

Tax Audits in Germany: a Primer and a Plan

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I. Introduction

In Germany, as in most other countries, taxpayers become anxious the moment the revenue authority starts an audit. Regardless of whether the taxpayer is German or foreign, neither one looks forward to an audit. Foreign corporations face a bigger challenge, however, because taxes, particularly international taxes, generally are managed by the parent company's tax department, very often with little involvement by the tax advisors of the various subsidiary companies other than the preparation of year-end financial statements and in dealings with the local tax authorities.

Herein lies the dilemma: the tax department of the parent company must be "in charge," but it may not know or have experience with the foreign tax laws and regulations affecting the various subsidiaries, familiarity with foreign languages and mentalities, and all the other aspects that can be described as "insight" or "insider knowledge." This dilemma is worsened by tight budgets, shortages of qualified support staff, and the frictions that often arise between tax advisors and business people, who often see the work of the "tax guys" as interfering with their creativity and freedom.

Establishing and balancing the roles of the local and non-local tax departments is the major challenge when it comes to dealing professionally with a foreign tax audit. Generally speaking, the in-house tax department can only lose. Even if a favorable tax settlement is reached, local management often feels inconvenienced by the presence of the parent company's advisors and is only relieved when the audit is over because it means that the "tax guys" will finally go away and let the local company get back to business. Important decisions in a foreign tax audit are how will the subsidiary's local accountants be involved, who should be in charge of negotiations with the local tax authorities, and how will the audit be managed in terms of time scheduling and budgeting.

II. The Audit Scenario

Before discussing a proven approach to tax audits, various relevant aspects of a German tax audit will be mentioned briefly.

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A. WHEN IS A GERMAN COMPANY SUBJECT TO AN AUDIT?

1. *General Principles*

The law provides no specific regulation as to when audits must be carried out or how often. The relevant tax office generally has discretion whether and when to audit a particular company within its jurisdiction. There are, however, tax audit administrative guidelines, *Betriebsprüfungsordnung* 2000 (BpO 2000), which detail the proceedings of a tax audit and give some information about audit frequency. For example, the BpO 2000 states that “large” companies (trading companies with turnover of greater than Euro 5.95 million or taxable profit of Euro 232,500) and producing companies with turnover of greater than Euro 3.4 million or taxable profit of Euro 207,500 generally will be audited continuously. Medium-sized or small companies normally will not be audited every year. Furthermore, large multinational companies generally will be subject to more frequent audit reviews, particularly if the German subsidiary has experienced losses for a number of years.

2. *Statute of Limitations*

Generally, for the corporate, the income, and the trade tax purposes, the statute of limitations to instigate an audit is four years after the year in which the tax return was due. However, if the tax authorities issue a tax assessment subject to the right to review, the period of limitation will be suspended from the time an audit is commenced until the date of effectiveness of an amended tax assessment notice issued on the basis of the audit.¹ In the case of a revenue misstatement or tax evasion, the statute of limitations is ten years.²

B. WHO IS THE AUDITOR?

As a rule, the local fiscal authorities of the individual federal states perform tax audits. In addition, the Federal Finance Office (*Bundesamt für Finanzen*) is authorized to participate in tax audits conducted by the regional tax authorities. The finance office may also carry out tax audits itself by agreement with the regional tax office, which otherwise has jurisdiction over a certain case. This will be the case particularly with audits involving non-German companies as well as audits that extend beyond the territory of the respective state.³

C. THE SCOPE OF THE AUDIT

1. *Types of Tax Audits*a. *General Tax Audits*

General tax audits are carried out by investigative agencies of the tax offices in charge of general taxation matters as well as by centralized investigative agencies such as audit agencies for large businesses or corporate income tax matters. The agencies' subject matter jurisdiction normally covers all types of taxes that fall within the jurisdiction of a local tax office. Some types of taxes may be subject to additional special tax audits.

b. *Special Tax Audits*

In addition to the general tax audits performed by the investigative service agencies of the regional finance authorities and the Federal Finance Office (income tax audits), a com-

1. § 169–171 Abgabenordnung (German Tax Code) [hereinafter AO].

