WHITE & CASE

Global Tax Report

April 2012

International Tax Controversy

In This Issue...

Mounting pressures on tax authorities to generate increased tax revenues have led to more aggressive implementation of tax laws and procedures in resolving tax disputes around the world. Taxpayers must stay informed of these changes and other global tax developments that may impact their global tax risk management, including their tax-planning decisions.

Privilege in the Context of a Multijurisdictional Taxpayer

Kim Boylan
Partner, Washington, DC
+ 1 202 626 3685
kboylan@washdc.whitecase.com

Ann Lilienthal
Associate, Washington, DC
+ 1 202 626 6542
ALilienthal@washdc.whitecase.com

Editor's Note
The White & Case GLOBAL TAX REPORT is prepared for the general information of our clients and other interested persons. It should not be acted upon in any specific situation without appropriate legal advice.

We welcome your comments and suggestions. If you have any questions or would like a copy of this issue, please contact:

Kim Boylan
Partner, Washington, DC
+ 1 202 626 3685
+ 1 202 639 9355
kboylan@whitecase.com

John Lillis
Partner, New York
+ 1 212 819 8512
+ 1 212 354 8113
jlillis@whitecase.com

Please refer to the White & Case website, www.whitecase.com, to access current and archived copies of our many newsletters and client memoranda.

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

Although privilege is frequently viewed as a litigation issue, taxpayers—particularly multijurisdictional taxpayers—should be aware of privilege issues that may arise in the context of an audit and, preferably, plan for such issues long before an audit begins. Why? Analyzing and preparing for privilege issues early on will help companies better manage their global tax risks and controversies.

Companies are more global, and taxing authorities worldwide are focused more than ever on international and cross-border transactions. Taxing authorities also are becoming better coordinated. For example, in 2004 the Joint International Tax Shelter Information Centre, or JITSIC, was formed under a Memorandum of Understanding between the tax administrations of Australia, Canada, the United States and the United Kingdom.[1] Today, Japan, China and the Republic of Korea are members, with France and Germany participating as observers.[2] JITSIC's purpose is to supplement the work of the individual members' tax administrations by identifying and curbing what they view as cross-border tax avoidance. JITSIC representatives do this through treaty mechanisms, and their work includes case-specific written exchanges of information and case conferences. These information exchanges "can involve testing a taxpayer's commercial rationale for a series of transactions, including whether both tax authorities are being told the same story… "[3] Further evidence of increased cooperation and coordination are the joint audit protocols that were set forth by the Organisation for Cooperative Development in September 2010,[4] as well as the joint audit program instituted by the Internal Revenue Service ("IRS") and the Australian Taxation Office.[5]

The laws of privilege are complex, and a document that would be privileged in one country may not be privileged in another. Careful consideration of both country-specific rules as to the potential existence of a privilege and choice-of-law issues as to which country's privilege laws control in a particular situation is therefore necessary before a providing a response to a taxing authority. Ideally, companies also should be mindful of the complexities of privilege in the context of multijurisdictional tax issues when creating and managing documents prior to the initiation of an audit.

An Overview of Privilege in the United States

In the United States, documents and communications may be protected from disclosure under: (i) the attorney-client privilege, (ii) the Internal Revenue Code Section 7525 tax practitioner privilege, or (iii) work product protection.

The first type of protection, the attorney-client privilege, seeks to "protect not only the giving of professional advice to those who can act on it but also the giving of information to the lawyer to enable him to give sound and informed advice."[6] Attorney-client privilege exists when legal advice is sought from a professional legal advisor in his or her capacity as such, the document at issue contains communications relating to the purpose of obtaining legal advice, and the communication is made in confidence by the client.[7] The communication must relate to the provision of legal advice rather than business advice.[8] Under US law, attorney-client privilege extends to communications with both in-house and outside counsel.[9]

Section 7525 provides for a tax practitioner privilege, similar to the attorney-client privilege, applicable to certain confidential communications between a taxpayer and a federally authorized tax practitioner.[10] The tax practitioner privilege, however, is more limited than the attorney-client privilege. It is limited to federal tax advice[11] and it applies only to noncriminal tax matters before the IRS or in federal court and only to the extent that the communication would be privileged if between an attorney and client. Importantly, no Section 7525 privilege can apply to written communications between a federally authorized tax practitioner and any person in connection with the promotion of the direct or indirect participation of the person in a tax shelter. A tax shelter is very broadly defined for purposes of Section 7525 and includes "any plan or arrangement, if a significant purpose of such plan or arrangement is the avoidance or evasion of federal income tax."[12]

Neither the attorney-client privilege nor tax practitioner privilege will apply to information provided in connection with the preparation of a tax return.[13] Any return-related activity must rise to a level beyond the mere preparation of the return.[14] Some courts have interpreted the privilege narrowly, holding that communications relating to both return preparation and litigation are not protected.[15] It is therefore important to understand the rules that are applicable in a taxpayer's jurisdiction. In addition, tax practitioners performing both return preparation and providing tax advice must be vigilant in segregating their work.

In the United States, a third type of protection also may be available. Work product protection is both broader and narrower than the attorney-client or tax practitioner privileges. The work product doctrine is intended to preserve "a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel."[16] It is not limited to communications and extends to the attorney's mental impressions, conclusions, opinions, or legal theories concerning the litigation.[17] However, work product protection is only afforded where the documents at issue were prepared in the context of actual or anticipated litigation.[18] At a minimum, this requires the documents to have been created "because of" the prospect of litigation, and certain courts have required that litigation be the "primary purpose" of the document.[19] Work product protection is not absolute, and a party may be forced to disclose a document upon certain showings by the adverse party.[20]

Waiver

The attorney-client and tax practitioner privileges generally are waived by disclosure of confidential communications to a third party (including the taxpayer's independent auditors).[21] Waiver of work product protection is more limited and occurs only upon disclosure to an adversary.[22] As discussed below, courts are split on whether the disclosure of work product (such as tax accrual workpapers) to independent auditors waives work product protection.[23] The scope of a waiver of the attorney-client privilege or work product protection is now defined by Federal Rule of Evidence 502.[24]

Tax Accrual Workpapers

To the extent tax accrual workpapers are protected from disclosure, courts have relied upon the work product doctrine. The courts, however, are divided on the extent to which this protection can apply to tax accrual workpapers and on whether disclosure to an independent auditor waives any protection that would otherwise exist.[25]

Although court decisions are not uniform, the IRS's policy of restraint (originally set forth in Announcement 2002-63) in seeking tax accrual workpapers is generally helpful to taxpayers.[26] However, taxpayers should be aware that the Department of Justice is not obligated to follow the policy articulated by the IRS, and the IRS remains free to modify the policy at any time.

Multijurisdictional Issues

Applicability of Privilege

Because the existence of privilege varies by country, a communication may be privileged under the laws of one country but not another.[27] For example, many countries exclude communications with in-house counsel from the scope of attorney-client privilege while the same communications would generally be privileged under US law.[28] In these circumstances, a taxpayer facing a request from a taxing authority for such a document must analyze choice of law principles to determine which country's law controls in determining whether the communication is privileged.

