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## **An Economic Analysis of Joint Tax Audits**

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# An Economic Analysis of Joint Tax Audits\*

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## Abstract

We investigate how tax authorities use joint tax audits as a coordinated enforcement tool in cross-border transactions of a multinational firm. Joint tax audits aim to resolve potential tax disputes early, before such disputes escalate into costly and time-consuming resolution procedures that may not fully eliminate double taxation. Employing a game-theoretic model, we identify settings in which we expect joint audits to occur and investigate their effect on the firm's expected tax payments and tax audit efficiency. We find that the occurrence of joint audits critically depends on the double taxation risk in the absence of joint audits. Unless tax rules are consistently applied, joint audits can occur more often when this risk is higher. The reason is that the firm changes its income-shifting strategy to reduce its expected tax payments, and thereby also enables tax authorities to better target tax disputes via joint audits that would otherwise escalate. However, we identify conditions under which joint audits are then detrimental to tax audit efficiency, particularly when the firm prefers them most. Our results imply that cost-sharing arrangements for joint audits should be tailored to the level of double taxation risk, with firm involvement having the potential to improve efficiency when this risk is high.

**Keywords:** joint tax audits, double taxation, dispute prevention, income shifting

**JEL classification:** H26, H87, F23, M42, C72

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*“TWO audit teams – ONE common solution – ZERO double or non-taxation.  
That is what joint audits are about!”<sup>1</sup>*

— Eva Oertel

## **1 Introduction**

Joint tax audits have emerged as a critical tool in international tax enforcement. They involve two or more tax authorities collaboratively reviewing taxpayer records, thereby ensuring consistent tax assessments across jurisdictions and preventing double taxation (Burgers and Criclivaia 2016, Čičin-Šain and Englisch 2022). Double taxation arises when two or more tax authorities assert the right to tax the same income, and is a result of inconsistent applications of tax rules across jurisdictions. Anecdotal and empirical evidence suggests that inconsistent applications of tax rules, for example of transfer pricing rules, are widespread (Rathke et al. 2020, Diller et al. 2025). Theoretical models similarly predict inconsistent applications of tax rules as a result of tax competition (Mansori and Weichenrieder 2001, Raimondos-Møller and Scharf 2002), and this problem is further aggravated by the widespread fiscal constraints currently faced by many countries (e.g., PwC 2025). Due to the economic distortions for firms, instruments to prevent double taxation ex ante, such as Advance Pricing Agreements (APAs) or Advance Tax Rulings (De Waegenaere et al. 2007, Diller et al. 2017), and to resolve double taxation of escalated disputes ex post, such as Mutual Agreement Procedures (MAPs) or arbitration (Martini et al. 2025), exist. However, these instruments are costly and time-consuming for all stakeholders (OECD 2019).

Given this context, joint tax audits have been introduced as a policy response to reduce international tax disputes through coordinated enforcement. Joint audits can be conducted across various cross-border transactions, including transfer pricing cases, profit attribution to permanent establishments, and complex business restructurings. First pilot projects indicate

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<sup>1</sup>The quote is cited in OECD (2019, p. 13). At that time, Eva Oertel was a Legal Counsel for International Tax Policy at the Federal Ministry of Finance in Berlin.

that joint tax audits can be an efficient and timely alternative to traditional dispute prevention and resolution instruments (Braun et al. 2020). Most recently, the Directive on Administrative Cooperation (DAC7) provides the first legally binding framework for conducting joint tax audits in the European Union (Form and Oestreicher 2021, Čičin-Šain and Englisch 2022). Despite the growing interest of policymakers and practitioners, we lack a theoretical understanding of when tax authorities are willing to engage in joint audits and what their economic implications are. This question is particularly pertinent because, although joint tax audits are expected to prevent disputes, they typically require greater administrative resources than national audits (Burgers and Criclivaia 2016, OECD 2019).