2. § 169 Nr. (2) 2 AO.

3. § 1, 22 ff BpO.

pany may be subject to specialized tax audits to verify liability for and payment of particular types of taxes, such as wage tax and the value-added tax (VAT).⁴ The specialized audits are carried out exclusively by auditors whose sole areas of jurisdiction are these types of taxes.⁵

2. *Scope of Review*

The auditor must review the taxpayer's books to the taxpayer's disadvantage and advantage, meaning that the auditor must reveal all mistakes made by the taxpayer, whether they disadvantage or advantage the taxpayer. As a result, a taxpayer may have to pay additional tax or, if he made a mistake against his company, he may receive a refund of overpaid taxes. The auditor may, and generally does, limit his examination to certain areas or even to one issue.

D. THE AUDIT PROCEDURE

1. *Notification*

Before starting an audit investigation, an audit agency must send a notification to the affected taxpayer specifying the type of audit to be conducted, the scope of the audit, the period to be examined, the date on which the audit is scheduled to begin, and the name of the auditor.⁶ The notification must be given to the taxpayer within a reasonable time before the audit is scheduled to begin, unless the examination purpose would be endangered. The notice period is generally four weeks for large companies and two weeks for medium-sized companies.⁷

The start of the audit examination may be postponed due to illness of the taxpayer, his tax advisor, or one of the employees designated to assist with the audit, or due to unusual circumstances affecting the company. In special situations, postponement may be granted to allow the taxpayer time to prepare.

Once an audit notification is received, the taxpayer should react immediately. The company should appoint a contact person who will be responsible for preparing the audit. The records that the auditor has the right to inspect should be reviewed and documented so that the company knows exactly what information the auditor can access. A review and audit of the records helps avoid any "surprises," which often occur when the auditor finds a particularly damaging document of which the company management was not aware.

2. *The "Start" of the Audit*

a. Suspension of the Statute of Limitations

Once an audit examination officially begins, the statute of limitations is suspended for tax assessments issued in the years under review.⁸

b. False or Incomplete Returns

A taxpayer who intentionally or unintentionally filed an inaccurate tax return has the right to file an amended return.⁹ However, if a tax auditor appears at the taxpayer's premises

4. § 194 Nr. (1) AO.

5. *Id.*

6. § 196 AO; § 5 BpO.

7. *Id.*

8. § 171 Nr. (4) AO.

9. § 371 Nr. (2) No. 1a AO.

to start an audit, a declaration at that time by the taxpayer regarding a false or incomplete tax return will not exempt the taxpayer from imposition of a penalty.¹⁰ The auditor is deemed to “appear” when she enters the business premises or any other agreed-upon premises to conduct the tax audit.

A recent change in the general tax code has created great uncertainty regarding penalty exemptions for an amendment of an inaccurate tax return. Currently, the exemption shall not be granted if a taxpayer has repeatedly misstated revenue amounts. It is not clear at the moment if, for example, the concealment of interest from one account for more than one year will be considered as “repeated misstatements.”¹¹

3. *The Examination*

a. Place of Audit

The legal regulations regarding audit procedures provide that the audit should take place at, in descending order of preference, the taxpayer’s place of business, the taxpayer’s premises, or, provided neither of the previous places is feasible, the offices of the tax authority.¹² Depending on the amount of documentation to be reviewed, the audit may also take place at the tax advisor’s office.¹³

b. Length of Audit Examination

There is no specific limitation on the time that an auditor may take in conducting an audit; the regulations merely provide that the audit should be limited to the time necessary.

c. Specification of Contact Person

At the time the audit begins the taxpayer must identify the person(s) who will serve as the auditor’s contact, if questions arise or additional information is needed.¹⁴ If the auditor wishes to obtain information from an employee or other representative whom the taxpayer has not specified, the taxpayer must be notified in order for the person to be named as an additional respective contact person.¹⁵

d. Initial Meeting

Taxpayers are advised to conduct an initial meeting with the auditor when it first appears an audit has begun. In this meeting, the contact person is specified, the issues are narrowed to the greatest extent possible, and procedures are set forth for the conduct of the audit (for example, it is recommended that the auditor present all questions in written form). The auditor’s initial impression of the company and the extent of cooperation that he feels he can expect will often set the tone for the entire audit and should not be underestimated. After all, auditors *are* human!

e. Documents Required

The German Tax Code (*Abgabenordnung* or AO) identifies the nature of documents that the taxpayer must retain for tax purposes: accounting documents, business letters, and other

10. *Id.*

11. Anja Hillman-Stadtfield, 11 DStR 434 (2002).

12. § 200 Nr. (2) AO.

