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Joint audits under the new DAC 7

Joachim Englisch (University of Muenster) and Nevia Cicin-Sain (Vienna University of Economics and Business) · Monday, March 22nd, 2021

*Nevia ?i?in-Šain and Joachim Englisch**

The sixth amendment of the Directive on administrative cooperation has just been adopted by Council, on 22 March. Earlier drafts of DAC 7 have received certain attention mostly for the new regime of documentation and reporting obligations imposed upon digital platforms. However, the new Directive also features numerous other important amendments, notably a clarification of 'foreseeable relevance' as a precondition for EoI, a new legal basis for EoI group requests, an extension of mandatory EoI to royalties, and a new legal framework for joint audits. In this contribution we focus on the latter development and we discuss some key clarifications and novelties to be found in the new Art. 12a DAC regarding joint audits.

Joint audits have received considerable institutional attention in recent years, especially on the part of the OECD and the European Union. Within the EU, some national governments have started a series of pilot projects with the support of the Fiscalis 2020 programme[1]. Participating taxpayers, their advisors and a growing number of contributions in literature have identified their potential for defusing double taxation disputes before they actually materialise. This notwithstanding, joint audits have still not arrived in the mainstream of international administrative cooperation. Their number makes up only a small fraction of dispute resolution by way of MAP. A primary reason for their still marginal role is the absence of a sufficiently clear legal framework for the highly coordinated manner in which those audits are actually carried out in practice. The lack of clarity, even regarding the relevant legal basis, has hampered their effective use, with some Member States even expressing doubts as to whether joint audits were allowed at all under the DAC.

The newest amendment to the Directive on Administrative Cooperation (DAC 7) is striving to fill this legislative vaccum and provide a solid legal framework in which joint audits can thrive. In the following, we will give an overview of the novelties, highlight some key aspects of the new legislation and critically address some remaining shortcomings. We build our analysis on our extensive previous research on the development of joint audits[2].

Concept of Joint audits under DAC 7

Currently, the legal basis for intra-EU joint audits concerning direct taxes is usually Art. 11 (2) DAC and the corresponding national implementing legislation. Art. 11 (2) DAD provides for the "active" participation of foreign officials in a local audit, which permits them to interview individuals and examine records. In practice, this legal basis was occasionally combined with Art.

12 DAC on simultaneous controls in more than one Member State, where the international team of tax inspectors sought to audit establishments of the taxpayer in different Member States, or affiliated taxpayers in more than one Member State. However, joint audits carried out by tax authorities of EU Member States are currently still very much fraught with legal uncertainty, which is – besides capacity constraints – the main reason why this instrument is still a sleeping beauty of international tax law. For instance, it is disputed whether joint audits based on Art. 12 DAC are still a form of EoI or an instrument of administrative cooperation *sui generis*, and as a consequence, there is also uncertainty as to the nature of public powers exercised by foreign inspectors in the local audit. A related, and indeed the most disconcerting issue, is the lack of clarity regarding the applicable procedural law.

As stated above, Art. 12a DAC 7 clearly represents a step in the right direction towards better legal certainty and more clarity. Joint audits are now for the first time defined in hard Union law as: "*an administrative enquiry jointly conducted by the competent authorities of two or more Member States, and linked to one or more persons of common or complementary interest to the competent authorities of these Member States.*" The expression "jointly conducted enquiry", as well as the insertion of a new Section IIa for Art. 12a DAC in the chapter on "Other forms of administrative cooperation" clarify that joint audits are not merely a form of EoI. They are a separate instrument of cooperation, and each tax administration involved directly collects all the information gathered during the joint audit, with no need for an exchange with the other participating authorities. Moreover, Art. 12a DAC offers a more detailed legal framework for the initiation of joint audits, for certain procedural aspects, and most importantly, the applicable national law.

As we shall briefly explore in the following sections, there is nevertheless still ample room for future improvement. Joint audits will still continue to be goverened, to a large extent, by domestic procedural rules, especially regarding taxpayer rights. This creates complexities and ambiguities. Moreover, the compromise version of DAC 7 adopted by Council has significantly amended the original proposal of the Commission[3], and thereby somewhat reduced its potential as a dispute prevention tool. And apparently, not all of the changes were fully thought through, leading to new areas of legal uncertainty.