To address this gap, we develop a game-theoretic model that analyzes the strategic interactions between a multinational firm, two tax authorities, and their respective national tax auditors. In particular, we study the conditions under which we expect joint tax audits to arise and their effects on the firm's expected tax payments and tax audit efficiency.

The model features a multinational firm operating in a high-tax and a low-tax country. Part of the firm's income is disputed with regard to its allocation between the two countries. The true allocation is determined by the state of the world. In "consistent" states, tax rules are consistently applied across countries even in a national audit. In the "inconsistent" state, tax rules are inconsistently applied if no joint tax audit is established and a national audit is conducted, leading to double taxation. The firm privately observes the state and reports the disputed income to one of the tax authorities. Reporting disputed income to the low-tax authority can constitute income shifting. In particular, the firm can engage in "aggressive" income shifting when both countries would agree the income should be taxed in the high-tax country (consistent state), in "moderate" income shifting when both countries would disagree on the income allocation (inconsistent state), or abstain from income shifting altogether.<sup>2</sup> For example, the firm can shift income by varying a royalty payment from a subsidiary located in

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<sup>2</sup>We refer to income shifting in this consistent state as aggressive, since the firm deliberately misreports against a shared understanding of where income should be taxed. In the inconsistent state, shifting is termed moderate, as any interpretation is reasonable and both countries can plausibly claim taxing rights.

the low-tax country to the parent company located in the high-tax country. Following the firm's report, both tax authorities independently decide whether to opt for a joint tax audit, which is established only if both give their consent. If no joint audit occurs, the decisions to conduct (in-depth) national audits are delegated to strategic tax auditors.<sup>3</sup> While joint audits involve additional coordination costs for both net-revenue maximizing authorities, joint audits prevent double taxation and avoid the costs associated with dispute resolution procedures (e.g., MAPs) when national audits would lead to double taxation. We label the latter as “inconsistency costs”.

Three key institutional characteristics that depend on the specific country pair shape the players' behavior in the model. *Tax rule inconsistency* reflects how likely it is that diverging interpretations are practically applied under national audits, which varies even within OECD countries (Diller et al. 2025). This institutional friction directly affects the behavior of national tax auditors. These auditors typically have implicit incentives to increase revenues by uncovering income shifting (Blaufus et al. 2025), but also face personal audit costs. As tax rule inconsistency increases, so does the likelihood that (at least moderate) income shifting occurs, making their decisions to conduct national audits more attractive. The tax authorities base their preceding joint audit decisions on the anticipated behavior of the national auditors. While national audits increase revenues if they uncover income shifting, they may trigger *inconsistency costs* in the case of double taxation. These costs capture the administrative and procedural burden of resolving disputes through mechanisms such as MAPs. The costs can vary across countries, as, for example, reflected in different MAP durations (Martini et al. 2025). Higher inconsistency costs make joint audits more attractive to the tax authorities as a means to prevent disputes ex ante. A third institutional factor is the *residual risk of double taxation* for the firm, which captures the effectiveness of dispute resolution mechanisms in eliminating double taxation after national audits. The higher this risk, the less likely the firm is to engage in moderate income shifting, and the more likely conflicting preferences become between the

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<sup>3</sup>We focus on permanently audited multinational firms, and thus the national audit decisions reflect auditors' decisions to conduct in-depth national audits of the underlying transaction.

firm and the authorities regarding joint versus national audits. This risk is low in country pairs with mandatory binding arbitration and can be high otherwise, particularly when the countries' tax rates are similar.