13. § 200 Nr. (2) AO.

14. § 200 Nr. (1) AO.

15. *Id.*

records concerning the business. The taxpayer is required to present exactly this documentation to the auditor, no more and no less.

Beginning in 2002, the taxpayer also must grant the auditor access to electronic systems used for bookkeeping.¹⁶ If the bookkeeping of a German subsidiary is undertaken by and retained at the place of the foreign parent company, the electronic data must be made available for the German auditor in a timely fashion.

f. The Auditor's Findings and the Taxpayer's Response

If the results of the audit lead to a tax adjustment for the years under review, the relevant factual situation and the legal basis for the adjustment must be presented to the taxpayer in the form of an audit report.¹⁷ The taxpayer then has the right to respond to the issues raised in the report. As a rule, a discussion or conference will be held between the tax examiner and the taxpayer, in which the taxpayer is given the opportunity to challenge the examiner's findings. During this conference, an agreement generally will be reached as to how various issues will be treated for tax purposes.

g. The Final Audit Report

Based on the discussion(s) with the auditor and the agreements reached, the auditor will issue a final report that presents his findings and serves as the basis for an amended tax assessment.

Taxpayers should be as involved as possible in the writing of the report so that the wording of the findings will not be detrimental to future tax periods.

h. Binding Rulings

Upon request by the taxpayer, the fiscal authority must issue a binding ruling as to how a matter or set of circumstances addressed in the audit will be treated in the future.¹⁸ The only prerequisites for requesting such a ruling is that the future tax treatment might impact business measures taken by the taxpayer and that the exact circumstances of the case is set forth in the final report.¹⁹ Only on the basis of the final report will the tax authorities issue a binding ruling.²⁰ Therefore, the taxpayer should ensure that all relevant data are included in the report, because the tax authority's ruling will not be binding if the actual future situation differs from the one contained in the report.²¹

4. *The Amended Assessment (Close of Audit)*

On the basis of the auditor's findings and the understandings reached during the audit conference, tax authorities will issue an adjusted tax assessment. The assessment notice normally is subject to amendment only if there is evidence of tax fraud, evasion, or failure to exercise due care.

16. § 147 Nr. (6) AO.

17. § 202 AO.

18. § 204 AO.

19. *Id.*

20. *Id.*

21. *Id.*

III. Selected Audit Issues

While all the issues that can be addressed in an audit are too numerous to mention in this summary, the following issues are the most common in tax audits involving the German subsidiary of a foreign-based multinational.

A. PRINCIPLES OF PROPER BOOKKEEPING

One of the main areas examined in every tax audit is whether the company has complied with the German generally accepted accounting principles (GAAP) and has produced the books and records required by law. In general, the accounting system must be set up so that it gives a qualified outsider an overview of the company's business activities and financial situation in a reasonable period of time. Furthermore, it must allow the outsider to follow the development and conclusion of the company's business activities. A computerized accounting system generally may be used as long as the principles of a manual accounting system are fulfilled, and, as mentioned above, the auditor is given access to the computerized system.²²

B. HIDDEN PROFIT DISTRIBUTIONS

The phrase "hidden profit distribution" is used in Germany to describe a transfer of benefits from a company to its shareholders by means other than a straightforward dividend distribution.²³ The reverse process, a "hidden capital contribution," transfers benefits from a shareholder to the company.²⁴ If an auditor determines that the company under examination has made a hidden profit distribution, the amount of the deemed distribution will be added back to the company's taxable income (thereby increasing its income tax burden), and a dividend withholding tax will be assessed.²⁵ While there are a number of situations in which hidden profit distributions may be found, the following are the most important for multinational companies.

