU Tax Disputes Directive were only recently introduced into Romanian legislation, so have not yet had an impact in

this domain. However, we expect the number of taxpayers challenging tax adjustments in cross-border situations based on the EU Tax Disputes Directive to increase in the future.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The GAAR and SAAR apply in cross-border situations covered by bilateral treaties. Case law provides no clear guidance in this respect.

Romania ratified the MLI in January 2022, and the convention will enter into force for Romania on 1 June 2022. Thus, it is too early to anticipate how the PPT test introduced by the MLI and the amendment of the DTT preamble will affect the way tax authorities combat BEPS in cross-border situations.

8.3 Challenges to International Transfer Pricing Adjustments

Usually, the international transfer pricing adjustments are challenged under domestic tax courts. In recent years, the number of transfer pricing local disputes and related resolutions has registered a significant increase. The existing double tax treaties mechanism and the multilateral transfer pricing convention are also used, but at a considerably lower level. Taking into account the implementation of the Tax Dispute Resolution Mechanisms Directive, we expect the number of taxpayers challenging international transfer pricing adjustments based on this mechanism to increase.

8.4 Unilateral/Bilateral Advance Pricing Agreements

In Romania, taxpayers can apply for unilateral, bilateral and multilateral advance pricing agreements (APAs). Although the number of taxpayers applying for APAs has increased in recent years, they cannot be considered a commonly used mechanism to avoid or mitigate litigation in transfer pricing matters. Based on our experi-

ence, taxpayers usually decide not to use such mechanisms due to the related costs and the extended periods of time in which the RTA issue the APA (which are usually longer than the deadlines imposed by the legislation).

The main stages of the procedure are as follows:

- preliminary discussion with the RTA (optional) – if requested, this should be accompanied by a preliminary request;
- filing for the APA – the request should include the proposed arm's length methodology for the intra-group transaction subject to the requested APA and the analysis performed in order to derive this methodology;
- evaluation of the request – in this stage, the RTA can request additional documents/information/explanations from the taxpayer;
- preliminary resolution – before issuing a final decision, the RTA will issue a preliminary project, in relation to which the taxpayer has the right to present its point of view;
- final resolution – the RTA can approve or reject the proposal of the taxpayer, and the taxpayer has the right to reject the final resolution of the tax authorities.

8.5 Litigation Relating to Cross-Border Situations

The cross-border matters which have traditionally generated the most litigation are transfer pricing issues. Furthermore, in recent years, withholding tax issues have significantly increased, with many consequences of this being closely related to transfer pricing issues (the focus being the application of the domestic withholding tax rate in connection to interest and royalty payments performed intra-group and exceeding the market level). Last, but not least, the presence of non-residents in Romania which triggers PE is also a current topic generating litigations.

A prerequisite for taxpayers to safeguard their transfer pricing position and, as such, to mitigate the risk of litigations, is to prepare the Local Transfer Pricing file on an annual basis, in accordance with local requirements. Where deviations from the arm's length principle are identified during this process, compensating transfer pricing adjustments may be considered. Going further, the safest measure that taxpayers can take to safeguard their transfer pricing position for future intra-group transactions is to apply for an APA.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

The case law of Romanian courts is not yet transparent in terms of access to all solutions issued by the courts. A state aid dispute involving taxes is possible and applicable under Romanian law. However, statistics on such case law would not be accessible.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

The general legal framework regarding national procedures on state aid is represented by the Government Emergency Ordinance No 77/2014 (GEO 77/2014). Based on this, depending on who enforces the recovery of the aid (the European Commission or the supplier of the measure), the procedure may vary, as detailed below.

Recovery of Unlawful/Incompatible Aid Enforced by the European Commission

The beneficiary of a state aid measure, in connection to which the European Commission has decided on the recovery, must repay the amount of the aid plus an interest established based on the applicable state aid recovery norms.

Once the Romanian Competition Council receives a recovery decision from the Commis-

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax

sion, such a decision is sent to the local body acting as aid supplier within five business days of receipt of the Commission's decision. The supplier, in turn, has five business days to inform the beneficiary of the obligation to reimburse the state aid.

In case the suppliers of the state aid do not benefit from their own enforcement body, or there are several public authorities acting in the capacity of suppliers/administrators, they may send the Commission a decision within 20 business days of the issuance of the Commission's decision. The suppliers/administrators may submit the decision to the competent fiscal bodies, together with the acknowledgement of receipt by the beneficiary.

If the beneficiary does not repay the aid to be recovered, the authorities should start recovery procedures based on general national norms. During the recovery procedure, the beneficiary may not access any further state aid measures.

Recovery of Unlawful/Incompatible State Aid Enforced by the Administrator of the Measure

The reimbursement/recovery of unlawful or incompatible state aid is initiated if:

- the criteria for granting the state aid were not met;
- an unlawful state aid was granted without the compatibility criteria provided for in the applicable European legislation being met.

Within five business days of the issuance of a state aid recovery issue, the suppliers must inform the Romanian Competition Council of a decision. The suppliers of aid have the obligation to submit to the Romanian Competition Council an informative notice on the final court decision on the recovery of aid. Such a notice must be sent within five business days of the date a final

court ruling was issued regarding the measures for recovering state aid.

In case the suppliers of the state aid do not benefit from their own enforcement body or there are several public authorities acting in the capacity of suppliers, the same principles discussed above in the case of aid recovery decisions issued by the Commission apply.

If the beneficiary does not repay the aid to be recovered, the authorities should start recovery procedures based on general national norms. During the recovery procedure, the beneficiary may not access any further state aid measures.

9.3 Challenges by Taxpayers

As indicated above, the case law of the courts is not fully transparent and relevant statistics on this matter are not available.

More generally, in Romania, the case law regarding class action lawsuits is not quite developed. However, we are aware of case law where third parties were challenged regarding court state aid (not necessarily in the tax sector) granted to the benefit of another market player.

9.4 Refunds Invoking Extra-Contractual Civil Liability

In theory, it is possible for refunds to be granted as a result of subsequent litigation against the state based on extra-contractual liability principles, if there is a fault of the state. Such cases would be judged based on national law principles.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Unexpectedly, Romania did not opt for mandatory binding arbitration according to Article 18 of the MLI. We are not aware of the reasons for which the authorities embraced this option.

10.2 Types of Matters that Can Be Submitted to Arbitration

As mentioned, Romania has not opted for mandatory binding arbitration according to the MLI.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

This is not applicable in Romania.

10.4 Implementation of the EU Directive on Arbitration

Romania has transposed EU Directive 2017/1852 on tax dispute resolution mechanisms in the European Union into its regulatory framework.

10.5 Existing Use of Recent International and EU Legal Instruments

These international and EU legal instruments to settle tax disputes were only recently introduced into Romanian legislation; therefore it is too soon to judge their effectiveness and will probably take some time for their applicability to increase significantly.

10.6 New Procedures for New Developments under Pillar One and Two

Regarding Pillar One, no developments on this topic were discussed recently, but Pillar Two has received attention, being topical in the recent period.

Romania has joined the plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate, and has agreed with the decision to have a uniform system for the EU when implementing Pillar Two.

Moreover, at a legislative level, this topic has been discussed in order for the Romanian Fiscal Code to be updated accordingly.

However, a significant impact of Pillar Two for Romania is not expected, considering the existing corporate income tax rate of 16% and the fact that Romania is not a common country for locating holding companies.

10.7 Publication of Decisions

Currently, the agreements reached by competent authorities in Romania are not published, being covered by confidentiality and fiscal secrecy provisions.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Currently, international tax disputes are generally settled in accordance with domestic procedure rules and under mutual agreement procedures.

Regarding the MLI, since Romania only recently ratified the convention (January 2022), with the MLI entering into force in Romania on 1 June 2022, there is no practical experience in using the MLI in order to settle tax disputes.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Taxpayers involve lawyers/tax consultants in the early stages of a dispute in order to better deal with a potential contingency, and many times during the tax audit, before a dispute has emerged.

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Tuca Zbârcea & Asociații Tax

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

Tax disputes in the administrative phase do not give rise to any fees payable to the RTA. However, they do involve professional/advisory fees, and significant amounts of management time and expenses, depending on the economic activity of the taxpayer, the tax amounts at stake, and the complexity of the issues.

11.2 Judicial Court Fees

The fees are relatively low (usually less than EUR100) and are due at the start of proceedings. They are initially split between the parties but are recoverable by the party who succeeds in the litigation.

11.3 Indemnities

The indemnities that can be obtained are the legal fees and the judicial court fees. Other pre-litigation costs incurred by the taxpayer cannot be recovered.

If the additional tax obligation has been paid by the taxpayer, they are entitled (after winning the case in court) to ask for interest for the period when the respective amounts have not been in their possession.

11.4 Costs of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

12. STATISTICS

12.1 Pending Tax Court Cases

There are no publicly available statistics on pending cases.

12.2 Cases Relating to Different Taxes

There are no publicly available statistics on the number of cases relating to different taxes. Based on the information provided by the RTA in their activity reports, on average there are 1,200 tax court cases initiated annually by taxpayers.

12.3 Parties Succeeding in Litigation

Based on the information provided by the RTA in their activity reports, the RTA is winning 60–70% of tax cases in court, the taxpayers have a success rate of 20–30%, and approximately 10% of cases end in a different solution (eg, retrial).

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Generally, it is advisable to use all the procedural means available as some of them can lead to a positive turnaround during a tax litigation.

Our team has in recent years extensively used different means as listed here, and this list is not exhaustive:

- providing written opinions to the RTA during the tax audit (even if not requested), to demonstrate the position of the taxpayer, accompanied by supporting documentation and relevant jurisprudence;
- making use of a written point of view, which can be submitted at the end of the tax audit;
- using the opportunity to request a formal meeting with the RTA to discuss the tax appeal;
- introducing third parties in the tax appeal procedure, if relevant;
- making use of the revision procedure in case of a negative answer to the tax appeal;
- during court litigation, it is highly recommended to ask for judicial tax expertise (an impor-

- tant part of cases won by taxpayers is based on favourable judicial tax expertise);
- in the case of VAT matters, it is recommended to try and refer preliminary questions to the Court of Justice of the European Union (until now, approximately 90% of VAT cases referred by Romania have been ruled in favour of the taxpayers).

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax

Țuca Zbârcea & Asociații Tax is a top-ranked tax consultancy firm in Romania. The last three years have seen a solid growth of its tax practice of approximately 20% year on year, significantly above the market growth rate. In contrast to its main competitors, Țuca Zbârcea & Asociații Tax is specialised in providing pure tax advisory services and tax litigation services. Its tax services cover all taxation areas (corporate income tax, individual taxation, international taxation,

VAT, excise duties, customs duties, local taxes, etc) and any type of tax-related project. The tax controversy cases in which it is involved for its clients cover a multitude of different industries (eg, energy and resources, real estate, automotive, agriculture, pharmaceutical). Tax litigation cases are managed by its tax professionals and specialised lawyers from its corresponding law firm.

AUTHORS



Alexandru Cristea is the co-ordinator of Țuca Zbârcea & Asociații Tax and has had a direct contribution to the firm's development during the difficult market period of recent years.

He is actively involved in managing various high-profile clients and tax matters, such as in the energy and real estate industries. Alexandru is a frequent lecturer at various tax events, and regularly contributes articles on fiscal and macroeconomic topics in leading local and international publications.



Ramona Chițu is a tax partner with Țuca Zbârcea & Asociații Tax. She has previously worked with Deloitte and as a tax manager for another multinational company, and has

more than 17 years of experience. Ramona manages the direct tax practice of Țuca Zbârcea & Asociații Tax, by co-ordinating projects in many areas, including M&A, tax litigations on corporate and individual tax, and tax reviews. She has been a speaker in various conferences and seminars, and is the author of professional articles published in specialised magazines and media. Ramona is a certified tax consultant, a chartered accountant, and holds a master's degree in finance and accounting.

Contributed by: Alexandru Cristea, Ramona Chițu, Cristian Velcu and Narcisa Ichim, Țuca Zbârcea & Asociații Tax



Cristian Velcu is a tax advisor at Țuca Zbârcea & Asociații Tax with more than 16 years of experience, and was a part of Deloitte Romania for 11 years. He is mainly specialised in VAT

and tax litigations, and has assisted many multinational and local companies on various tax matters, including more than 40 tax controversy cases. Cristian is a member of the Romanian Chamber of Tax Advisors and is a judicial expert on tax matters.



Narcisa Ichim specialises in transfer pricing and tax litigation, and has been co-ordinating the transfer pricing practice of Țuca Zbârcea & Asociații Tax since 2019. Before that, she provided

a full range of transfer pricing services to multinational and local companies through a boutique consulting firm of which she is co-founder. Prior to her entrepreneurial stage, Narcisa worked in the transfer pricing departments of Deloitte and KPMG. Narcisa started her transfer pricing career in 2010 and is a member of the Romanian Chamber of Tax Advisors (CCF), and a judicial expert on tax matters.

Țuca Zbârcea & Asociații Tax SRL

4-8 Nicolae Titulescu Avenue
America House, West Wing, 8th Floor
Sector 1, Bucharest 011141
Romania

Tel: +40 21 204 88 90
Fax: +40 21 204 88 99
Email: office@tuca.ro
Web: www.tuca.ro

TZ/A CONSULTANȚĂ
FISCALĂ

TAX ENTITY OF ȚUCA ZBÂRCEA & ASOCIAȚII

SOUTH KOREA

Law and Practice

Contributed by:

Jay Shim, Sung-Hyun Ryu and Jung-Ho Ryu
Lee & Ko see p.611



CONTENTS

1. Tax Controversies	p.591	5.3	Judges and Decisions in Tax Appeals	p.602
1.1 Tax Controversies in this Jurisdiction	p.591	6. Alternative Dispute Resolution (ADR) Mechanisms	p.603	
1.2 Causes of Tax Controversies	p.591	6.1	Mechanisms for Tax-Related ADR in this Jurisdiction	p.603
1.3 Avoidance of Tax Controversies	p.591	6.2	Settlement of Tax Disputes by Means of ADR	p.603
1.4 Efforts to Combat Tax Avoidance	p.591	6.3	Agreements to Reduce Tax Assessments, Interest or Penalties	p.603
1.5 Additional Tax Assessments	p.592	6.4	Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.603
2. Tax Audits	p.592	6.5	Further Particulars Concerning Tax ADR Mechanisms	p.603
2.1 Main Rules Determining Tax Audits	p.592	6.6	Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.603
2.2 Initiation and Duration of a Tax Audit	p.592	7. Administrative and Criminal Tax Offences	p.603	
2.3 Location and Procedure of Tax Audits	p.593	7.1	Interaction of Tax Assessments with Tax Infringements	p.603
2.4 Areas of Special Attention in Tax Audits	p.593	7.2	Relationship between Administrative and Criminal Processes	p.604
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.593	7.3	Initiation of Administrative Processes and Criminal Cases	p.604
2.6 Strategic Points for Consideration during Tax Audits	p.594	7.4	Stages of Administrative Processes and Criminal Cases	p.604
3. Administrative Litigation	p.595	7.5	Possibility of Fine Reductions	p.605
3.1 Administrative Claim Phase	p.595	7.6	Possibility of Agreements to Prevent Trial	p.605
3.2 Deadline for Administrative Claims	p.596	7.7	Appeals against Criminal Tax Decisions	p.605
4. Judicial Litigation: First Instance	p.596	7.8	Rules Challenging Transactions and Operations in this Jurisdiction	p.605
4.1 Initiation of Judicial Tax Litigation	p.596	8. Cross-Border Tax Disputes	p.605	
4.2 Procedure of Judicial Tax Litigation	p.597	8.1	Mechanisms to Deal with Double Taxation	p.605
4.3 Relevance of Evidence in Judicial Tax Litigation	p.598	8.2	Application of GAAR/SAAR to Cross-Border Situations	p.606
4.4 Burden of Proof in Judicial Tax Litigation	p.599			
4.5 Strategic Options in Judicial Tax Litigation	p.599			
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.601			
5. Judicial Litigation: Appeals	p.601			
5.1 System for Appealing Judicial Tax Litigation	p.601			
5.2 Stages in the Tax Appeal Procedure	p.602			

8.3	Challenges to International Transfer Pricing Adjustments	p.606	10.5	Existing Use of Recent International and EU Legal Instruments	p.608
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.606	10.6	New Procedures for New Developments under Pillar One and Two	p.608
8.5	Litigation Relating to Cross-Border Situations	p.607	10.7	Publication of Decisions	p.608
9. State Aid Disputes		p.607	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.609
9.1	State Aid Disputes Involving Taxes	p.607	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.609
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.607	11. Costs/Fees		p.609
9.3	Challenges by Taxpayers	p.607	11.1	Costs/Fees Relating to Administrative Litigation	p.609
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.607	11.2	Judicial Court Fees	p.609
10. International Tax Arbitration Options and Procedures		p.607	11.3	Indemnities	p.609
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.607	11.4	Costs of ADR	p.609
10.2	Types of Matters that Can Be Submitted to Arbitration	p.608	12. Statistics		p.609
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.608	12.1	Pending Tax Court Cases	p.609
10.4	Implementation of the EU Directive on Arbitration	p.608	12.2	Cases Relating to Different Taxes	p.610
			12.3	Parties Succeeding in Litigation	p.610
			13. Strategies		p.610
			13.1	Strategic Guidelines in Tax Controversies	p.610

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

Tax controversies arise in South Korea (“Korea”) when a tax assessment notice (TAN) and invoice is issued to a taxpayer after completion of a tax audit (or in the absence of a tax audit, if the statute of limitations on assessments is about to expire), or when a taxpayer’s requests for a refund of over-paid or over-withheld taxes are rejected by the relevant tax office.

1.2 Causes of Tax Controversies

Tax controversies can involve all types of issues, including corporate income tax, individual income tax, inheritance and gift tax, property tax, local taxes, transfer taxes, VAT, customs duties, and others. However, for foreign entities and foreign-owned Korean entities, the most frequently disputed issues involve transfer pricing, application of a tax treaty, withholding tax, and permanent establishment, which are all within the structure of corporate income tax law. There is no minimum threshold for invoking the tax dispute process and hence there are many small tax disputes involving domestic entities and individuals. However, for foreign entities and foreign-owned Korean entities, the amount in dispute tends to be higher since retaining counsel involves substantial costs. It is worth mentioning that the withholding tax dispute relating to the source of royalty income under the Korea-US Tax Treaty has been ongoing since 1992, and despite repeated losses by the Korean tax authority at the Korean Supreme Court, the Korean government has not acquiesced on this issue.

1.3 Avoidance of Tax Controversies

Unlike many Asian countries, Korea is a democratic but litigious nation, and it is unsurprising that during a tax audit, disputes between the tax examiners and taxpayers frequently arise. Often,

these disputes arise because the tax examiners have a specific mission to collect taxes and hence will raise issues based on aggressive technical and factual assertions pertaining to an issue, which may be challenged by the taxpayer. It is generally understood by the tax community that tax examiners are rewarded for being aggressive and assessing as many taxes as possible, rather than being co-operative with the taxpayer and focused only on whether the taxpayer properly complied with the tax law. However, the aggressive tax audit practice is tolerated in part due to the generally accepted view that taxpayers are not fully compliant with the tax law.

In order to mitigate the possibility of a lengthy tax controversy, taxpayers should keep good records and, where the tax treatment is unclear, consider obtaining an advance tax ruling from the tax authority. To avoid a potential dispute with respect to transfer pricing, the taxpayer should consider applying for an advance pricing agreement (APA). Effective management at the tax audit level may be a good preventative measure to mitigate a potential tax controversy that may arise after completion of the tax audit.

1.4 Efforts to Combat Tax Avoidance

The general view of practitioners in Korea is that the OECD recommendations pursuant to the BEPS Action Plans are likely to contribute to an increase in tax controversies. Since the main purpose of the BEPS project was to prevent tax avoidance and Korea recently ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), the tax auditors shall be provided with additional tools to challenge potentially tax abusive structures and transaction issues involving tax avoidance more aggressively. In accordance with the BEPS recommendations, Korea revised its tax law to prevent artificial avoidance of permanent establishment (Action 7), and tax

auditors can challenge Permanent Establishment (PE) issues more aggressively based on the revisions made to significantly broaden the definition of PE. Moreover, based on BEPS Actions 8-10 and 13, Korean transfer pricing regulations have been revised to include the concept of a “commercially realistic outcome” and also provide for more stringent compliance requirements and harsher penalty provisions. Lastly, as an OECD member country, South Korea is closely following the OECD’s approach to taxing digital commerce under the two-pillar approach (“Pillar One” and “Pillar Two”) currently being finalised in order to secure the taxation of foreign companies which would otherwise be subject to little or no tax in respect of revenue generated in Korea.

1.5 Additional Tax Assessments

Korea has a “pay and fight” system so that in order to avoid the accrual of interest while the dispute is ongoing, taxpayers are required to pay the amount shown in the TAN (which usually includes interest for under-payment of tax). Although this requirement to pay the tax upfront will not change the ultimate net tax position, it can cause harm to a taxpayer’s cash flow position if the amount is substantial. However, in the case of cross-border transactions that are covered by the mutual agreement procedure (MAP) under a tax treaty, acceptance by the competent authorities of a tax dispute within 90 days of issuance of the TAN would suspend further accrual of interest. Where a MAP request is made after the 90 days has passed, the Korean tax authority may allow the posting of a bond or collateral in exceptional cases (eg, transfer pricing disputes). In all other cases, following the expiration of 90 days, interest at the rate of 8.03% per annum would accrue on the amount shown in the TAN (same rate applies to underpayment of taxes generally), and, in large cases, the Korean tax authority may attempt to seek a preliminary attachment or lien over the taxpayer’s property. In the case of interest on under-withholding of

tax, a maximum of 10% applies. Certain additional taxes are applicable to a tax deficiency on cross-border transactions and non-compliance with transfer pricing regulations.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

Generally, there are two types of tax audit in Korea: a periodic audit that occurs every four or five years, coinciding with the statute of limitation period (SOLP) for initiating a tax audit; and a special audit that is focused on a certain industry or segment of population that carries a “high risk” of tax evasion which can occur randomly. Industry-focused tax audits may also be driven by the tax authority’s interest in certain types of revenue or items of deductions, and even accounting treatment dealing with timing for revenue recognition and deduction.

Recently, the tax auditors have intensified their audit scrutiny of foreign-owned Korean companies as well as high-net worth individuals who are engaged in offshore tax evasion or reduction of inheritance and gift tax. For the large, family-run conglomerates, known in Korea as “Chaebols”, the tax audits are continuous and ongoing, and recently, the focus has been on offshore activities, large companies, financial institutions, and foreign subsidiaries that are CFCs.

2.2 Initiation and Duration of a Tax Audit

Generally, a notice of tax audit is served on taxpayers 15 days in advance of an audit. One exception is where a taxpayer is suspected from engaging in criminal activities where the tax audit is made with an unannounced “dawn raid”, where a team of tax auditors physically enter the taxpayer’s premises and the notice of tax audit is served in person. The only other exception is where the SOLP is about to run out and so the

TAN, known as a jeopardy assessment, is issued without conducting a tax audit.

Unlike in many neighbouring countries, the format of a tax audit in Korea is typically quick and intensive, with the field component typically lasting between 8 and 12 weeks, unless suspended or extended with the taxpayer's consent.

Under Korean tax law, the SOLP is generally five years from the original due date of the tax filing and seven years for cross-border transactions. In the case of withholding tax on cross-border payments, the SOLP is five years from the tenth day of the month after the month in which the transaction subject to withholding occurred. However, for non-compliance, fraud or concealment of cross-border transactions, the SOLP can be extended to 7, 10 or 15 years, respectively.

2.3 Location and Procedure of Tax Audits

Tax audits are generally conducted at the taxpayer's premises and all requested documents specified in the notice of tax audit must be made available upon arrival of the tax auditors; however, tax auditors often agree with the taxpayer to conduct the audit in a specially prepared room within or near the taxpayer's premises. This is designed to avoid business disruption, as well as to provide the tax auditors with sufficient work space to review documents, working papers, and tax returns, and also to conduct interviews with employees of the taxpayer.

The request of documents in the notice of tax audit generally includes corporate documents such as board of directors' minutes, internal guidelines, accounting policies, books, records and journal entries, tax accrual papers, transfer pricing studies and related documentation, and any other documents deemed relevant to the tax auditors to adequately conduct their tax audit.

2.4 Areas of Special Attention in Tax Audits

For multinational companies with Korean subsidiaries, the focus is two-fold: first, whether transfer pricing arrangements between a Korean subsidiary and its overseas-related party are reasonable and undertaken at arm's length; and second, whether Korean withholding agents properly withheld an appropriate amount of tax on payments made to foreign recipients, regardless of whether such foreign recipients are related or unrelated. In particular, the tax auditors will aggressively examine whether any reduction or exemption of withholding tax claimed by the foreign recipient under a tax treaty was justified, invoking both domestic anti-abuse rules as well as a tax treaty's beneficial ownership requirements. One other area of focus is whether any expenses incurred are deductible under the domestic law's narrow definition of what constitutes a deductible business expense.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The trend of sharing cross-border exchanges of information has been slow in Korea; however, given that Korea has fully ratified the MLI as well as the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS), it is likely that the tax auditors will seek more co-operation from their counterparts in foreign jurisdictions. It should be noted that Korea has over 90 tax treaties containing mutual assistance provisions related to tax and financial information, and recently it has also implemented a number of agreements covering special information exchange and co-operation on tax matters.

2.6 Strategic Points for Consideration during Tax Audits

Understanding the Focus of the Tax Audit

Korean tax auditors are very thorough in conducting their tax audits because they conduct a pre-tax audit of a taxpayer in advance of the official tax audit, and hence obtain a general understanding of the taxpayer's strengths and weaknesses in respect of the various tax positions taken on its tax returns prior to a tax audit. Accordingly, they often begin their tax audit with a general understanding of the taxpayer's position in respect of various items of income, deductions and credits, and have a basic understanding of the strengths and weaknesses of the targeted taxpayer in respect of the tax positions taken on the tax return. However, a robust defence prepared in advance by the taxpayer of any items challenged as well as good documentation of the positions taken on the return may result in influencing the tax auditor that their preconceived positions on certain issues require change or modification. Accordingly, it is important to quickly understand the focus and objective of the tax audit and be able to direct the tax auditor to the issues that the taxpayer is best prepared to handle. By narrowing the focus of the tax audit, issues and items that could prove to be difficult to defend may be mitigated and sometimes avoided altogether.

Maintaining Good Relationships with Tax Auditors

During the course of a tax audit, it is absolutely paramount to gain the trust and goodwill of the tax auditors so that the tax audit can proceed smoothly and quickly. In this regard, it should always be remembered that the investigatory powers of the tax auditors are broad, and attempts to prevent them from accessing specific documents which are known to them will prove to be difficult. When the tax auditors feel that the taxpayer is not co-operating, they can request suspension of the tax audit and even

threaten to enlarge the scope of the tax audit to include a criminal investigation.

Handling Requests for Information/Documents

Accordingly, the best way to handle a broad information and document requests is to provide basic, routine information which is generally relevant but not documents that were not specifically requested. In the event the tax auditors do point to a specific document, the taxpayer must carefully determine whether it would be more useful to provide a summary of the information contained in such material than the material itself. Often, when the document requested contains a substantial amount of data, the tax auditors welcome a customised or summarised version of the information, rather than the entire document, since it may require a substantial amount of time and resources to extract the relevant information from such a document. In addition, if the scope of the request is simply too broad or appears to be a "fishing expedition", a taxpayer can politely request more specificity and detail as well as the reasons for requesting access to such documents, and their relevancy to the tax audit. In this regard, it would be extremely important to push back against the tax auditor's general attempt to obtain access to the taxpayer's e-ledgers and IT system (ERP, CRM, etc).

Unresolved Issues

Prior to the conclusion of a tax audit, every effort should be given to resolving all issues that were raised during the tax audit. Unlike some countries, there is no formal mechanism to settle disputed issues after the tax audit. There is also no mediation procedure available under the Korean tax system. Accordingly, concessions on issues and positions, as well settlement discussions on assessment amounts, etc, must be finalised before the completion of the tax audit. In the event that an issue cannot be settled, the taxpayer must be prepared to dispute the issue at

the Tax Tribunal (or other administrative forums to resolve disputes) or the courts, which can take several years.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase Pre-Tax Assessment Notice (PTAN)

Once the tax audit of a taxpayer has been completed, the tax auditor will provide a notice to the taxpayer of its findings and the proposed amount of additional tax that will be assessed (PTAN). Keeping track of when the PTAN was received by the taxpayer is important since the taxpayer has 30 days to appeal to an administrative body within the National Tax Service (NTS) to review the strength of the legal basis of the proposed tax assessment. This process is referred to as a request for a Review of Accuracy of Tax Imposition (RATI). Once filed, the tax auditor's right to issue a formal TAN which crystallises the taxpayer's obligation is suspended until the RATI procedure is completed. The RATI is reviewed by a panel of reviewers comprised both of NTS officials (head office or regional office, depending on the amount involved) as well as outside experts such as professors, accountants, licensed tax representatives, and attorneys who have good standing with the NTS. However, a senior official of the NTS has the final say in all decisions and sometimes conducts several hearings, in the event that this senior official disagrees with the decisions reached by the panel. The RATI procedure is informal and taxpayers are often provided with an opportunity to appear before the panel or submit additional documents in support of their position that some or all of the proposed tax assessment was unjustified. The RATI process typically takes several months to complete. In the event the taxpayer prevails, the RATI panel will issue a written decision that the

proposed tax assessment should be cancelled and the tax audit shall close.

Tax Assessment Notice (TAN)

In the event the taxpayer decides not to file a request for a RATI within 30 days of its issuance, or if the taxpayer receives an unfavourable decision, the tax auditor will issue a formal TAN. From the legal perspective, the issuance of a TAN formalises the taxpayer's obligation to pay the amount shown on the TAN (deficiency plus interest and penalty). Such an obligation must be settled (by payment or other arrangements such as posting a bond or obtaining a guarantee) within 30 days of receipt. In the event the taxpayer's obligation is not settled, additional interest can accrue and depending on the facts and circumstances, the tax authority can seek to attach or freeze a taxpayer's assets and bank accounts.

Keeping an accurate record of when the taxpayer received the TAN is also important because the taxpayer will have 90 days to file an appeal to one of three administrative bodies of the government, the Tax Tribunal, the Board of Audit and Inspection (BOAI) or the NTS's office of appeals. In the vast majority of cases, the taxpayers typically appeal to the Tax Tribunal as it is considered more independent than the BOAI or the NTS. Another important reason to file an administrative appeal is that under the Korean tax dispute system, the taxpayer must file the appeal and wait at least 90 days before the taxpayer can file a petition to the court.

The Tax Tribunal is established under the office of the prime minister and is administered by officials generally seconded from the Ministry of Economy and Finance (MOEF) and the NTS. Like the RATI panel, the adjudicators of the Tax Tribunal are comprised of Tax Tribunal officials and outside experts, and like the RATI panel, a senior official at the Tax Tribunal has the final say

in all decisions. A Tax Tribunal proceeding is less formal than a court proceeding but more formal than a RATI proceeding. Similar to a court proceeding, the taxpayer and the tax authority are expected to submit briefs with technical arguments and applicable evidence. The taxpayer will also be given a formal opportunity to speak and plead before the adjudicators, although recently some of these hearings have been held by videoconference.

A typical Tax Tribunal proceeding involving a foreign entity or Korean entity with foreign investment or where an international tax issue is involved may last six months, although a large or complex transfer pricing case can last a year or more. During the proceedings, it is also possible that the adjudicators may order a re-investigation which is effectively a re-audit of the taxpayer. However, such a re-investigation is essentially a desk tax audit, which involves the reviewing of files prepared by the tax auditor rather than undertaking another field examination at the taxpayer's premises.

3.2 Deadline for Administrative Claims

As noted at **3.1 Administrative Claim Phase**, Tax Tribunal proceedings can take between six months to a year. Once a written decision has been issued and received by the taxpayer, the statute of limitations for filing a petition to the court is 90 days. In addition, as noted at **3.1 Administrative Claim Phase**, so long as the appeal has been filed with the Tax Tribunal for at least 90 days, the taxpayer has the option to file a petition to the court without waiting for a decision from the adjudicators. This option is often exercised when the taxpayer believes that the issue is well-known to the adjudicator and notwithstanding the taxpayer's view that the assessment was erroneously made, the adjudicators have consistently sustained the tax auditor's position. One such issue is the application of the source rule for royalties under the Korea-

US Tax Treaty, where despite nearly 30 years of consistent taxpayer victories in the Supreme Court, the adjudicators have consistently sided with the tax authority, holding that royalties paid to US licensors in respect on non-Korean registered patents are nevertheless Korean source income and hence subject to withholding tax under the Korea-US Tax Treaty. However, it should be noted that some taxpayers will still continue until the Tax Tribunal proceedings are completed in the hope of obtaining a favourable decision. This is because unlike in the courts where the parties can appeal an unfavourable decision of the District Court to the High Court and thereafter to the Supreme Court, a decision in favour of the taxpayer is final, preventing the tax authority from further appeal. By contrast, a decision unfavourable to the taxpayer can be appealed to a District Court within 90 days of receiving a written decision.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Judicial tax litigation in Korea for cancellation of tax assessments or rejection of tax refund requests is initiated by the taxpayer by filing a petition of complaint against the relevant tax office that issued the TAN or denied the tax refund request. The complaint sets forth the names of the parties involved, a description of the relevant facts and applicable law, and the relief sought. In addition, the complaint will usually be accompanied by exhibits, including evidentiary documents and other supporting materials. Once the case is docketed in court, the taxpayer will also receive a notice of payment (ie, court filing fees), which can vary depending on the disputed amount. However, court filing fees are generally viewed as modest and rarely seen as a barrier to access the courts. The taxpayer filing the petition of complaint is referred to as

the “plaintiff”, and the tax office responding to the complaint is referred to as the “defendant”.

The prevalence of tax disputes in Korea is skyrocketing, but yet there are no formal tax courts to handle purely tax matters in Korea. All tax disputes are first litigated at one of many district courts in the country, which also handle other types of disputes, including all types of civil and criminal cases. In Seoul, tax cases are heard at the Court for Administrative Matters, which is a court specifically established to handle administrative grievances, including immigration, education, health, safety and security issues. District courts and the Court for Administrative Matters are often referred to as the “lower court” and “court of first impression”. Similar to the trial courts based on the continental system, district courts and the Court for Administrative Matters are comprised of three judges: a presiding judge who is an experienced judge with 20 to 30 years of experience and two associate judges, who are younger and less experienced. However, from time to time, and depending on the importance of the issues involved, an experienced judge may also be assigned to a case as an associate judge.

Until recently, the Korean judiciary had an unusual feature compared to most of the other jurisdictions in that judges were often appointed at a very young age with little or no experience. In many common law jurisdictions a judge can be expected to have a minimum of 15-20 years’ experience in legal practice before their first judicial appointment. In Korea, it was possible for law graduates without much experience in legal practice to be appointed as a judge. However, Korea has recently adopted a new policy for the appointment of judges, and now requires at least five years of post-bar admission experience to be appointed as a judge. This threshold will increase to seven years from 2025 to 2028 and ten years from 2029.

