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# Transfer Pricing

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# Tax disputes post-BEPS: A perfect storm

BEPS will inevitably lead to an increase in international tax disputes, write **Joe Duffy** and **Tomás Bailey** of **Matheson**.

The international tax landscape has changed dramatically since the OECD's Action Plan on Base Erosion and Profit Shifting was published in 2013. The BEPS Project has been both a vehicle and a catalyst for change. Taxpayers with cross-border operations now face a perfect storm of untested international tax rules, inconsistent implementation and interpretation in different jurisdictions, increased information sharing and a drive to raise tax revenues. An increase in international tax disputes seems inevitable.

This article will consider the primary causes for the increase in disputes, focussing on the implementation of international measures in Ireland to highlight the risk of disputes arising from inconsistencies in implementation. This article will also consider the steps taxpayers can take to mitigate the risk of disputes and to ensure that tax structures are fully defensible in the event of a challenge.

## **Batten down the hatches**

To fully appreciate a taxpayer's position in the current international tax climate, the perfect storm must be contextualised in the current international economic environment. Many countries are becoming increasingly reliant on enforcement of tax law as a revenue raising measure to address budgetary deficits without introducing measures, which could negatively impact on the ability to attract foreign direct investment. This has resulted in many countries, like Ireland, enhancing domestic revenue collection powers and resources.

It is imperative that international taxpayers adapt to the new international tax environment and implement a proactive and coordinated approach to tax policy and governance. In particular, taxpayers should ensure that operations and structures align in all respects to produce a robust and fully defensible position in the event of challenge.

It is equally important for a country like Ireland with an open, outward-facing economy that all domestic efforts are taken to promote certainty in taxation and to ensure that the appropriate infrastructure is in place to enable international taxpayers resolve disputes in an efficient and principled manner.

## **Fertile ground for disputes: The BEPS effect**

It is unquestionable that the OECD BEPS Project has had a significant reformative impact on international tax principles and policy. This impact has been two-pronged. Firstly, the proposals emanating from the

final BEPS reports are being transposed into national and supranational law. Secondly, many countries and institutions have sought to leverage the reformative impetus surrounding the BEPS Project to unilaterally drive developments beyond the boundaries of the BEPS reports.

The inevitable uncertainty arising from such large-scale reform together with a lack of uniformity in implementation in an environment of enhanced cooperation between tax authorities make it unsurprising that significant increases in international tax disputes are anticipated. The increase in tax disputes, both from an Irish and an international perspective, will largely emanate from the following sources:

- The disjointed domestic implementation, interpretation and enforcement of supranationally developed measures; and
- The increased transparency and enhanced cooperation between tax authorities internationally.

Ireland has traditionally operated a self-assessment based cooperative system of tax compliance for corporate taxpayers. By virtue of the changes to the international tax landscape, taxpayers located in Ireland with cross-border operations will experience an increase in tax disputes over the coming years. The Irish Revenue Commissioners have, like many tax authorities internationally, enhanced the resources allocated to its international tax, transfer pricing and competent authority divisions in order to increase domestic tax revenues and to defend the Irish tax base. Therefore, in addition to an increase in disputes, it is likely that taxpayers in Ireland will encounter more interactions generally with the Irish Revenue Commissioners, which are increasingly formal and adversarial in many instances.

### **Disjointed domestic implementation, interpretation and enforcement**

The measures proposed in the final BEPS reports are undergoing multi-speed domestic implementation. There is an obvious risk of inconsistency in implementation which could be caused by an à la carte uptake of BEPS measures or the adoption of alternative domestic interpretations of BEPS measures, for example. Any divergence or unilateral action on implementation is likely to impact significantly on taxpayer's with global operations. Such action would ultimately increase uncertainty, undermine the BEPS Project and result in a lack of taxpayer engagement in the reformative process.

The measures proposed in Action 7 for example are selective by design. Countries can choose whether or not to adopt the updated treaty provisions and commentary when ratifying the multilateral instrument (MLI). Although this selectivity should not directly result in an increase in disputes, it may do so indirectly by increasing the instances in which treaty relief is claimed by a resident of a treaty country that has not adopted the new lower

threshold of taxation provided for under Action 7. For example, where a country which adopts the Action 7 proposal when ratifying the MLI (Country A) extends the new understanding of permanent establishment into domestic law. In such circumstances, non-resident enterprises would exceed the threshold for taxation under domestic law in Country A more frequently which could result in greater reliance on the existing (pre-BEPS) permanent establishment provisions.

Another possible source of disparity is the domestic application of the updated OECD Transfer Pricing Guidelines contained in the final report on Actions 8-10. It appears that some taxing authorities have adopted a view that the updated guidelines are clarificatory in nature and as such apply with retroactive effect. There is no evidence to suggest that the Irish tax authorities have adopted such an approach to the application of the updated guidelines. In fact, the updated guidelines have not been implemented into domestic Irish law to date and therefore currently apply only in a double tax treaty context.