Our equilibrium analysis reveals how the firm's income shifting decisions, the tax authorities' decisions to opt for a joint audit, and the auditors' decisions to conduct national audits depend on these institutional characteristics. We find that the economic implications of joint tax audits critically depend on the firm's residual double taxation risk *absent* joint audits. When this risk is low, joint audits only occur when the tax authorities' expected inconsistency costs under national audits are higher than the additional coordination burdens under a joint tax audit. Therefore, a necessary condition for joint audits to occur is that the tax authorities' expected deadweight losses are lower than under national audits. Since these deadweight losses serve as our measure for tax audit efficiency, this reveals that when the residual risk is low, joint audits are always efficient if established. However, the converse is not true, as not all efficiency-enhancing joint audits are established. A joint audit requires mutual consent by both authorities, and the tax authority in the low-tax country blocks some efficiency-enhancing joint tax audits because the low-tax authority does not internalize the inconsistency cost savings that could be realized by the high-tax authority. This reveals a fundamental coordination problem in decentralized enforcement settings that efficiency can be necessary but not sufficient for implementation.

When tax rule inconsistency is sufficiently low but the risk of residual double taxation is high—that is, disputes are rare but in case of occurrence hard to resolve through traditional dispute resolution—we find that joint tax audits are unlikely to be initiated. However, as soon as tax rule inconsistency exceeds a threshold, we show that a national audit and a joint audit equilibrium may coexist. In the national audit equilibrium, the auditors of both countries conduct some national audits, and the firm engages in some moderate and aggressive income shifting. In the joint audit equilibrium, the firm engages in no moderate income shifting and

more aggressive income shifting compared to the national audit equilibrium. On the one hand, the different income shifting behavior enables the tax authorities' to more effectively use joint audits to target genuine tax disputes that emerge in the inconsistent state, as the required inconsistency costs for joint audits decrease. On the other hand, the changed income shifting behavior triggers the possibility that joint audits get inefficient, because these can occur even for low levels of inconsistency costs. Summing up, we generally find that the existence of joint audits can decrease tax audit efficiency. This result is striking given that our tax audit efficiency definition incorporates both tax authorities' expected deadweight losses and their mutual consent is required for joint audits to occur. Further, we also show that efficient joint audits can be blocked by either tax authority, which contrast the findings from the low risk case.

We also examine how the presence of joint tax audits affects the firm's expected tax payments compared to a setting with only national audits. Across all equilibria, our findings suggest that the expected tax payments in the consistent states are identical, and hence any differences originate from the inconsistent state. When the residual double taxation risk is low, joint audits can increase expected tax payments because they can prevent the firm from fully leveraging the tax rate differential through moderate income shifting. Once the residual risk of double taxation is sufficiently high, joint tax audits always reduce the firm's expected tax payments. Because joint tax audits require both authorities to agree on a common report that eliminates double taxation, a high residual risk undermines the prospects of reaching such an agreement due to negative revenue implications for at least one authority. Notably, the cases where joint audits reduce expected tax payments coincide with those in which joint audits may be inefficient.

Concerning regulatory implications, our findings suggest that when the residual double taxation probability is low, a regulatory cost-sharing mechanism that reallocates coordination costs from the low-tax to the high-tax authority could enable more coordinated enforcement and efficient outcomes. By contrast, when the residual double taxation risk is high, a third-party cost-sharing approach involving the firm is more suitable. If the firm shares part of the

coordination burden, such cost-sharing approach could better align the firm's preferences with overall efficiency goals.

We contribute to the literature in two ways. First, we contribute to the literature on strategic individual and corporate taxpayer audits (e.g., Graetz et al. 1986, Sansing 1993, Mills et al. 2010). Within this literature, De Waegenare et al. (2006) employ an international tax compliance model with potential inconsistent applications of transfer prices and investigate the economic effects of harmonizing transfer pricing rules on income shifting and audit strategies. Diller et al. (2025) examine the effects of enhancing standards consistency on a firm's reporting and tax authorities' audit strategies, additionally including real effects. Unlike these studies, we analyze joint tax audits as an institutional mechanism that can be used by tax authorities to overcome inconsistency when harmonization is difficult or practically impossible.