Although the judges assigned to the Court for Administrative Matters are considered more familiar with tax issues than judges generally, they are rarely respected for their deep tax knowledge, and litigating parties are expected to assume that the judges are unfamiliar with tax law. Indeed, judges who are familiar with tax law are rare in Korea, and those who are familiar with international tax matters are even rarer. There are many explanations for this phenomenon but many would single out the fact that until the end of the military dictatorship in the 1980s, disputing against the government was considered a futile exercise. Despite the democratisation of Korea, this view has stubbornly persisted amongst some taxpayers, who consequently prefer to settle at the tax audit level even though the taxpayer may believe that the additional tax assessment is not based on proper application or interpretation of law.

4.2 Procedure of Judicial Tax Litigation

Once the petition of complaint has been filed in a timely manner, a notice will be sent by the court to the defendant with a copy of the complaint. This is the beginning of the investigation stage where briefs are filed and requests for information and documents are made to the court. Generally, the defendant will then file an answer to the complaint setting forth their reasons why the complaint should be dismissed. For reasons of timing and for strategic purposes, the complaint and the answer will both be something of a “skeleton argument”, ie, they will contain only the rudimentary reasoning and argument in support of their respective view or position. In practice, the plaintiff can expect to receive the answer in two to three months, since the first court hearing usually takes place within four to six months from the date the petition of complaint was filed.

The first hearing is generally seen as a mere formality and limited to introductions and explana-

tions to the judges of the basic issues in dispute before the court. However, for novel or unusual issues, the first hearing can be very important to the plaintiff's counsel since it can serve to posture and frame issues in such ways that the judges can understand the key points that are relevant for proper disposition of the case; and competent counsel often introduce easily understood terms and examples that the judges may be more familiar with. Unless the issue is very well settled and the Supreme Court has consistently decided on the issue uniformly, it would be more important to provide a clear explanation of the background of the case and the facts and circumstances that brought the parties to court at the first hearing.

Following the first hearing, which may only last 20 to 30 minutes, the parties will begin submitting briefs which are more detailed before the next hearing. The plaintiff's brief will rebut the defendant's answer and the defendant will reply with additional arguments as to why its action was justified. Generally, one round of briefs is filed, but sometimes, two or even three rounds of briefs are filed before the next hearing, which would be held one to two months after the prior hearing (except in August when hearings are generally avoided due to a two-week court shut-down). In the event that the court deems additional information or documents necessary, based on the respective pleadings made by the parties, it can specifically issue an order to produce such information and documents. Further, in the event that additional analysis is required on a particular issue, the court can instruct each party to address such an issue in greater detail by submission of supplemental briefs. In general, three to five rounds of briefs are expected to be filed at the District Court (or the Court for Administrative Matters) level, meaning there would be about three to five court hearings. However, in complex international tax cases involving transfer pricing and other concepts

that are not familiar to the judges, additional rounds of briefs are expected to be filed and additional hearings are expected to take place. In complex cases, it is also usual for the parties to request a hearing where pleading by counsel would involve PowerPoint and other visual aids. Also, while not common, each party can submit a request for witnesses and experts to testify at a hearing in support of its position.

There is no formal cut-off period or procedure for ending the litigation. The decision to close the hearings is purely at the discretion of the court. However, if the court considers that the arguments made in the hearings, as well as in the evidentiary and supplemental documents submitted, are becoming repetitive, the court will inform the parties that the hearings will end and a decision will be rendered by a certain date, typically within several weeks. However, if one of the parties strongly objects and requests additional hearings, the court may agree to continue or request the objecting party to submit additional briefs within a certain timeframe. Once the decision is recorded and announced in the court's database system, a formal written decision is sent to the parties electronically, usually within two weeks.

The entire litigation process at the District Court (or the Court for Administrative Matters) from the time of filing the petition of complaint to the issuance of a written decision to the parties will generally take between one to two years.

4.3 Relevance of Evidence in Judicial Tax Litigation

Since the Korean judicial system is heavily influenced by the continental legal system, litigation at the District Court and the High Court levels is conducted by a series of court hearings led by a tribunal of three judges. During the initial investigation stage of tax litigation, evidence is submitted to the court accompanied by a brief

as well as requests for information or documents from the opposing party. A witness or expert testimony in person is rarely requested by the court. Unlike in some common law jurisdictions, a jury of peers is not involved in determining the veracity or accuracy of the facts submitted by the parties. In this context, the Korean approach is that an expert judge is in most instances able to analyse and assess the veracity of the evidence purely from an examination of the written statements and other submitted documents. Where each party's factual position differs, the courts will attempt to reconcile them based on all the evidence submitted by the parties as well as the circumstances supporting the facts alleged by the parties. In addition, in tax litigation, the focus is usually on the interpretation and application of a tax provision rather than the facts relating to the amount of revenue generated or expense incurred by the taxpayer.

It is important to note that even though there are no formal investigation rules, the plaintiff is well-served by submitting as many facts and as much evidence as possible, placing less emphasis on the legal arguments or supporting authority at the early stages of litigation. In tax disputes where the plaintiff is arguing that an assessment was erroneously made or an application for a tax refund was rejected without proper legal basis, Korean judges are inclined to side with the tax authority unless the facts and evidence clearly support the taxpayer's position. Moreover, the plaintiff's arguments at the mature stage of litigation are often more persuasive by referring to the evidence already submitted, instead of introducing new evidence at a later stage when the judges may have already formed their views based on their reviews of the previously submitted evidence, and may at this stage be unwilling to review the additional evidence in detail. In addition, where evidence submitted at different stages of litigation appears conflicting or causes confusion, the judges are likely to show defer-

ence to the evidentiary position taken by the tax authority.

4.4 Burden of Proof in Judicial Tax Litigation

Technically, the tax authority as the defendant has the burden of proof to establish that the assessment or rejection of a taxpayer's request for a tax refund was lawful and based on the relevant provision of the law. In this respect, the legal system in Korea differs from many other jurisdictions, where the burden of proof in non-criminal tax litigation proceedings is often on the party bringing the case to court, ie, the taxpayer. However, in Korean practice, the level of threshold to meet such a burden is quite low, ie, so long as some semblance of reason exists for the tax authority's action, the court will generally accept that the burden has been met. This means that even a subjective view such as "the taxpayer's structure or transaction appeared unusual or abnormal" should be sufficient to shift the burden to the taxpayer to explain why the structure employed or transaction undertaken was legitimate and not undertaken to avoid taxes.

4.5 Strategic Options in Judicial Tax Litigation

How to Approach Korean Judges

It is no secret that Korean judges are not familiar with tax issues, and culturally and historically, taxation was not considered a subject matter that judges were expected to master. It is only a recent trend that some law students and lawyers who studied economics and accounting continue to pursue their interest in tax law after becoming judges. Given this background, it is important to provide, as clearly and succinctly as possible at the outset of litigation, the facts and circumstances that compelled the taxpayer to file a complaint, and, most importantly, establish that it is an "innocent" and "compliant" taxpayer aggrieved by "unjust" actions taken by the tax authority. This is of paramount importance since,

all things being equal, the judges are likely to assume that the taxpayer has understated its liability. Moreover, in tax disputes involving foreign entities or Korean companies owned by foreign shareholders, the opposing counsel usually tries to influence the judges by suggesting that they have an obligation to decide for the tax authority who is only doing its “patriotic duty” in uncovering tax abusive structures and transactions.

Legal Analysis and Arguments

Once all pertinent facts and supporting evidence of why the tax authority has erred have been submitted, it is important for the taxpayer to then provide a full legal analysis of the supporting law. One mistake that inexperienced attorneys make is that they tend to argue from the position of being accused of wrongdoing rather than as a proactive taxpayer seeking to redress the unlawful actions committed by the tax authority. This results in arguments and analysis becoming defensive in nature, and could give the impression to the court that the taxpayer has done something wrong. A more fruitful approach is to make arguments and pose questions around the factual and legal basis for the actions taken by the tax authority, frequently reminding the court that it is the tax authority who has the burden of showing that its assessment of additional tax or rejection of a refund request was based on a sound understanding of the taxpayer’s facts as well as correct application of the law.

Witness Evidence: Live Witnesses versus Affidavits

From time to time, the intent, purpose and motive of directors and management personnel are important to establish whether the actions undertaken by the corporate taxpayer were for legitimate business purposes, or for tax avoidance. As these relate to a state of mind and can be quite subjective or even confidential, often such views or thoughts are not recorded or reflected in documents. Where they are con-

sidered to be important to the outcome of the case, instead of calling such witnesses to the court, it may be more effective for the taxpayer’s counsel to submit as evidence an affidavit or a signed written statement describing the facts and the thought process involved that resulted in taking certain action, which the tax authority suspects as being driven by a tax avoidance motive. This sort of substitution of a witness with an affidavit is usually welcomed by the court, since it is more efficient and avoids the need for setting up a recording device; this is especially preferred in the case of a potential foreign witness who is unable to speak Korean, which would then necessitate the use of a translator if the witness were to give evidence live in court. When a witness is submitting an affidavit, care should be taken by the counsel to make sure that the statements made are clear and concise. The judges are likely to frown on long-winded statements with self-declarations about how the tax authority is being unreasonable and how the case should be decided.

PowerPoint and Visual Aids

Another effective tool that can be leveraged by the taxpayer is use of a PowerPoint presentation or other visual aids, by requesting a special court hearing to explain and illustrate the various points made in its written briefs already submitted to the court. Such demonstrative pleading can be enormously beneficial when the facts involve complex financial transactions or a type of business or industry that are unfamiliar to the judges. Similarly, where an outcome of a case may hinge on whether the taxpayer has sufficient business substance in a particular geographic location, embedding a video recording or photographs of the physical premises, and showing employees working in such premises, may be used to counter the tax authority’s assertion that the taxpayer is a mere “paper company”.

Expert Opinions

One final item that should be noted as a recent trend in litigation practice is the submission of an expert opinion. These opinions are typically written by academics who are law or tax professors of well-known universities and may have published many articles related to an issue being disputed in the court. Usually, they relate to the interpretation and application of tax principles and new legal concepts or principles introduced into the law from the OECD or other jurisdictions. For example, the various rules implementing the OECD BEPS Action Plans are likely to be the subject of disputes in the near future, and academics specialising in international tax law are likely to be courted by both taxpayers and the tax authority to submit expert opinions in support of their respective positions.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Korea has adopted the continental legal system; hence, although the decisions of the Supreme Court are followed by the high courts and the district courts, it does not create law in the form of binding precedents, as would be the case in a common law system, and its decisions have no binding or precedential effect on the tax authority. Accordingly, while influential, the tax authority may not follow the interpretation of certain laws provided by the Supreme Court, although it will generally acquiesce after several consistent and uniform decisions have been issued.

As a member of the OECD, Korean courts may mention the Commentary to the OECD Model Tax Convention as well as the OECD Transfer Pricing Guidelines in support of decisions involving tax treaty interpretation and transfer pricing issues. However, although the taxpayer as a plaintiff may introduce related and influential court decisions from other OECD jurisdictions in support of their position, Korean courts have rarely cited such cases as supporting authority

for their decision. In the near future, it is likely that the reports of the OECD BEPS Action Plans will also be referenced by the courts in decisions involving international taxation.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Both the plaintiff and the defendant have the right to appeal decisions that are wholly or partially unfavourable, and in practice, the losing party is virtually certain to appeal a District Court's decision to the High Court that has competent jurisdiction. For example, a plaintiff appealing the decision of the Seoul Court for Administrative Matters can appeal to the Seoul High Court for Administrative Matters. The appeal period is two weeks from receipt of the written decision (unless extended due to a national holiday) and must be strictly adhered to. In the petition for appeal, it is normally sufficient to submit a statement describing the subject matter and the nature of the appeal as expected to submit the reason for appeal within a reasonable timeframe, typically within two to four weeks.

In Korea, the High Court has original jurisdiction and hence is not limited to reviewing the conduct of litigation or erroneous application of law by the District Court. The High Court functions much like the District Court and therefore the parties have no discovery restrictions and can freely submit additional evidence at any time during the litigation. Moreover, the parties can also introduce new legal arguments that were not raised at the level of the district courts. However, one notable difference is the length of litigation, as typically the entire proceedings in the High Court involve only one or two rounds of exchanging of briefs before the hearings are concluded. Accordingly, litigation

at the High Court generally takes between six to eight months to complete.

In terms of composition of judges, the high courts are comprised of a presiding judge and two associate judges like the district courts. These judges tend to be more senior and experienced. However, the likelihood is that the High Court judges have even less experience than the District Court judges in matters involving taxation and, given that international tax disputes have only proliferated over the past 10 to 15 years, they are unlikely to be familiar even with rudimentary international tax concepts (except at the High Courts based in Seoul or Suwon). Accordingly, the odds of having the District Court's decision reversed in favour of the appealing party at the High Court is somewhat higher for tax matters than matters involving general civil or criminal law.

5.2 Stages in the Tax Appeal Procedure

Under the Korean judicial appeal system, all decisions of the High Court can be appealed as a matter of right by the aggrieved party to the Supreme Court within two weeks from receipt of a written decision by the appealing party. However, unlike the District Court or the High Court, the Supreme Court does not have original jurisdiction and its role is limited to reviewing the technical accuracy of the legal analysis that formed the basis for the decisions rendered by the High Court. Moreover, after reviewing legal issues raised in the petition for appeal, the Supreme Court can decide to dismiss the petition without considering the merits of the appeal on the basis that that same issue has already been decided several times by the Supreme Court. Generally, this initial review process takes about four months and if the appellant's petition has not been dismissed, it is an indication that the Supreme Court will undertake a substantive review of the case which may take up to two or even three years before a decision is rendered.

During the review process, the parties are expected to file briefs (not to exceed 30 pages per brief) as often as they feel necessary. In these briefs, the focus will be more on the interpretation and application of law rather than facts, and unless already raised at the lower courts, new legal concepts introduced will not be included in the scope of review. Moreover, all pleadings in the Supreme Court will be performed by written submissions, as there are no oral hearings or witness testimony. Following the conclusion of the review process, the Supreme Court will render a decision, either upholding the decision of the High Court or reversing the High Court's decision, in which case the Supreme Court will render its own decision. From time to time, the Supreme Court will reverse the High Court's decision but instead of rendering its own decision, it will remand the case to the lower courts with specific instructions for further proceedings. Unless the case is remanded to the lower courts, the decision of the Supreme Court is final and not subject to further review. If a decision instructs the tax authority to refund taxes to the taxpayer, this refund must be paid by the relevant tax office immediately; otherwise, the taxpayer can demand additional interest from the tax office at the rate of 5% per annum, or in certain situations, at the rate of 12% per annum in respect of the amount that has not been refunded, calculated from the date the Supreme Court's written decision has been received by the tax office.

5.3 Judges and Decisions in Tax Appeals

Unless the case involves an important question of law, a panel of 3 out of 13 judges of the Supreme Court will review the appeal. The process of selecting the judges to form the panel is purely random and based simply on which day the appeal has been docketed for review. However, where an important legal issue is raised in the appeal, the Supreme Court will hear the case

“en banc”, meaning all 13 judges of the Supreme Court will be involved in the review process.

It is also noteworthy that not all judges of the Korean Supreme Court are career jurists, as is the case for judges sitting in the district courts or the high courts. From time to time, law professors and senior prosecutors are appointed directly to the Supreme Court Bench by the president. Notwithstanding this fact, many legal practitioners in Korea and around the world have remarked that the Korean Supreme Court has demonstrated a level of independence and autonomy, not witnessed in the highest courts of other Asian countries. However, recently the Korean Supreme Court has shown some reluctance to review cases being appealed by the taxpayers.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

There are no ADR mechanisms available in Korea to resolve tax disputes.

6.2 Settlement of Tax Disputes by Means of ADR

There are no settlement possibilities as there are no ADR mechanisms available in Korea.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

There are no mediation or arbitration systems in Korea.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

There are two types of ruling request in Korea. The first type is the ruling request for clarification

or interpretation of law. The request for this type of ruling is common and frequently issued by the tax authority. However, it is merely considered persuasive to a tax auditor and not binding.

The second type of ruling is the formal advance tax ruling, which is available in certain situations and in respect of certain provisions of the law. Although an advance tax ruling is not legally binding on the tax auditor either, under the general principle of good faith and reliance, the tax auditor is not allowed to issue a tax assessment that is inconsistent with the advance tax ruling which was specifically issued to that taxpayer, so long as the actual facts are the same or similar to the facts upon which the advance tax ruling was issued. For transfer pricing matters, APAs are commonly used to obtain certainty, and once issued, the tax auditor is generally forbidden to challenge the transfer price agreed to in the APA for as long as the APA is in effect.

6.5 Further Particulars Concerning Tax ADR Mechanisms

There is no applicable information in this jurisdiction.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

There is no applicable information in this jurisdiction.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Although a tax audit can begin with a notice to the taxpayer that an administrative tax investigation (which can ultimately result in referral to the prosecutor’s office) is also being conducted at the same time, generally such investigation at this stage is designed to provide the tax auditors

of the administrative investigation division with broad powers to investigate and obtain information (including documents) to determine whether an administrative offence has been committed. Moreover, even if a wrongdoing is found, so long as it is limited to violations specifically provided in the tax law and the amount of tax evaded is within a certain threshold, punishment is monetary rather than penal in nature. Accordingly, administrative tax investigations conducted at the tax audit level dealing with intentional non-compliance of the tax law (especially in the VAT area) or aggressive tax avoidance structures, generally lead to, if at all, administrative fines so long as the amount of tax deemed evaded is not viewed as egregious.

By contrast, a criminal investigation is initiated by the prosecutor's office and although the ultimate goal of the accused may have been to avoid paying taxes, there must be a specific violation of the Criminal Code. The types of violations that prosecutors focus on include fraud, concealment of income or assets, or fabricated transactions. Accordingly, although it is common for a tax audit to be accompanied by an administrative investigation on whether specific provisions of the tax code have been violated, it rarely leads to a criminal investigation, especially when the investigation is targeted at a large foreign multinational corporation or its Korean subsidiary.

7.2 Relationship between Administrative and Criminal Processes

The procedures for initiating administrative and criminal investigation, as well as indictments, are separate and independent of each other and often both procedures can proceed in parallel. There is no rule that the administrative procedure be suspended while the criminal procedure proceeds to completion, leads to an indictment by the prosecutor's office and conviction in a criminal court. The only potential overlap is

where an administrative fine is assessed against the taxpayer and the taxpayer disagrees with the fine and fails to pay. In this situation, the administrative investigators may refer the matter to the prosecutor's office, which can then initiate a separate investigation that may lead to a criminal indictment and, following a trial, result in imprisonment as part of sentencing.

7.3 Initiation of Administrative Processes and Criminal Cases

The initiation of a criminal investigation would begin when the administrative investigation team of the tax office formalises the matter by having an internal hearing on whether a referral to the prosecutor's office for criminal action is appropriate given the substantial amount of tax evasion involved. If there is an agreement, the tax office will contact the prosecutor's office and discuss the case. The prosecutor's office can then decide to proceed with a separate criminal investigation and later proceed to a criminal indictment or closing the case on the basis that no criminal wrongdoing occurred.

7.4 Stages of Administrative Processes and Criminal Cases

The administrative investigators of the tax office will first conduct their investigation with the principle purpose of determining whether administrative violations or infringements occurred. However, in the event that the evidence collected points towards a violation of criminal law, an internal discussion with the tax office takes place to determine whether it would be appropriate to refer the matter to the prosecutor's office.

In so far as the process at the prosecutor's office is concerned, the decision whether to proceed or drop the matter is purely at the discretion of the team leader assigned to the case. In criminal matters involving tax, the key driver will be the amount of tax involved. In high value cases involving a well-coordinated design and

scheme, the prosecutor's office will aggressively investigate with a view to indicting the criminal perpetrators, which may ultimately lead to their incarceration and imprisonment. In low value or less significant cases, the prosecutors may only issue a fine, a warning or a sanction. Like all criminal matters, the indicted must be found guilty following a trial at the criminal court before facing penal sentencing.

7.5 Possibility of Fine Reductions

In the case of an administrative fine, paying the fine to the tax office in full would conclude the matter. If the fine is paid within ten days of receiving the notice and without an appeal, then it will be reduced by 20%. In the event the fine is not paid, the administrative investigator can refer the matter to the prosecutor's office. If the taxpayer continues to protest their innocence but is ultimately found guilty of a criminal conduct at the criminal proceeding, the taxpayer can attempt to reduce or mitigate the length of incarceration by agreeing to pay some or all of the taxes evaded.

7.6 Possibility of Agreements to Prevent Trial

In a criminal tax trial based on a taxpayer's evasion of taxes, the payment of outstanding taxes, interest and fines can impact the sentencing.

7.7 Appeals against Criminal Tax Decisions

The avenue of appeal against an adverse decision rendered by the criminal court is the same as the other appeal procedures described in this chapter.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

In Korea, the GAAR (provisions in the tax law dealing with substance over form), the law on denial of unfair transactions, the law of matching bank accounts with real owners, and transfer pricing rules, are all designed for tax assessment

purposes, and therefore being subject to these rules would not generally give rise to criminal actions, unless the taxpayer also committed an administrative or criminal tax offence.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

Where a double taxation situation occurs due to an additional tax assessment on the same income or if a transfer pricing adjustment in a cross-border situation occurs, it is common to invoke both the domestic dispute resolution mechanism (ie, administrative tax appeal and litigation) and the MAP. In order to cancel such additional tax assessment, the taxpayer would ordinarily file an appeal to the Tax Tribunal and, if necessary, to the courts. During this process, the MAP may be invoked (within three years of receiving the TAN) if available under a tax treaty.

Since taxpayers are permitted to proceed with tax litigation and the MAP simultaneously, it is important to understand how those two processes interplay. First of all, an MAP may not be invoked under the Korean domestic tax law if, inter alia, the final judgment has been entered on the subject matter in the court of Korea or the other jurisdiction. Even if properly invoked, an MAP should halt once a court has rendered the final judgment on the subject matter. Where an agreement is reached and an MAP is concluded, the agreement reached should be implemented immediately once the applicant taxpayer has accepted the agreement, or where the MAP and court litigation against the subject tax assessment were concurrent, the applicant taxpayer should voluntarily drop the litigation. If the applicant taxpayer does not drop the litigation within two months from the receipt of notice of the MAP conclusion, and unless the taxpayer

otherwise submits their consent to the MAP conclusion to the competent authorities (ie, tax office or MOEF), the taxpayer may be regarded as having rejected the results of the MAP.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The Korean tax authority has aggressively applied the GAAR (in particular, the substance over form principle) to cross-border situations covered by a bilateral tax treaty, especially on the issue of whether the taxpayer is entitled to claim tax treaty benefits. For example, in the absence of the beneficial ownership requirement in a tax treaty in respect of capital gains to reduce or exempt Korean withholding tax, the tax authority has applied the domestic “substantive ownership rule” which generally mimics the beneficial ownership test that is applicable to interest, dividends and royalties. More recently, the Supreme Court has issued decisions that appear to say that, if applicable, both the beneficial ownership as well as the substantive ownership requirements must be satisfied to be eligible for tax treaty benefits.

8.3 Challenges to International Transfer Pricing Adjustments

Transfer pricing adjustments made during tax audits of foreign invested Korean companies remain the most important source of tax revenue for the tax auditors. Although Korean transfer pricing rules are largely based on the OECD Transfer Pricing Guidelines, the application of the rules requires the determination of whether the transfer price was at arm’s length by reference to benchmarking comparable transactions undertaken by local Korean companies. Until recently, such companies had often conducted global transfer pricing studies to support the transfer price, which was consequently not specifically based on local Korean comparables. As a result, the proposed adjustments would often be completely unexpected or unanticipated,

and hence reaching a compromise or settlement has been difficult. Moreover, in light of the adoption of the so-called “commercial rationality and economic substance” test, which has been applicable since 1 January 2019, tax auditors are expected to be even more aggressive with transfer pricing adjustments in the future.

Notwithstanding the frequency and size of the proposed transfer pricing adjustments, taxpayers have been successful in the courts. One reason for this is that taxpayers who are part of the multinational group often have substantial technical resources and data to defend their transfer pricing, including detailed economic analysis from transfer pricing economists and experts. Although the Korean tax authority has been building its transfer pricing analysis capability, insufficient expertise and analysis required to support the tax auditor’s argument in court justifying the adjustment have resulted in the taxpayer being less successful than in other general tax cases. This is likely to change in the future given the ever-increasing amounts at stake.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Unilateral, bilateral and multilateral APAs are secured by taxpayers to avoid or mitigate disputes in transfer pricing matters. Of these, the bilateral are most prevalent. As of the end of 2020, which is the latest data available, 225 APAs were being actively negotiated, some of which were filed by taxpayers several years ago and 52 cases (17 unilateral APAs and 35 bilateral APAs) have been concluded in 2020. The average time taken to conclude those cases in 2020 was one year and eight months for unilateral cases and two years and 11 months for bilateral cases.

On a cumulative basis, from 1997 to 2020, the average time taken to conclude APA cases was one year and nine months for unilateral cases

and two years and seven months for bilateral cases.

To secure an APA with the tax authority, a preliminary economic analysis should be undertaken and an informal pre-conference meeting should be held with the tax officials. At this meeting, the taxpayer would informally present its findings and propose the transfer pricing methodology to be employed as well as the transfer pricing rate for the transaction covered under the APA. If the tax officials react favourably, the taxpayer would undertake a detailed economic analysis which would accompany the APA application. Once filed, the taxpayer and the tax officials will meet several times to go over the application, and in bilateral APAs it is expected that the competent authorities on both sides will meet under the MAP mechanism and push back on the proposed transfer pricing rate to be applied if it is seen as too favourable to the other jurisdiction.

8.5 Litigation Relating to Cross-Border Situations

Over the last few years, tax treaties and withholding tax issues have dominated court litigations involving cross-border tax matters. Although transfer pricing adjustments and disputes occur frequently at the tax audit level, due to the significant amounts involved as well as the uncertainty of outcome (ie, the usual hazards of litigation), most transfer pricing disputes are settled at the tax audit stage or through the MAP. In addition, cases involving permanent establishment and the availability of tax incentives for foreign direct investments (repealed and inapplicable from 1 January 2019) find their way into courts.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

There is no applicable information in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

There is no applicable information in this jurisdiction.

9.3 Challenges by Taxpayers

There is no applicable information in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

There is no applicable information in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Korea has not opted into Part VI of the MLI and no existing tax treaties between Korea and other countries have a mandatory binding arbitration provision. However, in 2020, Korea amended its domestic tax law so that a taxpayer can submit an unresolved issue to arbitration where the competent authorities are unable to reach an agreement under the MAP, in accordance with the terms of the applicable tax treaties. This amended law was designed to accommodate future treaties containing an arbitration provision and has been applicable from 1 January 2021.

10.2 Types of Matters that Can Be Submitted to Arbitration

As Korea currently has no tax arbitration procedures, there is no applicable information.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

As Korea currently has no tax arbitration procedures, there is no applicable information.

10.4 Implementation of the EU Directive on Arbitration

There is no applicable information in this jurisdiction.

10.5 Existing Use of Recent International and EU Legal Instruments

There is no applicable information in this jurisdiction.

10.6 New Procedures for New Developments under Pillar One and Two

Under the current standards of Pillar One, which applies only to the multinational companies (excluding those carrying out extractives and regulated financial services) with greater than EUR20 billion (KRW27 trillion) in worldwide revenues and profitability before a tax margin of at least 10%, only two Korean companies – Samsung Electronics and SK Hynix – will be covered by Pillar One. Starting from 2030, when the revenue threshold decreases to EUR 10billion (KRW14 trillion), the scope of covered Korean companies may increase to several companies.

Under Pillar Two, which applies to the multinational companies with total consolidated revenue above EUR750 million (KRW1 trillion) and with subsidiaries established in low-taxed jurisdictions, there are approximately 81 identified Korean companies subject to Pillar Two, and around 150 subsidiaries of those companies are

found to be in low-taxed jurisdictions according to research.

The Korean government plans to undertake the necessary harmonisation process in Korea, including the enactment of domestic laws in 2022, following the implementation timeline of the OECD/G20 Inclusive Framework (“IF”). To this end, during the first half of 2022, it plans to launch a task force researching the codification of the IF in Korea, where professionals and experts in corporate and international taxes participate and then reflect the research results in the tax law amendment bill for 2022. The Korean government has announced that it aims to prepare a tax law amendment, which would cause domestic tax laws to be in line with the OECD model rules.

In 2022, the OECD will continue establishing specific rules for the GloBE Implementation Framework – for example, setting up the templates of reporting forms and other measures implementing the framework. In this regard, the Korean government expressed its willingness to participate in the process actively to minimise the burdens of businesses in implementing the framework. Furthermore, to address the double taxation problem caused by the adoption of Digital Tax, the Korean government endeavours to minimise the tax burdens of businesses by adopting measures such as allowing tax deductions or credits. Since the Korean government has shown its commitment to resolving the difficulties confronted by the companies, including double taxation problems, such efforts may mitigate potential controversies surrounding the adoption of Pillars One and Two in Korea.

10.7 Publication of Decisions

Although Korea currently has no tax arbitration procedures, the judicial courts sometimes recommend that the parties settle the matter. Although the parties are not required to follow

such a recommendation, it can lead to a settlement between the parties. Generally, the settlement process would start after the taxpayer agrees to withdraw the litigation and the NTS agrees to cancel its tax assessment against the taxpayer in whole or in part. The courts do not publish their reasons for the recommendation and the terms of settlement are not disclosed.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Since Korea currently has no tax arbitration procedures, the court's recommendation to settle is the most common way for the taxpayers and the NTS to resolve tax disputes.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

As Korea currently has no tax arbitration procedures, there is no applicable information.

11. COSTS/FEES

11.1 Costs/Fees Relating to Administrative Litigation

No fees are payable by the taxpayer for filing an appeal to the Tax Tribunal to cancel the additional tax assessment or the rejection of a tax refund request.

11.2 Judicial Court Fees

The taxpayer who is filing a petition of complaint to the District Court is required to pay a court filing fee and, thereafter, on appeals to the High Court or the Supreme Court. By contrast, if the taxpayer prevails at the District Court and the appeal is lodged by the defendant, the taxpayer is not required to pay a court filing fee to defend lower court's decision on appeal. The amount of court filing fees can vary due to the use of a formula based on the amount of tax that is

at dispute. Moreover, the court filing fees are increased at each stage of appeal.

For example, if the amount of tax at dispute is KRW3 billion (approximately USD2.5 million), the court filing fees payable at the District Court will be KRW4,055,000 (approximately USD3,570), calculated as $\text{KRW3 billion} \times \frac{1}{3} \times 0.0035 + \text{KRW555,000}$. This amount is increased by 50% (USD5,350) if the decision of the District Court is appealed to the High Court, and by 100% (USD7,140) if the decision of the High Court is appealed to the Supreme Court. Each amount is discounted by 10% when proceeding by electronic litigation system.

11.3 Indemnities

There are no indemnities provided by the tax office if the court decision results in the cancellation of the tax assessment. However, a small amount of the attorney's fee is awarded to the prevailing party (or to both parties if each party partially wins on its claim) based on the amounts involved in the dispute. The award is based on a statutory formula and is capped at approximately USD13,250 at each stage of litigation.

11.4 Costs of ADR

No alternative dispute resolution mechanism exists in Korea.

12. STATISTICS

12.1 Pending Tax Court Cases

Although the data on the number of the total tax appeals currently pending at the Tax Tribunal is not available, the number of tax appeals newly brought before the Tax Tribunal was 13,025 in 2021 and 12,795 in 2020. According to the statistics disclosed by the NTS for 2020, the number of tax cases disputed at the level of the district courts was 1,640, while 680 cases were

appealed to the high courts and 222 cases were appealed to the Supreme Court.

12.2 Cases Relating to Different Taxes

The total 3,851 tax cases litigated in court by the NTS (including cases carried over from the previous years) in 2020 can be categorised as follows:

- individual income tax – 574 cases (approximately 15%);
- corporate income tax – 687 cases (approximately 18%);
- VAT – 699 (approximately 18%);
- capital gains tax – 858 cases (approximately 22%);
- gift and inheritance tax – 535 cases (approximately 14%); and
- others – 498 cases (approximately 13%).

12.3 Parties Succeeding in Litigation

According to the statistics disclosed by the NTS, historically, the percentage of tax cases where the taxpayer totally succeeded is around 20%, while the NTS was at least partly successful in approximately 80% of the cases. For cases related to corporate income tax, the percentage of the corporate taxpayers' success is around 30%. For large international tax cases, the success rate is higher and, although no specific data is available, based on information shared by litigators handling these types of litigation, the taxpayers' success rate can be estimated to be around 40% to 50% and substantially higher in withholding tax cases.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Since negotiations and settlements are not possible after completion of the tax audit, taxpayers are advised to make every possible attempt to resolve all issues outstanding before the tax audit is concluded. However, if a resolution is not possible, taxpayers should consider using all the tools at their disposal, including the MAP, as well as filing an appeal to the Tax Tribunal and, if necessary, filing a petition of complaint to the District Court. Korean judges, while not necessarily experts in tax law, are nevertheless intelligent (usually selected from the top of their class) and highly dedicated public officials. Moreover, the courts are generally independent and decisions are rendered relatively quickly as the entire proceeding from the District Court to the Supreme Court can take as little as three to four years. In this regard, it is also noteworthy that litigating against the tax authority is a culturally accepted norm in Korea and taxpayers should have little to no fear of a potential backlash from the tax authority. Finally, in certain areas of corporate income tax law (transfer pricing), taxpayers have a good chance of prevailing in the courts so long as the facts are strong and the counsel is competent.

Lee & Ko was founded in 1977 and is one of the oldest and largest law firms in South Korea. The tax practice group includes lawyers with decades of experience in tax planning and complex tax disputes; former government and tax officials experienced in effectively handling civil and criminal tax investigations; former judges who have vast experience in handling cases at all levels of litigation; and certified public accountants with many years of dedicated tax experience, including assisting in tax audits. The

group offers focused advice on tax planning, consultancy, audits, disputes, advanced ruling and legislative consulting and transfer pricing. The practice's current clients include nearly all of the largest Korean corporations and financial institutions as well as many of the Fortune 500 companies. For many years the tax practice has been ranked at or near the top of the list of best Korean law firms by leading international and Korean legal directories.

AUTHORS



Jay Shim previously led the international tax team and served as the co-head of the tax practice group at Lee & Ko. He specialises in international tax planning, structuring and

dispute resolution. He serves as the chair of the Taxation Committee of the Inter-Pacific Bar Association, co-chair of the Taxation Committee of AmCham Korea and is a member of the International Fiscal Association, the American Bar Association and the International Bar Association. He regularly contributes to tax journals and legal publications on Korean and international tax developments and trends.



Sung-Hyun Ryu is a partner of Lee & Ko's tax practice group. He has been actively practising as a tax litigator and consultant using his experience and knowledge gained from his

career at the National Tax Service (NTS). During his tenure at NTS, he mainly handled tax litigation and played an active role as a committee member of the Taxation Dispute Review and Council Committee as well as the Joint Review Working-Level Committee, where he dealt with various cases filed under the administrative tax appeal procedures.