The diverging approaches to the application of the updated guidelines could give rise to significant disputes whereby taxpayers would be required to apply different standards to the two sides of the same intra-group transaction. Furthermore, there is also a risk that tax authorities in source jurisdictions, applying the updated guidelines, may seek to enhance the profits attributable to a local entity by attributing additional value to the functionality of that local entity based on a comparison with the overall group functions, where the group functions have been determined based on the pre-BEPS guidelines.

Empirical evidence suggests that tax authorities are also adopting a more aggressive approach to audits and investigations, particularly in a transfer pricing context where a revised tax assessment can involve substantial sums. Recourse to the criminal legal infrastructure, or at least threats thereof, is becoming increasingly commonplace. There is no evidence to suggest that the Irish Revenue Commissioners have adopted a similar approach.

### **Increased transparency and cooperation**

A number of initiatives in recent years have led to a significant increase in the information tax authorities will have at their disposal concerning a taxpayer's business operations and tax infrastructure. For example, in Ireland certain rulings relating to cross-border transactions issued since January 1 2010, including APAs, are within the remit of a retroactive spontaneous exchange of information regime pursuant to the OECD framework, as proposed by BEPS Action 5, and Council Directive (EU) 2015/2376. In addition, Ireland has implemented domestic legislation providing for the filing and exchange of country-by-country reports pursuant to BEPS Action 13.



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Tax authorities globally will be in possession of more relevant information concerning a taxpayer's tax affairs before the initiation of an audit or investigation. In addition, this information will in many instances have multi-jurisdictional relevance. Therefore, tax authorities will be in a relatively novel position of being able to undertake a multi-jurisdictional review and consideration of a taxpayer's global structure before engaging with the relevant taxpayer. While these developments strengthen the artillery of tax authorities internationally in combating aggressive tax structures, there is a real danger that, without appropriate controls, taxpayers will be prejudiced. For example, a taxpayer's position could be severely undermined where a disproportionate weight is attributed to information which favours a tax authority's position and which is ultimately considered without the benefit of the relevant underlying knowledge.

### Dispute resolution framework

The taxpayer's invidious position in the current international tax environment is compounded by the international tax dispute resolution framework which has failed to provide the efficiency and certainty required by international business to date. It is generally accepted that the mutual agreement procedure (MAP) framework is not fit for purpose, in its current guise at least. The system is undermined by:

- The lack of compulsion on parties to engage in the process;
- The absence of an obligation on the parties to resolve the dispute; and
- The lack of a time limit on negotiations.

As a result of these shortcomings, international tax disputes often remain outstanding and unresolved indefinitely, particularly where the views of the contracting states are diametrically opposed.

BEPS Action 14 seeks primarily to make international tax dispute resolution more effective. The Action 14 final report proposes a number of initiatives to enhance the MAP framework as a dispute resolution mechanism including a peer review of the implementation of minimum standards and the introduction of mandatory binding arbitration (MBA).

It is submitted that the introduction of MBA will provide a mechanism for resolving disputes in a decisive and efficient manner which will be crucial for taxpayers to achieve some level of certainty in the coming years. The certainty and efficiency achievable through MBA will be vital to protect enterprises with cross-border operations from double taxation and to promote confidence and engagement among the business community in the evolving international tax landscape. It is anticipated that Ireland will adopt MBA when implementing the MLI.

## **Staying afloat in turbulent waters**

Taxpayers with cross-border operations can take a number of steps to adapt to the changing environment by developing robust internal policies and procedures to manage and minimise international tax disputes. In particular, a globally focussed strategy should be developed to ensure that tax dispute risks are managed across the tax function in a pro-active, coordinated and consistent manner in order to minimise any potential disruptive impact on business operations. The details of any such strategy will be determined by the taxpayer's business model and the relevant perceived risks.

In anticipation of increased challenges and audits, taxpayers should undertake a detailed self-assessment of current tax practices, policies and structures to identify potential areas of weakness. Where weaknesses are identified, a concerted effort should be adopted to strengthen the position and to clarify relevant underlying technical support.

The proliferation of information is likely to have a significant impact on the approach adopted by tax authorities to the assessment of risk and to the conduct of audits and investigations. On this basis, the proactive management of information by taxpayers will be increasingly detrimental in preventing and settling disputes. Taxpayers should undertake a detailed review of all information available to tax

authorities (including information available on public forums and social or professional media platforms) to ensure that there is nothing which contradicts or casts doubt on the taxpayer's factual matrix. Such a review will enable the taxpayer to manage risk, to anticipate possible avenues for challenge by authorities and to exercise greater control of the weight attributable to unhelpful information.

Early engagement with tax authorities is crucial to managing tax disputes. Taxpayers should seek to identify the disputed issue as early as possible with a view to narrowing the scope of the disputed issue as quickly as possible. It is important to bear in mind that a tax authority's resources are not endless and that they will typically be receptive to proactive attempts to minimise the duration of a particular dispute. It is important to identify opportunities to settle the dispute where appropriate to avoid a prolonged engagement with the authorities or litigation. Taxpayers should however remain mindful of the importance of preserving confidentiality and privilege of information in all engagements with tax authorities in case litigation becomes inevitable.

Although tax disputes will be unavoidable for many in the coming years, by adopting a proactive tailored approach to managing tax risks taxpayers should be well equipped to weather the storm.