Similarly, other studies consider institutional mechanisms to resolve or prevent inconsistencies and disputes. Kourouxous et al. (2024) study how the presence of a court of appeals affects taxpayer reporting and the tax authority's audit process. In an international setting, Martini et al. (2025) analyze how different arbitration mechanisms to resolve double taxation affect tax audit qualities. Unlike these resolution mechanisms, preventive mechanisms, such as joint tax audits, are voluntarily established by some of the players. De Simone et al. (2013) examine when firms and tax authorities voluntarily enter into Enhanced Relationship Programs and how the benefits of the program are shared. Diller et al. (2017) analyze the circumstances under which investors request Advance Tax Rulings. Unlike these studies, we focus on dispute prevention in an international setting. Similar to our international setting, De Waegenare et al. (2007) examine when bilateral APAs arise and how they affect tax audit efficiency. They find that the absence of bilateral APAs can reveal private information which can decrease tax audit efficiency. Our study differs from De Waegenare et al. (2007) because joint tax audits do not require the firm's consent and the authorities' joint audit decisions are based on the firm's report. We find that the existence of joint tax audits can decrease tax audit efficiency because



the firm alters its income-shifting strategy, while the channel of De Waegenaere et al. (2007) is muted in our setting.

Second, we contribute to the literature on joint audits in non-tax settings. Deng et al. (2014) analyze joint audits in which two audit firms simultaneously but yet separately audit a firm's financial statement, considering two joint audit and one single audit regime. They find that joint audits can impair audit quality due to free-riding incentives. Biehl et al. (2022) propose an extension of this model and additionally consider joint audit synergies. Blaufus et al. (2024) examine whether tax audits become more efficient if tax auditors have access to information about statutory audit adjustments. Their setting can be interpreted as a sequential joint audit of two auditors with distinct but related audit fields. While these joint audit models also result in a common report, our tax setting differs because participation is voluntary and endogenous, the relationship absent a joint audit is more adversarial, and free-riding incentives are muted.

In sum, we are the first to theoretically examine the economic effects of joint tax audits and their distinct characteristics as compared to other dispute resolution mechanisms or joint audit arrangements. In particular, joint tax audits are a coordinated enforcement mechanism in an international tax setting and (only) require the tax authorities' consent.

The paper proceeds as follows. Section 2 describes the relevant elements of the institutional setting. Section 3 introduces the analytical model and its main assumptions. Section 4 presents the equilibria depending on the low or high residual double taxation risk. Section 5 identifies the economic effects of joint audits. Finally, section 6 concludes.

## **2 Institutional Framework**

The OECD's Base Erosion and Profit Shifting project marked a turning point in international tax cooperation. In particular, action 14 of the project emphasized improving tax dispute resolution mechanisms between member states to address double taxation and income shifting by multinational firms (OECD 2015). Against this backdrop, joint tax audits emerged as a

critical tool in international tax enforcement in a short period of time. In contrast to national or simultaneous audits, joint tax audits involve two or more tax authorities collaboratively reviewing taxpayer records, ensuring consistent tax assessments across jurisdictions and thereby avoiding double taxation (Burgers and Criclivaia 2016, Form and Oestreicher 2021). While information exchange is a key component of a joint tax audit, this exchange also exists outside joint tax audits. Thus, what sets the different audit types apart is the ability to reach a common assessment through mutual understanding (OECD 2019).

A joint tax audit typically replaces a national audit and renders subsequent MAPs, which are used to resolve double taxation arising from escalated disputes, unnecessary. An alternative for resolving double taxation issues related to transfer prices are APAs, which are based on the same legal provision as MAPs, namely Article 25 of the OECD Model Convention for Double Taxation Agreements. Even though both MAPs and APAs can provide solutions to double taxation issues, both exhibit similar weaknesses as they are time consuming and are mostly unable to resolve issues in advance of an audit (Zimmerl 2022).