Contributed by: Jay Shim, Sung-Hyun Ryu and Jung-Ho Ryu, Lee & Ko



Jung-Ho Ryu is a partner of the tax practice group of Lee & Ko. He is a member of the Korean (Seoul) Bar Association and earned his Taxation LLM degree from Georgetown University Law

Center. He has been actively practising as a tax litigator and adviser. His practice primarily focuses on the areas of finance, M&A, international and corporate tax matters. He also works closely with the firm's M&A and capital market practice. Prior to joining Lee & Ko, he worked as a portfolio manager in Allianz Global Investors and also passed the US Certified Public Accountant examination.

Lee & Ko

Hanjin Building
63 Namdaemun-ro
Jung-gu
Seoul 04532
Korea

Tel: +82 2 772 4000
Fax: +82 2 772 4001/2
Email: mail@leeko.com
Web: www.leeko.com



Law and Practice

Contributed by:

Felipe Alonso and Javier Povo

GTA Villamagna see p.637



CONTENTS

1. Tax Controversies	p.615	5.3 Judges and Decisions in Tax Appeals	p.625
1.1 Tax Controversies in this Jurisdiction	p.615	6. Alternative Dispute Resolution (ADR) Mechanisms	p.625
1.2 Causes of Tax Controversies	p.615	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.625
1.3 Avoidance of Tax Controversies	p.616	6.2 Settlement of Tax Disputes by Means of ADR	p.626
1.4 Efforts to Combat Tax Avoidance	p.616	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.626
1.5 Additional Tax Assessments	p.617	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.626
2. Tax Audits	p.618	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.626
2.1 Main Rules Determining Tax Audits	p.618	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.626
2.2 Initiation and Duration of a Tax Audit	p.618	7. Administrative and Criminal Tax Offences	p.626
2.3 Location and Procedure of Tax Audits	p.619	7.1 Interaction of Tax Assessments with Tax Infringements	p.626
2.4 Areas of Special Attention in Tax Audits	p.620	7.2 Relationship between Administrative and Criminal Processes	p.628
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.620	7.3 Initiation of Administrative Processes and Criminal Cases	p.628
2.6 Strategic Points for Consideration during Tax Audits	p.620	7.4 Stages of Administrative Processes and Criminal Cases	p.628
3. Administrative Litigation	p.620	7.5 Possibility of Fine Reductions	p.629
3.1 Administrative Claim Phase	p.620	7.6 Possibility of Agreements to Prevent Trial	p.629
3.2 Deadline for Administrative Claims	p.621	7.7 Appeals against Criminal Tax Decisions	p.629
4. Judicial Litigation: First Instance	p.622	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.630
4.1 Initiation of Judicial Tax Litigation	p.622	8. Cross-Border Tax Disputes	p.630
4.2 Procedure of Judicial Tax Litigation	p.622	8.1 Mechanisms to Deal with Double Taxation	p.630
4.3 Relevance of Evidence in Judicial Tax Litigation	p.622	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.630
4.4 Burden of Proof in Judicial Tax Litigation	p.623		
4.5 Strategic Options in Judicial Tax Litigation	p.623		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.623		
5. Judicial Litigation: Appeals	p.624		
5.1 System for Appealing Judicial Tax Litigation	p.624		
5.2 Stages in the Tax Appeal Procedure	p.624		

8.3	Challenges to International Transfer Pricing Adjustments	p.631	10.5	Existing Use of Recent International and EU Legal Instruments	p.633
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.631	10.6	New Procedures for New Developments under Pillar One and Two	p.633
8.5	Litigation Relating to Cross-Border Situations	p.631	10.7	Publication of Decisions	p.634
9. State Aid Disputes		p.632	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.634
9.1	State Aid Disputes Involving Taxes	p.632	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.634
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.632	11. Costs/Fees		p.634
9.3	Challenges by Taxpayers	p.632	11.1	Costs/Fees Relating to Administrative Litigation	p.634
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.632	11.2	Judicial Court Fees	p.634
10. International Tax Arbitration Options and Procedures		p.633	11.3	Indemnities	p.635
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.633	11.4	Costs of ADR	p.635
10.2	Types of Matters that Can Be Submitted to Arbitration	p.633	12. Statistics		p.635
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.633	12.1	Pending Tax Court Cases	p.635
10.4	Implementation of the EU Directive on Arbitration	p.633	12.2	Cases Relating to Different Taxes	p.635
			12.3	Parties Succeeding in Litigation	p.635
			13. Strategies		p.635
			13.1	Strategic Guidelines in Tax Controversies	p.635

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

As a general rule, tax controversies arise as a result of tax assessments derived from an administrative procedure initiated by the Spanish Tax Authorities (STA), such as those addressed to tax data verification, tax restricted checking or tax inspection (with either a general or partial scope).

However, they can also be initiated by the taxpayer in the event that they challenge their own self-assessed tax return (request for the rectification of a self-assessed tax return and refund of undue tax paid). Furthermore, taxpayers are also allowed to challenge withholdings and/or output VAT by lodging a claim against these before the STA.

1.2 Causes of Tax Controversies

The taxes that give rise to the most tax controversies are corporate income tax (CIT), personal income tax (PIT) and value added tax (VAT).

Corporate Income Tax

With regard to CIT, the most common controversial matters/issues are:

- the application of tax losses and deductions carried forward, which are open to amendment for a special ten-year period;
- the use of what are known as “brass plate companies” and/or “offshore companies”;
- the assessment of the existence of sound business reasons to carry out restructuring operations upon which the tax neutrality regime depends;
- transfer pricing issues in related-party transactions;
- deductibility for tax purposes of expenses linked to partners and board members’ remuneration;

- the “real residence” of foreign companies; and
- the application of tax transparency rules.

Personal Income Tax

With respect to PIT, the STA are focusing their attention on individuals who render professional services through their own companies when benefits from the professional activity are left and used at the company level; and not distributed to the individual. This is because this may lead to a lack of payment in terms of total tax due. Not only due to the difference in CIT/PIT tax rates, but because these entities are commonly used to acquire the personal assets of their partners.

In addition, the STA are increasingly focusing their attention on tax residence issues and their subsequent implications for direct taxes and existing formal obligations. Over the last few years, many high net worth individuals have moved to Spain, or simply visited or acquired properties or assets in the country, without being aware of the conditions under which an individual may become a Spanish tax resident and without having previously analysed the tax implications that arise from the condition.

Among other consequences derived from being considered a Spanish tax resident, during 2021 and early 2022 the STA were applying the tax penalties related to Form 720 (those derived from the lack of declaring this arrangement) to those individuals who, being Spanish tax residents (for whatever reason), have not declared all their assets deposited abroad. This was despite the arrangement and its consequences/penalties being challenged by the European Commission. One of the more burdensome consequences was the consideration of an unjustified increase in equity as entirely allocated to the oldest tax period for which the statute of limitations had not

expired. In addition, a tax penalty of 150% could be imposed (until 2022).

It must be highlighted that the Court of Justice of the European Union concluded that the penalties for non-compliance with the obligation to declare assets through Form 720 were disproportionate and unlawful. As was the obligation on the taxpayer to prove the statute of limitations. This extraordinary ruling has already led, in the year 2022, to a change in the regulatory regime and the suppression of paragraph 2 of Article 39 of the Personal Income Tax Law and, in any case, the suppression of the previous specific sanctioning regime.

In addition, this ruling may be brought up in “live” administrative and judicial proceedings so that the claims against tax acts raised may be upheld. Likewise, whether it is possible to challenge final administrative acts, insofar as they were issued under a regulation not in accordance with EU law, will be a matter for discussion.

Value Added Tax

Regarding VAT, the STA place special emphasis on:

- the tax regime on real estate transactions;
- the VAT status of holding companies and deductibility of input VAT borne; and
- pro-rata deduction of companies performing limited exempt transactions (ie, financial and insurance companies or companies belonging to the healthcare and education sectors).

1.3 Avoidance of Tax Controversies

Some recommended guidelines in order to mitigate potential tax controversies include the following.

- The management of tax compliance risks through the implementation of structured processes aimed at the systematic identification,

assessment, ranking, and treatment of those risks (eg, failure to register, or to properly report tax liabilities).

- Asking for tax and legal advice on the envisaged transactions in advance, in order to be aware of their tax and legal status before the STA and to avoid the execution of projected operations/transactions in any way that may lead to a tax controversy.
- Preparing and obtaining any supporting evidence through which the taxpayers could prove, within the tax audit procedure, the existence of (or the business reasons for) said business or a specific legal operation/transaction.
- Formulating, if deemed necessary by counsel, binding consultations to the General Directorate of Taxes (GDT) when no clear interpretative criterion exists about the transactions/operations that are intended to be carried out; this binding consultation is recommended to be prepared if a taxpayer does not want to assume any risk.
- Being aware of the STA's position on a tax issue and of the previous jurisprudence and pending litigation with respect to relevant transactions/operations or any other issues that may give rise to tax controversies.

1.4 Efforts to Combat Tax Avoidance

The STA have consistently shown a high level of commitment to the implementation of the measures proposed in the OECD's Base Erosion and Profit Shifting (BEPS) Project. Most of these measures have already been implemented, including EU Tax disclosure rules (DAC 6) and the Anti-Tax Avoidance Directive (ATAD) anti-hybrid legislation.

Additionally, further developments are currently being discussed in the Spanish Parliament to implement measures contained in Directive 2016/1164 as amended by Directive 2017/952 (ATAD I and ATAD II).

The hybrid asymmetry regulation has already been transposed.

It should be noted that Spain has approved the regulation of the “Google tax” in order to correct certain problematic aspects. However, as Spain has approved this tax unilaterally, there may be conflicts when it comes to applying the conventions approved to avoid double taxation; among many other issues.

Spain was one of the signatories of the OECD multilateral convention to implement tax treaty related measures to prevent BEPS (MLI), signed on 7 June 2017. The definitive MLI position of Spain is still to be approved by the Spanish Parliament.

The National Bureau of International Tax Affairs

The National Bureau of International Tax Affairs was created in 2013 to manage, plan and coordinate international tax affairs; in particular, certain risk areas directly connected with BEPS. This has led to increased attention from the STA that will certainly result in increased tax controversies in the following areas:

- transactions carried out by Spanish tax residents using hybrid mismatch or other aggressive tax planning arrangements;
- leveraged acquisition of participation in a company with the main aim of generating tax-deductible expenses;
- transactions carried out with low-tax countries (especially with those qualified as tax havens) and by persons or entities that change their residence with the aim of avoiding the payment of taxes;
- payments and complex transactions to which model provisions to prevent treaty abuse, including through treaty shopping, may be applicable – special attention will be paid to dividends and royalties paid through “conduit

companies” set up in countries with favourable tax treaties to channel investments and obtain reduced rates of taxation;

- permanent establishments of non-resident entities that are currently being taxed as if they were not established in Spain for tax purposes, especially in the cases of multinational enterprises; and
- effectiveness of information exchange and co-operation between tax administrations.

1.5 Additional Tax Assessments

According to tax regulations, the taxpayer will be entitled to file either an internal administrative appeal (*recurso de reposición*) or an economic-administrative claim against additional tax assessments or against the resolution of the appeal. If such appeals are totally or partially rejected by the administrative authorities, taxpayers may challenge/appeal those resolutions before the judicial courts.

The appeal of the tax assessment before an administrative court does not prevent its execution (payment of tax appealed), as an assessment is enforceable since it is issued by the STA. However, the taxpayer may choose to pay the appealed tax due or suspend its execution; bearing in mind that the payment choice does not determine the waiver of any right in the appeal or claim filed against them.

If the taxpayer decides to suspend the mentioned tax debt, whether the additional tax assessment comes from a tax settlement or a tax penalty must be determined. When deriving from a tax penalty, the file of an appeal determines the automatic suspension of its execution in administrative proceedings, without a need to provide any further guarantee. However, the suspension is not automatic when the appeal is filed before a judicial court once the economic procedure is finished.

When deriving from a tax assessment, however, the submission of an appeal does not determine the automatic suspension of the tax debt execution in administrative proceedings. Because cases in which the suspension is made without the granting of a guarantee are less common, taxpayers should grant the guarantee if they want to suspend the debt's execution. Thus, if they decide not to pay the tax due or not to apply for its suspension, the STA may initiate an enforcement procedure for the collection of the corresponding amount; which is absolutely independent of the appeal or claim filed.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The STA's main purpose is to monitor the proper compliance with their tax obligations of taxpayers and to fight against conduct that may give rise to tax fraud and/or tax evasion. As a consequence, because of their possibly "fraudulent" nature (under the scope of the STA), these are some actions or circumstances that may make a tax inspection or verification more likely. These include:

- the existence of tax losses to be offset and deductions from the tax quota pending application;
- the use of companies to allocate the personal costs of their partners;
- the use of companies known as "brass plate companies" or "offshore companies" which, in fact, do not carry out any economic activity from a Spanish law perspective;
- the presence of high financial expenses in relation to operating profits;
- the performance of business restructuring operations benefiting from tax deferral conditioned on sound economic reasons;
- the elimination of double taxation (either by the way of exemption or deduction); and

- tax residence issues, both for individuals and companies.

Regarding high net worth individuals, their tax residence and the applicable special tax regimes (such as those that apply to impatriates or in the near future those related to digital nomads) are relevant topics on which the STA are focusing their attention.

Likewise, the STA will check the amounts declared by taxpayers on their tax returns in order to determine whether they differ significantly from those declared in the business sector to which they belong.

Finally, it is important to note that very large companies, as well as those which operate in regulated sectors, and those ultra-high net worth individuals who are considered "major taxpayers" (*grandes contribuyentes*), are regularly subject to tax audit procedures.

2.2 Initiation and Duration of a Tax Audit

The regulation of tax verification and inspection proceedings is set out in the General Tax Law (GTL) and in its implementing regulations.

A tax inspection procedure could be initiated within the four years provided by the statute of limitations, to verify compliance with the tax obligation, as stated in Article 66 a) of the GTL. However, Article 68 of the GTL provides some actions or certain rules regarding the suspension of the statute of limitation which was affected due to the COVID-19 pandemic during the "state of alarm" in the year 2020. However, the states of alarm declared by the government were subsequently found to be illegal and unconstitutional by the Constitutional Court. This circumstance will, undoubtedly, have an impact on procedures that had already been initiated and were in the pipeline during the pandemic, or those that were

initiated during the states of alarm; and in which the statute of limitations is one of the grounds for challenging the administrative acts issued. Currently (May 2022), there is no state of alarm in force.

Generally, the tax inspection procedure cannot last for more than 18 months. Nevertheless, under certain specific circumstances, it may last up to 27 months. If the STA fail to comply with the above-mentioned maximum periods for tax inspection proceedings, the statute of limitations shall not be deemed to be interrupted. Nevertheless, the tax inspection procedure must continue and end, even after the deadlines have elapsed. However, if this happens, any action performed by the STA during the inspection proceedings will be understood as not having interrupted the statute of limitations.

In 2015, the GTL was reformed and Article 66 bis was added to it. In accordance with this Article, the STA are empowered to audit and consider legal operations/transactions concluded in tax periods whose statutes of limitations have expired and have or may have an impact on the tax period which is under tax inspection. However, this does not mean that the STA are empowered to request tax debts or penalties related to the time-barred periods, but rather to assess any additional tax adjustments arising in the tax period under tax verification as a consequence of those statutorily barred periods.

COVID-19 State of Emergency

The first Spanish state of emergency, declared last year as a consequence of the COVID-19 crisis, temporarily suspended the statute of limitations in tax administrative proceedings such as tax inspections. However, this suspension was lifted last September although a new state of emergency was declared from October to May 2021.

As already mentioned, both states of alarm have been declared unconstitutional and, therefore, illegal. Undoubtedly, this will have a very significant impact on the administrative acts raised by the STA. This argument will have to be invoked in the appropriate administrative or judicial appeals in which the mentioned acts are being challenged.

2.3 Location and Procedure of Tax Audits

Article 151 of the GTL provides that tax inspections may be carried out, at the STA's discretion, in any of the following places:

- at the tax domicile of the taxpayer, or where a representative of the tax payer is domiciled or has an office;
- the place where the taxable activities are carried out;
- the place where there is at least partial proof of the taxable event or of the de facto assessment of the tax liability; or
- at the STA offices, when those matters to be inspected could be examined there.

Notwithstanding the above, the examination of the legal documents of the taxpayer by the STA must be carried out at the domicile, premises, or office of the taxpayer, before the taxpayer themselves, or a person designated to such effect. However, as a matter of fact, the tax procedure is mainly processed in the STA's offices.

During the tax proceedings, companies must communicate with the STA through electronic means and the STA online platforms. Individuals are not obliged to use such electronic means and platforms.

Effect of COVID-19 on Auditing Procedure

As a consequence of the pandemic, the use of telematic media such as Zoom has become widespread. As a direct consequence of the

foregoing, the tax audit procedure has been expedited and, as a result, there is a risk to the taxpayer's rights, because these might be affected or even infringed until this new practice is duly regulated.

2.4 Areas of Special Attention in Tax Audits

In the authors' experience, key areas in a tax audit would be:

- tax residency
- partners/board members tax status and remuneration;
- real ownership for tax purposes of company assets;
- tax deferral special tax regime (restructuring companies);
- tax-deductible expenses;
- temporary allocation of financial expenses;
- tax-loss carry forwards;
- related-party operations/transactions;
- deductions/exemptions on operations/transactions which have been subject to double taxation;
- real estate operations/transactions;
- holding, foreign and offshore companies; and/or
- the nature of operations/transactions carried out according to GAAR.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Information exchanges and tax verification procedures have increased. This is due to the fact that the STA have more resources at their disposal in order to obtain information/documentation from taxpayers.

Despite the fact that our law firm has led the legal assistance and defence in more than 40 tax audit procedures in the last five years, we

are not aware of tax authorities from different jurisdictions having jointly initiated tax procedures against the same tax payer in their own jurisdictions. However, our firm is aware that tax authorities from different countries are closely co-operating and sharing relevant information/documentation. The tax authorities from the USA (IRS), the UK (HMRC), Italy (AE) and Switzerland (ESTV) should be expressly mentioned in this respect.

However, despite the fact that the existence of tax audit procedures initiated jointly by different states is not the general rule, for collection procedures inside the EU the rule is the other way round. Thus, both tax dues and tax penalties imposed and not paid in Spain would be prosecuted and executed by the tax authorities where the taxpayer is located or residing.

2.6 Strategic Points for Consideration during Tax Audits

The key strategic steps to take during a tax audit are, among others:

- to make a preliminary analysis of the controversial tax issues followed by a rigorous analysis of the request made by the STA;
- to provide the documentary support at the appropriate procedural moment; and
- to have a deep knowledge of the applicable tax legislation and accountancy, together with a wide experience in tax litigation.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

In general, the administrative procedure for appeals/claims in Spain, once a tax assessment or penalty has been notified by the STA, consists of two stages: an administrative phase and an economic-administrative phase.

The administrative phase is optional and is initiated through the appeal lodged before the same administrative body that issued the tax settlement or penalty (appeal for reversal). As it is optional, the taxpayer may instead submit an economic-administrative claim directly before the Tax Administrative Court without the need to first file an appeal for reversal.

The economic-administrative phase is mandatory. This phase begins with the lodging of the claim/appeal before a Tax Administrative Court – at first or single instance – (economic-administrative appeal). The economic-administrative appeal is thus the mandatory way to first challenge a tax assessment.

The appeal is submitted before the same tax administrative body that issued the tax settlement; and, depending on the amount of tax debt or tax penalty and/or its subject matter, it will be processed, whether within an ordinary proceeding or through a summary/fast track procedure, before the Tax Administrative Court.

In terms of deadlines, the economic-administrative appeal must be filed within one month as of the date of notice of tax assessment or tax penalty, or, otherwise, when a tacit negative decision takes place (this arises from the failure of the STA to raise the final resolution).

In the case of periodically accruing debts and collective notification, the period to file an appeal begins from the date following the end of the voluntary payment period.

Once all the administrative stages of appeal have been exhausted, taxpayers may file an appeal before the judicial courts.

In addition to the ordinary administrative review procedures mentioned above, there are several

special review proceedings that could be used in exceptional cases.

It is important to note that none of the administrative appeal proceedings before Tax Administrative Courts require the taxpayer's representation by an attorney (legal representative) or lawyer.

3.2 Deadline for Administrative Claims

The deadline for the appeal for reversal is one month from the day following the filing of this kind of appeal. The STA have a duty/obligation to resolve all claims/appeals. Nevertheless, if the STA have not issued their decision within a six-month period, the appellants may consider the claim/appeal dismissed (tacit negative administrative decision) and file an economic-administrative appeal before the Tax Administrative Court.

The deadline for an economic-administrative appeal/claim is one year, or six months in certain cases, such as appeals whose amount would be less than EUR600, from the day following the filing of this kind of appeal.

Nevertheless, if the Tax Administrative Court has not issued a resolution in the course of one year, the appellants would be able to consider the claim/appeal dismissed (tacit negative administrative decision) and file a further appeal before the judicial court. Likewise, the Tax Administrative Court also has the duty to resolve the appeals.

The deadlines to issue a decision/resolution can be interrupted under certain circumstances, for example if the Tax Administrative Court makes a request to the appellant.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Once all tax administrative proceedings are finished, taxpayers-claimants should lodge an appeal before the competent judicial court in order to initiate the contentious-administrative procedure. Normally, in such judicial procedures, appellants must first file the appeal showing their disagreement with the resolution raised by the Tax Authority/ Tax Administrative Court and, subsequently, once it has been admitted, they should file the proper lawsuit containing the merits.

The Jurisdiction Act governing the procedure contains the rules assigning competence for review to the different judicial courts, these are:

- the Contentious-Administrative Courts;
- the High Courts of Justice;
- the National Court; and
- the Supreme Court.

4.2 Procedure of Judicial Tax Litigation Ordinary Procedure

The appeal must be filed within a non-extendable period of two months from the notification of the administrative resolution. Once the appeal is admitted by the judicial body, the claimant is granted 20 working days to present its lawsuit, in which the legal merits and the evidence to support the claim have to be included/filed. Subsequently, a written summary with the conclusions could be granted. In this document both the plaintiff and the State Attorney should briefly argue on the respective legal merits of their cases and the evidence gathered. The average term for a court to issue its sentence ranges from two to three years.

Once the first instance judgment has been handed down, the possibility of a further appeal is

subject to special rules. When there is no second instance procedure, the judgment may be appealed before the Supreme Court, through the cassation appeal, provided that certain requirements are met, and solely on legal grounds.

In any procedure, the plaintiff may request that the judicial body submit a preliminary ruling request to the ECJ. However, with the sole exception of the Supreme Court, the decision to request such a ruling from the ECJ is exclusively at the discretion of the Spanish judicial body. However, the Supreme Court (because it is the court of final instance) is compelled to file this preliminary ruling unless it considers that there is no doubt about the tax controversy.

Abbreviated Procedure

This judicial procedure is very similar to the one outlined above; the main difference is that the notice of appeal must also include the facts and legal grounds against the contested administrative action and be accompanied by the relevant evidence.

Likewise, when the first instance judgment has been handed down, the possibility of a further appeal before the High Spanish Judicial Courts may be filed if, for example, the amount of the claim is EUR30,000 or more.

4.3 Relevance of Evidence in Judicial Tax Litigation

In this firm's experience, in judicial tax controversies, the evidence that is usually the most relevant includes the following:

- documentary evidence;
- witness evidence;
- expert reports; and
- the legalisation of signatures and the apostille of the Hague, if certain foreign documents are needed to be filed as evidence in a national procedure.

Any evidence on which the claim is based must be proposed and provided at the time of filing the lawsuit. Additionally, the plaintiff must provide at that time the reasons why the evidence is relevant to the appeal.

However, it is also possible to provide evidence after the lawsuit is filed, provided that such evidence was not available or known at the time of the filing and that it is relevant to the claim.

Expert evidence could also be provided after the lawsuit filing. But its issues and content should be detailed in advance within the lawsuit.

Witnesses and experts may be summoned to appear and be questioned before the judicial body.

Finally, note that for evidentiary rules, the civil jurisdiction regulations are supplementary to those applicable within the contentious-administrative system.

4.4 Burden of Proof in Judicial Tax Litigation

The GTL establishes the obligation of the STA to fully justify their tax assessments/settlements.

During the tax administrative procedure, the general rule regarding the burden of proof is that the party asserting its right must prove the relevant supporting facts. The burden of proof related to tax benefits or credits falls, therefore, on the taxpayer.

In judicial proceedings (contentious-administrative claims) the burden of proof follows the general principles of the law. Thus, whoever alleges a fact or invokes a right must prove its existence.

In the criminal jurisdiction, the Prosecutor's Office must discharge the burden and prove the commission of a criminal act during the trial.

The presumption of innocence fully applies otherwise. This principle is also applicable to tax penalties.

4.5 Strategic Options in Judicial Tax Litigation

In general, there is hardly any possibility of strategically scheduling the submission of evidence and/or arguments, since they must be submitted at the required times mentioned in **4.3 Relevance of Evidence in Judicial Tax Litigation**.

The possibility of reaching transactional settlements or agreements on tax disputes is strictly forbidden by the law.

If and when a taxpayer notifies the STA of the submission/lodging of a judicial appeal with a request for suspension of the execution of the tax debt or penalty, the suspension will be automatically granted or maintained until the judicial court issues its judgment on the stay for execution. Suspension of tax debts execution usually require the guarantees laid down by the GTL.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Case law in the Spanish legal system is key to guaranteeing the certainty and equality of citizens before the law with the unity of judicial decisions, as well as completing and integrating the legal system.

The judgments handed down by the Spanish Supreme Court constitute binding case law in tax matters, which all administrative and judicial bodies are obliged to apply and follow. Judgments issued by the rest of the judicial system (National Courts or High Courts of Justice, mainly) are not binding on different judicial bodies.

At the international level, the case law of the ECJ (in any issue related to EU tax law) is binding

both on the Spanish courts (including the Spanish Supreme Court) and on the STA.

In tax appeals raising constitutional and fundamental rights issues, the case law of the Spanish Constitutional Court, the ECJ and the ECHR could be relevant before Spanish judicial bodies and in claims brought before those courts.

OECD guidelines are deserving of greater scrutiny from, and influence on decisions taken by, Spain's jurisdictional and economic-administrative courts.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

In Spain, Tax Litigation issues are judicially reviewed in the contentious-administrative system.

It is composed of the following judicial bodies:

- the Contentious-Administrative Courts;
- the Central Contentious-Administrative Courts;
- the Contentious-Administrative Chambers of the High Courts of Justice;
- the Contentious-Administrative Chamber of the National Court; and
- the Contentious-Administrative Chamber of the Supreme Court.

In tax matters, the competence of the specific judicial body entitled to know and decide the appeal depends on the type of tax matter, the public body that issued the disputed administrative/tax act and on the amount appealed.

Contentious-Administrative Courts

The Contentious-Administrative Courts will hear, at sole or first instance according to the applicable law, appeals against the tax assessments of local entities.

High Courts of Justice

The Contentious-Administrative Chambers of the High Courts of Justice will hear, as courts of sole instance, the appeals arising from:

- the acts and resolutions issued by the Regional and Local Economic-Administrative Courts that put an end to the economic-administrative procedure; or
- the resolutions issued by the Central Economic-Administrative Court regarding transferred taxes to the corresponding Autonomous Community.

Also, they will hear, as courts of second instance, appeals (for taxes amounting to more than EUR30,000) against judgments and orders issued by the Contentious-Administrative Courts.

National Court

The Chamber of the National Court shall hear, as court of sole instance, the appeals against acts of an economic-administrative nature issued by the Minister of Economy and Finance and by the Central Economic-Administrative Court regarding any taxes, with the exception of transferred taxes.

Supreme Court

The Contentious-Administrative Chamber of the Supreme Court will hear cassation appeals of any kind, in the terms discussed in **5.2 Stages in the Tax Appeal Procedure**.

5.2 Stages in the Tax Appeal Procedure

In general, there is no second judicial instance in tax matters, except in the case of local tax-

es (and in the event that the amount appealed exceeds EUR30,000).

The second instance appeal shall be submitted to the court which issued the judgment under appeal within 15 days of its notification, by means of a reasoned document containing the merits on which the appeal is based. The appeal shall be heard by the competent High Court of Justice, which shall decide within ten days from its resolution that the lawsuit was concluded for judgment. In practice, the ten-day term to issue the judgment is seldom respected.

Extraordinary Cassation Appeal

Cassation appeal is not an ordinary appeal but an extraordinary remedy to challenge certain judgments. Since the last modification of the applicable jurisdiction law, the cassation appeal may only be admitted if all the following requirements are declared fulfilled by the Supreme Court:

- the judgment from the first or second instance court infringed either the law and/or Supreme Court precedents;
- there is an interest in passing judgment on the appeal related to precise binding precedents or issuing new ones; and
- the appellant's have provided evidence before the Supreme Court that the infringement committed by the instance court determined that court's dismissal resolution.

The extraordinary appeal of cassation must be filed within 30 working days before the same instance court which raised the judgment that is challenged on cassation appeal. In this respect, this appeal could be filed against National Court and High Court of Justice judgments. Residually, certain judgments raised by the Contentious-Administrative Courts could also be challenged through this appeal.

Once it is presented before the same instance court which solved the case at hand, and that court has granted initial leave for appeal, the appellant should lodge the appeal before the Supreme Court within 30 days. In this second procedural stage, the appellant may not introduce new arguments or legal grounds different from those filed in the first stage.

5.3 Judges and Decisions in Tax Appeals

The Contentious-Administrative Courts and Central Contentious-Administrative Courts are single judge bodies while the Contentious-Administrative Chambers of the High Courts of Justice, Contentious-Administrative Chamber of the National Court and Contentious-Administrative Chamber of the Supreme Court are collegiate bodies (composed of two or more judges).

Judges are designated to serve in each judicial body on the basis of their experience and merits. They are all career judges (civil servants) and their independence from any authority is legally protected.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

In Spain there are no ADR mechanisms regarding a pending judicial/administrative procedure.

In accordance with the provisions of the law, the rights of the Spanish Treasury may not be subject to the result of any agreed transaction either judicially or extra-judicially, nor may any disputes arising in connection with such pending procedures be submitted to arbitration, except by means of a royal decree agreed upon by the Council of Ministers. We are not aware

of any case in which such arbitration had been approved.

Notwithstanding the foregoing, in tax audit procedures and before any litigation is initiated, the GTL regulates a special agreement between the Tax Authorities and the taxpayer (*Actas con acuerdo*) for cases of special difficulty, whether in applying a specific rule or for the assessment or evaluation of elements of the tax obligation subject to uncertainties in their quantification.

6.2 Settlement of Tax Disputes by Means of ADR

See 6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

See 6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Before the term to exercise their rights ends, or the possibility of filing tax assessments and/or self-assessments or the fulfilment of other tax obligations is over, taxpayers may contact the GDT regarding the tax regime, classification or qualification that corresponds to them in each case. The GDT has six months to issue a ruling and answer the request. However, in practice it takes longer to obtain a ruling and quite often the answer is delayed or unclear. Moreover, failure to respond within the required term does not imply acceptance by the GDT of the proposed content for the requested ruling.

The ruling shall be binding for the STA in charge of applying taxes in their relationship with the consultant. Also, the STA shall apply the criteria contained in the binding rulings to any taxpayer, provided that the facts and circumstances are

identical to those included in such binding rulings.

It is very important that the case in question should be deemed to be almost identical to the one to which the binding ruling applies to avoid any kind of risk. However, if it arises from a close or similar situation, it could provide some legal certainty in order to show that a reasonable interpretation of the rules was followed and, therefore, that there was a lack of the subjective element (*mens rea* or negligence) required in the area of tax penalties.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See 6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See 6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Tax Penalties and Tax Offences

Not every tax adjustment/tax assessment automatically leads to the imposition of a tax penalty. A tax infringement will only be considered as a tax offence if and when the following requirements are met:

- the infringement results from a taxpayer action or omission regarded as an offence by the law;
- the offensive action or omission is attributable to the taxpayer as a consequence of its intention or negligence (the subjective element of the offence).

Both the forbidden actions or omissions and the intention or negligence of the agent in causing them, must be proved by the administrative entities in the tax penalty procedure.

An action or omission subject to the GAAR contained in Article 15 of the GTL is not considered as a tax offence. Tax shams (Article 16 of the GTL), however, are considered tax offences; this is the conclusion generally reached by our Supreme Court.

Penalty Reductions for Co-operation

When a taxpayer waives their right to appeal a tax adjustment/tax settlement, it is entitled to a 30% reduction (in case of conformity) and a 65% reduction (in case of agreement) on any tax penalty arising from the infringement. Furthermore, once the 30% reduction (from conformity) has been applied, where applicable, a further 40% reduction could be applied if the tax penalty is paid within the legal payment period and the taxpayer decides not to challenge it (not applicable when an agreement is finally reached).

Criminal Tax Offences

A criminal tax offence may be applied as long as the debt from a tax infringement exceeds EUR120,000 and it is proven that the taxpayer's conduct was intentional (*mens rea*). The existence of criminal tax offences can be appraised during the tax audit/verification procedure. In such a case the administrative proceeding must be suspended, and the prosecution referred to the Public Prosecutor's office. If the Public Prosecutor or the judicial court or judge consider that there is no crime, the proceedings are returned to the STA.

Regularisation and Surcharges

To date, if, as a result of a tax audit procedure, a taxpayer wants to regularise its tax situation regarding future tax periods to comply with the criteria settled by the STA in that procedure, a

complementary tax return must be filed. And if a new tax debt arises due to the regularisation, a surcharge is applied. In this scenario the STA cannot impose any tax penalty.

However, the Supreme Court, the Spanish National Court and the Central Economic Administrative Court have concluded – in broad terms – that in these cases the application of said surcharges should not be automatic and must be reviewed case by case. The purpose is to encourage extemporaneous but not spontaneous compliance (due to the taxpayer conduct being promoted by knowledge of a previous tax action) to comply with the authorities' criteria.

As mentioned in the **Spain Law & Practice** chapter of the 2021 edition of this guide, the “non-requirement” of surcharges has now been specifically regulated in cases in which the taxpayer extemporaneously and spontaneously regularises their tax situation in order to adapt it to the criteria previously established by the tax inspection in a tax audit procedure. This regulation is expected to provide certainty to the taxpayers in this regard.

However, regarding the existing case law and doctrine referred to above, a number of requirements must be met in order to do so:

- for this to be done within six months from the day following the date of notification of the act of the tax inspection whose criteria are now being complied with;
- that the taxpayer acknowledges payment of the tax debt resulting from the new self-assessment;
- that the taxpayer does not request its rectification in the future; and
- that the regularisation made by the STA during the tax audit procedure does not result in a tax penalty.

7.2 Relationship between Administrative and Criminal Processes

The tax verification proceedings are initiated first. Once they conclude with any tax assessment, the tax penalty procedure may be initiated, provided that the administrative entities consider there were tax infringements and penalties to be imposed.

When the STA find evidence of a criminal offence against the State Treasury/the public finances and the tax due is expected to exceed EUR120,000 (Article 305 of the Criminal Code), the procedure will be referred to the Public Prosecutor's Office or the judge. With only some exceptions established by the law, the STA should issue two different tax assessments: one containing the tax due as a consequence of actions or omissions deemed to be the criminal offence, and the other containing the tax due as a consequence of actions or omissions different from those constituting the criminal offence.