The differences in privilege laws among countries are extensive and can significantly complicate multijurisdictional audits. For example, in the United Kingdom, the legal professional privilege is comprised of two components: (i) legal advice privilege and (ii) litigation privilege. Legal advice privilege is akin to the attorney-client privilege in the United States and covers confidential communications between a lawyer and his or her client made for the sole or dominant purpose of seeking or giving legal advice. The United Kingdom litigation privilege is akin to work product privilege in the United States, but is arguably narrower, as it requires existing litigation or a "reasonable prospect or pending" litigation. Litigation privilege also defines purpose of the document more narrowly than the US work product doctrine and requires the pending or actual proceeding to be adversarial, rather than investigative, in nature. Neither of these privileges extends to advice given by non-lawyers.[29]

In addition, certain jurisdictions presume that communications with in-house counsel are not privileged because of the lack of independence arising from the employment relationship.[30] Again, however, the rules of the taxpayer's particular jurisdiction must be considered. Even within the European Union, for example, the privilege rules of member states are not uniform.[31] Importantly, the availability of privilege claims for communications with in-house counsel has been seriously called into question by a 2010 decision by the European Court of Justice. In *Akzo Nobel Chemicals Limited v. Commission of the European Communities*, the court upheld the UK's determination that no privilege exists with respect to in-house counsel.[32] The court held that while privilege does protect memoranda prepared by in-house counsel for the purpose of obtaining outside legal assistance, communications between a company's general manager and its in-house lawyer were not privileged. The court articulated two requirements for legal professional privilege to attach: (i) the communication must be connected to the client's right of defense, and (ii) the communication must emanate from independent lawyers and not in-house counsel. In addition, the court appeared to reaffirm its decision in *AM&S Europe Limited v. Commission of the European Communities*, in which it limited the privilege to only those lawyers governed by the applicable professional rules in one of the Member States.[33]

Conclusion

Given the complexity of cross-border privilege claims, it is important for taxpayers to consider privilege issues when responding to requests for information from taxing authorities. Companies would benefit by working with tax controversy counsel well-versed in these issues to develop and then implement a series of best practices and then involving skilled tax controversy counsel early on in an audit. In this way, the possibility of responses inadvertently waiving privilege, or a taxpayer determining during an audit that a privilege may be altogether lacking because, for example, of a failure to take the steps required under local law to establish the existence of a privilege in the first instance can be minimized.

1 *See* IR-2007-104 (May 23, 2007).

2 *See* Joint International Tax Shelter Information Centre, http://www.irs.gov/businesses/international/article/0,,id=223291,00.html (last visited Apr. 10, 2012); Targeting Tax Crime: A Whole-of-Government Approach, http://www.ato.gov.au/careers/content.aspx?menuid=49910&doc=/content/00271327.htm&page=12&H12 (last visited Apr. 10, 2012). *See also* Dave Hartnett, *JITSIC Six Years On*, Business IFC, http://www.businessifc.com/articles/Dave-Hartnett-Interview-JITSIC-six-years-on.htm (last visited Apr. 10, 2012).

3 *Id.*

4 The OECD Joint Audit Report analyses issues that may arise in conducting joint audits under existing legal frameworks. The Report also recommends a series of steps for initiating and conducting joint audits based on a survey of its members. *See* OECD Forum on Tax Administration Joint Audit Report (Sept. 2010), *available at* http://www.oecd.org/dataoecd/10/13/45988932.pdf.

5 *See* Kristen A. Parillo, *U.S., Australian Officials Hope Joint Audit Process Will Improve Tax Administration*, 2011 TAX NOTES TODAY 16-18 (Jan. 25, 2011).

6 *Upjohn Co. v. United States*, 449 U.S. 383, 390 (1981).

7 *United States v. El Paso Co.*, 682 F.2d 530, 538 n.9 (5th Cir. 1982) (quoting 8 WIGMORE, EVIDENCE § 2292 (McNaughton rev. 1961)), *cert. denied*, 466 U.S. 944 (1984).

8 *United States v. Adlman*, 68 F.3d 1495, 1499-1500 (2d Cir. 1995). Business advice is not privileged merely because counsel is present. *In re Fischel*, 557 F.2d 209, 211-12 (9th Cir. 1977).

9 Communications by a company's employees to in-house counsel are protected under the attorney-client privilege if the communications concern matters within the scope of the employee's corporate duties. *Upjohn Co.*, 449 U.S. at 395-96 .

10 A federally authorized tax practitioner is "any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code," including attorneys, certified public accountants, and actuaries. I.R.C. § 7525(a)(3)(A). *See also* S. REP. No. 105-174, at 70 (1998).

11 I.R.C. § 7525(a)(3)(B).

12 I.R.C. §§ 7525(b)(2), 6662(d)(2)(C)(ii).

13 The basis for denying the privilege varies by jurisdiction. *See, e.g., United States v. Gurtner*, 474 F.2d 297, 299 (9th Cir. 1973) (return preparation is an accounting service and not legal advice for purposes of the attorney-client privilege); *Canaday v. United States*, 354 F.2d 849, 857 (8th Cir. 1966) (in return preparation, the attorney is a mere scrivener); *Bernardo v. Comm'r*, 104 T.C. 677, 686 (1995) (privilege is waived by disclosure on a tax return).

14 *See, e.g., Canaday* , 354 F.2d at 857; *Colton v. United States*, 306 F.2d 633, 638 (2d Cir. 1962) (privilege is waived by disclosure on a tax return), *cert. denied*, 371 U.S. 951 (1963).

15 *In re Grand Jury Proceedings*, 220 F.3d 568, 571 (7th Cir. 2000) (citing *United States v. Frederick*, 182 F.3d 496, 500-501 (7th Cir. 1999)).

16 *Hickman v. Taylor*, 329 U.S. 495, 510 (1947).

17 FED. R. CIV. P. 26(b)(3). *See also Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 603 (8th Cir. 1977).

18 *Velsicol Chem. Corp. v. Parsons*, 561 F.2d 671, 676 (7th Cir. 1977), *cert. denied*, 435 U.S. 942 (1978). The work product doctrine has been held not to apply to materials prepared in anticipation of administrative proceedings, including IRS appellate conferee and field agent reports. *Peterson v. United States*, 52 F.R.D. 317 (S.D. Ill. 1971).

19 *See United States v. Adlman*, 134 F.3d 1194, 1203 (2d Cir. 1998) (memorandum prepared by outside accountant on whether to proceed with a proposed business transaction).

20 The standard in Fed. R. Civ. P. 26(b)(3) is that the adverse party "has substantial need of the materials in the preparation of [his] case and that [he] is unable without undue hardship to obtain the substantial equivalent of the materials by other means." Although the Tax Court did not adopt the "substantial need and undue hardship" exception in its own rules, recent decisions suggest it may be moving toward acceptance of that exception to work product protection. *See, e.g., Ratke v. Comm'r*, 129 T.C. 45, 52 (2007).

21 *El Paso*, 682 F.2d at 539-41.

22 *Cf. United States v. Textron Inc.*, 553 F.3d 87, 89 (1st Cir. 2009) (disclosure to auditors did not automatically waive work product protection where the auditors were not adversaries).

23 *Compare Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 448-49 (S.D.N.Y. 2004) (no waiver) with *Medinol, Ltd. v. Boston Scientific Group*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002) (waiver).