1. *Transfer Pricing*

a. The Increasing Significance of Transfer Pricing Issues in Germany

As in most countries, the German tax authorities are focusing increasingly on the transfer prices set between members of multinational groups to determine whether the German operations of such groups are paying their "fair share" of taxes.²⁶ As a result, the sophistication of the tax examiners in regard to transfer pricing issues has become quite high.²⁷ Furthermore, there has been greater involvement of the federal tax authorities in regard to transfer pricing issues.²⁸ However, the tax authorities currently are experiencing a shortage of staffing, which hampers their attempts to deal seriously with transfer pricing issues.

22. § 243 (HGB); Wolfgang Dieter Budde, Ingo Raff, Beck'scher Bilanzkommentar re. § 243.

23. Hermann Heuer Raupach, Kommentar zum Einkommen- und Körperschaftsteuergesetz, § 8, at 35a.

24. DIETER ENDRES ET AL., TAXES IN THE FEDERAL REPUBLIC OF GERMANY 15 (2d ed. 2001), available at <http://www.bmwi.de/Redaktion/Inhalte/Downloads/br-corporate-taxes-in-germany.pdf;property=pdf.pdf> (last visited Oct. 2, 2003).

25. *Id.*

26. *Id.* at 40–41.

27. *See id.* at 41–42.

28. *See id.*

b. Legislative and Administrative Provisions

Article 1 of the German Foreign Tax Code (*Außensteuergesetz* or AStG) permits the German tax authorities to increase the income reported by the German member of a multinational group of companies, if the related companies have agreed to prices between them that artificially shift profits from the German entity to another member of the group located in a foreign country.²⁹ To implement this provision, in 1983 the German federal tax authorities issued Principles for the Examination of Income Allocation in the Case of Internationally-Related Enterprises, more commonly known as the German Administrative Principles (GAP).³⁰ While GAP are not binding on taxpayers, they represent the considerations that will be applied by the German tax authorities in audits of multinational entities and, in practice they are applied on a regular basis.³¹ Since 1983, parts of the GAP have been under review and new administrative principles have replaced some of the previous guidelines.³² In December 1999, new guidelines regarding cost allocation agreements were published,³³ and in November 2001, guidelines regarding secondment of employees were issued.³⁴

c. Burden of Proof

The GAP provides that a tax auditor, during an audit investigation involving transfer pricing, must analyze transfer prices in two steps:

Step 1: The auditor must analyze whether the method used by the taxpayer fits the factual situation of the particular case; and

Step 2: The auditor must determine whether the chosen method has been applied properly.³⁵

Generally, tax auditors may apply any of the standard methods (comparable uncontrolled price, resale-price, and cost-plus methods) to verify the results of the method actually applied.³⁶ They may not, however, replace the method used by the taxpayer unless they determine that the method is inappropriate for a particular factual situation or industry.³⁷ Only if the auditors can show that the transfer prices applied to transactions between related parties would not have been agreed to by unrelated parties, can they recalculate the profit results of the German company or determine that a hidden profit distribution or hidden capital contribution was made.³⁸ The use of a “reasonable manager” standard further requires the German tax authorities to accept a company’s transfer prices as long as they fall within a range of prices that would be acceptable to similarly situated managers dealing

29. Alexander Vögele, *Key Transfer Pricing Statute Void Under EU Law?*, KPMG GERMAN NEWS, No. 1/2002, at 10–11 (2002), available at http://www.kpmg.de/library/english-language-publications/satellit/german_news_01_02.pdf (last visited Oct. 2, 2003).

30. BMF Decree 23. Feb. 1983 (BStBl S. 218).

31. See Scott M. Bennett, *New Principles for the Audit of Income Between Multinational Enterprises*, LEGAMEDIA (July 2002), at http://www.legamedia.net/legapractice/d-p/2002/02-07/0207_bennett_scott_aps_01.php.

32. *Id.*

33. BMF Decree 30. Dec. 1999 (BStBl S. 1122).

34. BMF Decree 9. Nov. 2001 (BStBl S. 796). (A secondment of employees is the sending of a related companies’ employees abroad to complete a specific task for a specified period of time.)