The amount due as a consequence of a tax criminal offence is thus initially assessed by the STA and confirmed, amended or rejected afterwards by the courts. It must be paid at the time of the assessment and credited according to the result from the final sentence of the competent court on the tax due (if any).

7.3 Initiation of Administrative Processes and Criminal Cases

The tax penalty procedures may be initiated by the tax administrative entities following a tax audit procedure when they consider that a tax infringement has taken place. There are different tax infringements codified by the GTL that involve different tax penalties.

The criminal proceedings against a taxpayer must be initiated – and any tax infringement procedure on the same subject discontinued – when the STA consider that there is evidence of

a tax criminal offence contained in the Criminal Code (Article 305) and the amount of the tax fraud exceeds EUR120,000.

Therefore, the difference between the offences and the procedures followed arise from the action or omission performed and the applicable law (GTL or Criminal Code). However, sometimes the STA tend to behave as if no clear legal distinction would exist between administrative tax offences and criminal tax offences.

“Non bis in idem” issues and limitations may be raised according to the jurisprudence of the Spanish Constitutional Court, the ECJ and the ECHR when an action or omission was considered not to be a criminal tax offence or tax administrative offence and different proceedings are subsequently initiated or followed.

7.4 Stages of Administrative Processes and Criminal Cases

In the tax penalty procedure, the taxpayer is first notified of a “proposal of tax penalty” in order to file the allegations considered appropriate. Once the allegations have been reviewed, the “tax penalty agreement” is notified if those allegations were dismissed. This agreement imposes the respective tax penalty according to the “tax penalty proposal” unless the administrative body has accepted the arguments raised by the taxpayer. The “tax penalty agreement” can be appealed.

The criminal procedure is initiated when the STA refer the proceedings to the Public Prosecutor's Office or directly to the criminal jurisdiction. The criminal procedure is composed of a set of procedural stages culminating in the trial before a general criminal court deciding on all kinds of criminal offences.

The criminal judicial courts are therefore different from the courts reviewing the legality of the settlement and the tax penalty.

The payment of the settlement issued in advance by the STA regarding the prosecuted criminal offence should afterwards be credited to the tax debt finally determined in the criminal procedure.

7.5 Possibility of Fine Reductions

As mentioned in **7.1 Interaction of Tax Assessments with Tax Infringements**, to date the tax penalty amount may be reduced by 30% (in case of conformity) and 65% (in case of agreement) if the tax assessment is not appealed, and by a further 40% (in case of conformity) if the tax assessment and penalty is not appealed and paid.

7.6 Possibility of Agreements to Prevent Trial

There is no such possibility regarding tax assessments and tax penalties either before their appeal or once appealed.

In the area of criminal offences, the STA will not forward the file to the Public Prosecutor's Office if the taxpayer has fully accepted and paid their tax debt before being notified of the commencement of any proceedings aimed at determining the tax debt. In other words, the full recognition and payment of the debt in these terms prevents potential criminal prosecution and conviction.

Once criminal proceedings have been initiated against the taxpayer, it is possible to reach an agreement with the Public Prosecutor's Office. In order to do this, it is necessary to accept all the terms indicated by the respective public prosecutor (such as paying the entire tax debt and accepting a large economic sanction). In the case of an agreement, the public prosecutor will reduce the length of the term of imprisonment that it is requesting from the court (when the pro-

posed prison sentence is two years or less, its execution can be suspended and the taxpayer will not be imprisoned at all).

7.7 Appeals against Criminal Tax Decisions

An appellate procedure (*recurso de apelación*) may be lodged against the conviction that ends the first instance. The judicial bodies competent to hear the appellate procedure are:

- the Provincial Courts (*Audiencias Provinciales*) for sentences handed down by the *Juzgados de lo Penal*; and.
- the Appellate Chamber of the National Court with respect to sentences issued by the National Court.

In addition to the appellate procedure, a cassation appeal (*recurso de casación*) could be lodged before the Supreme Court against the judgments handed down by the Provincial Courts and the Appellate Chamber of the National Court.

A constitutional appeal (*recurso de amparo*) could also be filed before the Spanish Constitutional Court against the final sentences handed down by the Provincial Courts or the Supreme Court.

Article 954 of the Criminal Procedure Act (*recurso de revisión de sentencias firmes*) allows the review of a final judicial decision when the ECHR has declared that the decision in question violates any of the rights recognised in the European Convention for the Protection of Human Rights and Fundamental Freedoms, provided that the violation entails effects that persist and could not cease except by means of revision. The Criminal Chamber of the Supreme Court is the competent body to hear and decide on the case.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

The Spanish Constitutional Court has ruled out tax transactions challenged under the GAAR (Article 15 of the GTL) being prosecuted as criminal tax offences.

Although it has not been specifically addressed and decided, a similar conclusion should apply in the case of tax transactions challenged under the SAAR contemplated in Council Directive 2009/133/EC applicable to mergers, divisions, partial divisions, transfer of assets and exchanges of shares. We do not know of any transaction of this kind being prosecuted as a criminal offence.

Tax shams (Article 16 of the GTL) have been prosecuted and sentenced as criminal offences.

There are also many rulings issued by the Supreme Court that refer to the GAAR and tax shams in administrative tax cases.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

The STA will, as a general rule, make use of double taxation treaties (DTTs) to solve double taxation situations as long as the taxpayer has evidenced that they can benefit from the DTT as they resident for tax purposes in one of the contracting countries.

However, eventually it may happen that either the taxpayer does not agree with the way in which the DTT has been applied or the DTT has not been applied to the taxpayer even though it should have been.

In both cases, the taxpayer may urge the tax authorities of the country in which they are resident to initiate a mutual agreement procedure (MAP) – regulated by a DTT or in an arbitration convention – with the tax authorities of another contracting state. The outcome of the MAP depends exclusively on the tax authorities of the contracting states.

Even though recourse to a MAP has increased in recent years, it is not a widespread way of resolving double taxation disputes because of the limited chances of success. Therefore, domestic litigation is still the most common solution to double taxation issues.

We are not aware on any decision related to the MLI or the EU Tax Disputes Directive that have had any consequence in this domain.

8.2 Application of GAAR/SAAR to Cross-Border Situations

As a general rule, the STA apply the domestic GAAR and SAAR in cross-border situations covered by bilateral tax treaties (without further analysis of potential conflicts between domestic and conventional rules). However, most of the past challenges raised have been so far rejected by the Supreme Court.

In particular, administrative courts have followed the criteria upheld by the ECJ in the Danish Cases not only in the case of dividends but also in the case of interest payments. Spanish courts have not yet ruled on this matter.

The domestic GAAR and SAAR already are considered to include a principal purpose test (PPT). Due to this, we do not expect the new developments introduced by the MLI and the amendment of the DTT preamble to affect the way tax authorities fight BEPS in cross-border situations.

8.3 Challenges to International Transfer Pricing Adjustments

Transfer pricing adjustments are usually challenged in the domestic tax courts, as this is the only way to impose tax penalties. However, EU arbitration convention or DTT MAPs have been increasingly used to challenge major international transfer pricing adjustments in recent years.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Even though their use is still not widespread, advance pricing agreements (APAs) are becoming increasingly common in Spain. Requests for APAs have risen significantly in the last few years.

Spanish law provides taxpayers with a statutory right to seek APAs, whose filing procedure is set out below.

Pre-filing Actions

The company may file a preliminary request, with the following contents:

- identification of the parties;
- brief description of the transactions; and
- basic elements of the intended pricing proposal.

Filing

The actual filing must be accompanied by a proposal that is consistent with the arm's length principle and contain a description of the method and the analysis followed to determine the market value.

Evaluation

The tax inspection department of the STA will examine the proposal together with the documentation submitted. In addition, it may request additional information related to the proposal from the taxpayer, as well as explanations or clarifications.

Final Resolution

The APA filing procedure will be finalised when the tax inspection department approves or rejects the proposal filed by the taxpayer.

8.5 Litigation Relating to Cross-Border Situations

The cross-border matters which have traditionally generated the most litigation are transfer pricing issues and the deductibility of intragroup financial expenses.

There are certain actions that could eventually help to mitigate the above-mentioned controversies. These include:

- requests for APAs, as explained in **8.4 Unilateral/Bilateral Advance Pricing Agreements**;
- formulation of binding consultations to the GDT in relation to those operations/transactions whose tax treatment may not be clear or straightforward;
- carrying out non-aggressive but conservative and prudent tax planning; and
- due justification and sound economic reasons underlying the operations/transactions carried out.

However, there are an increasing number of controversies regarding international tax residency issues with the STA, not only those related to ultra-high net worth clients/individuals, but also those related to the effective residency of entities (usually holding companies or heads of international structures).

In these cases it is highly advisable to have received prior legal advice so that everything related to the residence is clear in each jurisdiction and can be accredited not only through double tax conventions, but also with any additional means of proof. It is important to keep in mind that these conflicts always have implications in at least two jurisdictions.

The detriment of declaring a taxpayer, whether an individual or a legal entity, resident in more than one jurisdiction is the fact of being taxed in more than two states. The economic damage could be substantial.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

To the best of the authors' knowledge, there is no record of any case/legal proceeding related to state aid disputes involving taxes.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

To the best of the authors' knowledge, there is no record of any case/legal proceeding related to procedures used to recover unlawful/incompatible fiscal state aid.

9.3 Challenges by Taxpayers

To the best of the authors' knowledge, there is no record of any case/legal proceeding related to taxpayers challenging requests or additional tax assessments to recover unlawful/incompatible fiscal state aid.

9.4 Refunds Invoking Extra-Contractual Civil Liability

Recently, two relevant tax rulings have been issued. The first one stated the legal invalidity of Form 720 (declaration of assets abroad) and the penalties, or implications of not filing it with the STA when there was an obligation to do so (see **1.2 Causes of Tax Controversies**). The second has declared the unconstitutionality of the tax on the increase in value of urban land (*Plusvalía Municipal*) but incorporates a multitude of questionable limitations for taxpayers to review the liquidations that were dictated to them at the time.

The first ruling (Judgment of the Court of Justice of the European Union, First Chamber, of 27 January 2022, in Case C-788/19) led the Spanish government to amend the Spanish personal income tax regulations to eliminate the impossibility for taxpayers to prove the statute of limitations for income, presumed by the legislature to arise from the value of undeclared assets. At the same time, the tax regulations were amended to eliminate the specific (disproportionate) penalties for the non-filing or incorrect filing of Form 720.

In these cases, the regularisations dictated by the tax inspection at the time, on the basis of the penalties and sanctions associated with the Form 720 now annulled, and which were and are contested, will be won in administrative and/or judicial proceedings already initiated. But, in the event that the taxpayers' claim had not been appealed or, if they had appealed, the taxpayers' claim had been rejected through a judgment that is final, it will be possible to try to review it and obtain a refund through a special evaluation procedure, even demanding liability from the legislating state.

The second ruling issued by the Spanish Constitutional Court stated that *Plusvalía Municipal* is unconstitutional. However, this ruling cannot be applied retrospectively in broad terms. Thus, only those taxpayers who challenged in the tax levied in due time and are still pending resolution in the courts, are able to request the refund of the tax paid and potentially claim extra-contractual liability of the tax administration.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

The option is pending on final ratification (publication) by Spain of the MIL. The approved text includes the option to apply part VI to the CTA.

No DTT signed by Spain contains an arbitration clause.

10.2 Types of Matters that Can Be Submitted to Arbitration

The option adopted under the MLI is the one mentioned in **9.1 Application of Part VI of the MLI to Covered Tax Agreements (CTAs)**.

According to it (Article 19.12) Spain reserves the right for the following rules to apply with respect to its covered tax agreements notwithstanding the other provisions of the Article:

- any unresolved issue arising from a mutual agreement procedure case otherwise within the scope of the arbitration process provided for by this Convention shall not be submitted to arbitration, if a decision on this issue has already been rendered by a court or administrative tribunal of either contracting jurisdiction; and
- if, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities of the contracting jurisdictions, a decision concerning the issue is rendered by a court or administrative tribunal of one of the contracting jurisdictions, the arbitration process shall terminate.

The approved text pending ratification (publication) also contains specific reserves excluding

from Part VI, according to Article 28.2.a) of the MLI, the following issues:

- application of internal GAAR and SAAR rules; and
- cases in which the party has been finally sanctioned according to criminal or administrative tax rules.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

The approved text does not contain any specific option and/or provision on this subject.

10.4 Implementation of the EU Directive on Arbitration

This issue does not arise in relation to tax controversy in Spain.

10.5 Existing Use of Recent International and EU Legal Instruments

The authors are not aware of any use publicly revealed.

10.6 New Procedures for New Developments under Pillar One and Two Pillars One and Two in Spain

The Spanish Budget Law of 2022 adopted, on December 2021, a minimum corporate income tax, in line with the purpose of Pillar Two released by the OECD. This measure, effective from 1 January 2022, provides a minimum 15% corporate income tax rate applicable to taxpayers whose net turnover equals or exceeds EUR20 million and to consolidated tax groups – irrespective of their net turnover.

Although this measure and Pillar Two aim to establish a minimum floor for corporate income tax, the mechanisms differ in terms of the configuration of the effective implementation and the taxpayers concerned.

Considering that this measure was approved ahead of the implementation of Pillar Two in Spain, it is expected to produce a quick response from the Spanish tax system.

Will Pillars One and Two Lead to Effective Dispute Resolution?

While Pillar One aims to establish standard international tax rules adapting the global income tax system to new business models, Pillar Two seeks to ensure a minimum level of taxation of large MNEs in the jurisdictions where they operate and generate revenues, regardless of the company's tax domicile.

It seems that these proposals will ultimately provide greater legal certainty to the international taxation system, therefore preventing litigation. However, the implementation of new rules usually produces an increased number of controversies between taxpayers and tax administrations related to their legal interpretation and application.

10.7 Publication of Decisions

Decisions should be made public according to general rules.

10.8 Most Common Legal Instruments to Settle Tax Disputes

The authors expect DTT after the MLI and EU Directive and Convention as those possibilities are the most effective. This is due to the guarantees they provide to settle the disputes.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

The authors are not yet aware of actual or projected involvements of Spanish professionals in the international tax arbitration field.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

There are no costs involved in the appeal for reversal (which is the first possible appeal that could be filed before the STA). Likewise, the economic-administrative procedure will also be free of economic charge. However, if the economic-administrative appeal is dismissed or considered inadmissible, and the Tax Administrative Court finds that the claimant/appellant displayed recklessness or bad faith, then they may theoretically be required to pay the costs of the procedure. The authors are, however, not yet aware of this possibility being used.

11.2 Judicial Court Fees

There are the legal costs arising from parties' lawyers and representatives. At first or single instance, legal costs will be imposed on the party whose claim has been dismissed, unless the court finds serious doubts about the facts or the applicable law.

Where the sentence recognised some claims but not others, each party should pay its own legal costs, unless the court, after giving due reasons, orders one of the parties to bear all of them because it has sustained its action or brought the action in bad faith or in a reckless manner.

At second instance, legal costs should be imposed on the appellant if the appeal is dismissed in its entirety. Legal costs may be awarded in whole or in part, or up to a maximum amount.

In cassation appeals, the legal costs corresponding to the previous instance should be decided based upon the above rules. The legal costs corresponding to the cassation appeal should be paid by each party unless the judicial court orders one of the parties to bear all of them

because it has sustained its action or brought the action in bad faith or in a reckless manner. Cassation legal costs may be awarded in whole or in part, or up to a maximum amount.

Legal costs should be paid as requested by the court regarding each instance decision. Refunds are entitled in case of reversal. No interest is granted on these refunds.

11.3 Indemnities

In the event that the judicial court recognises the appellant/claimant's (taxpayer's) right and also grants it the refund of its legal costs, according to the rules mentioned in **11.2 Judicial Court Fees**, it should order the STA to pay legal costs. Therefore, the STA will compensate the taxpayer in this respect.

In addition, the STA will have to pay interest on the corresponding late payment since the taxpayer paid the tax debt now revoked by the judge. In the event that the debt was suspended, the STA must also pay the taxpayer the cost of the guarantees provided.

No further indemnities may, in principle, be claimed. In exceptional cases, however, some damages arising from the tax assessments – and different from the tax debts – interest on them and legal costs could be claimed when they resulted directly from the STA's actions.

11.4 Costs of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction**.

12. STATISTICS

12.1 Pending Tax Court Cases

There are no publicly available statistics on pending cases.

12.2 Cases Relating to Different Taxes

There are no publicly available statistics on the number of cases relating to different forms of tax.

12.3 Parties Succeeding in Litigation

There are no publicly available statistics on the proportion of tax cases that end in total or partial success for either the STA or the taxpayer.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

In recent years the use of electronic technology by the STA have increased and improved both the exchange of information between administrative entities at national and international level and the power to process and verify proper tax compliance from taxpayers.

In this scenario, our experience shows that, in order to manage the associated risks of tax disputes/controversies, it is important to follow these recommendations.

- A comprehensive and updated prior tax evaluation, as well as planning of transactions, should be performed, considering the approach of the STA to the transactions in question and the precedents from courts regarding issues previously raised by the STA.
- Produce and retain comprehensive evidence and documentary justification of any operation/transaction performed that may give rise to a tax controversy in a tax verification proceeding.
- Perform comprehensive and accurate tax compliance procedures and submit to the STA the evidence and documentary justification mentioned above.
- The burden of proof should be taken into appropriate consideration in order to dis-

charge it through any of the allowed means of proof.

- All the disputed issues, from the very beginning of the appeal, should be covered, properly addressing the questions of fact and law with sufficient evidence and legal arguments that are up to date with the latest binding precedents from the courts.

GTA Villamagna was founded by professionals of recognised standing, with over 30 years of experience in the civil service and private legal practice. The firm's tax controversies team is formed by highly qualified former members of international law firms and national tax administrations. It enjoys a reputation as a handler of complex, sophisticated and highly demanding tax procedures and its team is recognised by

clients and peers as one of the leading tax litigation departments in the Spanish market. Significantly smaller than all its major competitors, its senior qualified lawyers are actively involved in all of its services and offer personal attention. The firm has acted as legal counsel for major clients on some of the leading recent tax controversies in Spain and collaborates with leading law firms in many jurisdictions.

AUTHORS



Felipe Alonso co-founded GTA Villamagna in 2012 and specialises in general taxation, corporate tax law, indirect taxation and tax litigation.

Before that he was head of the tax departments of both CMS Albiñana & Suárez de Lezo and the Madrid office of Baker McKenzie, where he was a managing partner. Prior to going into private practice, Felipe was General Deputy Director of Legal Regulation and Legal Assistance for the Spanish Tax Agency and he has been a state tax inspector since 1982. Felipe is a member of the Madrid Bar Association and the Spanish Association of Tax Advisors, AEDAF.



Javier Povo started working with Felipe Alonso in 2007, first at Baker McKenzie and afterwards at CMS-Albiñana & Suárez de Lezo. In 2012 he participated in the founding of

GTA and was promoted to partner in 2019. Currently, he directs the tax department under the leadership of Felipe Alonso. He specialises in complex tax litigation and private wealth tax controversies regarding ultra-high net worth – national and international – clients. Javier has an LL.M. in Taxation and Tax Consultancy and is a member of the Madrid Bar Association and of the leading tax teams of the Spanish Association of Tax Advisors, AEDAF.

GTA Villamagna

Marqués de Villamagna 3
6th floor
28001 Madrid
Spain

Tel: +34 91 521 01 21
Fax: +34 91 575 76 85
Email: gta@gtavillamagna.com
Web: www.gtavillamagna.com

GTA VILLAMAGNA
ABOGADOS

Trends and Developments

Contributed by:

Felipe Alonso and Javier Povo

GTA Villamagna see p.641

Introduction

The article will reflect concisely on the issues that are likely to be the subject of significant debate in Spanish tax circles in the near term, and which may lead to relevant tax consequences for taxpayers, both high net worth individuals and legal entities. Notably, (i) the problems arising from conflicts around tax residence, both domestic and international (of private clients and entities); and ii) the derivation of tax liability (particularly the importance of joint or subsidiary liability).

Tax Residence

Controversies concerning tax residency (both international and domestic, between autonomous communities/regions), subjected to tax audit procedures and judicial proceedings, have increased exponentially in recent years.

This trend is highly likely to continue to grow due to globalisation and the importance of Spain as a centre of “interest” for specific clients (most obviously those coming from Latin America) for multiple reasons, including:

- the fact that the type of wealth structure employed by high net worth individuals located in many jurisdictions outside Spain may eventually lead to non-recognition of ownership and the transparency of income/returns; and
- the use of specific legal and economic structures that this segment of individuals often hold or set up in certain jurisdictions, with the aim of protect their assets and their succession.

Despite the fact that these structures are well regulated from a substantive and tax point of

view, they are not recognised as such in Spain, at least not for the purposes for which they were created at the time in said jurisdictions (eg, trusts).

Added to this, it is important to bear in mind newcomers’ evident lack of familiarity with the legislation regulating tax residence in the host jurisdiction, the functioning of the tax system, as well as the regulation contained in any double tax treaties which may be of application.

Hence the importance of knowing the criteria to acquire tax residence in the host country and the tax implications that derive from such a condition as a taxpayer in Spain.

Herein lies the importance of legal and tax advice to determine a client’s legal position prior to moving to a new jurisdiction. It is essential to know the conditions on which Spanish tax residence would be acquired and, if so, the implications that may arise in terms of direct taxation (from the perspective of personal income tax, wealth tax, as well as inheritance and/or gift tax) and in terms of obligations to provide worldwide information to the Spanish Tax Authorities (STA). The reason is that the acquisition of tax residence in Spain also implies the acquisition of residency in a specific Autonomous Community, which have a fair degree of legislative power in terms of taxation (there are substantial differences between them, both in terms of personal income tax and wealth tax and inheritance and/or gift tax (eg, Catalonia applies the highest tax rates, in contrast with Madrid or Andalucía, which have in force the lowest tax rates in Spain)).

Consequently, this will impact the client and taxpayer's future in terms of their personal taxation (general tax regime and worldwide income taxation or inpatriates' tax regime, if applicable, with its particularities) as well as the double taxation that may arise, their potential subjection to the wealth tax, and eventually to the inheritance and gift tax.

Another circumstance worth noting is related to compliance with the obligations to provide information on assets located outside of Spain (Form 720) and the foreseeable obligation to report any cryptocurrencies held by the taxpayer as of 2023 (Form 721).

Concerning the residence of corporate entities or legal entities, particular attention should be paid to the location of the effective place of management (effective headquarters), since this issue may eventually attract the attention of the STA.

At all events, this matter requires an exhaustive prior professional analysis for the reasons stated above and the accreditation of the tax residence by all means of proof available. In this regard, the tax residence certifications within the meaning of the double tax treaty applicable issued by the concerned tax authorities are considered as qualitative evidence for these purposes, although it should not be forgotten that it is ultimately only another piece of evidence and not binding on a court.

It is equally important not to lose sight of the fact that the Spanish state has extensive capacity to obtain information, both internally and internationally, resulting from the agreements signed with other states to this purpose.

Procedure for the Derivation of Tax Liability

Secondly, on a separate issue, it is worth emphasizing the significance and extent of the figure of

the "responsible party" regulated by the Spanish General Tax Law and the current interpretation and implementation carried out by the STA in recent years, which has generated a wide array of controversy.

Under this figure or condition, the Spanish legislature allows the STA to hold a third party accountable for another taxpayer's debt, whether an individual or a legal entity, separate and alien to the legal-tax relationship of the debtor with the STA. On this basis, the liability may be either joint or subsidiary. The difference lies in the kind of relationship that exists between the principal debtor and the third party and the legal relationship that exists concerning their preferential obligation to pay the principal debtor's tax liability. Thus, jointly and severally liable persons are on the same "level" as the principal debtor with respect to the obligation to pay the tax debt and among themselves and must always pay the debt in advance to the subsidiary debtor, if one exists.

It is true that the cases in which a third party can be held liable (jointly or subsidiarily), are restrictively listed and clearly stated in the tax regulation. However, in the authors' experience, in many instances, the STA will interpret the Articles that regulate the assumptions for assigning responsibility to a third party in a way that guarantees that someone settles the liabilities claimed by the STA (regardless of whether these cases are appealed and annulled in the future). In fact, it is common for the STA to try to assess cases of joint and several liability.

The mechanism available to this end, in the STA view, is the derivation of responsibility to a third party, since in practice it requires assigning an equal amount of debt to several persons simultaneously (individuals and legal entities). This practice does not imply, under any circumstance, that the STA has the right to raise the amount of

Contributed by: Felipe Alonso and Javier Povo, GTA Villamagna

debt several times, but rather that its chances of guaranteeing that someone will pay the liability or ensure its payment are higher inasmuch as more people are involved. Because what is certain is that if any of those involved (whether the principal debtor or those responsible third parties) pay the amount of the tax liability, the debt with the STA would be settled, giving rise to credit rights and liabilities between the debtor and the third parties concerned if the third party extinguishes the debt. On the other hand, if no one pays the debt, all of those involved would have to guarantee its amount through the means provided by the legislature.

Another of the main problems resulting from liability referrals is the time the STA has to go after the responsible party. Because, depending on the type of liability, it may take many years for the person held or declared liable to be held liable. This is how it is configured in the General Tax Law, but undoubtedly this generates situations where – because of the length of time that has passed – a defence is not possible.

Litigation on procedures for derivations of responsibility to third parties is becoming increasingly common in Spain. Courts (both administrative and judicial) often rule in favour of taxpayers, either on the grounds that the taxpayer does not meet the requirements for carrying out such a derivation or simply because the derivation is not correctly motivated (which is an obligation incumbent on the STA).

Given the circumstances and the direction in which the STA are heading in this matter, it has become essential to know and understand the assumptions for assigning responsibility to third parties foreseen by the Spanish tax law in order to avoid incurring any that may later lead to an actual derivation.

All of this underlines the importance of evidence that, in this domain, can subsequently prove that the individual or legal entity in question was not and cannot be liable from a tax point of view. Because, as stated, in the field of litigation in general and tax litigation in particular, every procedure and/or lawsuit is, ultimately, a question of evidence.

GTA Villamagna was founded by professionals of recognised standing, with over 30 years of experience in the civil service and private legal practice. The firm's tax controversies team is formed by highly qualified former members of international law firms and national tax administrations. It enjoys a reputation as a handler of complex, sophisticated and highly demanding tax procedures and its team is recognised by

clients and peers as one of the leading tax litigation departments in the Spanish market. Significantly smaller than all its major competitors, its senior qualified lawyers are actively involved in all of its services and offer personal attention. The firm has acted as legal counsel for major clients on some of the leading recent tax controversies in Spain and collaborates with leading law firms in many jurisdictions.

AUTHORS



Felipe Alonso co-founded GTA Villamagna in 2012 and specialises in general taxation, corporate tax law, indirect taxation and tax litigation.

Before that he was head of the tax departments of both CMS Albiñana & Suárez de Lezo and the Madrid office of Baker McKenzie, where he was a managing partner. Prior to going into private practice, Felipe was General Deputy Director of Legal Regulation and Legal Assistance for the Spanish Tax Agency and he has been a state tax inspector since 1982. Felipe is a member of the Madrid Bar Association and the Spanish Association of Tax Advisors, AEDAF.



Javier Povo started working with Felipe Alonso in 2007, first at Baker McKenzie and afterwards at CMS-Albiñana & Suárez de Lezo. In 2012 he participated in the founding of

GTA and was promoted to partner in 2019. Currently, he directs the tax department under the leadership of Felipe Alonso. He specialises in complex tax litigation and private wealth tax controversies regarding ultra-high net worth – national and international – clients. Javier has an LLM in Taxation and Tax Consultancy and is a member of the Madrid Bar Association and of the leading tax teams of the Spanish Association of Tax Advisors, AEDAF.

GTA Villamagna

Marqués de Villamagna 3
6th floor
28001 Madrid
Spain

Tel: +34 91 521 01 21
Fax: +34 91 575 76 85
Email: gta@gtavillamagna.com
Web: www.gtavillamagna.com

GTA VILLAMAGNA
ABOGADOS

SWITZERLAND

Law and Practice

Contributed by:

*Jean-Blaise Eckert and Jenny Benoit-Gonin
Lenz & Staehelin see p.659*



CONTENTS

1. Tax Controversies	p.645	5.3 Judges and Decisions in Tax Appeals	p.649
1.1 Tax Controversies in this Jurisdiction	p.645	6. Alternative Dispute Resolution (ADR) Mechanisms	p.650
1.2 Causes of Tax Controversies	p.645	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.650
1.3 Avoidance of Tax Controversies	p.645	6.2 Settlement of Tax Disputes by Means of ADR	p.650
1.4 Efforts to Combat Tax Avoidance	p.645	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.650
1.5 Additional Tax Assessments	p.646	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.650
2. Tax Audits	p.646	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.651
2.1 Main Rules Determining Tax Audits	p.646	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.651
2.2 Initiation and Duration of a Tax Audit	p.646	7. Administrative and Criminal Tax Offences	p.651
2.3 Location and Procedure of Tax Audits	p.646	7.1 Interaction of Tax Assessments with Tax Infringements	p.651
2.4 Areas of Special Attention in Tax Audits	p.646	7.2 Relationship between Administrative and Criminal Processes	p.652
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.646	7.3 Initiation of Administrative Processes and Criminal Cases	p.653
2.6 Strategic Points for Consideration during Tax Audits	p.647	7.4 Stages of Administrative Processes and Criminal Cases	p.653
3. Administrative Litigation	p.647	7.5 Possibility of Fine Reductions	p.653
3.1 Administrative Claim Phase	p.647	7.6 Possibility of Agreements to Prevent Trial	p.653
3.2 Deadline for Administrative Claims	p.647	7.7 Appeals against Criminal Tax Decisions	p.653
4. Judicial Litigation: First Instance	p.647	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.653
4.1 Initiation of Judicial Tax Litigation	p.647	8. Cross-Border Tax Disputes	p.654
4.2 Procedure of Judicial Tax Litigation	p.647	8.1 Mechanisms to Deal with Double Taxation	p.654
4.3 Relevance of Evidence in Judicial Tax Litigation	p.648	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.654
4.4 Burden of Proof in Judicial Tax Litigation	p.648		
4.5 Strategic Options in Judicial Tax Litigation	p.648		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.648		
5. Judicial Litigation: Appeals	p.648		
5.1 System for Appealing Judicial Tax Litigation	p.648		
5.2 Stages in the Tax Appeal Procedure	p.649		

8.3	Challenges to International Transfer Pricing Adjustments	p.654	10.5	Existing Use of Recent International and EU Legal Instruments	p.656
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.654	10.6	New Procedures for New Developments under Pillar One and Two	p.656
8.5	Litigation Relating to Cross-Border Situations	p.655	10.7	Publication of Decisions	p.656
9. State Aid Disputes		p.655	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.656
9.1	State Aid Disputes Involving Taxes	p.655	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.656
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.655	11. Costs/Fees		p.657
9.3	Challenges by Taxpayers	p.655	11.1	Costs/Fees Relating to Administrative Litigation	p.657
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.655	11.2	Judicial Court Fees	p.657
10. International Tax Arbitration Options and Procedures		p.655	11.3	Indemnities	p.657
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.655	11.4	Costs of ADR	p.657
10.2	Types of Matters that Can Be Submitted to Arbitration	p.655	12. Statistics		p.657
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.655	12.1	Pending Tax Court Cases	p.657
10.4	Implementation of the EU Directive on Arbitration	p.656	12.2	Cases Relating to Different Taxes	p.657
			12.3	Parties Succeeding in Litigation	p.658
			13. Strategies		p.658
			13.1	Strategic Guidelines in Tax Controversies	p.658

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

As a preliminary remark, it should be emphasised that taxes in Switzerland are levied at three different levels: federal, cantonal and municipal. Certain taxes are only levied at the federal level (eg, withholding tax, stamp duties or VAT) while some other taxes are only levied at cantonal levels (eg, gift tax, inheritance tax or wealth tax). As cantons still have a high level of independence regarding tax matters, this can result in significant differences in the handling of tax controversies between the various cantonal and federal tax authorities.

Tax controversies usually arise by way of a formal complaint filed by the taxpayer against a tax assessment decision rendered by a tax authority. In the fields of withholding tax, stamp duty and VAT, where the principle of spontaneous taxation applies (meaning that taxpayers themselves calculate the amount of tax due, declare it and pay said amount to tax authorities), controversies usually start as a result of a tax audit conducted by the Swiss Federal Tax Administration (SFTA).

1.2 Causes of Tax Controversies

All tax matters may give rise to tax controversies, regardless of the type of tax or of the values involved.

According to the latest report of the SFTA, tax controversies related to corporate income and individual income tax matters raised, in 2021, CHF136 million of additional revenues (including back taxes and fines) at federal level. The amount of such revenue is subject to major variations as it always depends on the tax matters at hand (eg, less than CHF50 million was raised in 2018).

On the other hand, in 2019, VAT audits conducted by the SFTA increased VAT revenues by CHF142 million and withholding tax audits conducted by the SFTA raised less than CHF20 million of additional revenues (including back taxes and fines). In 2021, 840 audits were conducted by the SFTA for tax controversies related to withholding tax and stamp duties. Revenues from such audits, depending on the tax matters at hand, are also subject to major variations from one year to another.

1.3 Avoidance of Tax Controversies

Broadly speaking, Swiss tax authorities are quite open to discussion with taxpayers, which serves to mitigate the possibility of tax controversies further down the line. In particular, tax rulings (see **6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests**) provide a powerful tool to ensure certainty and avoid subsequent disputes.

The latest report from the SFTA indicates that, in 2019, more than 6,000 tax rulings were handled showing the relevance of such advance discussions in Switzerland. Tax rulings filed by taxpayers each year to the various cantonal tax authorities are also of major importance and are frequently used to mitigate disputes on taxes levied at cantonal level.

1.4 Efforts to Combat Tax Avoidance

In an effort to comply with the Base Erosion and Profit Shifting (BEPS) Recommendations of the OECD, as well as with the EU's various measures to combat tax avoidance, Swiss tax authorities have taken, over the years, an increasingly strict approach in many tax matters. This has led to a growing number of tax controversies in Switzerland, with, for instance, offshore structures being increasingly challenged and transfer pricing matters being more strictly reviewed.

1.5 Additional Tax Assessments

When faced with an additional tax assessment, the taxpayer is not obliged to pay or guarantee the tax assessed in order to be able to lodge a formal complaint, and subsequently an appeal, against it. If a taxpayer considers that an amount of tax is not due, the main recommendation is rather to avoid paying the challenged amount. In the field of spontaneous taxation, in particular VAT matters, any payment of tax is a recognition of taxes owed.

Alongside the additional tax assessment, Swiss tax authorities will typically open criminal proceedings against the taxpayer; for instance, due to the misdemeanour of not having declared a taxable event to the tax authorities.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The Swiss tax authorities do not share the criteria on which they base their decisions to perform a tax audit. The various tax authorities have a certain flexibility in this matter. Some tax authorities set year-to-year variation thresholds regarding the taxable amounts reported, which can trigger a verification process.