24 FED. R. EVID. 502 became effective on September 19, 2008 and resolves the differing views of the courts as to the scope of a waiver, *i.e.*, whether disclosure results in subject matter waiver. FED. R. EVID. 502 provides that waiver will extend to an undisclosed communication or information only if the waiver is intentional, the disclosed and undisclosed communications or information concern the same subject matter and they ought in fairness to be considered together. The rule also addresses other issues, including inadvertent disclosures.

25 *See, e.g., United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. 2009) (en banc) (tax accrual workpapers not protected because they would have been prepared regardless of whether the company anticipated litigation). As discussed in note 22, *supra*, the First Circuit also held that disclosure to independent auditors did not automatically waive work product protection and remanded the issue of waiver to the District Court. *Textron Inc.*, 553 F.3d at 89. *See also Schlicksup v. Caterpillar Inc.*, No. 09-CV-01208 (C.D. Ill. Aug. 19, 2011) (the mere expectation of scrutiny by the IRS does not constitute a prospect of litigation for purposes of work product protection). *But see United States v. Deloitte LLP*, 610 F.3d 129, 138 (D.C. Cir. 2010) (work product doctrine held to protect tax accrual workpapers that served multiple purposes to the extent they were prepared "because of" the prospect of litigation and disclosure to independent auditor did not waive the protection). The *Deloitte* case is particularly important because the United States Tax Court applies the precedent of the U.S. Court of Appeals for the D.C. Circuit to evidentiary rules pursuant to I.R.C. § 7453.

26 Under the policy of restraint, the IRS will not seek tax accrual work papers that are otherwise protected and were provided to an independent auditor as part of an audit of the taxpayer's financial statements. The IRS recently confirmed that its policy of restraint applies to tax accrual workpapers relating to the schedule of uncertain tax positions that must now be filed by certain U.S. taxpayers. I.R.S. Announcement 2010-76, 2010-41 I.R.B. 432.

27 In the United States, the compelled production and dissemination of otherwise-privileged materials in a foreign jurisdiction have been held not to constitute a waiver for purposes of U.S. privilege. *See In re Parmalat Securities Litigation*, No. 04 MD 1653, 2006 U.S. Dist. LEXIS 88629 (S.D.N.Y. 2006) (no waiver where Italian officials seized documents for use in a criminal action and then disseminated the documents to parties in the Italian and U.S. actions). *Cf. Cason-Merenda v. Detroit Med. Ctr.*, No.06-15601, 2010 U.S. Dist. LEXIS 103462 (E.D. Mich. Sept. 30, 2010) (involuntary or compelled disclosure of documents does not constitute a waiver of the privilege); *Fed. Nat'l Mortgage Ass'n v. v. Olympia Mortgage Corp.*, No. CV 04-4971, 2007 U.S. Dist. LEXIS 24912 (E.D.N.Y. Mar. 30, 2007) (same).

28 *See, e.g., In re Rivastigmine Patent Litig.*, 239 F.R.D. 351, 359-60 (S.D.N.Y. 2006); Case C-550/07P, *Akzo Nobel Chems., Ltd. v. European Comm'n*, 2010 E.C.R. 00000.

29 In *Prudential v. Special Commissioner of Income Tax*, the U.K. High Court held that the legal professional privilege does not extend to advice on tax law given by accountants. The court held that the privilege was linked to the legal profession and did not apply to any professional other than a solicitor, barrister, or appropriately qualified foreign lawyer. *Prudential v. Special Commissioner of Income Tax*, [2009] EWHC 2494 (Admin) (Oct. 14, 2009).

30 In-house lawyers may be treated (i) similarly to external lawyers, as in Mexico, (ii) within the scope of the privilege in qualified circumstances, as in Argentina, or (iii) beyond the scope of the privilege, as in India.

31 For example, in France, communications with in-house lawyers are not privileged because in-house lawyers are not *avocats* or members of the bar. Conversely, in Germany, attorney-client privilege may exist if certain conditions are satisfied.

32 *Akzo Nobel Chemicals Limited v. Commission of the European Communities*, Case C-550/07P (Sept. 14, 2010).

33 *AM&S Europe Limited v. Commission of the European Communities*, Case C-155/79 (1982).

Binding Tax Rulings System in Poland—A Case Study

Marcin Panek
Senior Counsel, Warsaw
+ 48 22 50 50 136
MPanek@whitecase.com

Tax law is typically considered everywhere to be highly complicated and full of potential traps that may result in severe financial trouble for any taxpayer. Such a view is commonly expressed in Poland, particularly by business societies which constantly complain regarding the quality of tax regulations and—more importantly—their interpretations by tax authorities.

As a response to those views and complaints, in 2004 the Polish government introduced a specific law on binding tax rulings. Under this law, taxpayers are entitled to obtain a tax ruling from tax authorities on the relevant tax treatment of their particular case, whether concerning past or future (even theoretical) transactions. The law came with a strong binding effect, i.e., protection for taxpayers against unfavorable decisions of the tax authorities if a taxpayer receives a tax ruling and follows the tax treatment presented in it. The entire binding tax rulings system was designed to be fully transparent and objective, which was sealed by a possibility to appeal unfavorable tax rulings to the administrative courts (including the Supreme Administrative Court). The tax ruling system was thus to provide taxpayers with the required level of tax certainty in doing business and planning business transactions. The administrative fee for applying for a ruling is minimal.

After several years of the law being in place, what was very well received at first has become the subject of litigation between taxpayers and tax authorities in Poland. Flooded with tens or hundreds of thousands of applications for tax rulings each year, the tax authorities have gradually become less eager to issue positive tax rulings, i.e., rulings that would confirm a favorable interpretation of tax regulations for the benefit of the applicants. As a result, it is now officially estimated that more than 70 percent of court cases on taxation are tax ruling cases, which leaves less than 30 percent for actual tax assessment cases. Needless to say, the waiting periods for court hearings have grown significantly.

One of most recent cases involved the taxation of shareholders in Polish joint-stock partnerships. Joint-stock partnerships are not legal persons, but are legal entities that can conduct business activity in their own name and on their own behalf. At least one partner in the partnership must bear unlimited liability for the partnership's liabilities and at least one partner should be a shareholder whose position is generally the same as any shareholder of a capital company. Joint-stock partnerships (like all partnerships in Poland) are transparent for income tax purposes, i.e., their profits (revenues and costs) are allocated to partners in proportion to their share in profits and the partners are responsible for making tax settlements as if the activity of the partnership was their own activity. A controversy arose regarding the tax advances that each business in Poland would be obliged to pay (monthly or quarterly) during the tax year.

The tax authorities have taken the position that all partners in any partnership have the same obligations towards the state budget since the tax law does not provide a specific regime for joint-stock partnerships. As a consequence, shareholders should monitor the activity of their partnership and report taxable profits and make tax advances on a regular basis as the profits are generated by the partnership. The approach of the tax authorities was therefore very literal and formal in nature.

Taxpayers have argued that such a tax treatment is inappropriate considering the position of a shareholder, who does not receive cash until a dividend is distributed. Requiring a shareholder to pay taxes before the dividend date is de facto requiring him to pay taxes without income being received. Moreover, shareholders generally have limited access to a partnership's accounting records, thereby limiting the ability of a taxpayer to determine the right amount of taxes to pay. Shareholding is easily and often transferred, so it may well be that a shareholder may pay taxes and sell its shares before getting any dividend out of the partnership. The argument of taxpayers is thus very much based on "common sense" and a sense of justice rather than a precise reading of the law.