35. See ENDRES ET AL., *supra* note 24, at 42.

36. *Id.* at 41.

37. See *id.*

38. See *id.* at 15, 41–42.

with an unrelated company.³⁹ The reasonable manager standard recognizes that a single correct transfer price generally does not exist in regard to any transaction.⁴⁰

The type of documentation that a taxpayer must present in order to avoid the questioning of his transfer prices by the tax authorities is in discussion at the moment.⁴¹ The tax authorities tend to shift the burden of proof to the taxpayer, although two rulings of the Federal Tax Court in 2001 ran contrary to this and appear to have strengthened the position of the taxpayer.⁴²

2. Cost Allocation Agreements

The members of a multinational group of companies often have agreements to allocate costs incurred by the parent (or another group entity) in providing services that benefit the group as a whole.⁴³ In the event that group cost allocations are not accepted by the German tax authorities, the amount that has been charged to the German subsidiary generally will be treated as a hidden profit distribution.⁴⁴ Cost allocation agreements must be in writing to be accepted by the German tax authorities.⁴⁵ The administrative guidelines issued in 1999 give a detailed summary of the relevant issues here.⁴⁶

The main problem that arises in regard to cost allocation agreements within the scope of German tax audits is the lack of sufficient documentation supporting both the agreement itself as well as the costs that it allocates and the allocation formula used. Therefore, it is advisable to ensure that proper documentation is maintained to support both the types and amounts of costs allocated.

3. Thin Capitalization

The German rules regarding thin capitalization have been restricted by recent changes to the Corporate Tax Code (*Körperschaftsteuergesetz* or KStG).⁴⁷ Section 8a KStG provides that interest payments made on financing provided by affected shareholders will be reclassified as hidden profit distributions if certain debt capitalization ratios are exceeded.⁴⁸ The rule distinguishes between capital-based and hybrid financing.⁴⁹ In regard to capitol-based financing, a reclassification will occur if the shareholder debt financing exceeds one and one-half of the shareholder's proportionate shares of the company's equity capital.⁵⁰ The most important change to the tax code prohibits the use of hybrid financing by shareholders.-

39. *See id.*

40. *See id.*

41. Alexander Vögele & William Bader, *New Deal for German Transfer Pricing*, KPMG GERMAN NEWS, No. 1/2002, at 3 (2002), available at http://www.kpmg.de/library/english-language-publications/satellit/german_news_01_02.pdf (last visited Oct. 2, 2003).

42. BFH (NV 2001), (957); BFH (NV 2002), (134).

43. Alexander Vögele, *Germany Redefines its Cost Contribution Policy*, KPMG GERMAN NEWS, No. 1/2000, at 19–20 (2000), available at http://www.kpmg.de/library/english-language-publications/satellit/german_news_01_00.pdf (last visited Oct. 2, 2003).

44. *See* ENDRES ET AL., *supra* note 24, at 15.

45. Vögele, *supra* note 43, at 22–23.

46. *See id.* at 19–24.

47. Adam Craig et al., *ECJ Holds German Thin Cap Rules Incompatible with EC Treaty*, WORLD TAX ADVISOR, Jan. 2003, at 1, available at <http://www.deloitte.com/dt/cda/doc/content/WTAJan03%282%29.pdf>.

48. *See id.*

49. *See id.*

50. *See id.*

The earlier version of the code allowed this, only applying a different ratio when examining the issue of thin capitalization. Now the tax authorities will not accept anything other than capital-based financing.⁵¹

Every multinational firm with German subsidiaries should ensure that all financing arrangements comply with the new, stricter regulations.