It should also be noted that the "old" provision that is used as a legal basis for joint audits sofar, namely Art. 11 DAC, was not deleted. On the contrary it was "revamped" and will co-exist alongside the newly introduced Art. 12a DAC. Under the newly formulated Art. 11 DAC, remote participation of foreign officials through the use of electronic means of communication becomes possible, and certain own enquiries by foreign officials must be admitted by the requested State as long as its national procedural arrangements are respected. However, in our view the new Art. 12a DAC captures much better the spirit of joint audits as they are already conducted in practice, and moreover provides a more comprehensive legal framework. We therefore expect that in the future, Art. 11 DAC will only be used as a legal basis for sporadic participation in a foreign audit to clarify a limited number of pre-selected issues, whereas comprehensive joint audits will rely on Art. 12a DAC.

Initiating a joint audit

Joint audits are considered to be a dispute prevention tool. They can serve the interest of taxpayers in cross-border situations by getting two or more potentially affected tax administrations to discuss the taxpayer's factual and legal situation at the earliest stage possible. Experience so far shows that this significantly increases chances of a common understanding and thereby reduces the risk of

international double taxation. Therefore, the taxpayer can have a legitimate interest to request such an audit. While the Commission had therefore proposed to allow taxpayer(s) to make a request to one or more competent authorities to conduct a joint audit, at the discretion of the latter, this is no longer foreseen under the final version of DAC 7. Admittedly, this does not exclude an informal request of the taxpayer vis-à-vis the tax administration in its State of establishment to initiate a joint audit. However, whether such a request needs to be considered at all now largely depends on the respective Member State's internal law and regulations.

Consequentially the only formal way a joint audit can be initiated is by a request of a competent authority of one or more Member States directed to the competent authority of another Member State (or other Member States) based on Art. 12a(2) DAC. The requested tax authorities must respond within 60 days and can reject such a request only based on justified grounds. This is not specified any further, in particular it is unclear whether this includes the lack of administrative capacity of the requested tax administration(s). In our view, this will have to be decided on a case-by-case basis and should not provide an excuse for a general unwillingness to engage in the process and build up the necessary human resources.

Applicable procedural law

As we have already mentioned, only relatively few details of the joint audit procedure have been fully harmonized through DAC 7. And while any joint audit based on Art. 12a DAC must respect the fundamental rights and general principles of EU law, as an implementation of the latter, their implications and possible limitations need to be fleshed out in detailed legislative provisions. But again, only a rudimentary array of taxpayer rights in the context of joint audits can be inferred from the Directive itself. In particular, DAC 7 does not detail the limitations of inspection powers itself, but delegates this matter to the applicable national law.

However, DAC 7 does specify the national procedural law that needs to be applied during the joint audit. This is perhaps the most important change introduced by the new Directive. Art. 12a(3) DAC clearly states that the applicable procedural law for all officials involved in the joint audit is the law of the country in which the respective activity takes place. In addition, the legal standards to be observed by foreign tax officials are duplicated, since they must also not exercise any powers that would exceed the scope of the powers granted to them under the laws of their Member State. . This means that for the foreign tax officials, the stricter rules of either the host State or the sending State (i.e., the home state of the foreign tax offical) shall prevail. We would assume that this requirement will *de facto* also have an impact on the *modus operandi* for officials of the host state, since they will be inclined to accommodate to the restrictions imposed on the officials from the partner tax administration in order to "jointly conduct" the audit. For example, stricter deadlines stipulated in the procedural law of foreign officials will likely be respected in practice by the entire joint audit team.

Final report

Another important issue that DAC 7 addresses is the possibility for the participating tax administrations to issue a final report. According to the text of the Directive as adopted by Council, this final report *should* reflect the findings on which the competent authorities agreed. Moreover, the competent authorities concerned *could* also agree that the report includes any issues where an agreement could not be reached. We assume that these latter findings might then be used by the taxpayer as a starting point for MAP.

This does not in any way mean that the final joint audit report will substitute national tax assessments and that the latter will no longer be issued. On the contrary, national tax assessments will remain essential in order to draw legally binding conclusions from an eventual understanding reached during the joint audit. Besides, such findings could also become binding for participating Member States by way of rulings, mutual agreements with the taxpayer, or APAs. However, all of this will depend on the respective national law of each participating Member State, and on eventual bilateral agreements concluded between them. The Directive itself simply encourages the participating Member States to take into account mutually agreed findings of the final report in the relevant instruments issued by the competent authorities following that joint audit. It does not provide, by itself, any possiblity for the involved tax administrations and the taxpayer to come to a mutually binding understanding.