2.2 Initiation and Duration of a Tax Audit

Tax authorities may initiate tax audits as soon as they receive any relevant information for taxation that was previously unknown to them.

The statutory limitation on initiating a procedure for the collection of back taxes is ten years after the end of the tax period for which the tax has not been levied, preventing any such procedure afterwards. For withholding tax, stamp duties and VAT, this statutory limitation is five years after the end of the relevant tax period.

Once the procedure has been initiated, the statutory limitation on determining a supplementary tax is 15 years after the end of the tax period to which the procedure relates, preventing any levy of tax afterwards, even if a back-taxes procedure has been opened. For VAT, this statutory limitation is ten years. Withholding tax and stamp duties, however, benefit from a specific status as no statutory limitation applies once a procedure has been initiated.

2.3 Location and Procedure of Tax Audits

As a rule, tax authorities in Switzerland, whether cantonal or federal, have an audit department with an internal and an external unit. The latter can visit the taxpayer's premises.

These audits are only based on printed documents. Data made available electronically for such purpose is not available in Switzerland yet.

2.4 Areas of Special Attention in Tax Audits

Tax inspectors may be interested in all aspects of taxation. Regarding companies, compliance of the accounts with accounting and tax rules is the most important aspect for legal entities examined by tax auditors. Whereas, for natural persons, justification of the deductions claimed and the existence of unlimited liability are frequently examined.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

The exchange of information, mutual assistance between tax authorities as well as the constant development of international tax rules have certainly led to an increase in tax audits in Switzerland.

Assisting clients targeted by requests for information from foreign countries in the context of a foreign tax audit is a frequent activity of this firm.

2.6 Strategic Points for Consideration during Tax Audits

One unique feature of the Swiss tax authorities is their willingness to discuss tax matters with taxpayers openly. In the context of a tax audit, the best strategy is often to demonstrate transparency regarding the facts and technical accuracy regarding the legal analysis.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

If a taxpayer disagrees with an assessment decision made by a tax authority, they may submit a formal complaint to the tax authority that has issued the assessment decision, within 30 days as from notification. The formal complaint procedure is an official appeal procedure that forces the tax authority to subsequently issue a new decision.

Such a formal complaint must be filed in writing. With regard to income tax, the complaint does not need to be substantially motivated (except if the complaint is made following a discretionary assessment decision). The taxpayer only has to express their unquestionable disagreement with the assessment decision. Formal complaints in the field of other taxes must be sufficiently motivated, meaning that the taxpayer has to demonstrate that the assessment decision is obviously inaccurate.

If the formal requirements are met, the tax authority has to re-examine the tax assessment decision and may modify, in whole or in part, the first decision or reject the taxpayer's formal complaint.

The filing of such an administrative complaint is a requisite step before initiating a judicial phase. Under certain circumstances and only if approved by the taxpayer, a sufficiently motivated administrative complaint filed to the tax authorities may be directly transferred to the judicial authorities.

3.2 Deadline for Administrative Claims

While Swiss tax law does not provide for a particular deadline for the tax authorities to respond to a formal complaint lodged by a taxpayer, they have a constitutional obligation to process the claim within a reasonable time. The meaning of "reasonable time" is not clearly defined and depends on the specific circumstances of the case at hand. The taxpayer can lodge a judicial claim if a tax authority does not process their formal complaint within a reasonable timeframe. Such a situation rarely occurs in practice.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

If the taxpayer is not satisfied with the decision of the tax authority on their formal complaint, they have the ability to lodge an appeal with a first-instance cantonal court or, in matters falling under the authority of the SFTA, with the Swiss Federal Administrative Court. The deadline to lodge an appeal is 30 days as from notification of the contested decision on a formal complaint.

4.2 Procedure of Judicial Tax Litigation

Swiss administrative procedure rules, including tax procedure rules, provide for an essentially written litigation process and imply few or no investigative acts, such as hearings, due to the technical nature of tax law and the generally numerical content of litigation.

Following the taxpayer's appeal, the tax administration files a reply before the court, supporting the position of its tax decision. Usually, an additional exchange of replies is allowed, before the case is kept to be judged by the court until the judgment is rendered.

4.3 Relevance of Evidence in Judicial Tax Litigation

Evidence must be provided in writing at the time of lodging the appeal and is particularly important because of the burden of proof in Swiss tax litigation (see **4.4 Burden of Proof in Judicial Tax Litigation**).

4.4 Burden of Proof in Judicial Tax Litigation

Regarding tax matters in general, as well as within the context of judicial tax litigation, the tax authority must establish the facts upon which the tax liability is based, while the taxpayer has to prove the facts that reduce or eliminate that liability.

If the elements gathered by the tax authority provide sufficient evidence of the existence of taxable items, it also falls upon the taxpayer to establish the truth of their own claims and to bear the burden of proof regarding elements that justify their exemption.

Under a criminal tax procedure, the tax authority may use coercive measures (eg, warrants and sequestrations) to gather sufficient evidence against the taxpayer.

4.5 Strategic Options in Judicial Tax Litigation

Legal analysis and reassessment of the tax administration's position is the most important aspect of tax litigation. While producing new documents, evidence or even expert reports is still possible under judicial proceedings (except in front of the Federal Supreme Court), it is usu-

ally more efficient to produce evidence during the proceedings' early stages.

Settlements with the tax administration are still possible but less likely once the dispute has begun, as tax authorities sometimes have an interest in having their practice confirmed by the courts.

With the exception of a back-taxes procedure, which often covers the previous ten years and where statutes of limitation may play a minor role for the earliest years depending on the case at hand, timing is generally not an efficient strategy.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

Statutes and case law are the most important sources for Swiss tax courts. With regard to cross-border and local tax issues, the ECHR's case law is also taken into account, in particular within criminal tax procedures. International guidelines also provide elements of interpretation on which the courts occasionally rely. Tax doctrine (academic articles) is a source of interpretation used by courts, but they are not bound by it.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Appeal before a Second-Instance Court

Any tax decision previously challenged before a first-instance court may be appealed. There is no limit based on the value of the dispute. A decision of a first-instance court can be appealed to a second-instance cantonal court (if provided by cantonal rules) within 30 days of service of the first-instance court's decision. The tax authority or the taxpayer, or both, can lodge an appeal.

The procedural principles are the same as those applying before the first-instance court. Judgments of a second-instance court may be appealed to the Federal Supreme Court.

Appeal before the Federal Administrative Court

The Federal Administrative Court is the ordinary administrative tribunal of the Swiss Confederation. The main role of the Federal Administrative Court is to examine the legality of decisions in matters falling under the authority of the Federal Administration.

Lower instances are mainly the federal departments and subordinate federal offices. The Federal Administrative Court hears appeals against decisions of federal authorities, in the fields of withholding tax, stamp duties and VAT in particular.

A decision of the Federal Administrative Court may be appealed to its second-instance court within 30 days following the first-instance court's decision under certain circumstances. The appeal can also be lodged by the tax authority or the taxpayer, or both. Judgments concerning tax matters processed by the Federal Administrative Court may be appealed directly to the Federal Supreme Court.

Appeal before the Federal Supreme Court

If the taxpayer considers that the final decision of the second-instance cantonal court or of the Federal Administrative Court violates their rights, they may lodge an appeal before the Federal Supreme Court. Such an appeal must be lodged within 30 days of notification of said contested decision.

The Federal Supreme Court is the highest judicial authority within the federal state. It issues final rulings in tax matters.

5.2 Stages in the Tax Appeal Procedure

For the different stages in tax appeal procedures before all Swiss courts, see **4.1 Initiation of Judicial Tax Litigation** and **4.2 Procedure of Judicial Tax Litigation** regarding the first-instance cantonal court, as well as **5.1 System for Appealing Judicial Tax Litigation** regarding the second-instance cantonal court, the Federal Administrative Court and the Federal Supreme Court. At these various stages, the procedure is essentially the same.

However, it should be noted that the Federal Supreme Court does not re-establish the relevant facts of the case. These facts may only be corrected by the Federal Supreme Court if it finds that they have been blatantly incorrectly established by a lower court, or that they have been based on a violation of law. This means that the Federal Supreme Court takes its decisions solely by applying the law to facts that have already been determined.

5.3 Judges and Decisions in Tax Appeals

In the canton of Geneva, before the first-instance cantonal court, judges usually renders their decisions with the help of two associate judges specialised in tax law. The second-instance cantonal court is usually composed of three professional judges. The composition of cantonal courts may vary depending on the case at hand and local rules.

The Federal Administrative Court and the Federal Supreme Court are, as a rule, composed of three judges but may be composed of five judges in special cases. Before these courts, a single judge may render a judgment for clearly inadmissible or insufficiently motivated cases.

Swiss courts do not share the criteria on which they appoint judges to render their decisions.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Swiss tax law does not provide for national mediation or arbitration procedures.

With regard to forms of alternative dispute resolution (ADR), double taxation treaties concluded by Switzerland usually refer to a mutual agreement procedure (MAP), which is independent of Swiss domestic law procedures. Thus, the time limits provided for by domestic law have no influence on the MAP and vice versa. In particular, the 30-day deadline to file a claim against a tax assessment decision is not suspended by a request for a MAP. In order to preserve their rights according to Swiss tax law, taxpayers should file a complaint against the relevant tax authority, which will be suspended during the MAP.

Following the initiation of a MAP, certain double tax treaties provide arbitration procedures in tax disputes. After a certain period (from two to three years), taxpayers may request that unresolved questions under the MAP be settled by an arbitration procedure. Such procedure may be denied if a domestic court has already rendered a decision (unlike the initiation of MAPs).

6.2 Settlement of Tax Disputes by Means of ADR

In international tax matters, a MAP may be carried out if the procedure initiated before the competent Swiss and foreign authorities is unsuccessful.

The MAP is initiated at the taxpayer's request before the competent authority in the taxpayer's country of residence. However, the taxpayer

itself is not a party since the MAP is a procedure between one state and another.

In Switzerland, the competent authority for MAPs is the State Secretariat for International Financial Matters (SIF). There is no obligation of result between Switzerland and the relevant other state.

The international arbitration process (as part of an initiated MAP) starts with the taxpayer's request. Double tax treaties define the applicable terms of the arbitration process, if available. Requests for tax arbitrations are quite rare in practice.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

Swiss tax law does not have national mediation or arbitration procedures.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

Given the overall complexity of taxation in Switzerland, taxpayers have an interest in discussing the more complex cases with the tax authorities at an early stage; for instance, in the case of international corporations considering moving to Switzerland, so they can obtain confirmation of their future taxation. The same applies to individuals.

In this regard, tax rulings are commonly used in Swiss tax practice, although Swiss tax law does not expressly refer to rulings. It should be noted that a tax ruling does not provide any preferential taxation over the applicable law. It constitutes, instead, a quicker and more efficient way to provide clarity with regard to taxation questions.

In order to obtain a ruling, the taxpayer has to disclose all relevant information, usually in the form of a letter. If the competent tax authority

agrees with the taxpayer, the ruling request is sent back to the taxpayer with the stamp of the authority, which provides the taxpayer with confirmation from the State on the tax treatment of a transaction or a situation. Tax rulings are not public.

Regarding the binding effect of such rulings, the taxpayer is protected by the constitutional principle of good faith as far as they rely on the information received by the competent tax authority. Swiss case law also especially emphasises the importance of implementing the facts precisely described in the ruling.

There is no legal entitlement for a taxpayer to obtain a binding ruling, even though tax authorities are mostly willing to deal with ruling requests. This means that taxpayers cannot contest a refusal to give a ruling request.

6.5 Further Particulars Concerning Tax ADR Mechanisms

As mentioned in **6.2 Settlement of Tax Disputes by Means of ADR**, the MAP or arbitration procedure (if available), in the case of double taxation with a country with which Switzerland has signed a double taxation agreement, requires that all relevant steps between the relevant Swiss and foreign entities be respected.

There is no limit to the value of the claim. According to the OECD Model Tax Convention on Income and on Capital of 2017, the taxpayer has to request the initiation of a MAP within three years from the first notification of the action resulting in double taxation. Under these same rules, the taxpayer may only request an arbitration afterwards if the competent authorities under the MAP have not reached an agreement within two years after the initiation of a MAP.

Under BEPS rules, an average of 24 months has been set to finalise MAPs. Switzerland committed

to this objective in relation to the improvement of dispute settlement as from 2016. According to the latest report of the SIF, the average time taken in Switzerland to finalise an open case in 2020 was 20 months. In 2021, Switzerland won the first international 2020 MAP award from the OECD, for the average time taken to close transfer pricing cases.

There is no appeal possible against the outcome of a MAP or arbitration procedure.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

ADR is mostly used in transfer pricing cases. With regard to MAPs, and according to the 2020 statistical report of the competent authority, out of 430 cases pending as at 31 December 2020, 200 related to transfer pricing issues.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

As a preliminary remark regarding direct taxes, it should be underlined that a taxpayer seeking to limit the amount of tax it pays is not acting in a criminally punishable manner. Furthermore, in Switzerland, anti-avoidance rules are not contained in one specific piece of legislation; they actually take different forms.

Back-Taxes Procedure

Swiss tax law includes a purely administrative procedure, the back-taxes procedure, which aims at recovering amounts not dutifully declared by the taxpayer.

Swiss criminal tax law deals with misdemeanours (or “contraventions”), which lead to a fine, and tax offences, which may imply imprisonment.

Breach of procedural obligations, tax evasion and attempted tax evasion are the main misdemeanours.

Breach of procedural obligations refers to situations where, for example, the taxpayer fails to file a tax return or does not comply with a duty to provide information. Regarding the sanction, for direct income and equity taxes, the penalty is limited to CHF10,000. For other types of tax, the limit varies as developed below.

Tax evasion related to direct taxes is where the taxpayer, with intent or through negligence, omits certain items in their tax return, or causes a final assessment to be incomplete. If a tax evasion is ruled, the fine may vary from one third to three times the amount of tax evaded. The statute of limitations is ten years. Regarding attempted tax evasion, where a taxpayer tries to elude taxes, the fine amounts to two thirds of the amount determined for complete evasion. The statute of limitations is six years.

Regarding indirect taxes, where the principle of spontaneous taxation applies, the SFTA can issue additional tax assessments in the event of tax evasion, tax jeopardy or non-compliance with legal requirements (eg, failure to report within the deadline provided by law).

For withholding tax purposes, fines vary from CHF5,000 to a maximum of CHF30,000. The same applies to stamp duties, except that the maximum amount, if it results in a higher fine, can be extended to up to three times the amount of evaded tax.

Under VAT provisions, tax evasion can lead to a maximum penalty of CHF800,000, which is extendable to up to twice the amount of evaded tax. In the event of aggravating circumstances, the maximum penalty is doubled and can lead to imprisonment for up to two years.

Tax Evasion Procedure

A back-taxes procedure, which aims at recovering amounts not dutifully declared by the taxpayer, generally triggers a tax evasion procedure. Forgery and withholding tax at source diversion are the main tax offences.

Forgery is the use of fraudulent documents (eg, false financial statements or salary certificates) and is a qualified tax offence with a maximum penalty of imprisonment for up to three years and a minimum fine of CHF10,000. Tax at source diversion is where a person required to collect tax at source misappropriates the amounts collected for their own benefit or for that of a third party. The maximum penalty is imprisonment for up to three years.

In tax offences, the payment of back taxes is always due. Under certain circumstances, a criminal process is avoidable if the taxpayer spontaneously announces amounts not dutifully declared to the tax authorities.

7.2 Relationship between Administrative and Criminal Processes

For tax misdemeanours, the competent authority for the processing of back taxes and for tax-evasion procedures is the same authority, namely the cantonal tax authorities or the SFTA for federal taxes and then the courts. As a rule, these two procedures are conducted simultaneously and set by tax law.

For tax offences, the Public Prosecutor is competent. In such cases, the tax or criminal authority, depending on the case, may decide to suspend one procedure during the settlement of the other. The procedure is set by criminal law. The criminal procedure is generally more elaborate than the tax procedure and leaves more room for investigative acts.

The Public Prosecutor is only competent regarding the criminal part of the tax offence. The calculation of the amount of taxes due remains within the tax authorities' competence.

7.3 Initiation of Administrative Processes and Criminal Cases

Tax authorities initiate such proceedings when they suspect that a tax return or final assessment is incomplete, or that self-reporting requirements are missing (under the spontaneous declaration procedure). As mentioned (see **7.1 Interaction of Tax Assessments with Tax Infringements**), a back-taxes procedure generally implies a tax evasion procedure, which is of a criminal nature.

Depending on the case at hand, the case may evolve into a more serious offence, but most cases develop into a two-way procedure of back taxes and tax evasion.

7.4 Stages of Administrative Processes and Criminal Cases

For tax misdemeanours, as the tax authority establishing the back taxes also establishes the criminal tax penalty, the process is treated by the relevant authority, whether it is the tax authority or the relevant administrative court.

For tax offences, while the back-taxes procedure will still be treated by the tax authority or the relevant administrative court, the Public Prosecutor is competent regarding the criminal aspect.

7.5 Possibility of Fine Reductions

In cases of tax evasion, the good co-operation of the taxpayer makes it possible to reduce the amount of the fine within the framework of the law.

However, the amount of taxes due, which relates to the back-taxes procedure, cannot be reduced.

7.6 Possibility of Agreements to Prevent Trial

For tax misdemeanours, if the taxpayer does not challenge the decision of the tax administration, the procedure is not pursued before the administrative courts, but the payment of the fine remains due. Before the administrative courts, full payment of the tax, late interest and the fine, and withdrawal of the appeal, are also possible. However, this does not change the criminal tax qualification of the procedure.

For tax offences, the issue is a matter for the criminal courts and the mere payment of the tax due is not enough to stop the procedure, since the issue of tax payments is not addressed by the Public Prosecutor.

Where the taxpayer acknowledges the material facts, a simplified procedure may be possible before the Public Prosecutor under certain conditions. The Public Prosecutor prepares an indictment that the taxpayer may accept or refuse.

7.7 Appeals against Criminal Tax Decisions

For tax misdemeanours, appeal possibilities are the same as explained in **7.4 Stages of Administrative Processes and Criminal Cases**, **7.5 Possibility of Fine Reductions** and **7.6 Possibility of Agreements to Prevent Trial**, if specific deadlines are observed.

For tax offences, an appeal to the second-instance court and then, to the criminal chamber of the Federal Court is possible, if specific deadlines are observed.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

As a rule, transactions and operations challenged under transfer pricing rules or general anti-avoidance rules have resulted in two-way

procedure cases of back taxes and tax evasion before the competent authorities.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In the vast majority of double taxation cases, domestic legal remedies are used first to correct the tax situation. However, in parallel with domestic remedies, taxpayers increasingly use MAPs available under double tax treaties. As to arbitration, it is quite rare in practice, as arbitration clauses are still relatively new in double tax treaties signed by Switzerland.

For Switzerland, the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) entered into force on 1 December 2019. As Switzerland follows the amending view, the implementation of new standards on dispute resolution to avoid double taxation (MAPs and arbitration) require, following internal procedures, a modification of double tax treaties. As only a few Swiss double tax treaties have been amended bilaterally, or have recently been implemented with such new standards, no impact has yet been observed regarding the use of international remedies by taxpayers. In recent years, MAPs on transfer pricing issues have continued to increase.

8.2 Application of GAAR/SAAR to Cross-Border Situations

As mentioned, in Switzerland, anti-avoidance rules are not contained in a specific act or provision. However, the Swiss Federal Supreme Court has developed a general exception of tax avoidance and abuse of rights, applicable to almost all Swiss taxes.

This general exception also applies to Swiss double tax treaties if no other anti-avoidance provision is provided under such treaties.

Under the principal purpose test (PPT) introduced by the MLI, the scope of anti-avoidance rules is broader than the previous applicable rules developed by the Swiss Federal Supreme Court. It is thus expected that additional controversial issues will be raised between tax authorities and taxpayers. As the interpretation of the PPT is broadly discussed among scholars, Swiss tax courts will probably have to clarify the application of the PPT.

8.3 Challenges to International Transfer Pricing Adjustments

International transfer pricing adjustments are usually challenged first and foremost under domestic tax courts. Although Switzerland does not have any explicit transfer pricing legislation, those courts as well as the tax authorities, will, in practice, apply the OECD Transfer Pricing Guidelines.

The majority of tax treaties signed by Switzerland do not contain the corresponding adjustment provisions of Article 9, paragraph 2 of the OECD Model Tax Convention. Consequently, taxpayers in practice increasingly request MAPs.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Advance pricing agreements may be used in the context of rulings (see **6.4 Avoiding Disputes by Means of Binding Information and Ruling Requests**) to avoid or mitigate transfer pricing matters.

With regard to APAs, and according to the 2020 statistical report of the competent authority, 304 cases were pending during 2020. Their number has increased compared to the 2019 statistical report.

8.5 Litigation Relating to Cross-Border Situations

Among the various cross-border tax situations, withholding tax is probably the matter that gives rise to the most litigation. This is due to the high withholding tax rate (35%), as well as the fact that Switzerland is a large importer of foreign capital. In this respect, transfer pricing policies as well as transfer of assets and functions within multinational groups are under increasing scrutiny from the Swiss tax authorities.

In general, a ruling is the most effective way to prevent litigation under Swiss tax law and to prevent the risk proactively.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

As Switzerland is not an EU member, this issue does not arise.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

As Switzerland is not an EU member, this issue does not arise.

9.3 Challenges by Taxpayers

As Switzerland is not an EU member, this issue does not arise.

9.4 Refunds Invoking Extra-Contractual Civil Liability

As Switzerland is not an EU member, this issue does not arise.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Under the Swiss double tax treaties, arbitration clauses are currently not always provided for and, if available, rarely used.

As part of the MLI, Switzerland has accepted to apply part VI to its amended or recently implemented double tax treaties (see **8.1 Mechanisms to Deal with Double Taxation**).

10.2 Types of Matters that Can Be Submitted to Arbitration

When an arbitration clause is available, double tax treaties concluded by Switzerland do not limit access to specific matters but may require the fulfilment of certain conditions (eg, no binding decision rendered by a domestic court of one of the states involved in the cross-border dispute).

Under the MLI, Switzerland has reserved its right to replace the two-year period provided with a three-year period before authorising the initiation of arbitration.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

Switzerland prefers the baseball arbitration procedure, a method also known as “final offer arbitration”, under which a proposal is submitted by each competent authority of the relevant state to the arbitration panel. The arbitration panel is then bound and has to decide between the two proposals.

This methodology is preferred by Swiss authorities as it stimulates reasonable proposals from the various competent authorities involved and

eases dispute settlements. It is currently available under the double tax treaty with the USA, and the double tax treaty with Germany.

10.4 Implementation of the EU Directive on Arbitration

Switzerland is not an EU member state but is actively involved in the recent developments made by the OECD.

As mentioned above, Switzerland implemented the MLI as part of the BEPS recommendation of the OECD and accepted the inclusion of binding arbitration clauses under its amended double tax treaties (see **8.1 Mechanisms to Deal with Double Taxation**).

10.5 Existing Use of Recent International and EU Legal Instruments

Apart from a constant growth in the use of MAPs, the initiation of an arbitration process within a cross-border tax disputes is still rarely seen in practice. According to the 2020 statistical report of the competent authority, out of the 236 cases opened under MAPs, 181 were closed. It is expected that the implementation of binding arbitration clauses under double tax treaties may ease the settlement of disputes under MAPs, as competent authorities may prefer to avoid binding decisions from an arbitration court.

10.6 New Procedures for New Developments under Pillar One and Two

From their inception, Switzerland actively participated in discussions related to the OECD Two-Pillar solution in order to ensure a consensus-based multilateral solution and that the position of small and innovative countries be taken into account in the final design of the rules. In January 2022, the Swiss Federal Council confirmed its intention to implement Pillar One and Pillar Two into national law. Swiss citizens are expected to vote around June 2023 on the implementa-

tion of the new rules, in particular Pillar Two, as from 1 January 2024.

Pillar One should only have few consequences in Switzerland compared to Pillar Two. The consensus-based multilateral solution supported by the Swiss authorities is expected to mitigate controversies related to the digital economy and provide certainty for concerned entities at international level. However, the implementation of such new rules still implies various challenges for the authorities and may result in additional complexities for taxpayers residing in Switzerland, which may trigger additional controversies at Swiss level.

10.7 Publication of Decisions

The Swiss competent authorities do not publish decisions related to international settlement of disputes, which are confidential to ensure a framework of compromises between the competent authorities of various states.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Switzerland benefits from a wide tax treaty network, currently being renewed following the recent entry into force of the MLI. Such network is thus the main source of legal instruments used by the competent Swiss authorities to settle international tax disputes (see also **8.1 Mechanisms to Deal with Double Taxation**).

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Taxpayers are not part of the international tax arbitration process they initiate (see **6.2 Settlement of Tax Disputes by Means of ADR**) and thus, are not able to hire any independent professionals to engage in arbitration discussions. They are, however, able to hire such professionals to be their representatives as well as initiate

the procedure on their behalf and at their own costs.

Competent authorities, as part of the arbitration procedure, are usually able to designate at least one representative to the arbitration board. According to the set of rules provided by the relevant double tax treaty, independent professionals may be designated due to the competent authorities' inability to appoint their own employees.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

A formal administrative complaint with the tax authority is free of charge. However, such a procedure may take some time and lead to significant late interest fees on the amount of taxes due if the taxpayer does not settle enough instalments. This item needs to be addressed at an early stage to mitigate costs related to administrative litigation.

11.2 Judicial Court Fees

Before cantonal courts, the amount of the fees varies from one canton to another. In Geneva, before the first-instance court, the fees are calculated according to the complexity of the case, but cannot exceed CHF10,000. An indemnity for legal costs may be charged to the unsuccessful party, including the tax authority. The same rules apply before the second-instance court.

Before the Federal Administrative Court and the Federal Supreme Court, fees are calculated based on the challenged amount, the scale and complexity of the case, the parties involved in the procedure and their financial situation. As a rule, legal costs are borne by the unsuccessful party.

Fees are settled once the judgment is rendered, but an advance payment is generally required by the courts. There is no interest payment on it. If the required advance payment is not paid, the courts are unable to move forward with the procedure if the applicable law specifies that this is an admissibility requirement.

11.3 Indemnities

There is no possible compensation based on taxation ultimately considered void and null under Swiss tax law. However, any amount already paid by the taxpayer will have to be reimbursed with potential interest in their favour.

11.4 Costs of ADR

The MAP, including the arbitration procedure, is free of charge. However, the taxpayer bears the costs incurred by their request (in particular, the fees of their possible representative).

12. STATISTICS

12.1 Pending Tax Court Cases

Statistics of the Geneva authorities are not publicly available.

The latest report available from the Federal Supreme Court indicates that this Court processed, during 2021, 323 cases in tax matters. Additional statistics on the values dealt with are not available.

The latest report available from the Federal Administrative Court indicates that this Court processed, during 2021, 170 cases in tax matters. Additional statistics on the values dealt with are not available.

12.2 Cases Relating to Different Taxes

In 2021, the Federal Supreme Court processed 227 cases for direct taxes, two for stamp duties, 20 for indirect taxes, seven for withholding tax,

two for military tax, seven for double taxation, 50 for other taxes, nine for customs and six for tax exemption. Additional statistics on the values dealt with are not available.

In 2021, the Federal Administrative Court processed 30 cases for subsidies, 71 cases for customs, six cases for stamp duties, three cases for direct taxes, 48 for VAT taxes, six for various indirect taxes, 20 for withholding tax, none for double taxation and one for miscellaneous finance. Additional statistics on the values dealt with are not available.

12.3 Parties Succeeding in Litigation

According to a private study carried out in 2017, and on the basis of Federal Supreme Court data from the past ten years, an appeal filed by a taxpayer with the Federal Supreme Court in tax matters succeeds only 14% of the time. No update is available yet.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The best way to manage a tax dispute is to avoid it by planning, essentially through an early tax analysis of the situation and, if necessary, by an advance tax ruling.

In pending procedures, the legal analysis of the tax administration's position is an essential step. Using a tax specialist is also key when dealing with a tax controversy.

Lenz & Staehelin is one of the largest law firms in Switzerland, with over 200 lawyers. Internationally oriented, the firm offers a comprehensive range of services and handles all aspects of international and Swiss law. Languages spoken include English, French, German, Italian, Russian and Spanish. Lenz & Staehelin's tax team is one of the largest among Swiss law firms, with more than 25 tax attorneys offering a full range

of tax advice in its three offices in Geneva, Zurich and Lausanne. Tax practice areas include M&A; restructurings and buyouts; financing; financial products and derivatives; estate and tax planning for executives, including employee share and stock option plans; investment funds; private equity funds; property (acquisition and development); value-added tax; internal investigations; and tax litigation.

AUTHORS



Jean-Blaise Eckert is considered a leading lawyer in tax and private client matters in Switzerland. He is the co-head of Lenz & Staehelin's tax practice in Geneva and advises

numerous multinational groups of companies as well as high net worth individuals. A certified tax expert and Certified Specialist SBA Inheritance Law, Jean-Blaise Eckert is the secretary general of the International Fiscal Association.



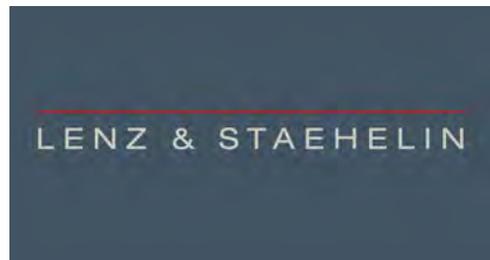
Jenny Benoit-Gonin is a senior associate in the tax department of Lenz & Staehelin in Geneva. She specialises in all aspects of national and cross-border corporate tax law as well as tax

planning for Swiss and foreign private clients. In particular, she advises individuals and multinational groups in the area of restructurings.

Lenz & Staehelin

Route de Chêne 30
CH-1211 Geneva 6
Switzerland

Tel: +41 58 450 70 00
Fax: +41 58 450 70 01
Email: geneva@lenzstaehelin.com
Web: www.lenzstaehelin.com



Law and Practice

Contributed by:

*Andriy Stelmashchuk, Tetyana Berezhna and Alina Ratushna
Vasil Kisil & Partners see p.677*



CONTENTS

1. Tax Controversies	p.663	5.3 Judges and Decisions in Tax Appeals	p.669
1.1 Tax Controversies in this Jurisdiction	p.663	6. Alternative Dispute Resolution (ADR) Mechanisms	p.669
1.2 Causes of Tax Controversies	p.663	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.669
1.3 Avoidance of Tax Controversies	p.663	6.2 Settlement of Tax Disputes by Means of ADR	p.669
1.4 Efforts to Combat Tax Avoidance	p.663	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.669
1.5 Additional Tax Assessments	p.664	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.669
2. Tax Audits	p.664	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.670
2.1 Main Rules Determining Tax Audits	p.664	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.670
2.2 Initiation and Duration of a Tax Audit	p.664	7. Administrative and Criminal Tax Offences	p.670
2.3 Location and Procedure of Tax Audits	p.665	7.1 Interaction of Tax Assessments with Tax Infringements	p.670
2.4 Areas of Special Attention in Tax Audits	p.665	7.2 Relationship between Administrative and Criminal Processes	p.670
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.666	7.3 Initiation of Administrative Processes and Criminal Cases	p.670
2.6 Strategic Points for Consideration during Tax Audits	p.666	7.4 Stages of Administrative Processes and Criminal Cases	p.671
3. Administrative Litigation	p.666	7.5 Possibility of Fine Reductions	p.671
3.1 Administrative Claim Phase	p.666	7.6 Possibility of Agreements to Prevent Trial	p.671
3.2 Deadline for Administrative Claims	p.667	7.7 Appeals against Criminal Tax Decisions	p.671
4. Judicial Litigation: First Instance	p.667	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.671
4.1 Initiation of Judicial Tax Litigation	p.667	8. Cross-Border Tax Disputes	p.672
4.2 Procedure of Judicial Tax Litigation	p.667	8.1 Mechanisms to Deal with Double Taxation	p.672
4.3 Relevance of Evidence in Judicial Tax Litigation	p.667	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.672
4.4 Burden of Proof in Judicial Tax Litigation	p.668		
4.5 Strategic Options in Judicial Tax Litigation	p.668		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.668		
5. Judicial Litigation: Appeals	p.668		
5.1 System for Appealing Judicial Tax Litigation	p.668		
5.2 Stages in the Tax Appeal Procedure	p.669		

8.3	Challenges to International Transfer Pricing Adjustments	p.672	10.5	Existing Use of Recent International and EU Legal Instruments	p.674
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.672	10.6	New Procedures for New Developments under Pillar One and Two	p.674
8.5	Litigation Relating to Cross-Border Situations	p.673	10.7	Publication of Decisions	p.674
9. State Aid Disputes		p.673	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.674
9.1	State Aid Disputes Involving Taxes	p.673	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.674
9.2	Procedures Used to Recover Unlawful/ Incompatible Fiscal State Aid	p.673	11. Costs/Fees		p.675
9.3	Challenges by Taxpayers	p.673	11.1	Costs/Fees Relating to Administrative Litigation	p.675
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.673	11.2	Judicial Court Fees	p.675
10. International Tax Arbitration Options and Procedures		p.673	11.3	Indemnities	p.675
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.673	11.4	Costs of ADR	p.675
10.2	Types of Matters that Can Be Submitted to Arbitration	p.673	12. Statistics		p.675
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.673	12.1	Pending Tax Court Cases	p.675
10.4	Implementation of the EU Directive on Arbitration	p.674	12.2	Cases Relating to Different Taxes	p.675
			12.3	Parties Succeeding in Litigation	p.676
			13. Strategies		p.676
			13.1	Strategic Guidelines in Tax Controversies	p.676

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

In Ukraine, most tax controversies arise following a tax audit of a taxpayer company. Corporate income tax (CIT) controversies in particular may arise because of allegedly illegal deductions for CIT purposes. Such allegations relate to violations discovered by the tax authorities during tax audits of the taxpayer's business partners.

Taxpayers often initiate tax disputes concerning value added tax (VAT) liabilities. VAT controversies arise from either a tax audit of the taxpayer's VAT return or from the tax authorities' denial or inaction concerning a claimed VAT refund.

Property tax disputes usually have their origin in the tax base assessment conducted by a tax authority.

1.2 Causes of Tax Controversies

All taxes may give rise to tax controversies, but CIT and VAT disputes generate most of the administrative courts' caseload. While carrying out audits, tax authorities usually focus on whether a taxpayer has made a proper assessment of tax amounts for accounting and reporting purposes. Taxpayers often dispute additional assessments by challenging both the amount of the tax and administrative decisions forming the grounds for the tax audit. Taxpayers also often challenge the tax authority's denial of a VAT refund or of registration of tax invoices required to receive a VAT refund.

Tax controversies are also initiated by taxpayers because of the continuing inaction of a tax authority regarding a taxpayer's requests or applications. Individuals often challenge property tax assessments by a tax authority or social contributions liabilities.

Tax disputes on tax debt recovery initiated by tax authorities constitute a significant amount of the tax disputes in Ukraine.