Important milestones in institutionalizing joint tax audits within the European Union include the EU directive on Tax Dispute Resolution Mechanisms and DAC7. While the former introduced mandatory binding arbitration and encouraged member states to conduct joint audits (EU Council 2017), the latter establishes a legal and administrative framework by providing a structured approach to collaboration and information sharing mechanism aimed at standardizing joint audit procedures within the European Union (Form and Oestreicher 2021, Čičin-Šain and Englisch 2022). The 2008 revision of Article 26 of the UN Model Tax Convention also played a key role in facilitating joint tax audits. It influenced agreements at both the European and OECD levels and supported the establishment of joint audits through bilateral treaties by promoting information exchange between contracting states. Its provisions regarding the scope of information, confidentiality, and conditions for exchange were a contributing factor that led to the facilitation of joint audits globally. However, to this point, there is no institutional

framework that mandates joint tax audits. In all cases, joint tax audits have to be initiated by one party and subsequently mutually agreed upon by the other participating parties (OECD 2019). In addition, under the current European and global provisions, taxpayers do not have a legally standardized right to request or reject a joint audit (Form and Oestreicher 2021, Čičin-Šain and Englisch 2022).

Globally, by 2020, we observe 232 joint audit cases (Braun et al. 2020). Although administrative barriers with regard to aligning the various tax audit procedures of participating jurisdictions were not yet fully resolved, first pilot projects between Germany, France, and the Netherlands in the early 2010s demonstrated that joint tax audits have the potential to prevent international tax disputes (OECD 2019, Criclivaia 2020). The majority of the pilot projects were initiated by member states of the European Union with Germany in the lead having initiated 113 of those 232 joint audits (Braun et al. 2020, Criclivaia 2020).<sup>4</sup> Recently, we also observe joint tax audits with a number of non-European countries. Initial reports indicate that joint tax audits can be a time-saving tool as compared to other traditional resolution procedures, as most cases have been resolved and double taxation has been avoided. However, joint tax audits still lack mass suitability (Form and Oestreicher 2021). Also, joint audits are conducted by a limited pool of specialized auditors, and impose additional coordination burdens on tax authorities due to differences in procedures, legal frameworks, and audit standards, as well as practical challenges such as language barriers (Burgers and Criclivaia 2016). This calls for a theoretical foundation of joint tax audits.

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<sup>4</sup>Joint tax audits exhibit a close resemblance to the interstate tax audits conducted by the Multistate Tax Commission in the United States (Burgers and Criclivaia 2016). Within the United States, first pilot projects regarding state-level sales and income tax were completed as early as 1969 (Multistate Tax Commission 1970).

### 3 Model

#### 3.1 Model setup

**Basic assumptions** Subsequently, we introduce the setup of our model.<sup>5</sup> We assume that a firm with worldwide income  $W$  operates in two countries, a low-tax country  $L$  and a high-tax country  $H$ . The firm's income must be taxed in either of these countries. Income is subject to tax rate  $\tau_L$  in the low-tax country or tax rate  $\tau_H$  in the high-tax country with  $\tau_H > \tau_L \geq 0$ . Part of this income is disputed, where the disputed income is normalized to one. There are three possible states of nature:  $y_L$ ,  $y_H$  and  $y_B$ . In state  $y_L$  ( $y_H$ ), both tax authorities agree that the firm's disputed income should be taxed in country  $L$  ( $H$ ). In state  $y_B$ , a tax dispute arises as both tax authorities claim the right to tax the firm's income following national audits, resulting in double taxation. The probabilities of the states are  $\Pr(y_L) = \Pr(y_H) = (1 - p)/2$  and  $\Pr(y_B) = p$ , where  $p \in [0, 1]$  reflects the probability that the tax rules are inconsistently applied by the tax authorities. For example, a high  $p$  may reflect transactions between countries with fundamentally different transfer pricing systems (Rathke et al. 2020). However, even among countries aligned with OECD guidelines, inconsistent applications of rules are prevalent, as shown by anecdotal evidence (Diller et al. 2021, Diller et al. 2025) and the high concentration of arbitration cases within this group (Martini et al. 2025).