4. *Hidden Transfers of Customer Base*

The situation often arises in multinational groups, where the parent company sets up a new subsidiary in a market formerly served by its German subsidiary (for example, a new subsidiary in Austria which previously had been handled out of Bavaria). While the overall results for the company may remain the same or even increase, the profits of the German subsidiary may be reduced significantly. To the extent that the German company is not compensated for the lost business and makes no claim against the parent company for such loss, the German subsidiary generally will be deemed to have made a hidden profit distribution to the parent.⁵²

IV. Special Topics

A. EXCHANGE OF INFORMATION

Article 117(1) of the AO says "the tax authorities may make use of mutual legal and administrative assistance in accordance with provisions of German law."⁵³ This rule implies that the German tax authorities may use international legal provisions to obtain information regarding the determination of a taxpayer's tax burden. Therefore, in addition to the information obtained from the taxpayer directly, the German tax authorities may obtain information from the tax authorities in foreign countries. This procedure is described in extensive administrative guidelines issued in February 1999.⁵⁴

B. COMPETENT AUTHORITY PROCEEDING (CAP)

In April 1993, the Federal Finance Ministry for the first time issued an instruction sheet regarding international CAPs in tax matters. The instructions set forth the procedures for an initiation and implementation of CAPs authorized by the various double taxation conventions to which Germany is a party. The initial instruction sheet was updated by a new version issued in July 1997.⁵⁵ The instruction sheet is generally only applicable to CAPs in the "narrow sense," that is, situations in which a taxpayer can show that taxation measures taken by one or both contracting countries have led or will lead to results contrary to the terms of the double taxation treaty. The purpose of such a proceeding is to realize the affected taxpayer's right to taxation in accordance with the applicable double taxation convention.

A request for a CAP may be filed even though other legal actions are pending in regard to the double taxation in either contracting country, or when other legal remedies exist

51. *See id.*

52. *See* ENDRES ET AL., *supra* note 24, at 15.

53. Karl-Jakob Schmitz, *Exchange of Information Agreements: A Review of the Federal Republic of Germany's Information Exchange Agreements and Practices*, 90 TAX NOTES INT'L 25, 8 (1990).

54. BMF Decree 3. Feb. 1999 (BStBl S. 228).

55. BMF Decree 1. July 1997 (BStBl S. 717).

which have not yet been exhausted. However, a CAP will be opened only if the tax authorities of one of the contracting countries have taken concrete actions that have led or could lead to double taxation. For purposes of a German CAP, this will be assumed where the tax authority of the other contracting country has made a determination within the scope of a tax audit or has issued a binding ruling in regard to the taxation of a particular factual situation.

C. ARBITRATION PROCEEDINGS

As a member of the European Union, Germany is party to the so-called arbitration convention of July 23, 1990.⁵⁶ Under the convention, the tax authorities of each contracting country are authorized to adjust the income of an enterprise resident in their country if its income has been artificially reduced through its dealings with related entities in another contracting country.⁵⁷ Article 5 of the convention provides, however, that the tax authority will notify the affected entity of the proposed adjustment so that the entity can inform its related entity in the other contracting country and this entity can, in turn, inform the competent tax authorities.⁵⁸

If the tax authorities of the other contracting country do not agree to the proposed adjustment by the first contracting country, then the affected enterprise is allowed to initiate a CAP involving all affected countries.⁵⁹ If the competent authorities of the affected countries fail to reach agreement regarding the proposed adjustment within two years from the date on which the case is first submitted to a CAP, then the convention provides that an arbitration proceeding will be initiated.⁶⁰ The convention further provides how the arbitration panel (advisory commission) is to be constituted and the general procedural rules to be applied in the arbitration proceeding.⁶¹

D. SIMULTANEOUS AUDITS

The possibility exists, at least in theory, of requesting the German tax authorities to commence an audit in regard to a German subsidiary when one or more of its related companies is subject to audit by a foreign tax authority. However, since there is no legislation and no written guidelines in regard to a request for simultaneous audits, the granting of such a request will be within the sole discretion of the German tax authority having audit jurisdiction over the company.

E. MANAGEMENT'S LIABILITY

The managing director of a German limited liability company is responsible to the government to ensure the company's compliance with its tax obligations.⁶² This includes not

56. No. 90/436/EWG.

57. Dr. Jean-Philippe Chetcuti, *EU Tax Dispute Resolution: The EU Tax Arbitration Convention* (2001), § 2.2, available at <http://www.chetcuticauchi.com/jpc/research/eu-tax-arbitration-convention.htm> (last visited Oct. 2, 2003).

58. *Id.* § 5.

59. *See id.* § 6.