In hundreds of tax ruling applications, taxpayers tried to convince the tax authorities that shareholders in such partnerships should only pay taxes upon receiving a dividend. The tax authorities responded negatively to all such applications. Taxpayers appealed, and in some cases, the lower instance administrative courts ruled in the taxpayers' favor. Nevertheless, the tax authorities continued to issue negative tax rulings on this issue. Finally, on January 16, 2012, a case was brought before seven judges of the Polish Supreme Administrative Court.

The Supreme Administrative Court ("SAC") ruled in favor of the taxpayers. According to that judgment, a shareholder of a joint-stock partnership derives income only upon receipt of a dividend, whereas the partnership's profits should remain untaxed in the proportion in which they are allocable to a given shareholder. The court determined that the specific position of a shareholder is enough of an argument to defer taxation until profits are distributed to the shareholders. This ruling was a surprise, as in most cases the SAC rules in favor of the tax authorities and, more importantly, the judges favor the letter of the law, which in this case arguably supported the tax authorities' view, rather than that of the taxpayers.

Analysis of the decision seems to imply that the court equated the position of a shareholder in a joint-stock partnership to that of an investor in an investment fund. Investment funds are tax-exempt legal entities in Poland, i.e., their profits are not subject to income tax until they are distributed to investors either as a dividend or through redemption/buyback of investment certificates. Investment funds can therefore reinvest money without suffering taxation, thus creating more value for investors than a usual LLC. This special tax position of investment funds comes with a cost of being a regulated entity, operating on the basis of a permit, being subject to close supervision from fund authorities and having significant diversification requirements. Now, joint-stock partnerships can do the same with no restrictions or supervision.

Is this situation too good to be true? The Polish tax authorities seem to think so. Under the Polish legal system, there is no common precedent rule, i.e., court rulings do not have a direct binding effect outside the individual case that was ruled upon. Tax authorities are therefore using the argument that a new case means new litigation. Taxpayers may, of course, generally expect that courts will follow the same pattern established by the SAC; however, there are no legal guarantees. Moreover, the tax authorities are starting to use delay tactics to their advantage. It takes approx. 3 – 4 months to obtain a tax ruling in Poland. Appealing a ruling means an additional 3 – 4 months. Then, the case can go to court, which takes about 9 – 12 months to resolve. Taking a case to the SAC adds an additional 15 – 18 months. After the decision of the SAC, the tax authorities are legally bound to issue a positive ruling, which takes approximately another 3 months. Therefore, if a tax official resists a ruling sought by a taxpayer, it can take up to 3.5 years to obtain a favorable tax ruling. What business can afford to wait that long before the commencement of operations? This sounds like a rhetorical question, but one that has real business implications.

Does this mean that tax ruling requests in Poland are pointless? Well, no; there are still many cases in which the tax authorities can be convinced to issue positive rulings without the threat of the SAC forcing them to do so. Nevertheless, the emphasis on tax planning in Poland is slowly shifting toward obtaining tax opinions issued by reputable advisors instead of only applying to the tax authorities for a tax ruling and waiting for their response.

On Tax Controversy in Hungary

Orsolya Bárdosi
Local Partner, Budapest
+ 36 1 4885 269
obardosi@whitecase.com

With the increasingly rigid and aggressive approach from the Hungarian tax authority that taxpayers have been experiencing in the past few years, areas of tax controversy are steadily growing. The Hungarian tax authority works to achieve set yearly targets of amounts to be collected from each type of tax through audits, which they usually achieve. For this reason, the tax authority very rarely revises its own proposed resolution of a tax audit, and instead requires taxpayers to take their case to courts, where, in the majority of cases, disputes are decided in favor of the tax authority.

Hungarian taxpayers generally have little awareness of their rights and therefore limited opportunities to actively represent their position early enough in a tax audit, as the tax inspector most often fails to initiate any kind of communication with the taxpayer about the processes, peculiarities and goals of the inspected business during the audit process. The audits are conducted through the review of documents requested from the taxpayer, and carried out at the headquarters of the tax inspector, rarely sharing with the taxpayers information on potential areas of concern, unless the taxpayer actively requests a dialogue through, for example, offering to submit more information on particular matters of interest. In many cases, unless the audit is carried out at the premises of the taxpayer, information about the tax authority's progress, problematic areas and issues of concern are very difficult to obtain until the audit phase is closed and the tax authority has prepared the official "minutes" of the audit, which include the tax authority's findings of the facts and circumstances.

As a basic and fundamental problem, taxpayers often fail to ensure that their conduct of business administration, systems and procedures are robust enough to withstand the scrutiny of the tax authority should they be selected for a tax audit. This is partly due to the frequent changes in Hungarian law, which often leaves very little or no time for the taxpayers to digest and prepare for significant changes of law.

The tax authority has the right to challenge transactions and business payments serving the purposes of the company's business if there is a tax advantage generated by such transactions. Oftentimes, the documents required to be kept by taxpayers with respect to transactions that may be audited are not expressly required by any legislation, but are determined through the tax authority's audit experiences. In addition, the number of unfavorable tax authority challenges to transactions, taken on the basis of substance over form reclassifications or the infringement of the rule of law doctrine is rapidly increasing. This is because Hungarian anti-avoidance legislation is very generally phrased, which provides the tax authority with relative freedom of interpretation when it comes to cases where substance over form and rule of law clauses may be called upon. It is therefore advisable to collect and maintain as many supporting documents as possible in case the need later arises to present them to the tax authority during an audit to support the fact that certain events have indeed occurred and the conduct of the taxpayer has been exercised diligently and out of genuine business interest.

Another problematic point is the unclear and uncertain nature of the tax legislation that prevents the taxpayer from clearly understanding what constitutes proper business conduct and the tax implications, a fact that has even been realized by the Hungarian legislature. At the end of 2011, the legislators created a new institution as of January 1, 2012, called the "notification of uncertain tax position". Under this new opportunity, if a taxpayer makes an appropriate notification in its tax returns, the taxpayer could be released from the obligation to pay a tax penalty with respect to the tax deficiency resulting from mistaken legal interpretation, and may be obliged to pay only a default penalty. The protections afforded by this new institution were short-lived, however, as—another good example of turbulent law-making practice in Hungary—it was abolished effective March 31, 2012.

Taxpayers may gain certainty of the correctness of their business conduct with respect to transactions by obtaining a binding advance tax ruling from the Ministry for National Economy, usually costing rather hefty statutory fees in the range of US$35,000. Since the beginning of 2012, binding rulings of the corporate income tax treatment of a transaction may also be obtained to survive any legislative changes for three years, irrespective of future changes to the respective legislation. Advance pricing agreements also remain available to taxpayers to ensure the correctness of the applied method of transfer pricing in related party transactions.