The firm privately observes the state of nature, which captures the informational asymmetry typically assumed between the firm and the tax authorities or auditors before any audit. After observing the state, the firm reports its aggregate taxable income  $W$  to country  $L$  and  $H$ . We restrict our focus to income shifting, which requires that aggregate income reported must equal  $W$ . For example, the firm can vary a royalty payment from a subsidiary located in  $L$  to the parent company located in  $H$  owning the intangible property. Therefore, we implicitly assume that cross-border information exchange, disclosure requirements, and substantial penalties for misreporting deter tax evasion (i.e., reported aggregate income smaller than  $W$ ). The critical

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<sup>5</sup>Our model is a variation of the international tax compliance model of De Waegenaere et al. (2006).

decision concerns the country to which the firm shifts the disputed income, either to  $L$  or  $H$ , as reflected in the respective reports  $x_L$  and  $x_H$ .

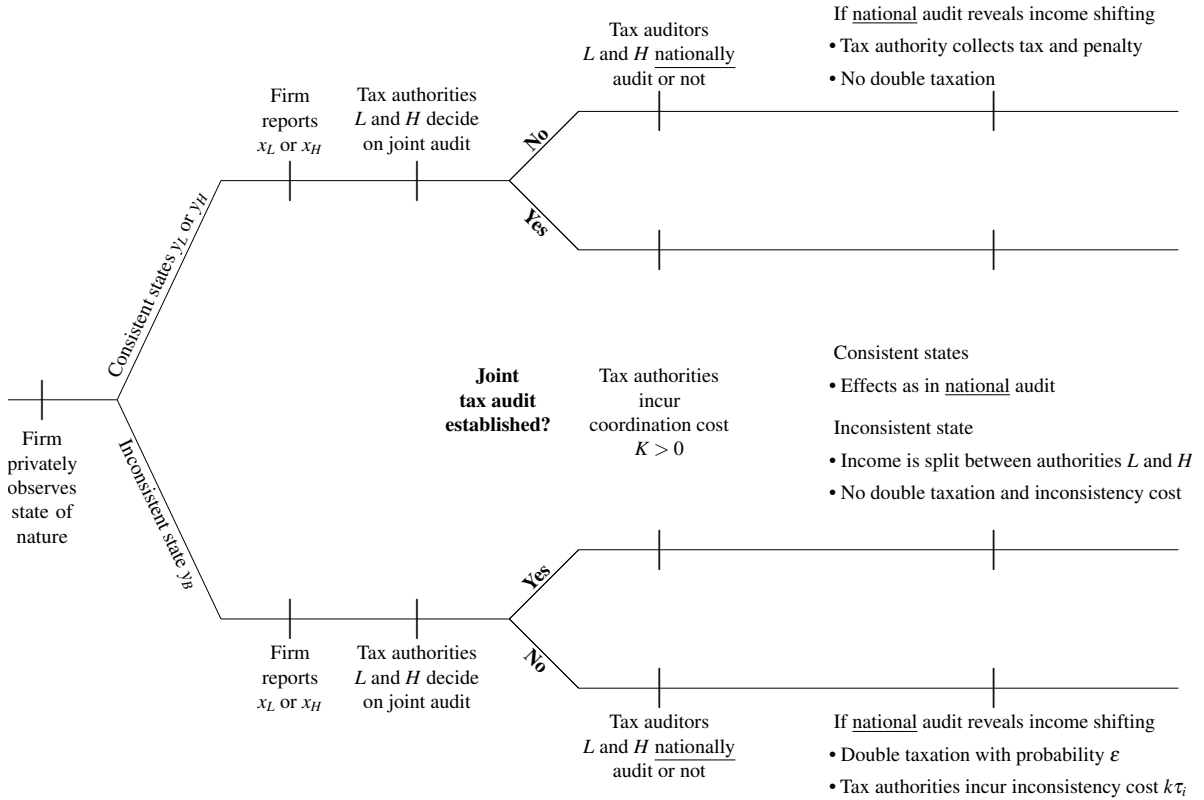
Next, both tax authorities observe the firm's report  $x_L$  or  $x_H$  and simultaneously decide whether they want to opt for a joint tax audit. Only when both tax authorities independently opt for the joint audit, it is established. Otherwise, the audit decision is delegated to strategic tax auditors who can audit nationally.<sup>6</sup> Joint tax audits involve additional coordination burdens relative to national audits (Burgers and Criclivaia 2016, OECD 2019). We model this by a cost  $K > 0$  each tax authority incurs in case of a joint tax audit. Ultimately, the tax authorities' joint audit decisions are a trade-off between the additional coordination cost and the potential to avoid inconsistency costs associated with costly MAPs or arbitration, while accounting for the expected tax revenue consequences of the different types of audits. The payoffs are described in the following. Figure 1 depicts the game tree.