60. *Id.* § 7.1.

61. *Id.*

62. Peter Jaspers, *The Responsibilities and Liability of a Managing Director of a GmbH*, B JL LEGAL FORUM, Nov. 2000, at 1–2, available at <http://www.bjl-legal.com/rahmen.pl?http://www.bjl-legal.com/legalforum.pl/sprache=e>.

only filing tax returns and paying the taxes due but also withholding and paying the taxes due by third parties (such as the withholding taxes payable in regard to actual as well as hidden dividend distributions).⁶³ Managing directors who intentionally or negligently cause the company not to fulfill any of its tax obligations will be personally liable for the payment of the relevant taxes and may also be subject to administrative sanctions and criminal penalties.⁶⁴

V. The Proven Approach

A company preparing for an audit should use a project-management orientation, which is a standardized analysis approach tailored to the needs of a particular case. Within the scope of this approach, the company develops a budget, timetable, and project plan. Reports to management on a regular basis are necessary, as are discussions regarding any changes to the project plan that become necessary during the course of the audit examination.

Below is a brief summary of the “6 Golden Audit Rules.”

Rule Number 1: Be Prepared

The old Boy Scout motto “be prepared” applies best to tax audits. The more work that the company to be audited does up-front, the lower the risk of surprise during the course of the audit. The company should define in writing the rules to be followed by everyone and appoint an audit team or individual who will act as contact person and will be responsible for providing the auditor with the information he requests.

Rule Number 2: Establish a Worst-Case Scenario

Establishing a worst-case scenario helps the attorneys and audit team define their audit strategy and calculate their expenses on an ongoing basis.

Rule Number 3: Set the Tone

Before the audit, an initial meeting should be held with the auditor at which the contact person should be introduced, the issues to be examined are narrowed as much as possible, and procedural rules are established (for example, the auditor shall submit all questions in writing).

Rule Number 4: Control the Flow of Information

As noted earlier, it is very important to review the documents that the auditor will have access to before the audit so that the company knows exactly what information the auditor will have. It is not unusual for the auditor to find a particular document that company management believes to have been segregated from the materials provided to the auditor. In one particular case, the document stated the opposite of what management and its advisors were arguing in regard to a particular issue and proved to be quite damaging to the company’s position (and quite expensive). It is therefore of paramount importance to know exactly what information the auditor has obtained.

In no case should the auditor be placed in a room with free access to information; he should be given only the files that he specifically requests, and, as noted above, those files should be reviewed before being presented to him.

63. *Id.*

64. *Id.*

Rule Number 5: Do not underestimate the Auditor

Many companies make the mistake of considering tax auditors to be of lesser intelligence simply because they work for the government. On the contrary, they are generally intelligent and quite educated in tax and accounting matters.

Rule Number 6: Do not forget that Auditors are Human, Too

As noted above, it is important to develop a cooperative relationship with the auditor. Since the auditor is often present at the company for an extended period of time during the audit examination, it is important to make him feel welcome. While there are limits as to the amenities with which auditors may be provided, it certainly does not do any harm to offer him coffee or to treat him in a friendly manner. Creating an atmosphere of hostility, on the other hand, generally encourages an auditor to intensify his efforts to uncover something that he can use against the company.

VI. Implications for a Foreign Tax Department

As noted at the beginning of this article, it is important for the tax department of a multinational enterprise (MNE) to be involved in the audits of its German subsidiaries. The main question in this regard is the extent to which the local management and its tax advisors can be trusted with tax issues potentially affecting the entire MNE. On the other hand, knowledge of the local rules and the tax authority involved is absolutely necessary for an effective handling of audit investigations. The need for balancing these two issues shows the wisdom of engaging outside tax professionals and attorneys early in the process. With an unbiased view, taking in the impact on the MNE as a whole, the outside team can effectively coordinate the overall strategy with the need for local information and input, thus arriving at the best possible outcome for both the local subsidiary and any other affected units of the MNE. As they say, one must learn from history. If the recent histories of some of the once-mighty corporations have taught us anything, it is that leaving the same team that audited a company's books in charge of an outside audit can lead to disastrous consequences.