On the other hand, informal discussions, cooperation between the taxpayer and the tax authority concerning the proper interpretation of tax legislation, is not a customary exercise in Hungary, as the tax authority is viewed as an unapproachable institution that is rather avoided by the taxpayers. Written guidance issued by the tax authority is caveated as merely an opinion, which cannot be relied on in court. Further, unless the question is very basic, no assistance in interpretation of the tax law is available to taxpayers through the telephone. The written guidelines received from the Ministry for National Economy pursuant to a request from a taxpayer are more useful and informative. However, these guidelines, like the tax authority's own written guidance, are not binding to the tax authority and cannot be relied on in court. Taxpayers, therefore, mostly rely on the assistance and representation of professionals with respect to their business conduct in order to identify tax audit and controversy risks and exposures and, once risks are identified, develop and implement appropriate measures in order to mitigate the taxpayer's risk profile.

During the audit process, taxpayers and their representatives have the right to be present at any audit event conducted by the tax authority, unless expressly refused, and may provide proof of any relevant fact or circumstance that may help in unfolding the background of any business transactions under inspection.

Once the tax authority has completed the audit process, it issues its minutes. The minutes detail all the findings of facts of the audit and serves as the background of the tax assessment, and the basis on which the tax authority will pass its resolution. Upon receipt of the minutes, the taxpayer has the opportunity to submit its remarks to the minutes and raise any disagreement with the findings of the audit. In addition, further facts may by introduced by the taxpayer in expectation that the content of such submission will be taken into consideration by the tax authority when passing its resolution.

It is very rare that the fact pattern of the minutes is changed based on the taxpayer's remarks, and the resolution containing the tax assessment itself is usually reciting the content of the minutes.

In case of a dispute, the tax assessment of the tax authority may be appealed and challenged before the second-instance tax authority, which has the right to annul the first-instance resolution and decide on the merits of the case, or to instruct the first-instance tax authority to carry out a new audit if the facts and circumstances have not been appropriately and fully developed. As previously mentioned, settlement discussions between the taxpayer and the tax authority are not routinely carried out; the dispute is generally handled in a formal fashion from the outset and very likely to end up before the administrative courts, despite the fact that litigation is uncertain, costly and time-consuming.

The decision of the second-instance tax authority is final and binding. This decision must be issued within five years from the end of the calendar year in which the tax return in issue was required to be filed, otherwise the tax authority becomes time-barred from issuing a tax assessment with respect to the given tax period. This deadline is extended by six months in cases when the decision of the second-instance tax authority is annulled by the courts and the tax authority has to carry out a repeated audit. While the court procedure suspends the lapsing period, it continues to run once the tax authority restarts its audit.

The final and binding resolution of the second-instance tax authority serves as the basis for the execution of the tax assessment. The taxpayer may request the suspension of the execution of the tax authorities' tax assessment in an appeal submitted to the courts within 30 days from the date of receipt of the resolution. Rather controversially, the tax authority may exercise its right to execute its assessment should the taxpayer not voluntarily pay within 15 days from the date when its resolution becomes binding, meaning that the tax authority may collect the tax it asserts is due before the court has the opportunity to decide the suspension request of the taxpayer. This procedural disharmony puts many taxpayers in the rather difficult position of having to pay disputed tax liabilities before the contentious remedies would have been exhausted.

Prior to the commencement of tax litigation, the head of the tax authority or the Minister for National Economy may take a supervisory measure upon the request of the taxpayer or ex officio if the resolution infringes the relevant legislation or if the resolution has been adopted in violation of the law. The petition for such supervisory decision is a useful tool in the hands of the taxpayer as it does not have a time bar for submission, as long as a court claim has not been filed by the taxpayer in the matter.

Tax litigation in Hungary is conducted under the rules of administrative litigation, which since 1999 is a one-instance procedure. When the taxpayer challenges the second-instance resolution of the tax authority before the administrative courts, the court may only decide in the question whether breach of law—either procedural or substantive law—has occurred in the previous stages of the procedure. Before the administrative courts, the substantiation of facts and circumstances of the case only arises in the context of, and as a basis for, breach of law. The courts rarely question or elaborate further on the factual background of any case during the litigation phase by, for example, hearing witnesses or experts. For this reason, it is imperative to clarify the background of all relevant events relating to a transaction, to the fullest extent possible, in the early stages of audits. Having capable representation in the audit stage, and preferably before an audit begins, is therefore very important.

During the audit phase of any tax controversy, the burden of proof principally falls on the tax authority, which has the duty to unfold all relevant facts and circumstances of the case and must substantiate its tax assessments with evidence in the minutes of the tax audit. This, however, changes in the litigation phase, where it is for the taxpayer to prove that the tax authority's assessment is unlawful or unfounded and demonstrate the facts and evidence supporting the taxpayer's case.

There are certain types of subject matters where the burden of proof practically shifts from the tax authority to the taxpayer, even in the procedures undertaken before the litigation phase. One current item on the tax authority's agenda is the capturing of VAT invoicing between business partners. In numerous cases, the tax authority denies the taxpayer's VAT deduction claiming that the provision of services with respect to which the invoice has been issued did not in fact occur between the parties indicated in the invoice or the taxpayer receives the VAT invoice from a business partner other than the one who actually provided the services.

At first glance, it may seem easy to prevent such a situation, but in many transactions, it is rather complicated to discover which entity has indeed provided the services in question. For instance, with respect to construction work, the tax authority considers an invoice to be fictitious even if the issuer is an existing taxpayer, the services have indeed been provided and their results may clearly be examined, but the subcontractor of the issuer of the invoice does not have any legally employed workforce that could have performed the services. The European Court of Justice has established (the Optigen Case) that the right of tax deduction may not be denied to the taxpayer on the basis that the supplier of the seller is fictitious, provided that there was actual performance between the taxpayer and its seller and the taxpayer was not aware of, and exercised reasonable prudence to become aware of, that fact. The Hungarian tax authority does not seem to accept the ECJ's case precedent by placing objective liability on the taxpayer to the extent of the deductable VAT amount.

From March 1, 2012, tax litigation cases are principally decided by the administrative court without any hearing, and purely on the basis of the documentation presented. At the request of any of the parties, however, the court must hold a hearing. The court may decide to hold a hearing by its own initiative as well. This new procedural rule aims to make deciding tax disputes as quick and cost-effective as possible. Having said that, however, taxpayers with competent legal representation will almost certainly opt for the possibility to call a court hearing to present their case and present their arguments more effectively. In practice, we believe only a small number of cases will be deterred by the new rules.

The judgment passed by the administrative court is final and binding and as administrative litigation is a one-instance procedure, only extraordinary remedies, such as the judicial review by the Supreme Court, are available against such judgment. A petition for judicial review of a final judgment may be submitted to the Supreme Court on the grounds of infringement by the party, the intervener, or by any person to whom any provision of the decision may be of concern, against the appropriate section. Judicial review in practice, however, is exhausted in most cases, without any effective forum of appeal against the judgments of the administrative courts.

According to statistics, administrative courts pass judgments in favor of the tax authority in more than 70 percent of the cases. Such numbers make one wonder whether the taxpayer and the tax authority step into the courtroom with equal chances. While the answer to that question seems to be discouraging, during the total length of the life cycle of tax controversies—that may be as long as three to five years from the start of an audit until appearing before the Supreme Court—there are numerous opportunities for the taxpayer to influence the outcome of its case.