1.3 Avoidance of Tax Controversies

A taxpayer may mitigate the possibility of tax controversy prior to a tax audit through the following means:

- proper maintenance of the documentation which is required for an audit;
- regular verification of business processes and accounting records;
- assessment of the credibility of business partners to avoid potential tax risks;
- obtaining binding rulings from a tax authority – a binding ruling on the application of the legislation in certain circumstances may be either applied by the taxpayer or challenged in court;
- comprehensive and timely submission of responses to the tax authority's requests; and
- preparation for a tax audit, once it is anticipated – big companies engage external advisors to help prepare employees for planned audits concerning complicated tax issues.

Once a tax authority has initiated a scheduled or unscheduled tax audit, the possibility of a tax controversy is mitigated by working co-operatively with the auditors. A taxpayer should provide the inspectors with the records requested. Nevertheless, a taxpayer should check whether the grounds for the audit as well as the auditors' authorisation are valid.

1.4 Efforts to Combat Tax Avoidance

Currently, Ukraine is in the process of implementing mechanisms to combat tax avoidance. In December 2019, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) entered into force in Ukraine. From January 2020, its provisions concerning tax liabilities

of non-residents are applicable for bilateral tax treaties concluded by Ukraine. Other provisions applied from June 2020.

In January 2020, the Parliament adopted large-scale amendments to the Tax Code of Ukraine aimed at implementing the BEPS Action Plan in Ukraine (Actions 3, 4, 6, 7, 8–10 and 13).

1.5 Additional Tax Assessments

After additional tax assessments, the tax must be paid within ten days unless a taxpayer initiates an administrative complaint procedure or challenges the tax notice of assessment in court. An administrative complaint postpones the payment date until a taxpayer receives the State Tax Service's decision on its complaint. Commencement of litigation in the court of first instance or in the appellate court postpones the payment deadline until the court's judgment enters into force. However, there is no possibility of such postponement if a taxpayer files a cassation appeal unless the Supreme Court suspends the enforcement of the appeal court's ruling.

If the taxpayer fails to pay the amount of tax due on time, the tax authority may place a tax lien or administrative arrest on the taxpayer's assets, file a judicial claim on tax debt recovery, and enforce collection of the additional tax by seizing bank accounts and taxpayer's property.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits High-Risk Companies

The State Tax Office selects a company for scheduled audits owing to the presence of certain tax risks. A company is considered a "high-risk" taxpayer based on the following conditions:

- the increase in the rate of a company's CIT or VAT liabilities is 50% lower than the compa-

ny's annual outcome or average tax amounts in the business sector;

- a company has made payments to, or engaged in, commercial relationships with risky business partners (eg, insolvent entities) or offshore companies; and/or
- a tax authority has received notification about alleged tax avoidance from a criminal investigation office.

"High-risk" taxpayers may be included in an audit schedule annually.

Middle- and Low-Risk Companies

"Middle-risk" and "low-risk" companies are businesses that participate in risky commercial relationships or declare income decreases in tax returns; they may be audited once every two and three years respectively.

A tax authority may conduct an unscheduled tax audit if:

- there is information on potential tax avoidance on the part of the taxpayer and the latter did not provide explanations and documents upon official request;
- a tax return has not been filed due;
- a taxpayer has filed a correcting return to the audited documentation; or
- a taxpayer has filed a tax return for a VAT refund.

Tax authorities regularly audit large corporations or certain business sectors. Lately, tax authorities have audited fuel sector businesses on excise duty payments.

2.2 Initiation and Duration of a Tax Audit

A tax authority may conduct a tax audit and assess additional tax within the statute of limitations. In most circumstances, the statute of limitations expires after three years following the

date of filing of a tax return (seven years in the case of transfer pricing audits). The statute of limitations shall not apply if (i) a taxpayer has not filed a tax return for a tax period subject to an audit, or (ii) a company's official has been found guilty of a criminal offence relating to tax avoidance.

The duration of tax audits ranges from a few days to 18 months and depends on the type of audit:

- a desktop audit of tax returns shall be conducted in 30 days once the filing date has expired or a tax/correcting return has been filed;
- the duration of a factual audit (at the location of the taxpayer's business) should not exceed ten days but can be extended for a maximum of five more days;
- the duration of a scheduled documentary audit (with or without a visit to the taxpayer's location) ranges from ten business days for small enterprises (can be extended for a maximum of five more days) to 30 business days for large companies (can be extended for a maximum of 15 more days);
- the duration of an unscheduled documentary audit (with or without visiting the taxpayer's location) ranges from three business days for certain individual entrepreneurs to 15 business days for large companies (can be extended for a maximum of ten more days); and
- transfer pricing audits must be conducted within 18 months.

Martial law has been in force in Ukraine since 24 February 2022. Consequently, the *Verkhovna Rada* of Ukraine (the nation's Parliament) has imposed new restrictions on tax audits: during the martial law tax authorities are entitled to conduct only the following tax audits:

- desk audits;
- unscheduled documentary audits at the taxpayer's request and in the case of liquidation of the company; and
- factual audits.

2.3 Location and Procedure of Tax Audits

The location of a tax audit depends on the type of audit. Factual or scheduled or unscheduled visiting documentary audits occur on the taxpayer's premises. Scheduled or unscheduled documentary office audits as well as desktop audits are conducted in the tax authority's headquarters.

Both desktop and electronic audits are based on data available on the electronic databases of the tax authority. When conducting documentary and factual audits, a tax authority may request documentation confirming a real taxpayer's commercial relationships with its business partners. A taxpayer is entitled to submit either printed or electronic documents. In practice, taxpayers usually submit printed documents even though they are maintained electronically in accordance with the law.

2.4 Areas of Special Attention in Tax Audits

Key areas drawing tax auditor's special attention include:

- the existence of commercial relations between a taxpayer and sham businesses;
- the participation of a taxpayer in business relations with companies subject to criminal investigation for alleged tax fraud/avoidance; and
- substantial formal mistakes and anomalies in tax returns, as well as a lack of accounting documents; and

- documentation on transfer pricing, relationships with non-residents or offshore companies.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

Ukraine has not yet implemented mechanisms for the automatic exchange of tax information. Therefore, the tax authority receives tax information from foreign tax agencies only on request.

In 2019, the Parliament ratified the Agreement between the Government of the United States of America and the Government of Ukraine to Improve International Tax Compliance and to Implement FATCA and adopted the amendments to the Tax Code of Ukraine connected to the ratification of this Agreement. The Parliament has also adopted the laws in connection with the implementation of the Common Reporting Standard (CRS) in Ukraine.

Once Ukraine adopts measures on cross-border automatic exchange of tax information, the number of international tax controversies is likely to increase.

2.6 Strategic Points for Consideration during Tax Audits

During a tax audit, a taxpayer should focus on the following key points:

- whether the reasons to conduct a tax audit are lawful and well-grounded and whether a taxpayer has been notified of the tax audit in advance;
- whether tax auditors have filed requests for explanations and documents concerning the subject of a tax audit;
- whether tax authorities' information requests meet the formal requirements; and

- whether a tax audit is carried out in full compliance with the procedural requirements.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Additional tax assessment, as well as any other decision of the tax authorities, can be challenged before the supreme tax authority (State Tax Service) or in court. The administrative complaint phase is an optional pre-trial procedure.

The deadline for lodging an administrative complaint is:

- ten business days after the receipt of the decision if the tax assessment is carried out because of any violations on the part of the taxpayer; or
- 30 calendar days after the receipt of the decision if the tax authority is obliged by law to carry out the tax assessment.

These deadlines can be extended if the individual at the taxpayer responsible for lodging a complaint was somehow restricted from making that complaint because of a range of circumstances or if that person was outside the territory of Ukraine at the time. This applies only if there is no other person in charge of calculating and paying taxes who could lodge the complaint on time.

During the period of martial law (which started on 24 February 2022) these terms have stopped running.

Administrative complaints must be filed in writing and can be supported by any documents, calculations or evidence which the taxpayer considers it necessary to provide.

Normally there is a meeting between the taxpayer's representative and the tax authority in charge of reviewing the claim, during which the case is discussed, and relevant documents are presented.

The burden of proof in the administrative tax procedure lies upon the tax authority which adopted the contested decision.

As a result of the administrative complaint review, the contested decision can be annulled as a whole or in part or can be left without change.

3.2 Deadline for Administrative Claims

The deadline to decide on the administrative complaint is ten working days. This deadline can be extended by the authority in charge of reviewing the claim, but the procedure cannot last more than 60 calendar days in total. The extension must be communicated to the taxpayer in writing within the initial review deadline.

If the taxpayer does not receive the decision on the administrative complaint or the deadline extension notice within the time period prescribed, it is assumed that the complaint is accepted as a whole.

The decision of the State Tax Service on the administrative complaint is final in the pre-trial stage, its assessment can only be challenged in court.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

The taxpayers can contest the decision of the tax authorities either in court directly or after the administrative complaint stage. The case should be brought in front of the Circuit Administrative Court by the taxpayer or its representative within

the six-month time limit (for a direct claim) or within one month (after the receipt of the decision on the administrative complaint).

4.2 Procedure of Judicial Tax Litigation Proceedings before the Court of First Instance

The ordinary procedure has a preparatory stage, where all the evidence is gathered, and a stage of substantial review, where the evidence is examined and evaluated. The simplified procedure has only one stage and is either wholly conducted in writing or with only one court hearing. First instance proceedings usually take more than a year, even in the case of the simplified procedure, which requires the judgment to be given within 60 days. The judgment enters into force if no appeal is lodged.

Proceedings before the Appellate Court

This stage takes two to three months. The judgment of the appellate court enters into force on the day of its adoption, regardless of a subsequent cassation appeal to the Supreme Court.

Proceedings before the Supreme Court

This stage usually takes up to three months. The judgment of the Supreme Court is final and can be reviewed only exceptionally or, under strict conditions, due to newly discovered circumstances.

4.3 Relevance of Evidence in Judicial Tax Litigation

All the evidence must be presented during the proceedings in the court of first instance. New evidence can be brought before the appellate court only if there are valid reasons for it not being presented before. The Supreme Court cannot examine any new evidence at all.

The court can, on its own initiative or on the motion of a party to the proceedings, order a

person or entity to provide any evidence they possess.

Usually evidence is provided in documentary form, witnesses statements are rarely supplied.

4.4 Burden of Proof in Judicial Tax Litigation

The burden of proof lies on the tax authorities. No new reasoning, which did not form the basis of the adoption of the contested decision, can be presented at the tax litigation stage.

However, in some cases the burden of proof is effectively shifted to the taxpayer, for instance in determination of the beneficial ownership of the recipient of income.

In criminal proceedings, the presumption of innocence applies, and the investigating authorities must prove the existence of the offence related to tax.

4.5 Strategic Options in Judicial Tax Litigation

Usually the evidence must be provided to the court of first instance at the time the claim is lodged. New evidence and arguments can, in principle, be presented, if necessary, during the preparatory stage of the court of first instance proceedings before the case is reviewed on substance.

The possibility of settlement is prescribed by law, but it is not common in tax disputes.

Litigation suspends the obligation to pay the contested amount. It is therefore better not to pay until the end of the proceedings to avoid further reimbursement delays.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

The courts are obliged by law to apply ECHR jurisprudence as a source of law and to follow the conclusions of the Supreme Court in similar cases. Doctrine is not taken into consideration at all. As for guidelines, their application is more common, but is not obligatory.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

The first instance is a Circuit Administrative Court (situated in each district and in Kyiv), which examines all the relevant evidence and provides its judgment.

The appeal can be lodged by the parties to the proceedings or by the persons or entities whose rights are affected by the court judgment. Administrative appellate courts review the appeals against first instance courts' judgments in tax litigation. There are eight administrative appellate courts in Ukraine. Until the end of the appeal proceedings, the judgment of the court of first instance does not enter into force.

Cassation appeals are brought to the Cassation Administrative Court, which is a part of the Supreme Court. The Supreme Court does not examine the factual circumstances of the case and evidence, it only determines whether the subordinate courts correctly applied procedural and material norms to the case. The Supreme Court can decide on the case directly, or, if the circumstances were not properly examined by the subordinate court, it can refer the case to the court of first instance for reconsideration. In this latter circumstance, a new judge is appointed to the court of first instance.

The possibility of appeal does not depend on the value of the case or on the nature of the controversy. The right to a cassation appeal is limited in simple cases, or in cases where the simplified procedure was applied by the lower courts.

5.2 Stages in the Tax Appeal Procedure

See **4.2 Procedure of Judicial Tax Litigation** and **5.1 System for Appealing Judicial Tax Litigation**.

5.3 Judges and Decisions in Tax Appeals

In the first instance, the case is decided by one judge. In the appellate and cassation proceedings the case is decided by a panel of three judges, one of which is a reporting judge.

The judges are appointed randomly by the automatic case distribution system. At the same time, the panels in courts of second and third instance are stable, thus when the reporting judge is appointed by the automatic system, their panel takes part in proceedings by default.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

One of the ADR mechanisms mentioned in the Code of Administrative Proceedings is the settlement of a dispute with the participation of a judge. According to this mechanism, the judge holds consultations with or without the parties in order to resolve the dispute peacefully.

6.2 Settlement of Tax Disputes by Means of ADR

The Settlement of a Tax Dispute with the Participation of a Judge

There are following conditions to apply this procedure:

- the trial has not actually begun;
- both parties have agreed to settle the dispute with the participation of a judge; and
- there are no third parties who make independent claims relating to the matter in dispute.

The Mediation

This ADR mechanism can be used before appealing to the court, and during the execution of a court decision. The mediator is only an intermediary – they have no authority to provide consultations or recommendations to the mediation parties on the decision on the merits of the dispute and make such decision instead of the parties.

Despite the legislative regulation allowing it, using ADR mechanisms is not common in Ukrainian dispute resolution. Taxpayers usually prefer classic mechanisms.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

No agreement can be reached outside the scope of the administrative complaint procedure or litigation.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

The taxpayer is entitled to obtain advance individual tax advice concerning the application of a relevant piece of legislation to a specific situation. Individual tax advice can be relied on only by the taxpayer to whom it is addressed, but

such advice is also published on the official website of the State Tax Service.

General tax advice is applicable to all taxpayers. Taxpayers cannot be held liable through financial penalties for actions based on general or individual tax advice. However, the obligation to pay the amount of tax prescribed by law still applies.

Tax advice can be contested in court. If the court declares tax advice void, new tax advice that pays due attention to the court's judgment must be provided to the taxpayer.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction** and **6.2 Settlement of Tax Disputes by Means of ADR**.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

No ADR mechanisms are available in such cases.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

A criminal investigation is usually initiated following the alleged tax offence identified by a tax authority in the tax audit report. If an additional tax assessed by a tax authority exceeds USD100,000, the authority shall notify the tax offences investigation office of a potential criminal offence. In practice, the outcome of criminal proceedings depends on the existence of a final judgment in a tax dispute.

The tax offences investigation office may also carry out criminal proceedings independently from a court dispute (eg, perform a preliminary inquiry).

Following a tax audit, a tax authority can also initiate an administrative offence procedure against a taxpayer's official, where that official was responsible for calculating and paying taxes.

7.2 Relationship between Administrative and Criminal Processes

The relationship between tax litigation and criminal proceedings concerning the alleged tax avoidance of a taxpayer varies from case to case. A court may suspend administrative litigation concerning a review of a tax authority's additional assessment if the trial is objectively impossible until the final judgment in another dispute is given. In practice, courts rarely suspend the administrative process.

Criminal and administrative offence proceedings may be conducted by the court either separately from or following a tax litigation. In practice, both pre-trial investigation and the trial itself are significantly time-consuming. Therefore, criminal litigation usually depends on the results of a tax dispute.

7.3 Initiation of Administrative Processes and Criminal Cases

If the actions of a taxpayer's official constitute an administrative offence under the law, a tax authority shall initiate an administrative infringement procedure. In practice, tax authorities start administrative infringements following a tax audit.

Additionally assessed liability following a tax audit in the amount of approximately USD100,000 or more can potentially mean the existence of a crime of tax avoidance. As a result, an investigation office, when notified of such facts, shall initiate criminal proceedings.

Administrative infringements and criminal offences are considered separately. At the same time, facts found by the court in one of these

proceedings may constitute prejudicial information in another.

7.4 Stages of Administrative Processes and Criminal Cases

The administrative infringement process consists of the following stages:

- initiation of a tax infringement file;
- administrative investigation performed by a tax authority;
- judicial review and the court's ruling;
- appeal against the ruling of the court of first instance to the appellate court (optional); and
- enforcement of a ruling.

Criminal proceedings in tax offences are much more complicated and include:

- pre-trial investigation;
- preliminary procedure;
- court trial;
- appeal proceedings;
- enforcement of the judicial ruling; and
- cassation appeal in the Supreme Court (optional).

General local and appellate courts hear criminal cases and administrative infringements related to tax while administrative courts decide on the legality of a tax authority's additional assessment. The parties file cassation appeals to the Supreme Court, where its respective subdivisions perform cassation review of the lower court's judgments.

7.5 Possibility of Fine Reductions

A taxpayer must pay the additional tax assessed, plus fines and penalties. Ukraine does not have a mechanism for the reduction of potential fines and penalties if payment is made up front.

7.6 Possibility of Agreements to Prevent Trial

A taxpayer may enter into an agreement with the prosecution in order to terminate a criminal trial. The agreement prescribes the taxpayer's explicit admission of guilt for a crime, governs conditions for partial relief of civil liability for damages caused to the state, and contains obligations for the suspect/accused regarding co-operation in disclosing other criminal offences. The court is obliged to approve the agreement.

An agreement with the public prosecutor does not impact payment of the tax assessed by a tax authority. Under the law, the tax authorities cannot enter into agreements with taxpayers.

7.7 Appeals against Criminal Tax Decisions

There is only one strategy concerning appeal against criminal tax decisions. If a taxpayer or a taxpayer's official is found guilty, they may file an appeal to the appellate court of the region. The appeal court's ruling enters into force once it is announced. Nevertheless, the convicted person may file a cassation appeal to the Supreme Court.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

Ukraine does not have a general anti-avoidance rule or specific anti-avoidance rules. A taxpayer may challenge transactions and operations in the administrative court. The proportion of these cases is small. There is no public information on criminal tax cases concerning transfer pricing rules in Ukraine.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

In cases of double taxation, a taxpayer shall file a lawsuit against a tax authority. The mutual agreement procedure is not efficient in Ukraine even though it is prescribed under double taxation treaties. In January 2020, the Ukrainian Parliament adopted amendments to the Tax Code of Ukraine which establish mutual agreement procedures available for both taxpayers and tax authorities. Arbitration procedures concerning double taxation situations are not available.

The mutual agreement procedure was approved in Ukraine only recently, at the end of 2020. For this reason, there are no cases which show its impact yet.

However, in 2021 other measures adopted under the MLI began to apply. For example, tax authorities are currently registering non-residents who have permanent establishment in Ukraine taking into account the features of such permanent establishment adopted through Article 12 of the MLI.

8.2 Application of GAAR/SAAR to Cross-Border Situations

Ukraine does not have a general anti-avoidance rule or specific anti-avoidance rules.

In December 2019, the principal purpose test (PPT) entered into force in Ukraine through the MLI. The PPT is an anti-abuse rule similar to a GAAR for transactions and arrangements. Most of the double taxation treaties between Ukraine and foreign countries also include PPT provisions. There are no judicial decisions or pending court disputes concerning the PPT so far. Additionally, in January 2020 the Parliament adopted

amendments to the Tax Code of Ukraine introducing the PPT into Ukrainian tax legislation.

It is hard to predict how taxpayers and courts will react to the PPT introduced by the MLI and the amendment of the double taxation treaties (DTTs) because this rule will only come into force in 2022.

8.3 Challenges to International Transfer Pricing Adjustments

In Ukraine, a taxpayer may only challenge international transfer pricing adjustments in court.

8.4 Unilateral/Bilateral Advance Pricing Agreements

Unilateral, bilateral and multilateral advance transfer pricing agreements are available in Ukraine. The parties to the agreement are large businesses and the State Tax Service. A foreign tax authority may be engaged under a double taxation treaty. The agreement may cover current or previous tax periods.

Stages of the procedure include:

- submitting a proposition for preliminary consideration of an advance transfer pricing agreement procedure, and preliminary consideration (optional stage);
- submitting proposals for a transfer pricing agreement procedure;
- consideration of the procedure with discussion between a taxpayer and a tax authority;
- making a decision;
- signing of an agreement; and
- termination of an agreement.

A taxpayer and the State Tax Service are entitled to terminate a procedure at any stage.

8.5 Litigation Relating to Cross-Border Situations

Transfer pricing situations give rise to most cross-border court disputes in Ukraine. However, permanent establishment issues constitute a significant part of the cross-border caseload.

Withholding tax (WHT) also causes tax disputes in Ukraine and the main reasons for such disputes are the existence of a duty to pay WHT and application of tax benefits related to WHT.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

As a non-EU jurisdiction, state aid disputes do not arise in Ukraine.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

As a non-EU jurisdiction, state aid disputes do not arise in Ukraine.

9.3 Challenges by Taxpayers

As a non-EU jurisdiction, state aid disputes do not arise in Ukraine.

9.4 Refunds Invoking Extra-Contractual Civil Liability

As a non-EU jurisdiction, state aid disputes do not arise in Ukraine.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Ukraine has signed 76 DTT. Although, as of 2021, an arbitration clause exists only in three of them. These are the DTTs signed by Ukraine and:

- Switzerland;
- Great Britain;
- the Netherlands.

The reason for this is that not all countries have agreed to extend the MLI to DTTs they have signed with Ukraine.

10.2 Types of Matters that Can Be Submitted to Arbitration

DTT Signed by Ukraine and Switzerland

Any unresolved issues in a case submitted for mutual agreement may be resolved by arbitration if the competent authorities are not able to resolve the case within three years and the taxpayer so requests. However, arbitration is not available if the unresolved issues have been decided through an arbitration within another case.

DTT Signed by Ukraine and Great Britain

Any unresolved issues in a case submitted for mutual agreement may be resolved by arbitration if the competent authorities are not able to resolve the case within two years and the taxpayer so requests. However, arbitration is not available if the unresolved issues have been decided by a domestic court or administrative tribunal.

DTT Signed by Ukraine and the Netherlands

Any unresolved issues in a case submitted for mutual agreement may be resolved by arbitration if the competent authorities are not able to resolve the case and both countries agree to resolve it by arbitration procedure.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

The DTT signed by Ukraine and Switzerland provides for the baseball arbitration procedure, in which the arbitrators are not allowed to reach an independent decision – they only choose

between two solutions proposed by contracting states.

The DTTs signed by Ukraine with Great Britain and the Netherlands provide for the independent opinion procedure, which is typical for the OECD Model. According to this procedure the arbitrators are not restricted in any way and can decide independently based on facts and law.

10.4 Implementation of the EU Directive on Arbitration

International practice shows that in most cases a mutual agreement procedure (MAP) can work well, but there is still a high number of cases in which the MAP does not work. Therefore, tax arbitration, provided by the OECD and the UN, is an enhancement of the MAP, rather than a replacement. In tax disputes arbitration is an optional agreement instrument.

10.5 Existing Use of Recent International and EU Legal Instruments

There are no cases in Ukraine where such types of procedures have been used to settle tax disputes.

10.6 New Procedures for New Developments under Pillar One and Two

In October 2021 Ukraine joined the two-pillar large-scale plan to reform the international tax system for large business (the “Two-Pillar Solution”). To implement these rules, Ukraine has to:

- sign a number of international agreements; and
- develop amendments to its national legislation.

Ukrainian authorities have been working on these tasks. Unfortunately, due to the outbreak of war on 24 February 2022, the issue of implementing the Two-Pillar Solution has receded into the background.

Given the current situation in Ukraine, it is difficult to determine the consequences of the implementation of the Two-Pillar Solution with any precision. As a general point, however, it can be noted that the enactment of amendments to the tax legislation usually leads to new disputes in Ukraine.

10.7 Publication of Decisions

According to Article 21 of the MLI, all information related to the arbitration procedure is confidential. Moreover, the members of an arbitration commission undertake not to disclose the information they discover during a dispute settlement.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Besides the fact that the EU Dispute Resolution Directive and MLI provides new legal instruments to settle tax disputes, the most commonly used instruments so far are administrative appeal and litigation.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

In Ukraine, taxpayers hire lawyers, attorneys-at-law, and practitioners to initiate the procedure of international arbitration and to accompany the case.

Independent professionals can be hired by the state using the procedure of public procurement to represent the interests of government or of state-owned enterprises.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

The administrative complaint procedure is completely free of charge.

11.2 Judicial Court Fees

Court fees are paid in each instance by a person lodging a claim, appeal or cassation appeal. Payment of the court fee is a prerequisite for considering the respective submission.

The common approach of the courts is that annulment of the tax assessment is a pecuniary claim. The court fee in the first instance in such cases is in the amount of 1.5% of the claim's value for companies and 1% for individuals. There are minimum and maximum court fee amounts, these being approximately USD70 and USD700 for companies and approximately USD30 and USD350 for individuals. For each non-pecuniary claim, a court fee in the amount of approximately USD70 is paid by companies and approximately USD30 by individuals.

The common approach of the courts is that annulment of the tax assessment is a pecuniary claim. The court fee in the first instance in such cases is in the amount of 1.5% of the claim's value for companies and 1% for individuals. There are minimum and maximum court fee amounts, these being approximately USD70 and USD700 for companies and approximately USD30 and USD350 for individuals. For each non-pecuniary claim, a court fee in the amount of approximately USD70 is paid by companies and approximately USD30 by individuals.

In the appellate court, the court fee is 150% of the amount paid in the first instance. The maximum court fee for lodging an appeal is approximately USD1,050.

In the Supreme Court, the court fee is 200% of the amount of the court fee in the first instance, the maximum being approximately USD1,400.

If the claim brought by a taxpayer is satisfied by a final judgment, the court fee is reimbursed by the tax authorities from the state budget. If the claim is denied, the court fee paid by a taxpayer is not refunded. No interest is applicable.

The court fees paid by the tax authorities must not be reimbursed by a taxpayer.

11.3 Indemnities

Indemnity mechanisms are available within the proceedings for contesting a tax assessment, but they are rarely used by taxpayers since the damage is, in most cases, not easy to calculate. Indemnity can also be claimed separately in commercial or civil proceedings.

11.4 Costs of ADR

See **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction.**

12. STATISTICS

12.1 Pending Tax Court Cases

As of 1 January 2022, more than 77,400 tax-related cases are pending before the courts.

In 2021 the courts considered more than 25,400 tax-related cases, and 69% of these cases were considered in favour of the tax authorities. In 2019 these figures were slightly higher. In particular, 26,900 tax-related cases were considered by the court during 2019 and about 60% of those were decided in favour of the tax authorities.

12.2 Cases Relating to Different Taxes

In 2019, VAT was the most commonly litigated form of tax, accounting for approximately 30%

of cases (with a value of approximately USD13.5 million), followed by CIT and personal income tax, which were the subject of approximately 8% of cases each (with a value of approximately USD7 million and USD130,000, respectively).

12.3 Parties Succeeding in Litigation

In 2019, approximately 30% of final judgments in all tax-related cases were given in favour of the taxpayers and approximately 70% in favour of the tax authorities. These statistics include all the cases to which tax authorities were party. There are no separate statistics relating solely to tax assessments.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

The number of disputes between taxpayers and tax authorities is likely to decrease in the near future. At the same time, those tax controversies that do still arise will be more and more complicated, especially when tax authorities start auditing compliance with the newly adopted Tax Code amendments. Therefore, the role of a lawyer or a tax consultant will become crucial.

Preparation for a potential tax controversy starts well in advance. Proper maintenance of the accounting documents, regular verification and updates of business processes and accounting records are the key elements of such preparation. In addition, tax advice should be obtained in the case of any uncertainty over tax legislation compliance.

If a tax issue arises, a taxpayer should first communicate with a tax authority (by requesting a binding ruling, filing an application/letter). At the same time, a taxpayer should be prepared for a potential administrative complaint procedure or court dispute. If a tax audit is initiated, a taxpayer should become familiar with the legal grounds for that tax audit, its subject, terms, etc. If a tax authority finds any violations on the part of the taxpayer, which are not well reasoned, the taxpayer should submit objections to the audit report.

If a taxpayer disagrees with a tax notice or any other administrative decision issued by a tax authority, the taxpayer should file an administrative complaint to the State Tax Service. If that complaint does not succeed, a lawsuit should be initiated. Preparation for a court dispute includes analysis of the relevant court practice to identify the possible risks and chances of success.

Contributed by: Andriy Stelmashchuk, Tetyana Berezhna and Alina Ratushna, Vasil Kisil & Partners

Vasil Kisil & Partners is a full-service law firm founded in 1992 in Ukraine. Comprised of 8 partners and over 50 attorneys, the firm's practice covers agribusiness, antitrust and competition, corporate/M&A, dispute resolution, energy and natural resources, IP, international trade, labour and employment, private clients, public-private partnerships, concessions and infrastructure, taxation, real estate and construction, and white-collar crime. Its clients come from

over 50 countries and industries, including, in particular, agribusiness, aviation, energy, IT, real estate and construction. The firm is an exclusive member of TerraLex in Ukraine, a worldwide network of independent law firms in over 100 countries; and of Ius Laboris, a global employment law alliance in Ukraine; and is a partner in Cathay Associates, a business bridge to China formed by over 600 lawyers in more than 50 countries.

AUTHORS



Andriy Stelmashchuk is a managing partner at Vasil Kisil & Partners and an expert in dispute resolution, particularly tax dispute resolution. He has been defending clients' interests in courts since 2003. Andriy is the Legal Tech projects ambassador in Ukraine, a board member of the Ukrainian Bar Association and a Supervisory Board Secretary of the National University of Kyiv-Mohyla Academy.



Tetyana Berezhna is a member of the executive team at Vasil Kisil & Partners who specialises in tax disputes and administrative litigation. She has been defending clients' interests in courts since 2011.



Alina Ratushna is a junior associate who specialises in tax disputes and advises clients on a complete range of Ukrainian tax issues.

Vasil Kisil & Partners

17/52A Bohdan Khmelnytsky St
Kyiv 01054
Ukraine

Tel: +380 445 817 777
Fax: +380 445 817 770
Email: vkp@vkp.ua
Web: www.vkp.ua



VASIL KISIL

Law and Practice

Contributed by:

Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen
and Sheri A. Dillon

Morgan, Lewis & Bockius LLP see p.701



CONTENTS

1. Tax Controversies	p.681	5.3 Judges and Decisions in Tax Appeals	p.690
1.1 Tax Controversies in this Jurisdiction	p.681	6. Alternative Dispute Resolution (ADR) Mechanisms	p.690
1.2 Causes of Tax Controversies	p.681	6.1 Mechanisms for Tax-Related ADR in this Jurisdiction	p.690
1.3 Avoidance of Tax Controversies	p.681	6.2 Settlement of Tax Disputes by Means of ADR	p.691
1.4 Efforts to Combat Tax Avoidance	p.682	6.3 Agreements to Reduce Tax Assessments, Interest or Penalties	p.692
1.5 Additional Tax Assessments	p.682	6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests	p.692
2. Tax Audits	p.683	6.5 Further Particulars Concerning Tax ADR Mechanisms	p.692
2.1 Main Rules Determining Tax Audits	p.683	6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax	p.693
2.2 Initiation and Duration of a Tax Audit	p.683	7. Administrative and Criminal Tax Offences	p.693
2.3 Location and Procedure of Tax Audits	p.684	7.1 Interaction of Tax Assessments with Tax Infringements	p.693
2.4 Areas of Special Attention in Tax Audits	p.684	7.2 Relationship between Administrative and Criminal Processes	p.693
2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits	p.685	7.3 Initiation of Administrative Processes and Criminal Cases	p.694
2.6 Strategic Points for Consideration during Tax Audits	p.685	7.4 Stages of Administrative Processes and Criminal Cases	p.694
3. Administrative Litigation	p.686	7.5 Possibility of Fine Reductions	p.694
3.1 Administrative Claim Phase	p.686	7.6 Possibility of Agreements to Prevent Trial	p.694
3.2 Deadline for Administrative Claims	p.687	7.7 Appeals against Criminal Tax Decisions	p.695
4. Judicial Litigation: First Instance	p.687	7.8 Rules Challenging Transactions and Operations in this Jurisdiction	p.695
4.1 Initiation of Judicial Tax Litigation	p.687	8. Cross-Border Tax Disputes	p.695
4.2 Procedure of Judicial Tax Litigation	p.687	8.1 Mechanisms to Deal with Double Taxation	p.695
4.3 Relevance of Evidence in Judicial Tax Litigation	p.688	8.2 Application of GAAR/SAAR to Cross-Border Situations	p.695
4.4 Burden of Proof in Judicial Tax Litigation	p.688		
4.5 Strategic Options in Judicial Tax Litigation	p.688		
4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation	p.689		
5. Judicial Litigation: Appeals	p.689		
5.1 System for Appealing Judicial Tax Litigation	p.689		
5.2 Stages in the Tax Appeal Procedure	p.689		

8.3	Challenges to International Transfer Pricing Adjustments	p.696	10.5	Existing Use of Recent International and EU Legal Instruments	p.698
8.4	Unilateral/Bilateral Advance Pricing Agreements	p.696	10.6	New Procedures for New Developments under Pillar One and Two	p.698
8.5	Litigation Relating to Cross-Border Situations	p.696	10.7	Publication of Decisions	p.698
9.	State Aid Disputes	p.697	10.8	Most Common Legal Instruments to Settle Tax Disputes	p.699
9.1	State Aid Disputes Involving Taxes	p.697	10.9	Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes	p.699
9.2	Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid	p.697	11.	Costs/Fees	p.699
9.3	Challenges by Taxpayers	p.697	11.1	Costs/Fees Relating to Administrative Litigation	p.699
9.4	Refunds Invoking Extra-Contractual Civil Liability	p.697	11.2	Judicial Court Fees	p.699
10.	International Tax Arbitration Options and Procedures	p.697	11.3	Indemnities	p.699
10.1	Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)	p.697	11.4	Costs of ADR	p.699
10.2	Types of Matters that Can Be Submitted to Arbitration	p.697	12.	Statistics	p.700
10.3	Application of the Baseball Arbitration or the Independent Opinion Procedure	p.698	12.1	Pending Tax Court Cases	p.700
10.4	Implementation of the EU Directive on Arbitration	p.698	12.2	Cases Relating to Different Taxes	p.700
			12.3	Parties Succeeding in Litigation	p.700
			13.	Strategies	p.700
			13.1	Strategic Guidelines in Tax Controversies	p.700

1. TAX CONTROVERSIES

1.1 Tax Controversies in this Jurisdiction

The largest tax controversies in the USA (in terms of amount at issue) usually arise in one of two ways. First, after the United States Internal Revenue Service (IRS) audits a taxpayer's income tax return, the IRS may assert that the taxpayer owes additional tax ("deficiency" posture). Second, after paying tax the taxpayer may file a claim for a refund asserting that the taxpayer overpaid its correct tax liability, and the IRS may deny that claim ("refund" posture).