The original proposal of the Commission was much more ambitous on the matter. It specified that Member States conducting a joint audit *shall* agree on the facts and circumstances of the case and that they shall *endeavour* to reach an agreement on the tax position of the audited person(s) based on the results of the joint audit. Also, the Commission proposed that the conclusions of the audit *shall* be incorporated in a final report which *shall* have equivalent legal value to the relevant national instruments issued following an audit. It was also foreseen that Member States *shall* provide by law for the possibility to perform a corresponding adjustment when implementing the final report.

It is obvious that Member States preferred to retain more liberty and therefore toned down the Proposal, removing virtually all obligations to make the findings of the joint audit legally binding for the follow-up national instruments. Consequentially, this also means that the taxpayer cannot invoke these findings if they are not included in the corresponding national instruments following the joint audit.

Conclusion

We regard DAC 7 as an important step towards improved legal certainty and efficiency of joint audits. In this respect, having the first hard law definition of joint audits is highly commendable. Also, some vital issues that are crucial for legal certainty and protection of taxpayer's rights have been addressed; in particular, the issue of applicable procedural law has now been settled.

Yet a complex procedure such as a joint audit which might include several taxpayers, span across multiple jurisdictions, and raise complex issues of legal coordination, cannot possibly be comprehensibly addressed by solely one article the size of Art. 12a DAC. On top of that, the Commission's proposal was significantly "watered-down" in Council, demonstrating that Member States are still eager to protect their procedural autonomy and sovereignty in the matter. Additionally, their reluctance can probably be explained by their fear not to be able to provide the administative capacities necessary to conduct joint audits, both in terms of personal and financial resources. As a consequence, the now adopted compromise text still has many open or unclear issues, leaving it up to tax administrations to resolve them in practice. While important, DAC 7 is therefore in our view also merely a first step towards the development of a pan-European, genuinly "joint" audit.

Finally, we would like to point out the fact that in recent years, Member States have increasingly made efforts to strengthen dispute resolution mechanisms, notably by introducing Council Directive (EU) No 2017/1852 or within the framework of BEPS Action 14 (concerning, i.a., the

peer review and monitoring process for MAPs). All these legal instruments, as commendable as they might be, have one commonality and that is that they come into play only *ex post,* after precious time and considerable resources on the part of both, the taxpayer and the tax administration have already been invested. Therefore, it is high time that the Member States intensify their efforts in strengthening *ex ante* dispute prevention mechanisms such as joint audits.

** Dr. Nevia ?i?in-Šain, LL. M. is an Assistant Professor at the Vienna University of Economics and Business, Institute for Austrian and International Tax Law. Prof. Dr Joachim Englisch holds a chair for tax law and is director of the Institute of Tax Law at Muenster University, Germany.*

[1] Established by Regulation (EU) No 1286/2013 of the European Parliament and of the Council.

[2] See Nevia ?i?in-Šain, Tina Ehrke-Rabel and Joachim Englisch, *Joint Audits: Applicable Law and Taxpayer Rights*, World Tax Journal, 4/18, November 2018; N. ?i?in-Šain, *Joint and Simultaneous Audits*, in *Tax Procedure*, EATLP International Tax Series, vol.18, (P. Pistone ed., IBFD 2020), Books IBFD; N. ?i?in-Šain, *Joint Audits,* in CJEU, *Recent Developments in Valued Added Tax 2019,* (G. Kofler et al. eds. Linde 2020).

[3] European Commission, Proposal for a Council Directive amending Directive 2011/16/EU on administrative cooperation in the field of taxation, COM/2020/314 final, (15 July 2020).

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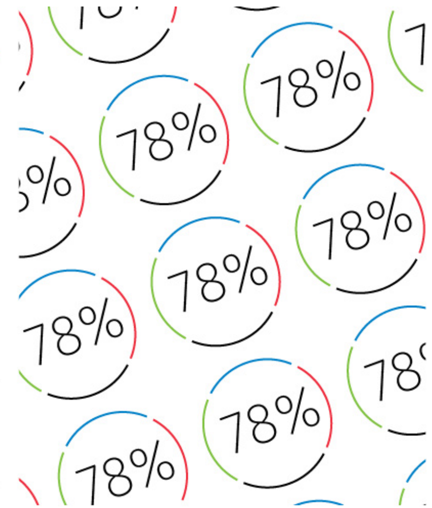

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