Tax Pitfalls Arising From Collateral in the Company Group

Dr. Andreas Knebel
Partner, Frankfurt
+ 49 69 29994 1225
aknebel@whitecase.com

Thomas Schmidt
Local Partner, Frankfurt
+ 49 69 29994 1261
tschmidt@whitecase.com

The operating business of company groups is to a large extent financed by debt capital. The financing banks regularly require appropriate security. The ongoing financial crisis and the implementation of the Basel III rules coming into force in 2013 increase demand for better accessibility to guarantees. Whereas shares of the subsidiary company were considered sufficient security in the past, a guarantee from the subsidiary itself is also generally required now.

Transfer-pricing issues have arisen from the change of practice. In particular, it is unclear whether the parent company should pay a guarantee fee and if so, how to set the fee at arms-length.

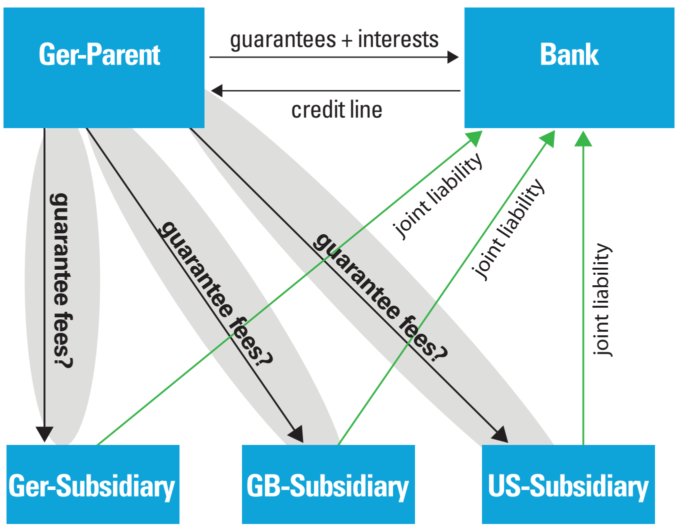
Step One: Is the Provision of the Guarantee Subject to Transfer-Pricing Regulation?

According to generally accepted principles, cross-border related party transactions are to be carried out at arm's length. To assess whether a particular transaction requires the payment of a fee, hidden distribution of profits and arm's-length (i.e., at customary third-party prices) principles are applied.[1]

Generally, if an unrelated party would require payment for a guarantee provided under the same circumstances, failure to pay a fee to the subsidiary could indicate that there has been a prevented increase of assets, which is considered to be a hidden distribution of profit. However, all circumstances must be examined before reaching a conclusion because not all financial disadvantages automatically cause hidden distributions of profit. For example, there may exist advantages for the subsidiary (e.g., more favorable credit conditions) that compensate for the disadvantage. Also, before a hidden distribution of profits can be established, there would have to be a determination that the parent company benefited from joint liability with its subsidiary. This is commonly not the case since the parent generally will provide its shares in the subsidiary as a guarantee anyway (i.e., the quality, not the quantity of the guarantee is affected by the accession of the subsidiary).

Guarantee fees arising from cross-border transactions between related parties also must comply with the arm's-length principle.[2] Thus, it must be examined whether remuneration would be paid where an unrelated party would be providing a lender with easier access to a guarantee that has already been provided by the actual borrower (as opposed to providing a separate and independent guarantee to the lender).

Figure 1: Example Group Financing Structure



The arm's-length principle has been found to be satisfied where interest on loans within a group of companies is not adapted to account for the absence of a guarantee (even though a guarantee would have been common between unrelated parties). This result has occurred where guarantees are granted within the framework of a "backup within the company group" (i.e., the relationship of the related parties per se provides a guarantee).[3] If the arm's-length principle is satisfied in the "backup" situation, one could argue that it also should be satisfied where a subsidiary guarantees a parent's credit line without the payment of a guarantee fee (provided there are non-tax reasons for such an arrangement).

Step Two: How to Set the Arm's-Length Fee?

Although there may be strong support for no payment of a guarantee fee, the German Tax Authorities have not yet ruled on this issue. Should it be the case that a fee should be charged, the difficult question of how to set an arm's length price arises. Again all the facts must be examined. For example, some sources suggest a range from 1/4 percent to 1/8 percent of the volume of the credit might be an appropriate arm's-length fee for guarantees by a subsidiary, however, no explanatory calculations are provided.[4] Banks provide guarantees for a fee ranging between 1 percent and 3 percent of the volume of the credit, but this would not appear to be an appropriate comparison, because such an amount would reflect the circumstances of the bank rather than the subsidiary (e.g., strict regulatory requirements applicable to banks and costs associated with obtaining information which the subsidiary already has and risks related thereto).

Furthermore, the subsidiary's specific facts and circumstances must be considered (e.g., its interest or/and conditions) and whether more than one subsidiary is guaranteeing the same credit line. The effects of these factors on the arm's-length price, while difficult to calculate, should be examined.

Cash-Pooling Structures Also Affected

Modern cash-pooling structuring presents a case similar to bank loans in company groups. It is a common practice for banks to require security from subsidiaries with an indirect relationship to liabilities arising from a master account. Therefore, the same issues arise in this circumstance as well.

Conclusion

Even though the German Tax Authorities require application of the arm's-length principle, there may be support for the non-payment of a guarantee fee, for example, where it can be established that there is no advantage to the parent company, the parent company may be able to support the position that its situation is analogous to the general backup in the company group situation.

If an arm's-length fee were found to be necessary, there are many "corporate effects" that make it difficult to establish an appropriate arm's-length fee. At least it could be argued that the fee should not be lower than costs incurred by the subsidiary through the guarantee risk, and not higher than interest savings for the parent borrower.

Since the topic will grow in importance, and there are no clear answers at this time, all financing structures will have to be examined case by case. The transfer-pricing rules are an essential part of this analysis.

1 Sec. 8 Para. 3 German Corporate Income Tax Act (KStG) and Sec. 1 German Foreign Tax Act (AStG):

2 Sec. 1 German Foreign Tax Act (AStG).

3 Circular of the Ministry of Finance from March 19, 2011, IV B 5 – S 1341/09/10004, German Federal Tax Gazette I 2011, p. 277.

4 *Gundel*, IStR 1994, 263, 267; *Baumhoff*, in: Flick/Wassermayer/Baumhoff, Außensteuerrecht, § 1 AStG, Anm. 767; and *Oho/Behrens*, IStR 1996, 313, 316.

New Control and Penalty Provisions Against Fraud

Alexandre Ippolito
Partner, Paris
+ 33 1 55 04 15 68
aippolito@whitecase.com

Christel Alberti
Associate, Paris
+ 33 1 55 04 58 10
calberti@whitecase.com

New control and penalty provisions against fraud have been introduced by the Amended Finance Bill for 2012 as enacted on March 14, 2012

Reporting of Foreign Bank Accounts

Foreign bank accounts (including foreign life insurance contracts) have to be declared on a yearly basis subject to a minimal €1,500 penalty (increased up to €10,000 for accounts opened in a Non-Cooperative Jurisdiction).

The amended bill supplements this legislation by providing that, when the total of credit balances of the unreported accounts located abroad is equal to or greater than €50,000 on December 31 of the year under which the reporting statement should have been made, the penalty is 5 percent of the credit balance of each undeclared account, but cannot be less than €1,500 or €10,000 as mentioned above.