Tax controversies also can arise in other ways. For instance, without auditing a taxpayer's tax return, the IRS may assert that the taxpayer owes additional tax based on information reported to the IRS from other sources (such as a financial institution). A taxpayer's failure to notify the IRS of particular items – such as a foreign bank account – can also yield tax controversies. Tax controversies also arise when the IRS invokes specific rules in an attempt to collect one taxpayer's tax from a third party (such as a shareholder or an employee). In addition to income taxes, tax controversies can arise when a taxpayer fails to submit gift and estate taxes (taxes required to be paid upon the making of certain gifts or leaving money or property to others upon death) or various excise taxes (taxes required to be paid upon the buying or selling of certain products or services). Substantial tax controversies also arise when employers fail to withhold or pay to the IRS employment taxes (various taxes on monetary and other compensation employers pay to their employees). Tax controversies can also arise when a state in the USA (rather than the IRS) asserts that a taxpayer owes additional tax or has not fulfilled its tax obligations to that particular state.

1.2 Causes of Tax Controversies

Measured by aggregate dollar amounts at issue, individual income taxes generally give rise to the most tax controversies.

However, measured by dollar amounts at issue in each case, tax controversies with a small number of entities (often corporate taxpayers or partnerships) tend to give rise to the most substantial and contentious income tax controversies.

1.3 Avoidance of Tax Controversies

The best way to attempt to mitigate possible tax controversy is to pursue upfront compliance. Taxpayers most commonly accomplish this by relying on, and co-operating with, one or more advisors (accounting firms or tax lawyers) well before filing a tax return. Advisors help taxpayers compile and understand the relevant tax laws and apply them to taxpayers' factual circumstances. Of course, even if a taxpayer fully pursues upfront compliance, the IRS may disagree with the taxpayer's position and controversy may ensue.

Where applicable, the IRS has certain mechanisms to enable an upfront agreement between a taxpayer and the IRS and thereby avoid future controversy. Such IRS mechanisms include:

- a private letter ruling (a written statement issued by the IRS to a taxpayer that applies the tax law to the taxpayer's specific facts);
- an advance pricing agreement (an agreement between a taxpayer and the IRS (and potentially other governments as well) with respect to the proper pricing of intercompany transactions including those involving goods, services, and/or intangibles); and
- for certain business taxpayers, the Compliance Assurance Process (a programme where the IRS and a taxpayer work together to

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

resolve potential issues prior to the filing of a tax return).

Other avenues to mitigate possible tax controversies include pursuing pre-filing agreements (agreements between the IRS and certain large business taxpayers that resolve the treatment of certain transactions before a tax return is submitted) and obtaining a closing agreement or accelerated issue resolution agreement for an issue addressed and resolved in a prior IRS examination that might arise again in later tax years.

1.4 Efforts to Combat Tax Avoidance

Certain of the OECD's base erosion and profit shifting (BEPS) reports were addressed through aspects of the Tax Cuts and Jobs Act (TCJA) in 2017. For instance, the TCJA included provisions attempting to:

- neutralise the effects of hybrid mismatch arrangements (BEPS Action 2);
- design effective controlled foreign company rules (BEPS Action 3); and
- limit base erosion involving interest deductions (BEPS Action 4).

The law also contains a global anti-base erosion proposal that influenced recent proposals from the OECD regarding the tax challenges of the digitalisation of the economy. These new provisions may well increase tax controversies in the USA in the next several years.

However, while the USA supports and participates in the discussions at the OECD regarding the international tax system, it has generally opposed digital services taxes and departures from arm's-length transfer pricing and taxable nexus standards.

In recent years, the IRS has also increased its network of tax information-exchange agree-

ments and made greater use of the information-exchange aspects of tax treaties. Exchange of information in the cross-border context has generated additional tax controversies in the USA. Since 2004, the IRS has participated in the Joint International Tax Shelter Information Centre, established to combat cross-border tax avoidance. The IRS has also implemented country-by-country reporting requirements for certain large multinational businesses. While these disclosure initiatives may not increase tax controversies, they will arguably enable the IRS and foreign authorities to pursue perceived tax avoidance in a more targeted fashion.

1.5 Additional Tax Assessments

If the IRS audit function determines that a taxpayer owes additional tax, the taxpayer generally need not pay the additional tax before challenging the audit determination. Taxpayers have the potential ability to challenge the IRS's determination administratively at the IRS's Independent Office of Appeals, as described in **3. Administrative Litigation**. Failing administrative resolution, taxpayers can challenge the IRS's determination in court, as described in **4. Judicial Litigation: First Instance**. Generally, if a taxpayer is ultimately determined to owe additional tax, the IRS formally "assesses" the tax due at that time. Interest on the additional tax runs from the due date of the taxpayer's tax return for the year at issue.

However, taxpayers can stop the running of interest on an asserted tax deficiency by first paying the additional tax that the IRS claims is owed and then submitting an administrative claim for a refund with the IRS. If the IRS denies a taxpayer's refund claim, then the taxpayer can sue the USA for a refund, as described in **4. Judicial Litigation: First Instance**.

2. TAX AUDITS

2.1 Main Rules Determining Tax Audits

The IRS determines whose returns it will audit based on a number of criteria, some driven by particular enforcement initiatives. Over the past five years, as part of its strategic plan, the IRS has continued to increase its use of and reliance upon data analytics in making enforcement decisions, including the selection of issues and taxpayers to examine. Multinational enterprises – regardless of whether their businesses are conducted through corporations, partnerships, or as individuals – have received heightened scrutiny by the IRS. In addition, as a result of changes to the audit and tax collection procedures for partnerships under the Bipartisan Budget Act of 2012, the IRS has increased its examinations of partnerships and announced the Large Partnership Compliance Pilot Program as a focused approach to best identify the highest risk issues in partnerships. On a regular basis, the IRS issues a public list of “campaigns” or “particular issues” that will receive heightened attention and for which additional IRS resources will be dedicated. Today, how taxpayers have complied with the new provisions of the Tax Cuts and Jobs Act of 2017 (the TCJA) is an increasing area of IRS focus.

Many large companies are under continuous audit by the IRS, which means as soon as one audit is complete the following one will begin. In many instances, prior to the remote work undertaken due to COVID-19 concerns, the IRS would establish an office on the company’s premises from which the IRS examiners completed their work. Audits are typically in two or three-year “cycles,” with the goal of being as current as possible. The IRS’s “Compliance Assurance Process” is designed to allow large-case taxpayers with the best records of compliance to have their tax positions reviewed and, ideally, approved by the IRS even before the tax returns

are filed. These “real time” audits come with benefits and challenges but allow taxpayers to know the IRS’s views at the time of filing their returns.

For individuals, high-net-worth or otherwise, the IRS looks for signs of non-compliance, often through automated tools that allow it to compare an individual’s reported income with the payments that employers or investment funds or others make to the taxpayer. By this comparison, the IRS can determine if there is a mismatch in the income reported by a taxpayer and the payments reported by these other parties. For many taxpayers, this mismatch is the surest way to cause the IRS to start a “paper audit” of the taxpayers’ returns to determine compliance.

2.2 Initiation and Duration of a Tax Audit

Typically, the IRS must commence an audit of a timely filed tax return and assess any additional taxes within three years of the return’s filing date. This limitations period may be extended by the agreement of both the taxpayer and the IRS. The commencement of an audit does not suspend this “statute of limitations”. Therefore, this three-year period is generally, the only time constraint on the IRS to conduct an audit, subject to some nuances that can arise under certain circumstances.

Depending on the complexity of the audit and the willingness of the taxpayer to afford the IRS more time, corporate taxpayers generally agree to extend this period to allow the IRS to complete its audit and, hopefully, to reach an agreement with the IRS about any potential adjustments. It is not unusual for complex audits of multinational companies to take two to three years to complete with the limitation period having been extended by agreement for five or more years after the original expiration date. If, following an audit, the taxpayer and the IRS have been una-

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

ble to reach an agreement as to disputed issues on the taxpayer's return, the statute of limitations can and often will be further extended by agreement to allow the taxpayer to proceed to various administrative dispute-resolution forums such as IRS Appeals (discussed in **3. Administrative Litigation** and **6. Alternative Dispute Resolution (ADR) Mechanisms**).

2.3 Location and Procedure of Tax Audits

The IRS will generally conduct the tax audit of a business or corporation "on site" at the company's headquarters. However, due to COVID-19 concerns, audits have shifted and are now conducted remotely with little to no face-to-face contact between taxpayers and their exam team, which is increasingly spread out across the USA. The IRS often conducts audits of individuals through the mail and telephone calls. For taxpayers whose audit is conducted by the Large Business and International division of the IRS, the IRS follows an examination process outlined in Publication 5125, which highlights the key elements of all phases of an examination, including planning, execution and resolution.

The IRS's data gathering is mostly conducted through requests for information called "Information Document Requests", which seek written answers to questions, printed documents, and electronic data. Today, most information is transmitted to the IRS auditors electronically. The IRS may also seek interviews from people with knowledge of specific information within the company as well as from third parties, such as customers of the company, in the appropriate circumstances. The IRS also may seek "tours" of the company's facilities if useful to its examination. Interviews may be conducted informally without the taxpayer's or the IRS's counsel present. Or, they may be conducted more formally, with counsel involved and the interviewees' statements transcribed.

If there is a dispute between the IRS and the person or entity from whom it is seeking information or documents about the propriety of the requests, the IRS may issue an administrative "summons," which is a more formal request for information. If the recipient refuses to comply with the summons, the IRS may seek to "enforce" the summons by commencing an action in a federal district court. Such actions happen infrequently and usually occur only after all other opportunities to reach an agreement with the IRS have failed.

As a result of the Taxpayer First Act, enacted in July 2019 and intended to improve the taxpayer's experience when engaging with the IRS, including during the audit process, the IRS is prohibited from issuing summons unless it meets articulated criteria and from contacting third parties without providing 45 days' notice to the taxpayer before the beginning of a contact period.

2.4 Areas of Special Attention in Tax Audits

As discussed in **2.1 Main Rules Determining Tax Audits**, the IRS annually publishes a list of its priority areas for enforcement, which it now calls "campaigns." There are currently just over 50 active campaigns, in addition to the over 20 enforcement issues that have been undertaken and retired, including those arising out of the TCJA. For multinational taxpayers, the IRS has historically focused and continues to focus on transfer pricing issues, as well as, for example, those issues arising out of supply chain restructurings, cross-border acquisitions, worthless stock losses, and transactions that seek to maximise the tax effects of business losses.

Among the first requests for information that the company will receive, after a request for access to the company's electronic books and records that support its tax returns, is a request for the

company's transfer pricing documentation, which must be provided within a statutory period of time in order to ensure its use as "penalty protection" under the Internal Revenue Code. Transfer pricing issues can relate to the provision of cross-border services and tangible goods, the licensing of intangibles, intercompany debt, and manufacturing and distribution activities. The IRS has often identified these types of cross-border issues as priorities for civil investigation and enforcement because the tax effect of the IRS's adjustments can be in the hundreds of millions of dollars. Additionally, in instances where the company has made a large acquisition or disposition of an aspect of its company or operations, the IRS will request materials and documentation regarding that transaction, including purchase agreements and support for the manner in which the transaction was reported on the return.

2.5 Impact of Rules Concerning Cross-Border Exchanges of Information and Mutual Assistance between Tax Authorities on Tax Audits

For the past several years, as countries have been more willing to utilise treaties and other information-sharing arrangements between them, the IRS has issued a growing number of requests for information on behalf of other countries. Likewise, the IRS has been gaining access to a greater amount of information from other jurisdictions than ever before. Taxpayers are also only beginning to see the effect of "country by country" transfer pricing documentation. This information exchange has made it that much more important for taxpayers to co-ordinate their global responses to taxing authorities' requests to ensure that they remain cognisant of how different jurisdictions might use or interpret that information. The "global controversy" position within companies has become increasingly important as a result. In the USA, however, this information exchange has not yet led

directly to a material increase in IRS audit activity. Whether the increased co-operation among taxing authorities will affect this over time is to be determined.

2.6 Strategic Points for Consideration during Tax Audits

As taxpayers prepare themselves to manage an IRS audit, there are three key initial considerations. First, before a taxpayer even files its tax return, it should identify those areas where it would expect a potential disagreement. This will allow a taxpayer to ensure that it has the documentation and facts and analysis it will need already in place once the IRS begins asking questions during the audit. In addition, it might allow the taxpayer to seek an advanced ruling from the IRS (such as a "private letter ruling" or an "advanced pricing agreement") that may allow it to avoid the dispute altogether.

Second, once the audit commences, which normally will be at least a year or two after the tax return has been filed, the taxpayer should re-evaluate the merits of its position given how the law and the IRS's view of it may have changed. The taxpayer should then determine the amount of the potential exposure for both tax and financial purposes so that it can assess the materiality of the issue accordingly. Finally, if the IRS disagrees with the taxpayer's position, the taxpayer should assess the adequacy of its documentation to help protect itself from civil penalties.

Third, through the course of the audit, the taxpayer should endeavour to maintain control over the factual record. The taxpayer is the one that knows the facts (or should), and the IRS is seeking to learn them. So, the taxpayer must always consider whether it has mastered the facts and is able to answer the IRS's questions. A taxpayer does not want to be in the position of learning facts at the same time as the IRS does.

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

Perhaps the most important “asset” a taxpayer has at its disposal during an IRS audit, however, is its credibility. Taxpayers must answer questions truthfully, stand by their commitments to the IRS for responses and information, and ensure that any representation they make can be proven if necessary. Developing a respectful and credible relationship with the IRS examiners may contribute significantly to ensuring that the audit proceeds in a timely, efficient, and, ideally, successful manner.

3. ADMINISTRATIVE LITIGATION

3.1 Administrative Claim Phase

Before the IRS notifies a taxpayer of an additional tax assessment, the taxpayer has options to resolve its tax liability without filing an administrative refund claim. Upon receiving a final examination report and a “30-day letter,” a taxpayer may pursue an administrative appeal by filing a protest and requesting a conference with the Independent Office of Appeals (“IRS Appeals”), the arm of the IRS responsible for settling tax cases on their merits before litigation. IRS Appeals procedures are outlined below in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction** and **6.2 Settlement of Tax Disputes by Means of ADR**.

If the taxpayer does not respond to the 30-day letter, the taxpayer loses its administrative-appeal rights, and the IRS will issue a statutory notice of deficiency. A taxpayer normally has 90 days to file a petition with the United States Tax Court to redetermine the deficiency asserted in the notice of deficiency. Tax Court litigation is outlined in **4. Judicial Litigation: First Instance**. A Tax Court litigant who has not previously pursued an administrative appeal before IRS Appeals can be given the opportunity for

IRS Appeals review, called a “post-docketed appeal,” during litigation.

If the taxpayer does not pursue either an administrative appeal or Tax Court litigation, the IRS may make an “assessment” to fix the additional amount owed by the taxpayer, after which the taxpayer must engage in the administrative claim phase if it still seeks to contest the assessment.

Administrative Claim Phase (Post-Assessment)

Once the IRS issues a notice of assessment and demands payment from a taxpayer, the administrative claim phase becomes mandatory before initiating refund litigation in either a United States district court or the United States Court of Federal Claims. This phase gives the IRS notice of the claim and the facts on which it is based so that it may consider the matter and correct any errors. However, as a practical matter in most cases, the administrative claim phase is largely procedural and does not permit the taxpayer a hearing or other adjudicative vehicle or provide a meaningful opportunity to have the IRS’s initial decision reconsidered.

An administrative claim must generally be filed within the later of three years from the time the original return was filed, or two years from the time the tax and/or penalty was paid. A refund claim is usually made on an amended return and filed with the IRS office where the taxpayer submitted its original return and must contain each ground on which a refund is claimed and all relevant facts.

The IRS may accept, deny, or examine a claim. If a claim is examined, the procedures are similar to an IRS audit of an original tax return, including the ability to file an appeal of a denial with IRS Appeals. However, if a taxpayer seeks a refund based only on contested issues considered in previously examined returns and does not want

to appeal within the IRS, it can request in writing that the claim be immediately rejected.

3.2 Deadline for Administrative Claims

There is no deadline for the IRS to decide an administrative claim filed by a taxpayer. If the claim is denied, the IRS will mail a notice of claim disallowance to the taxpayer. A taxpayer has two years from the date of the IRS's mailing of this notice to file a refund suit in a United States district court or in the United States Court of Federal Claims. Alternatively, if the IRS does not render a decision on the claim within six months after its filing, the taxpayer may file suit in one of those courts at any time.

4. JUDICIAL LITIGATION: FIRST INSTANCE

4.1 Initiation of Judicial Tax Litigation

Tax litigation in the USA is usually initiated through one of two avenues: deficiency litigation and refund litigation. The law generally requires the IRS to issue a taxpayer a document called a "notice of deficiency" before the IRS can record a tax debt against the taxpayer and seek to collect the tax. The notice of deficiency allows the taxpayer to petition the United States Tax Court to challenge the asserted tax and to do so before paying the tax.

If the taxpayer chooses not to file a Tax Court petition in response to a notice of deficiency, then the IRS may assess and seek to collect the tax. In that case (or if the taxpayer otherwise pays the tax before receiving a notice of deficiency), the taxpayer may not seek judicial review of the tax assessment without first paying the tax in full and seeking a refund. This requires that the taxpayer first file a claim for refund with the IRS. If the IRS does not respond to the claim for refund within six months or if it denies the claim for refund, then the taxpayer may file a

lawsuit seeking a refund in a federal district court or the United States Court of Federal Claims. The taxpayer may not file a refund suit in the Tax Court, although the Tax Court is empowered to order a refund for a period over which it possesses deficiency jurisdiction.

There are different, specialised procedures for partnerships and for taxpayers who have otherwise sought protection from the bankruptcy courts. There are also separate procedures for other, more specialised kinds of cases, including those involving collection and interest abatement.

4.2 Procedure of Judicial Tax Litigation

Whether in the Tax Court or a refund forum, tax litigation involves a pretrial discovery and motion phase, a trial phase, and a post-trial briefing and decision phase.

The Tax Court requires informal discovery and emphasises a stipulation process in which the parties agree to everything relevant and not in dispute. Discovery in the refund forums tends to be formal, and stipulations are less common.

Tax Court proceedings are held before a Tax Court judge, who, if the matter proceeds to trial, will issue an opinion after the post-trial briefing. In most cases, a process follows the opinion in which the parties submit agreed or unagreed computations to the Court so that a final tax liability for the years at issue may be determined. The Tax Court then issues a decision that reflects the amount of additional tax owed, if any. The Tax Court will not consider new issues during this computational-phase. The "decision" is the final, appealable judgment of the Tax Court.

In refund forums, court proceedings may be tried to a jury (in federal district courts only) or to a judge. If the matter is tried to a judge, the court will issue an opinion that reflects the court's fac-

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

tual and legal conclusions. If the court orders a refund, then the court might seek the parties' input into the tax and interest computations by requiring status reports or a joint motion for entry of final judgment. A case is concluded by the entry of a final "judgment" reflecting the outcome, which is the final, appealable determination by the court.

4.3 Relevance of Evidence in Judicial Tax Litigation

Documentary and witness evidence are relevant in practically all civil tax litigation. A taxpayer must produce documents in response to discovery requests regardless of whether those documents were produced during the underlying audit. The IRS and the US Department of Justice (DOJ) may also subpoena documents (or witnesses) in connection with a deposition or trial.

Fact and expert witness depositions are available in the Tax Court and the refund forums, although depositions are less common in the Tax Court.

Direct and cross-examination of fact and expert witnesses are common in all civil tax litigation.

Expert witness reports are common in larger tax litigation. In the Tax Court, the parties exchange expert witness reports and submit them to the Court prior to trial. At trial, the Tax Court will admit the expert reports into evidence, and those reports will serve as the experts' direct testimony. The Tax Court will sometimes allow limited additional direct testimony by experts. In refund forums, the courts typically do not admit expert reports into evidence, and experts provide direct testimony that summarises their expert opinions. Experts' reports in those forums are used mostly for illustrative purposes only.

4.4 Burden of Proof in Judicial Tax Litigation

The taxpayer bears the burden of proof in all civil tax litigation unless exceptional circumstances apply (eg, the IRS alleges fraud or raises a new issue not raised in the pleadings). The USA always bears the burden of proof in criminal tax cases.

4.5 Strategic Options in Judicial Tax Litigation

As noted in **4.1 Initiation of Judicial Tax Litigation**, a taxpayer may generally choose whether to contest the tax in Tax Court, before payment, or in a refund forum (a federal district court or the United States Court of Federal Claims), after payment as well as the filing of an unsuccessful administrative refund claim. Choosing which forum and which approach is an important strategic decision for a taxpayer deciding to challenge its dispute in judicial tax litigation.

There are a variety of other factors that may influence a taxpayer's choice of whether to litigate in the Tax Court or a refund forum. Those factors include the applicable judicial precedent in the relevant forum, which could differ, timing to the commencement of litigation, and, of course, whether it is able to pay the tax before commencing litigation. A taxpayer has far more control over when to initiate refund litigation than it does Tax Court litigation. If a taxpayer has not pursued an administrative appeal before the IRS, then the taxpayer would also want to consider whether to pursue an administrative appeal after docketing the case in court. Such a route is possible in the Tax Court but not in the refund forums. There are various other factors to consider, including the judges and government lawyers in the different forums and differences in the different forums' procedural rules.

All taxpayers will have to consider these and other common strategic options regardless

of whether they choose to litigate in the Tax Court or a refund forum. These options include whether to file pretrial motions to try to dispose of some or all of the case, whether to offer expert testimony, and whether and when to initiate settlement discussions.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation

As a common law jurisdiction, jurisprudence is always relevant in tax litigation in the USA, although its effect differs depending on the type of jurisprudence. The Tax Court is bound by its own precedent and that of the appellate court to which the decision in the case would be appealed. The Tax Court is not bound by the jurisprudence of the refund forums but would look to such jurisprudence and could adopt the reasoning if the Tax Court finds it persuasive. Like the Tax Court, the refund forums are bound by the precedent of the appellate court to which the decision in the case would be appealed. They are not bound by the Tax Court's jurisprudence or that of the other refund forums but tend to look to it for guidance.

In international tax cases, the courts would also look to double-tax treaties and international guidelines to the extent relevant. Treaties have the force and effect of law and are binding on the courts. Guidelines such as the OECD Transfer Pricing Guidelines do not bind the courts, which would instead look to the US transfer pricing regulations. But the parties can and do reference the OECD Transfer Pricing Guidelines, and the courts will consider them for guidance and persuasiveness. The same is true of foreign court opinions.

Academic opinions and articles never bind the US courts, although parties often do (and should) cite them if relevant and helpful. Courts often look to such materials for guidance and cite them in opinions.

5. JUDICIAL LITIGATION: APPEALS

5.1 System for Appealing Judicial Tax Litigation

Appeals from opinions of the Tax Court, a federal district court, or the Court of Federal Claims are first made to one of 13 Circuit Courts of Appeal located across the USA. These appeals can typically be made as a matter of right. A further appeal from an opinion of one of the Circuit Courts can be made to the United States Supreme Court. However, the Supreme Court does not have to accept such an appeal and, as a practical matter, rarely grants appeals in tax cases. Whether the Supreme Court accepts an appeal depends on various factors – such as whether Circuit Courts disagree about the issue being appealed and the degree to which the question is one of public importance.

Appeals from the Court of Federal Claims are made to the United States Court of Appeals for the Federal Circuit. Generally, appeals from Tax Court decisions are made to the Circuit Court for the circuit in which the taxpayer has its principal place of business or principal office or agency (or if the taxpayer is not a corporation, where the taxpayer's legal residence is located). An appeal from a district court decision is generally made to the Circuit Court covering the district where the district court is located. As noted above, any further appeal is made to the Supreme Court.

5.2 Stages in the Tax Appeal Procedure

The stages in a tax appeal procedure are generally like the process for appealing other types of cases. First, there are deadlines within which a party must file a notice of appeal (typically 60 days after the entry of judgment in district court and Court of Federal Claims cases, and 90 days after the entry of decision in Tax Court cases).

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

Second, once a case has been appealed to a Circuit Court, the Circuit Court generally issues a schedule with deadlines by which each party – the taxpayer and the government – must submit written briefs arguing the issues being appealed. Cases on appeal are generally decided by a panel of three judges. After the parties file their respective briefs, in some cases the three judges will hear oral argument from the parties. After briefing concludes and, if applicable, oral argument, the three judges will decide the issue on appeal. Generally, a Circuit Court will affirm the lower-court decision, reverse the lower-court decision, or send the case back (remand) to the lower court to decide additional factual or legal issues. On rare occasions, the decision of a three-judge panel will be formally reviewed en banc by all the full-time judges of the Circuit Court.

Finally, a party can generally request a further appeal to the Supreme Court within 90 days after entry of a judgment in the Circuit Court. The primary means to petition the Supreme Court for review is to ask it to grant a writ of certiorari. This is a request that the Supreme Court order a lower court to send up the record of the case for review. The Court usually is not under any obligation to hear these cases, and it usually only does so if the case could have national significance, might harmonise conflicting decisions in the federal Circuit Courts, and/or could have precedential value. In fact, the Court accepts only 100–150 of the more than 7,000 cases that it is asked to review each year. If the Supreme Court accepts the appeal, the parties submit written briefs arguing the issues being appealed. The Supreme Court also commonly, but not always, hears oral argument.

5.3 Judges and Decisions in Tax Appeals

As noted in **5.2 Stages in the Tax Appeal Procedure**, appeals to a Circuit Court are typical-

ly decided by a panel of three judges. Circuit Courts hear all types of cases and do not specialise in tax law. The total number of judges for each Circuit Court varies. Generally, while most Circuit Courts have more than ten judges, some have more than 25 judges. In rare cases, after the decision of a three-judge panel, an appeal might be further heard by all a Circuit Court's full-time judges – a so-called en banc review.

The Supreme Court has nine justices. Generally, all nine participate in cases in which the Supreme Court grants an appeal.

All Circuit Court judges, and Supreme Court justices have life tenure. They are appointed by the president of the USA and approved by the United States Congress.

Notably, unlike judges on the Tax Court, most Circuit Court judges, and Supreme Court justices are not necessarily experts in tax law. Their legal backgrounds and expertise are often in another subject matter.

6. ALTERNATIVE DISPUTE RESOLUTION (ADR) MECHANISMS

6.1 Mechanisms for Tax-Related ADR in this Jurisdiction

Traditional IRS Appeals

The principal ADR mechanism for federal taxes in the USA is an administrative appeal to IRS Appeals, which is the arm of the IRS responsible for resolving tax controversies without litigation on a basis that is fair and impartial to both the government and the taxpayer. A taxpayer that disagrees with adjustments proposed by the IRS Examination team has the option, but is not required, to pursue an administrative appeal to IRS Appeals. Ordinarily, a taxpayer must request an appeal and lodge a formal protest within 30

days of receiving a “30-day letter” and the final examination report. An extension of up to 30 days may be requested and is often granted. In many cases IRS Examination prepares a rebuttal to the protest, after which the case is transferred to IRS Appeals for settlement negotiations.

Special ADR Programmes

ADR mechanisms exist to involve administrative tax appeals at different points in the process to facilitate a negotiated resolution. Under the Fast-Track Settlement (FTS) programme, the taxpayer and IRS examiners may mediate a dispute before an IRS Appeals officer while the case remains under IRS Examination jurisdiction. The Early Referral programme allows large corporate taxpayers to ask the IRS Examination team to refer disputed but fully developed issues to IRS Appeals while the audit team continues to work on other issues.

The Rapid Appeals Process (RAP) is an ADR procedure in which IRS Appeals can bring the IRS Examination team and a large business taxpayer together early in the appeals phase to attempt to resolve an issue and thereby shorten the normal IRS Appeals timeline. Finally, if IRS Appeals and the taxpayer cannot reach a settlement, Post-Appeals Mediation (PAM) is available for many types of cases and may be used as a “last shot” to avoid litigation.

Court ADR Procedures

Once in the judicial phase, taxpayers and the IRS can pursue ADR mechanisms in the same way as any other civil litigants. Most courts have rules that allow the parties to engage in court-supervised arbitration or mediation, and many courts require the parties to engage in a mediation procedure before trial.

6.2 Settlement of Tax Disputes by Means of ADR

Traditional IRS Appeals

In a typical administrative appeal, an IRS Appeals officer reviews the parties’ written submissions and, after a “preconference” in which the IRS Examination team presents its position in support of the proposed adjustments, holds one or more conferences with taxpayer representatives in an attempt to settle the case. Appeals officers are expected to act independently from IRS Examination and in a quasi-judicial manner. Appeals conferences are informal to promote frank discussion and mutual understanding. After considering the parties’ positions, IRS Appeals officers may reject either party’s position entirely or propose a settlement based on their assessment of the hazards of litigation.

Special ADR Programmes

In an FTS proceeding, an IRS Appeals officer acts as a mediator and helps the parties resolve factual or legal issues but cannot compel a settlement. If agreement is reached, IRS Appeals will exercise its settlement authority and effect the settlement. If no agreement is reached, the taxpayer may later protest the Fast-Track issues to IRS Appeals via traditional administrative appeal procedures. In an Early Referral case, IRS Appeals can exercise its settlement authority to settle the Early Referral issue. Unresolved issues are returned to IRS Examination. If the case is later protested, those issues will not be reconsidered by IRS Appeals. In the RAP, the IRS Appeals officer serves as a mediator and uses their settlement authority to effect any settlement reached. In a PAM, a different IRS Appeals officer acts as a mediator between the taxpayer and the original IRS Appeals officer. In addition, the taxpayer may elect to involve a private co-mediator at its own expense. The mediation is non-binding. If agreement is reached, IRS Appeals will use its authority to effectuate

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

the settlement. If agreement is not reached, the taxpayer may pursue litigation alternatives.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

A settlement reached with IRS Appeals under any of the ADR procedures described in **6.1 Mechanisms for Tax-Related ADR in this Jurisdiction** may be used to reduce the amount of taxes or penalties asserted by IRS Examination and any related interest charges.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

A taxpayer may seek guidance on the proper tax treatment for a particular item in the form of a pre-filing agreement (PFA) between the IRS and the taxpayer or by requesting a private letter ruling (PLR) or technical advice memorandum (TAM) from the IRS National Office.

The PFA programme allows a taxpayer to request consideration of an issue before the tax return is filed and thus resolve potential disputes and controversy earlier in the examination process. PFAs can cover the current and up to four future tax years, but the transaction must be complete.

PFAs may also be used to determine the appropriate methodology for determining tax consequences affecting future tax years and are available for international issues. PFAs require a USD181,500 user fee and typically take more than a year to complete.

Before filing a tax return, a taxpayer may seek a PLR applying federal tax law to the taxpayer's facts. A PLR binds both the IRS and the requesting taxpayer but may not be relied on as precedent by other taxpayers. A TAM is like a PLR, but it deals with a completed transaction rather than a proposed transaction and is typically obtained during the course of an IRS examination.

In appropriate cases, PFAs, PLRs, and TAMs can be effective devices to remove uncertainty concerning the application of federal tax law to a significant transaction. However, advance rulings are expensive, time-consuming, and not advisable in all cases, such as where the law is relatively clear, time is of the essence, or there is a significant risk of an adverse ruling.

6.5 Further Particulars Concerning Tax ADR Mechanisms

With very limited exceptions, the IRS Appeals has jurisdiction over all types of tax claims regardless of the amount involved. However, IRS Appeals may refer a case back to IRS Examination where a new issue is raised, or additional fact-finding is required to resolve the case. In addition, in exceptional cases the IRS National Office can preclude IRS Appeals review by designating a case for litigation where it involves significant issues affecting many taxpayers or determining that IRS Appeals consideration is inconsistent with sound tax administration. Such a determination is not subject to judicial review.

There is no deadline for a decision by IRS Appeals. However, if the expiration of the statute of limitations on assessment becomes imminent and no statute extension can be obtained from the taxpayer, IRS Appeals will terminate the appeal and issue a statutory notice of deficiency.

In large cases, the issues may be divided among a team of Appeals officers, some of whom may be specialists such as engineers, economists, appraisers, or subject-matter experts. The team will be led by an Appeals Team Case Leader (ATCL), who has ultimate settlement authority.

Appeals officers are expected to resolve issues with strict impartiality as between the taxpayer and the government and consistently as between similarly situated taxpayers. IRS Appeals settles cases based solely on the hazards of litigation,

considering existing legal precedent and the taxpayer's particular facts, and does not take considerations of equity or public policy into account.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

The ADR mechanisms are available to settle disputes arising under transfer pricing cases. Alternatively, where a transaction may result in double taxation in the USA and another country, and those countries have entered into a tax treaty containing a Mutual Agreement Procedure (MAP), the taxpayer may invoke its rights under that treaty to seek the assistance of the US competent authority (or foreign competent authority in some treaties) to alleviate that double taxation. If the MAP does not produce an acceptable resolution, the taxpayer may pursue all available domestic remedies, including the ADR mechanisms described throughout **6. Alternative Dispute Resolution (ADR) Mechanisms**. IRS Appeals has jurisdiction over certain types of indirect excise taxes assessable by the IRS.

7. ADMINISTRATIVE AND CRIMINAL TAX OFFENCES

7.1 Interaction of Tax Assessments with Tax Infringements

Most taxpayer disagreements with the IRS do not rise to the level of criminal offences. When the IRS believes that a taxpayer has particularly poor support for the positions taken on a tax return or has understated its taxable income by significant amounts, the primary tools the IRS uses to deter this behaviour are civil penalties for negligent filing of tax returns or for substantially understating taxable income. Even when the behaviour is particularly extreme, the IRS will primarily use civil penalties (up to 40% of the underpayment of tax, for example) to "punish" the taxpayer. If a taxpayer is alleged to have

committed civil fraud by, for example, grossly overstating a deduction, then the statute of limitations for the IRS to assess the penalty remains open indefinitely. While the US tax system does not technically have a general anti-abuse rule (GAAR) or a specific anti-avoidance rule (SAAR), it does have anti-abuse provisions that oblige a taxpayer not to engage in "abusive" tax avoidance behaviour, and civil penalties are used accordingly.

Taxpayers will find themselves subject to criminal investigations and fines and potential imprisonment, however, for the most egregious conduct and for the wilful failure to pay tax. Wilful failures to report the right amount of taxable income, fraudulent tax returns, and obstruction of an IRS investigation are the types of conduct that lead the IRS to refer matters to its Criminal Investigation Division (CID). The CID will initiate matters in a number of ways: a referral from the IRS civil tax auditors; a referral from other governmental agencies; as a result of information provided by private citizens; or as part of a CID enforcement effort or initiative. The DOJ may initiate its own tax-related criminal investigation as well, seeking the assistance of the CID, which is the agency responsible for criminal tax investigations. Once a criminal investigation is "opened," civil tax investigations are often suspended, although parallel civil and criminal tax proceedings may occur.

7.2 Relationship between Administrative and Criminal Processes

As described in **7.1 Interaction of Tax Assessments with Tax Infringements**, some criminal tax matters arise as a referral from the IRS while conducting a civil tax examination; others arise independently. Once a criminal tax investigation has been started, the civil tax examination is often suspended. Upon the completion of the criminal tax investigation, the matter is often referred back to the IRS's civil tax examiners to

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

determine their own adjustments and impose their own penalties. If criminal charges are recommended, the case will be referred to the DOJ for potential prosecution. A taxpayer may, therefore, find itself subjected to both criminal charges and fines and civil tax penalties, in addition to an increased tax liability and interest.