Absent any evidence to the contrary, the amounts received on or transferred out of undeclared foreign accounts (including life insurance accounts) of French residents are deemed to constitute French taxable income. A 40 percent penalty shall apply on the related income tax and such income is also subject to social contributions (CSG, CRDS).

Prohibition of the Offset of Tax Reductions Against Taxes That Have Been Subject to a 40 percent (or Higher) Penalty.

The bill strengthens some tax penalties for offenses constituting serious breaches: it removes the option to benefit from tax reductions in income tax or the wealth tax on the additional tax resulting from the amounts not declared spontaneously and, as such, giving rise to a 40 percent increase.

- Covered offenses

  These offenses are:

  - Failure or delay of reporting despite a formal notice or in case of occult activity (40 percent or 80 percent increase)
  - Insufficient reporting in case of willful neglect, abuse of rights or fraud (40 percent or 80 percent increase)
  - Opposition to tax audit resulting in an estimated assessment of tax bases (100 percent increase)

- Scope of the device

  Impact on personal income taxation

  - The amended bill prohibits the allocation of tax reductions on the rights resulting from the application of one of the increases referred above. Similarly, losses cannot be charged on the amounts affected by these increases.

  Impact on wealth tax

  - The amended bill prohibits the allocation of tax reductions or refunds for investments in SMEs and in respect of gifts in case of application of increases.

Tightening of Fight Against Tax Fraud

The amended bill provides several measures to improve the fight against tax evasion, strengthening the applicable tax penalties in case of concealment of bank accounts or life insurance contracts held abroad. As noted by the preparatory work, the amount of the fine had not been updated since 1977, making them particularly unsuitable for fighting fraud effectively. Thus, the amount of the fine sanctioning criminal tax evasion is thus increased from €37,500 to €500,000 and €75,000 to €750,000 when the offences are made or facilitated by means of either buying or selling without invoice or by billing without being related to real operations, or that the intension was to get unwarranted reimbursements from the State administration. Finally, for international tax evasion performed or facilitated by accounts or contracts located in a Non-Cooperative Jurisdiction, the exposure shall increase up to seven years and €1,000,000.

International Exchange of Information—General Framework and Practical Use

Aleš Zídek
Partner, Prague
+ 420 255 771 293
azidek@whitecase.com

Jakub Zavadil
Associate, Prague
+ 420 255 771 332
jzavadil@whitecase.com

Introduction

In the Czech Republic, the means for tax administrators to obtain information from foreign tax administration bodies, as well as the competence of tax administrators to successfully apply the information obtained, continue to increase. Greater emphasis has been placed on this trend in connection with the global financial crisis, which has forced the state to seek new potential sources of income.

Taxpayers in cross-border business relations are, in many respects, limited in their powers in comparison to those given to tax administrators. It is in the best interest of the taxpayer to (where possible) collect and maintain information from abroad in advance, so they are able to react in a timely manner to any objections raised in the course of a Czech tax audit. Otherwise, they could find themselves in a difficult position when facing tax administrators who are challenging their tax duties declared in good faith.

Legal Background

Double Taxation Treaties concluded by the Czech Republic (or the Czechoslovak Socialist Republic, its predecessor, which remain in force and effect in regard to the Czech Republic) usually include standard OECD wording of Article 26 of the OECD Model Double Taxation Convention (applicable at the time of concluding each respective Double Taxation Treaty).

Generally, the contracting states are entitled, and at the same time obliged, to mutually provide each other with relevant information for the due collection of taxes within the scope of the Double Taxation Treaty, provided that such information can be obtained pursuant to local regulations. Czech Double Taxation Treaties based on the 2000 OECD Model Double Taxation Convention and later do not limit the scope of taxes covered and potentially available for the exchange (i.e., the exchanged information could relate to any local taxes).

The procedural framework for the international exchange of information was not introduced in Czech tax law until 2000, when Act No. 253/2000 Coll., on international cooperation in tax administration (the "Act"), entered into legal force.

The Act regulated the exchange of information pursuant to the Double Taxation Treaties, and also made preparations for the application of EU regulations on the exchange of information (the relevant part of the Act entered into legal force as of the Czech Republic's accession to the EU in 2004) implementing Directive 77/799/EEC, as amended[1] (the "Directive").

EU Directive 77/799/EEC has been repealed and replaced by Directive 2011/16/EU,[2] which is aimed at broadening the exchange of information by introducing real-time cooperation between the tax administrations of the EU member states. EU Directive 2011/16/EU should be implemented into local law by January 1, 2013; the bill of the new act implementing the new directive into Czech law is currently being prepared.

Czech law allows tax administrators to make use of all three traditional methods of the exchange of information described by the EU Directive, including automatic exchange of information, exchange on request and voluntary (spontaneous) provision of information (if the reciprocity is ensured as regards the other state concerned).

On request, an exchange of information allowed by the applicable Double Taxation Treaty or Directive (as implemented into the Act) occurs pursuant to the procedural rules and limitations stipulated by the Act. According to the Act, the Czech Authorities should generally provide information automatically to another state if it can be reasonably assumed that there could be a tax loss in that other state (caused by an event disclosed in the Czech Republic). On the other hand, the information should not be provided if (i) it cannot be obtained by means available pursuant to Czech law, (ii) the foreign tax administrator does not ensure the confidentiality of the information provided to a level equal to that required by Czech regulations, or (iii) the provision of such information is in conflict with public order or public policy (ordre public).

To clarify and strengthen the framework for the automatic exchange of information, the Czech Ministry of Finance (the supreme tax administration body in charge of the international exchange of information) negotiates and concludes memoranda of understanding, which define the scope of information to be provided in this manner and the methods of exchange.

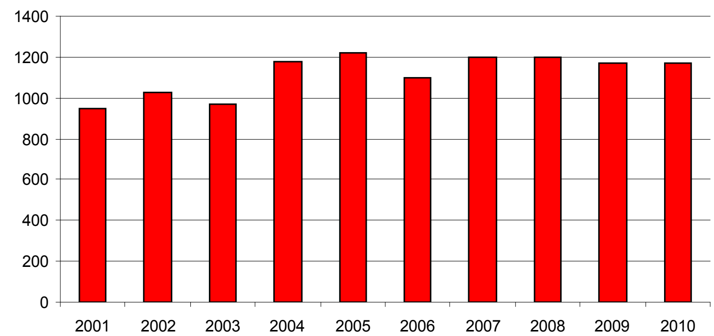
As of now, the Czech Republic has concluded such memoranda with 13 countries. The memoranda have been (or are to be) concluded with some of the most important business partner countries of the Czech Republic, including Germany, Slovakia and the United States. Of the holding company jurisdictions commonly used to invest in the Czech Republic, such memorandum has thus far only been concluded with the Netherlands.

The memoranda also vary significantly in defining the types of information subject to automatic exchange. The extent varies from relatively broad, as is the case with the memorandum concluded with Germany (covering business profit derived by permanent establishments, dividends distributed, interest credited to bank accounts, royalties paid, as well as capital gains realized), to much narrower, as is the case with the Dutch memorandum (limited with respect to legal entities to royalties paid).

Moreover, the Czech Republic recently concluded or is about to conclude Tax Information Exchange Agreements (based on the OECD model Tax Information Exchange Agreement) with several off-shore jurisdictions, including the Isle of Man, Jersey, Guernsey and the British Virgin Islands. These agreements, however, have not yet entered into legal force (it is expected that the agreement with the British Virgin Islands will become effective in the coming months).

The Extent of the International Exchange of Information

According to the most recently available statistics provided by the Czech Ministry of Finance, the number of tax proceedings opened as regards the international exchange of information was close to 1,200 as of the end of 2010[3].



Over the last decade, the number of cases has been relatively consistent. Statistics issued by the Czech Ministry of Finance also state that the number of new cases is about 400 to 500 per year. It could indicate that, on average, closing a case of international exchange of information takes more than two years and, as a result, the system of exchange as a whole could be viewed as rather inflexible.

International Exchange of Information in Practice of Tax Administrators

Opening a Tax Audit on the Basis of Information Provided by Foreign Tax Administrator

The German tax authorities carried out a tax audit of a German company having a Czech subsidiary. In the course of the tax audit, the German tax administrator found that certain employees and officials of the German company spent a significant portion of their working time in the Czech Republic.

The German tax administrator spontaneously informed the Czech tax administrator of this fact, claiming that a permanent establishment of the German company may have been created in the Czech Republic. Based on the information received, the Czech tax authority initiated a tax audit of the Czech subsidiary to establish the merits of the information provided.

The above could serve as an example of how a tax audit in one country, which included an international element, could translate into a tax audit in the Czech Republic. Such implication should, therefore, be communicated upfront to any potentially affected Czech company in order to enable the company to prepare for potential proceedings before the Czech tax authorities.

Procedural Aspects of International Exchange of Information

In the course of a tax audit, the Czech tax authority challenged the deductibility of certain expenses of a Czech company relating to services purchased from a company based in the Republic of South Africa (the RSA). The tax audit was closed without any tax assessment. After several months, the Czech tax authority re-opened the tax audit. The basis for re-opening the tax audit was additional information obtained from the RSA tax administrator. Additional tax was assessed on the Czech company in the course of such re-opened tax audit.

The court upheld the approach of the tax authority and dismissed the objections of the Czech company, which argued that its tax duty was already conclusively examined during the original tax audit (*res iudicata*).

Generally speaking, the information obtained within the international exchange of information could form the basis for opening a tax audit in the Czech Republic, or (in an open case) would be treated as evidence available to the tax authority in determining the tax duties of a Czech taxpayer. The initiation of the exchange of information by making a request to the tax authority of another state also suspends the regular three-year time within which tax can generally be assessed in the Czech Republic.

Therefore, the dynamics of the international exchange of information should be taken into account in the local tax proceedings and while considering the lapse of time period opened for potential tax assessment. As follows from the decision of the court, even the information received by the Czech tax authority after a tax audit has been officially closed may be sufficient to re-examine the tax position of a taxpayer and potentially assess additional tax.

Failures in International Exchange of Information

Official stamps were stolen from a foreign tax administrator. These stamps were subsequently used to confirm due deliveries of goods (subject to excise tax) transported in the tax suspension arrangement regime from a bonded depot in another EU member state. The Czech tax administrator confirmed that the goods were actually delivered to the Czech Republic instead, and after several failed attempts to obtain cooperation from foreign tax authorities, assessed excise tax in the Czech Republic on the operator of the bonded depot.

The operator argued that such transport of goods was marred by clear fraud (of currently unknown persons), and that such fraud, including damages connected thereto, could have been prevented if the tax authorities involved had duly performed their obligations to inform the tax administrators and taxpayers in potentially affected countries about the loss of the stamps. The operator challenged the conclusions of the Czech tax administrator, and the case will be decided by the courts.

Considering the above case, it could be concluded that the taxpayers should not rely on the international exchange of information. The lack of cooperation and exchange of information did not prevent the Czech tax authority from issuing the tax assessment. However, as noted, the case is now to be considered by the courts.

1 Council Directive of December 19, 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums.

2 Council Directive 2011/16/EU of February 15, 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC.

3 Automatic exchange of information is not included in the summary

White & Case Global Tax Group—Worldwide

Beijing
Jiang Bian

Berlin
Dirk Eisolt
Sebastian Goette
Andreas Pochhammer

Bratislava
Tomáš Cibul'a
Matej Firický

Budapest
Orsolya Bardosi
Gabor Peter Nagy
Aniko Sebok

Frankfurt
Alexander Born
Cornelia Geißler
Josef Große
Christina Hueschemenger
Andreas Knebel
Michael Kunze
Thomas Schmidt
Robert Weber

Hamburg
Günter Kahlert
Jürgen Detlef W. Klengel
Arne Schmidt

London
Peita Menon
Prabhu Narasimhan
Jeremy Reynolds

Miami
Lindsay Mischon Cohen*
Michael Kavoukjian*
Edward E. Sawyer

Moscow
Victor Biryukov
Irina Dmitrieva
Evgeny Saklakov
Artem Toropov

New York
Olga Bogush
J. William Dantzler Jr.
Maureen D. Donovan*
David H. Dreier
Steven Gee
Stephanie Gentile
Michael Greenberg
Mark Hamilton**
James F. Hayden
Sang I. Ji
John T. Lillis
Cecily Maguire*
Timothy Mulvey
Jeremy M. Naylor
Maryanne O'Connor
John Olivieri*
Kerry O'Rourke Perri*
Edward F. Rover
Winthrop Rutherfurd Jr.*
Ray Simon
Alex Specht
Isaac Tendler

Paris
Christel Alberti
Alexandre Ippolito
Norbert Majerholc**
Pascale Morescaux
Emmanuelle Pontnau-Faure

Prague
Michal Gregor
Tomáš Hlaváček
Jan Pařík
Jakub Zavadil
Aleš Zídek

Singapore
Barrye L. Wall*

Tokyo
Akira Akamatsu
Jun Sawada
Shimon Takagi*
Gary M. Thomas
Yoko Ueda

Warsaw
Natalia Banasiewicz
Grzegorz Jukiel
Marzena Matuszyk-Aubertin
Marcin Panek
Joanna Sapiezko-Samordak

Washington, DC
Kim Marie Boylan
Linda E. Carlisle**
Bruce N. Davis
Mark Davis
Brian S. Gleicher
Patrick Holten
Geoffrey B. Lanning
Ann Lilienthal
Spencer J. Lucas
Michael Quigley

* Also advises on Private Clients matters

** Also advises on Executive Compensation, Benefits, Employment and Labor matters

Supporting Our Clients Around the Globe

White & Case is a truly global law firm, uniquely positioned to help our clients achieve their ambitions in today's G20 world.

As a pioneering international law firm, our cross-border expertise and diverse team of local, US and English-qualified lawyers consistently deliver results for our clients.

In both established and emerging markets, our lawyers are integral, long-standing members of the community, giving our clients insights into the local business environment alongside our expertise in multiple jurisdictions.

We work with some of the world's most respected and well-established banks and businesses, as well as start-up visionaries, governments and state-owned entities.

In this publication, White & Case means the international legal practice comprising White & Case LLP, a New York State registered limited liability partnership, White & Case LLP, a limited liability partnership incorporated under English law and all other affiliated partnerships, companies and entities.
NY/0412/T/N/06985_14