7.3 Initiation of Administrative Processes and Criminal Cases

Once the CID determines that a case is appropriate to pursue, the matter is referred to the DOJ, Tax Division, which, along with the US Attorney's offices, is responsible for prosecuting the case. In civil tax proceedings, the taxpayer has the "burden" to show in federal court by a "preponderance of the evidence" that the IRS's position is wrong. In a criminal tax matter, however, the DOJ has the burden to show that the taxpayer is guilty "beyond a reasonable doubt." Also, unlike in civil tax matters, only federal district courts have jurisdiction over criminal cases, which may be decided by a judge or a jury. Criminal cases cannot be brought to or heard by the US Tax Court or the US Court of Federal Claims, which both conduct "bench" (judge) trials only.

7.4 Stages of Administrative Processes and Criminal Cases

Upon the matter being referred to the CID for investigation, the stages of the criminal tax process are generally as follows:

- initial investigation by the CID;
- special agent report (SAR), recommending criminal investigation;
- review by the special agent-in-charge (SAC) of the CID, who, if in agreement, refers the matter to the DOJ or the US Attorney's office;
- review by the DOJ and assignment to an Assistant US Attorney;
- referral to a grand jury to assist the Assistant US Attorney in its investigation and, if

appropriate, to approve indictments (criminal charges) against the taxpayer;

- once indictments are issued, the taxpayer is "arraigned" by a federal district court to explain to the taxpayer the charges being brought and to ask for its plea (guilty or not guilty);
- from this stage, the government and the taxpayer enter into plea bargaining negotiations and pretrial proceedings;
- if a plea bargain cannot be reached, then the taxpayer must proceed to trial, typically a jury trial;
- if found guilty, the taxpayer may be subject to fines, imprisonment, or both; and
- once a final judgment is rendered, the taxpayer or the government may appeal the decision to the federal appellate court with authority over the federal district court where the matter was tried – see discussion in **5. Judicial Litigation: Appeals**.

7.5 Possibility of Fine Reductions

A taxpayer's paying the asserted tax, penalties, and interest will not bar a criminal tax prosecution, particularly if the taxpayer makes the payment after an investigation has been commenced. A taxpayer's wilful failure to pay the right amount of tax in the first instance will be the determining factor. A taxpayer's co-operation, including its payment of the asserted additional taxes, interest, and penalties, will be relevant, however, to a court if it is deciding the ultimate penalty to impose, such as a fine or imprisonment, or both.

7.6 Possibility of Agreements to Prevent Trial

As discussed in **7.5 Possibility of Fine Reductions**, simply paying the amount owed, plus interest and penalties, does not necessarily protect someone from criminal prosecution. Plea agreements are very useful, however, as a way to negotiate a reduction in fines or the amount

of time in prison or even a waiver of prison time altogether. From the government's perspective, the ability to impose a hefty (and very public) fine with or without imprisonment may send the same enforcement message as a victory at trial and negates the risk of losing at trial. Likewise, if the taxpayer is able to negotiate a reduced sentence or fine, it too benefits, because it also avoids proceeding to trial, losing, and suffering an even greater penalty.

7.7 Appeals against Criminal Tax Decisions

Appeals from judgments in federal district court proceed in the same manner to federal appellate courts and the US Supreme Court, as described in **5. Judicial Litigation: Appeals**.

7.8 Rules Challenging Transactions and Operations in this Jurisdiction

While the wilful avoidance of tax can lead to a criminal tax investigation and charges, there have been few if any criminal tax cases brought against taxpayers who have had their tax returns challenged by the IRS or the DOJ under the anti-abuse or transfer pricing rules of the Internal Revenue Code. Promoters of overly aggressive "tax shelters," however, have been subjected to criminal tax charges for their roles in enticing taxpayers into engaging in transactions that are motivated solely by improper tax avoidance, rather than legally justifiable tax reduction.

8. CROSS-BORDER TAX DISPUTES

8.1 Mechanisms to Deal with Double Taxation

A United States taxpayer may pursue either a treaty mechanism or domestic litigation in a situation involving potential double taxation. The treaty mechanism is often the more prudent path, however, if avoiding double taxation is the

primary goal. This is because, when faced with a United States federal court's final determination of the taxpayer's United States federal tax liability, the United States competent authority will entertain only a request for correlative relief from a foreign competent authority and will not otherwise endeavour to reduce or eliminate double taxation.

In circumstances not involving a final court determination, a taxpayer has more options. A taxpayer can seek assistance from the United States competent authority. Such assistance can take the form of a Mutual Agreement Procedure (MAP) request, or a unilateral, bilateral, or multilateral advance pricing agreement, depending on whether one taxing authority has already stated a claim that may give rise to double taxation and further depending on the transaction(s), affected jurisdiction(s), and treaty(ies) at issue.

Certain of the USA's bilateral income tax treaties also provide for mandatory arbitration if the competent authorities do not resolve double taxation issues within a specified period of time.

The USA has not signed the MLI and is not an EU member state governed by the EU Tax Disputes Directive.

8.2 Application of GAAR/SAAR to Cross-Border Situations

The USA does not have a general anti-avoidance rule (GAAR) that applies to cross-border situations or generally in tax cases. Although the USA's tax treaties do not contain a GAAR, they typically contain multiple specific anti-avoidance rules (SAARs) (ie, beneficial ownership, limitation on benefits, and limitation on residents).

While the USA does not have a GAAR per se, courts in the USA have developed multiple doctrines over decades to address abusive tax transactions. Chief among those doctrines is the

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

economic substance doctrine, which is often the most important factor in applying a GAAR for countries that have one. The United States Congress codified the economic substance doctrine in 2010, and one could view that doctrine as the closest United States analogue to a GAAR.

Some statutes and regulations in the USA have specific anti-abuse or anti-avoidance provisions.

As noted in **8.1 Mechanisms to Deal with Double Taxation**, the USA has not signed the MLI.

8.3 Challenges to International Transfer Pricing Adjustments

In the USA, many international transfer pricing adjustments have been challenged by invoking the mutual agreement procedure in the applicable treaty. Some important transfer pricing disputes have been challenged in the domestic courts, primarily the United States Tax Court.

8.4 Unilateral/Bilateral Advance Pricing Agreements

APAs are somewhat common and have become more so recently. In 2021, taxpayers submitted a total of 145 APA applications. Of these, 16 were unilateral, 121 were bilateral, and eight were multilateral.

In certain instances, taxpayers are required (or encouraged) to submit a pre-filing memorandum to the Advance Pricing and Mutual Agreement (APMA) programme before submitting their request for an APA. Generally, pre-filing memoranda contain material relevant to a potential APA request. Similarly, taxpayers are sometimes required (or encouraged) to meet with representatives of the APMA programme before submitting an APA request. The meeting also covers information and topics relevant to a potential APA request including, if applicable, a discussion of a taxpayer's pre-filing memorandum.

Taxpayers who meet certain requirements initiate the APA process by submitting a request for an APA and paying a user fee. A taxpayer's APA request contains a host of specified information relevant to the covered transaction(s) at issue and the taxpayer. After the request is submitted, the APMA programme contacts the submitting taxpayer with notification as to whether the request for an APA has been accepted, or for any additional required information. Once a taxpayer's request for an APA is complete, in most cases APMA representatives will hold an opening conference with the taxpayer. The opening conference generally entails a dialogue between the taxpayer and APMA representatives about questions and information relevant to the taxpayer's APA request. With respect to requests for bilateral or multilateral APAs, APMA representatives will consider requests from, and may invite or require, the taxpayer to provide joint presentations to APMA representatives and those of the foreign competent authority(ies). The APMA representatives will also consult as needed with any foreign competent authorities and generally keep taxpayers informed of the progress of negotiations.

If the terms of an APA are ultimately agreed upon, the APA becomes effective when executed by the taxpayer and the IRS. Thereafter, the taxpayer and the IRS take certain steps to monitor compliance with the APA. In very rare instances, the IRS might revoke or cancel an APA after its execution.

8.5 Litigation Relating to Cross-Border Situations

Transfer pricing has generated more substantial litigation in the USA over the past decade than any other cross-border issue. That trend continues. The recent lowering of the US corporate income tax rate, inclusion of a minimum tax, and adoption of provisions designed to incentivise "onshoring" of intellectual property could even-

tually mitigate transfer-pricing litigation, but that remains to be seen. Indeed, the number of transfer pricing disputes that continue to be litigated or otherwise pursued in various forums pre-litigation suggests that cases are not decreasing any time soon.

In addition, the ability of US taxpayers to “credit” their foreign taxes paid against their US tax liability is an area that is becoming more contentious as recent US statutory and regulatory changes have made the ability to seek “foreign tax credits” more difficult. The effect of this may lead to more disputes in the foreign jurisdictions so that the US taxpayers can show that they have “exhausted their remedies” (a prerequisite to the tax credit) and, likewise, more disputes and litigation in the US as taxpayers defend their credits against the IRS’s additional scrutiny.

9. STATE AID DISPUTES

9.1 State Aid Disputes Involving Taxes

No information is available in this jurisdiction.

9.2 Procedures Used to Recover Unlawful/Incompatible Fiscal State Aid

No information is available in this jurisdiction.

9.3 Challenges by Taxpayers

No information is available in this jurisdiction.

9.4 Refunds Invoking Extra-Contractual Civil Liability

No information is available in this jurisdiction.

10. INTERNATIONAL TAX ARBITRATION OPTIONS AND PROCEDURES

10.1 Application of Part VI of the Multilateral Instrument (MLI) to Covered Tax Agreements (CTAs)

Over 100 jurisdictions participated in negotiations on the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Although nearly 100 jurisdictions have signed onto the MLI to date, the USA has not.

In the USA, the 2016 US Model Income Tax Convention now includes binding arbitration provisions that supplement MAPs. However, only a handful of US income tax treaties provide for mandatory binding arbitration. These provisions are applicable when the competent authorities have been unable to reach a complete agreement. Such arbitration clauses are included in the US income tax treaties with Belgium, Canada, France, Germany, Japan, Spain, and Switzerland.

10.2 Types of Matters that Can Be Submitted to Arbitration

Generally, for those US tax treaties that contain such a provision, the binding arbitration clause applies to situations where an agreement cannot be reached under a MAP. For binding arbitration to apply, generally, two years must have passed since a MAP was commenced and:

- the taxpayer must have filed tax returns with at least one of the contracting states;
- the case must involve the application of one or more articles of the income tax treaty;
- the competent authorities must agree that the case is suitable for determination by arbitration; and
- the taxpayer must agree to the release of their information to the arbitrators and agree

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

to agree to treat the arbitration process as confidential.

Most of the bilateral treaties that include arbitration clauses also allow, typically through the memoranda of understanding or other similar implementing documentation, for APAs to be submitted for binding arbitration in certain circumstances. This expansion applies to the bilateral treaties with Canada, Belgium, Switzerland, Japan, and Germany.

10.3 Application of the Baseball Arbitration or the Independent Opinion Procedure

In the USA, cases are resolved by an arbitration board comprised of three members: each competent authority selects a single member, and those members select a chair from a list of candidates agreed upon by the competent authorities.

Generally, each competent authority must submit a proposed resolution with accompanying supporting papers. A so-called “baseball-style” approach means that the arbitration panel may not propose alternative resolution or forge a compromise; instead, the arbitration panel must then select one of the two proposed resolutions for each issue and inform both competent authorities of its determination.

10.4 Implementation of the EU Directive on Arbitration

The USA is not an EU member state and did not execute the MLI.

Beginning in 2013, the OECD and G20 countries have been working to close gaps in international tax rules that allowed for perceived opportunities for BEPS. Over the last few years, the OECD has developed two pillars that have proposed major changes to existing profit allocation and nexus rules and a global minimum tax rule.

To implement these pillars, the OECD is considering the creation of a new multilateral convention. Unlike the MLI, this new multilateral convention would apply between jurisdictions that do not currently have a bilateral treaty, supersede the relevant provisions of existing treaties concluded to eliminate double taxation, and contain all the international rules needed to implement the two pillars. The OECD has also proposed a vast dispute resolution mechanism, which would potentially include mandatory binding dispute resolution mechanisms that the new multilateral convention would likely incorporate.

10.5 Existing Use of Recent International and EU Legal Instruments

The USA has not signed the MLI or any EU legal instruments. And, as discussed in **10.7 Publication of Decisions**, because of the confidential nature of the decisions by an arbitration panel under US income tax treaties, any details about specific cases initiated or concluded are not released to the public and the USA does not publish any official data regarding the use of binding arbitration.

10.6 New Procedures for New Developments under Pillar One and Two

In the USA, current proposed tax legislation has been in favour of adopting Pillars One and Two in whole or in part. The legislation has not yet passed into law, however, and there remain many questions as to what the final tax legislation will look like, if it is enacted at all, during 2022. To date, few expect that the enactment of tax legislation that reflects or is consistent with Pillars One and Two will mitigate controversies for the foreseeable future. If anything, it may increase them as taxpayers and the IRS determine what the implementation of such legislation will mean.

10.7 Publication of Decisions

Generally, all information provided to, and all information received from the arbitration panel

must remain confidential. Thus, the competent authorities must agree not to disclose any information relating to the panel, including the arbitration panel's determination, except in certain circumstances. Moreover, because the determinations are not binding, the arbitration panel does not always provide an explanation or analysis of the issues but only provides limited information necessary to implement the determination.

10.8 Most Common Legal Instruments to Settle Tax Disputes

Because the USA has not signed the MLI or any EU legal instruments, the most common legal instrument used are the US income tax treaties that include binding arbitration provisions.

10.9 Involvements of Lawyers, Barristers and Practitioners in International Tax Arbitration to Settle Tax Disputes

Generally, for US income tax treaties that contain an arbitration clause, the competent authorities deal directly with a three-member arbitration panel. Taxpayers or their representatives are not then involved.

11. COSTS/FEEES

11.1 Costs/Fees Relating to Administrative Litigation

There is no "administrative litigation" in the USA, as all litigation is judicial. There is, however, an administrative appeals process before the IRS, as described in **3.1 Administrative Claims Phase**. There are no filing fees for pursuing an administrative appeal with IRS Appeals. The costs of an administrative appeal depend on whether the taxpayer hires advisers, how extensive the issues are, and how long the process lasts.

11.2 Judicial Court Fees

There are small fees required to initiate litigation in the Tax Court and the refund forums. The taxpayer pays the fee. A low-income taxpayer can seek a filing-fee waiver. There is also a small filing fee for filing a judicial appeal. The taxpayer must pay the filing fee if initiating the appeal. The fee for initiating an appeal is paid to the trial court with which the notice of appeal is filed. The government is generally exempt from fees and does not have to pay a filing fee if it initiates an appeal.

In limited instances, a taxpayer that prevails against the government can seek an award of litigation fees (including attorneys' fees). Various limitations restrict the taxpayers eligible for such relief.

11.3 Indemnities

The IRS is not required to indemnify a taxpayer if the IRS's position is ultimately rejected in an administrative or judicial proceeding. In limited circumstances, the taxpayer can seek to recover from the IRS the costs and fees incurred by the taxpayer in contesting the IRS's adjustment. In refund proceedings, the taxpayer is entitled to statutory interest on the amount of tax it is determined to have overpaid.

11.4 Costs of ADR

There are large user fees associated with ADR-type programmes used to avoid litigation. An example is an advance pricing agreement, which is used to avoid transfer pricing disputes. The current user fee for filing a new advance pricing agreement request is USD113,500. The user fees for renewals and amendments are lower. For private letter rulings and pre-filing agreements, the current user fees are USD38,000 and USD181,500, respectively.

ADR is rare once a case is docketed in Tax Court. The Tax Court Rules provide for voluntary

Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon, Morgan, Lewis & Bockius LLP

binding arbitration or non-voluntary mediation. Those procedures are rarely used, and the fees are not set forth in a rule. If the parties pursue ADR, the Tax Court would presumably address fees and who pays them in the order addressing the arbitration or mediation process. Mediation is common in the federal district courts. Local court rules often address payments for neutrals, which differ among courts. The Court of Federal Claims has flexible procedures that allow for various types of ADR, some of which are at no cost to the parties.

12. STATISTICS

12.1 Pending Tax Court Cases

The United States Tax Court does not publish case statistics on its pending cases. Generally, as the only available prepayment forum, the Tax Court hears most tax cases, with 35,297 cases filed in 2021. In comparison, the United States district courts and the Court of Federal Claims hear far fewer tax cases. In 2020, taxpayers filed 319 new tax cases in the United States district courts, and in 2020 74 new tax cases were filed in the United States Court of Federal Claims.

12.2 Cases Relating to Different Taxes

There is no reliable data regarding the number of cases initiated and terminated each year relating to different taxes.

12.3 Parties Succeeding in Litigation

There is no reliable data available regarding the party (tax authority or taxpayer) that succeeds in litigation.

13. STRATEGIES

13.1 Strategic Guidelines in Tax Controversies

Taxpayers should fully develop their tax positions before filing their returns and be prepared for IRS review before the audit begins. This includes investigating the relevant facts, gathering appropriate substantiation, analysing applicable legal authorities, memorialising such analysis, and preserving material information. Ideally tax personnel will be integrated into the overall operation, leverage available technological and digital tools, and monitor relevant judicial, legislative, regulatory and tax administration developments.

During the audit, taxpayers should be prepared and proactive, take care in responding to information and document requests, preserve applicable privileges, communicate their tax positions clearly and in the strongest possible light, and involve outside advisors and experts early enough in the process to minimise the risk of a protracted dispute. Taxpayers should attempt to resolve the issue during the audit, if possible.

If a satisfactory resolution is not possible at the examination level, taxpayers should carefully consider the available administrative and judicial dispute-resolution procedures and pursue those most appropriate for their issues to maximise their ability to obtain a favourable result.

*Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon,
Morgan, Lewis & Bockius LLP*

Morgan, Lewis & Bockius LLP is a global law firm with approximately 2,200 legal professionals in 31 offices across North America, Europe, Asia, and the Middle East. The firm's global tax practice includes more than 80 practitioners and represents clients in all phases of tax-related planning, transactional, controversy, and litigation matters. It represents clients on their most significant and complex matters, in every major industry, and across virtually all major substantive tax areas; those clients include a

number of the world's largest companies. The tax practice includes a former Chief Counsel of the Internal Revenue Service (IRS), a former Legislation Counsel for the US Congress's Joint Committee on Taxation, a former Tax Legislative Counsel for the US Department of the Treasury, and many other lawyers who have held positions at the IRS, at Treasury, in the Justice Department's Tax Division, at the United States Tax Court, and on Capitol Hill.

AUTHORS



Thomas V. Linguanti

specialises in complex tax controversies and tax litigation. Tom assists both companies and individuals in determining the appropriate strategy in

disputes with the US Internal Revenue Service (IRS), and other international taxing authorities, during audit, alternative dispute resolution proceedings, and trial and appellate litigation. He began his 30-year tax litigation career as a trial and appellate attorney in the Tax Division of the US Department of Justice. Tom is a frequent speaker on federal tax controversies and negotiation strategies and serves as a teaching faculty member of the National Institute for Trial Advocacy (NITA).



Alex E. Sadler

represents clients in complex tax controversies and litigation. He has litigated numerous tax cases in the US Tax Court, the US Court of Federal Claims, and

federal district and appellate courts. A focus of Alex's practice is the research and development (R&D) tax credit. He has litigated several R&D cases and helped clients resolve issues with the IRS without litigation. Alex is the author of a guide on research tax credit and frequently speaks on this topic. He has also served as chair and vice-chair of the DC Bar's Tax Audits and Litigation Committee.

*Contributed by: Thomas V. Linguanti, Alex E. Sadler, Jennifer E. Breen and Sheri A. Dillon,
Morgan, Lewis & Bockius LLP*



Jennifer E. Breen represents clients in tax controversy and planning matters, with an emphasis on audits and controversies and Internal Revenue Service (IRS)

administrative proceedings. Jennifer routinely handles matters involving US federal income tax, foreign tax, state and local corporate and business tax, and sales and use tax. She has experience representing major corporations, partnerships, S corporations, and individuals in resolving domestic and international compliance and controversy issues before the IRS.



Sheri A. Dillon represents clients in federal tax controversy matters, guiding clients through IRS examinations and appeals, the administrative claims process, and litigation. Sheri

also counsels clients on a variety of business and tax-planning matters that involve acquisitions, dispositions, combinations, and debt restructuring and reorganisations, with a special focus on partnership transactions and closely held businesses.

Morgan, Lewis & Bockius LLP

1111 Pennsylvania Ave. NW
Washington
DC 20004-2541
USA

Tel: +1 312 324 1486
Fax: +1 312 324 1001
Email: thomas.linguanti@morganlewis.com
Web: www.morganlewis.com

Morgan Lewis

Trends and Developments

Contributed by:

Brian Kittle, Joel Williamson, Anthony Pastore and Samantha Bear

Mayer Brown LLP see p.709

Introduction

In 2022, we foresee several trends and developments that will converge to substantially impact tax controversies in the United States. The COVID-19 pandemic will likely continue to change how US taxpayers, the Internal Revenue Service (IRS), and courts approach tax controversies. Modest increases to the IRS's funding – as well as a new “issue-focused” approach – facilitate a more aggressive agency that is increasingly focused on enforcement, especially for corporate taxpayers. And more multilateral, international engagement continues to enhance the ability of the IRS to co-ordinate with foreign taxing authorities, increasing global pressure on US companies.

Increased Enforcement and the IRS's Issue-Focused Approach

In 2015, the IRS Commissioner stated that the agency planned to do “less with less”. Plagued by years of budget cuts and hiring freezes, the IRS was struggling to maintain the same level of enforcement activity that it had maintained previously. The ensuing years were no different: the IRS has spent nearly a decade searching for strategies to make do with its limited resources.

Recently, that trend has begun to reverse itself. Taxpayers are seeing a more aggressive IRS that is increasingly focused on enforcement. The IRS's expenditure has started drifting back up after years of steady declines. Hiring is also trending upward. For example, in January 2022, the IRS announced that it would hire 200 experienced attorneys to focus on tax deals that it claims are “abusive”, including syndicated con-

servation easement transactions and micro-captive insurance arrangements.

Even so, the IRS learned some lessons during the “less-with-less” era that it will likely carry with it going forward. Among those lessons is that the IRS should focus its enforcement activity on “issues”, rather than taxpayers.

An example of the IRS's issue-focused approach is the enforcement “campaign”. Traditionally, the IRS initiated audits by selecting particular taxpayers for examination. But in an era of reduced resources, the IRS's Large Business & International Division (LB&I) started selecting a tax issue for audit, rather than auditing every potential issue on a taxpayer's return. In theory, these enforcement campaigns are supposed to help LB&I more efficiently target enforcement where it matters most for compliance.

Since the campaigns began in early 2017, the IRS has maintained a website that describes each active campaign in a short paragraph and, in some cases, provides a “treatment stream”. For example, the IRS kicked off a campaign dedicated to the 2017 Tax Cuts & Jobs Act, the goal of which “is to identify transactions, restructuring and technical issues and better understand taxpayer behavior under the new law”. According to the IRS, “[t]he treatment streams for this campaign may include examinations, soft letters, outreach, new and improved practice units and development of future issue-based campaigns”. Little additional detail has been provided.

In practice, it has been unclear what effect, if any, campaigns have been having on tax enforce-

ment. In 2019, the IRS's watchdog concluded that the "campaign program as a whole has not met initial expectations". It also suggested that LB&I had not developed a well-reasoned process for selecting campaigns.

That said, the list of campaigns provides at least a glimpse into the IRS's enforcement priorities.

We can also glimpse the IRS's enforcement priorities in the agency's so-called "Priority Guidance". The stated goal of the guidance is to identify and prioritise tax issues that should be addressed through regulations and other administrative guidance. But we have seen the IRS focus enforcement on many of the very same topics. As an example, the guidance announces several regulatory projects on issues related to crypto and other virtual currencies, which the IRS has also aggressively pursued in audits and court cases.

The Biden administration has made it clear that it wants to increase enforcement on corporate taxpayers, and Congress has attempted to pump more resources into the IRS for enforcement. The administration's "Build Back Better" plan would have allocated eye-popping sums to the agency to ramp up audits. And while that legislation appears to be stalled, at least at the moment, the desire remains to increase IRS funding substantially.

Remote Audits and Court Proceedings

After a brief pause in the spring of 2020, the IRS resumed auditing taxpayers. Rather than a return to normal, though, the IRS has transitioned to performing audits remotely. Perhaps coincidentally – or perhaps due in part to cost and time savings – the transition to remote audits has been accompanied by a marked increase in auditing activity.

Before the pandemic, the IRS typically audited large corporate taxpayers in person. It was common for large companies to set aside dedicated office space for IRS examiners in their corporate offices. IRS examiners might request in-person interviews (or even depositions) of key company employees to carry out the audit. And, for certain issues, IRS examiners would make in-person "site visits" to manufacturing plants or other important company locations (this is especially true in transfer pricing, where the "value-add" of a manufacturing plant might be the crux of the issue in the case).

The transition to remote audits, necessitated by the coronavirus, has significantly impacted how the IRS and taxpayers approach audits. The biggest change of all may be interpersonal: it is far less common in the pandemic era for the taxpayer and the IRS agents to be in the same room together. Whether this phenomenon benefits taxpayers is an open question. Perhaps an impersonal audit experience where technology keeps the parties at a distance is preferable. Or, maybe the clearest communication occurs when everybody is in the same room, since large Zoom meetings often result in presentations, as opposed to an active exchange of positions and their respective merits. Most likely, it depends. This same transition to remote meetings, however, has undoubtedly improved the efficacy of the IRS's Advance Pricing & Mutual Agreement (APMA) Program – providing more comfort to taxpayers navigating the complicated cross-border tax landscape.

The logistics of a remote audit are also drastically different. Witness interviews are particularly challenging, because witnesses, taxpayers' counsel and representatives, and IRS questioners are usually in different locations, sometimes in different countries. Additionally, draft information document requests (IDRs) that typically would require an in-person conversation before

being finalised are now being discussed by phone. While this has had some positive effects, such as having more focused conversations, it has presented challenges too: it is more difficult to engage with the IRS about what information it is actually seeking, as the IRS has limited videoconferencing capabilities. Finally, a site visit might now be conducted remotely using a camera, with the IRS agents never setting foot in the company's plant or office.

In an effort to make remote auditing easier, the IRS has eased some of its rigid procedures, though the reality still poses challenges. Certain important forms (such as powers of attorney) can now be submitted online. And the IRS will continue to accept electronic signatures on forms that cannot be filed electronically at least through October 2023. The IRS will also continue its expansion of permissible methods to receive and transmit documents, allowing taxpayers the option to send documents to the IRS simply as email attachments.

Tax litigation has also gone – intermittently – virtual. Most tax disputes in the United States are litigated in the US Tax Court. In the past, trials were in person. After the pandemic began, though, the Tax Court announced that it would begin conducting trials and other proceedings by Zoom. The procedure forced taxpayers to either proceed remotely (with large disputes posing particularly burdensome logistical challenges) or delay trials until in-person trials resumed. Since then, the Tax Court has followed the larger trends regarding COVID restrictions; sometimes easing restrictions and holding in-person proceedings and sometimes returning to strictly virtual proceedings. It has viewed these virtual proceedings as a success, and it has signalled that it might seek to conduct trials virtually even after the pandemic ends, at least for disputes involving smaller-dollar issues. We have seen similar trends in other courts – such as federal

district courts and the Court of Federal Claims – where tax disputes are sometimes litigated.

Transfer Pricing Disputes

Whether true or not, the perception has been that the IRS has not fared well in major transfer pricing cases. In the past, the IRS would often assert an adjustment using a transfer pricing method based on profitability, such as the comparable profits method (CPM). In theory, the goal was to indirectly allocate income among controlled entities so that each entity's operating results are similarly profitable to similarly situated third parties, as opposed to allocating profits directly by reference to specific comparable transactions. But the IRS's CPM approach would often be too aggressive (usually by assigning an unreasonable share of the profits to the US headquarters, with almost nothing left for the foreign subsidiaries). It would not prevail because the discerning eye of the court viewed the functional analysis holistically to determine the true drivers of value.

Recently, however, the IRS's fortunes appear to have changed, with wins in the US Tax Court and in other courts. The IRS is likely to try to build upon its momentum by pursuing greater transfer pricing enforcement in 2022 and beyond.

Specifically, the IRS has stated that one of its priorities for 2021–22 is to issue regulations under Internal Revenue Code section 482, which address “passive association”: the incidental benefit, or “implicit support”, that an entity receives from lenders because of its association with other members under the same multinational umbrella. Whether the IRS issues proposed regulations (which are persuasive but non-binding), temporary regulations (which have the force of law), or fails to issue new regulations at all this year, multinational enterprises should expect more scrutiny of their transfer pricing allocations – and, perhaps, a departure from the traditional interpretation of the arm's-length

principle. Moreover, developing case law that challenges existing transfer pricing regulations may accelerate this departure.

Beyond the IRS, US states have also focused more attention on transfer pricing. Historically, states relied on their discretionary power to adjust income in transfer pricing disputes. But as more and more states have adopted section 482 or section 482-like statutes, state taxing authorities are more likely to challenge transactions using the arm's-length principle. And the State Intercompany Transactions Advisory Service Committee (relaunched by the Multistate Tax Commission after more than four years of inactivity), finalised an information exchange agreement which may facilitate, signalling more aggressive and co-ordinated enforcement.

Cross-Border Information Gathering and Sharing

US companies have always faced the prospect of burdensome information-gathering efforts by the IRS. Through IDRs, the IRS often requests hundreds, thousands, or even tens of thousands of documents from taxpayers under audit.

Increasingly, US companies have been confronting a new challenge: they are receiving similarly broad document requests from foreign taxing authorities. The United Kingdom and countries in Europe have been particularly aggressive. And taxing authorities worldwide have been ramping up their information gathering on US companies.

These requests come in one of two ways. The taxing authority could request documents directly, issuing the request either to the US parent or to the foreign subsidiary. Or the taxing authority could invoke the "exchange of information" provision in a bilateral tax treaty with the US. In that case, the IRS issues an IDR to the taxpayer on behalf of the taxing authority and has the power

to pursue the request as if it were itself auditing the taxpayer.

Either way, these requests are presenting US companies with unique challenges:

- **privilege** – US companies often withhold from the IRS some types of tax-planning documents on the basis of privileges, such as the attorney-client privilege, attorney work product doctrine, or tax practitioner privilege (section 7525), but with these foreign-initiated requests, US companies have been forced to wrestle with difficult choice-of-law questions when making privilege determinations;
- **data privacy** – US companies must consider burdensome data privacy rules in Europe and elsewhere when collecting, reviewing and producing foreign-based documents to the IRS (through the exchange of information process) or the foreign taxing authority; and
- **possession** – it is not always clear which entity in the corporate structure possesses the documents; for example, documents held by a foreign subsidiary might be subject to the request, whereas documents held by the US parent might not be.

Consistent with a global trend towards multilateralism, we are also seeing greater information sharing between the IRS and foreign taxing authorities. Bilateral tax treaties give the US and many foreign jurisdictions the power to share documents among themselves, even spontaneously. So when US companies produce documents to a foreign taxing authority, they must assume there is a substantial likelihood that the same documents will wind up in the hands of the IRS eventually.

Looking Forward

In our view, the biggest open question hanging over the rest of the year is whether the White House will secure any legislative changes to the

tax law. The administration's "Build Back Better" proposal would have marked a sea change in corporate taxation, leading to higher tax rates and – in all likelihood – more disputes. The legislation would also have pumped an enormous amount of additional money into the IRS for increased enforcement. At the time of writing, the prospects for that legislation look grim.

But at some point, the US will need to implement the substantial developments occurring at the OECD. For example, the OECD has set a global minimum tax which the administration has endorsed. As another example, the US will need to make changes to the rules on Global Intangible Low-Taxed Income (GILTI) to conform with the OECD's so-called GloBE Rules. So, there is some chance that we will see substantial tax legislation in the US in the upcoming year. US taxpayers would be well advised to stay abreast of any proposed legislative changes, as they will undoubtedly impact tax controversies.

Contributed by: Brian Kittle, Joel Williamson, Anthony Pastore and Samantha Bear, Mayer Brown LLP

Mayer Brown LLP is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes, with offices in the Americas, Europe and Asia. The firm's 100-plus tax lawyers are committed to delivering sound, creative and practical tax advice, representing clients at the global, national and local levels. Mayer Brown's deep experience allows it to effectively represent clients in a variety of situations, including during the

structuring of transactions, during tax audits and administrative appeals of audit results, in litigation of tax matters at the trial court and appellate court level, and in ongoing international tax matters such as transfer pricing. The firm's clients include many of the world's largest food, transportation, banking and financial, apparel, healthcare, industrial, pharmaceutical and technology companies, as well as high net worth individuals and high-value estates.

AUTHORS



Brian Kittle is co-head of Mayer Brown's Tax Controversy & Transfer Pricing practice, and has a deep track record of successfully resolving high-stakes and sophisticated tax

disputes. Brian achieved a rare Bench Opinion for Cross Refined Coal LLC and its partners, Fidelity Investments, Schneider Electric and AJ Gallagher, in the US Tax Court. He also secured a taxpayer victory for Eaton Corporation in the first case involving a court's consideration of an IRS decision to retroactively cancel an advance pricing agreement. Having clerked at the US Tax Court, he brings an insider's perspective to trial preparation and presentation. Brian frequently speaks on and authors articles about substantive and procedural tax issues.



Joel Williamson is co-leader of Mayer Brown's Tax Controversy & Transfer Pricing practice. He has litigated over 60 tax cases. His unprecedented experience includes the trial of seven major

IRC 482 transfer pricing cases. He successfully represented Eaton Corporation in the first case involving a court's consideration of an IRS decision to retroactively cancel an advance pricing agreement. Joel also represented Guidant LLC in a settlement with the IRS of key transfer pricing issues related to the development, manufacturing and sale of life-saving medical devices. Joel is a thought leader in the industry and frequently speaks on tax issues.

USA TRENDS AND DEVELOPMENTS

Contributed by: Brian Kittle, Joel Williamson, Anthony Pastore and Samantha Bear, Mayer Brown LLP



Anthony Pastore is an associate in Mayer Brown's Tax Controversy & Transfer Pricing practice. Anthony has represented corporate, partnership and individual

taxpayers in all stages of tax controversy, including examination, administrative appeal, litigation and trial. He has experience with transfer pricing allocations, debt-equity characterisation, valuations, accounting method changes, substance-over-form arguments, and penalties. Anthony focuses a significant portion of his practice on tax matters involving complex discovery, privilege and document production issues. As a complement to his controversy practice, Anthony counsels multinationals on the transfer pricing of related-party transactions. He is co-editor of Best Methods, Mayer Brown's blog on transfer pricing issues.



Samantha Bear is an associate in Mayer Brown's Chicago office and a member of the Tax Controversy & Transfer Pricing practice. She has a BA with honours from Brown University

and received her JD cum laude from University of Michigan Law School.

Mayer Brown LLP

1221 Avenue of the Americas
New York, NY 10020-1001
USA

Tel: +1 212 506 2187
Email: bkittle@mayerbrown.com
Web: www.mayerbrown.com

MAYER | BROWN



Chambers Guides to the Legal Profession

Chambers Directories are research-based, assessing law firms and individuals through thousands of interviews with clients and lawyers. The guides are objective and independent.