**National tax audits** If no joint tax audit is established, the tax authorities delegate the audit decisions to their respective national auditors, who also observe the report  $x_i$  with  $i \in \{L, H\}$ . If conducted, national audits reveal the state. The tax auditors in both countries receive a fixed benefit  $b > 0$  if they uncover income shifting. For example, tax auditor  $H$  receives the benefit when  $x_L$  is reported and he uncovers state  $y_H$  ("aggressive" income shifting) or  $y_B$  ("moderate" income shifting). Conversely, auditor  $L$  receives the benefit when  $x_H$  is reported and states  $y_L$  or  $y_B$  are uncovered. However, auditing is personally costly to the auditors at cost  $c_i > 0$  with  $c_i < b$ . These assumptions reflect that tax auditors typically have implicit incentives to generate additional revenues through tax audits (Blaufus et al. 2024, Blaufus et al. 2025). The benefit in state  $y_B$  reflects the current environment of intensified competition for tax revenues across

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<sup>6</sup>The simultaneous joint audit decisions avoid introducing strategic timing frictions unrelated to the core question of coordinated enforcement and reflect the institutional reality that the momentum for coordination is typically lost once in-depth national audits have commenced (OECD 2019). In addition, the setup reflects that national audits are typically delegated to national tax auditors, whereas joint audits require higher-level coordination between authorities that are conducted by other auditors (Braun et al. 2020, Federal Central Tax Office 2025).

Figure 1: Game Tree



countries (e.g., Blaufus et al. 2023). In addition, we require that  $b > 2c_H$ , which guarantees that auditor  $H$ 's audit threat is credible even if there is no inconsistency ( $p = 0$ ).

The auditors' decisions affect the tax authorities' collected revenues. If the firm shifts income aggressively (report  $x_H$  in state  $y_H$ ) and auditor  $H$  conducts an audit, the tax authority collects the tax and an additional penalty  $\tau_H(1 + \pi)$ . This is similarly true in the opposite case when the state is  $y_L$ , the firm reports  $x_H$ , and auditor  $L$  audits, but this case never occurs in equilibrium. Thus, only the penalty  $\pi$  imposed by country  $H$  is relevant. In either case, the other authority collects no revenues because the allocation of income is undisputed in the consistent states.

If an audit is conducted in the inconsistent state  $y_B$  by auditor  $i$  after a report  $x_{-i}$ , both tax authorities claim the right to tax the disputed income, resulting in double taxation. Authority  $i$ , however, does not claim a penalty as any interpretation is reasonable in state  $y_B$ . To resolve

double taxation, we assume that the firm initiates a MAP (potentially followed by arbitration) or litigates nationally.<sup>7</sup> The outcome of the dispute resolution procedure is that tax authority  $i$  (auditor  $i$  has audited  $x_{-i}$ ) collects  $\varepsilon \tau_i$  with  $0 \leq \varepsilon \leq 1$ , and tax authority  $-i$  taxes the full income. In the following, we refer to  $\varepsilon$  as the residual double taxation risk, where “residual” refers to double taxation after the dispute resolution procedure. For example, if  $\varepsilon = 0$ , there would be mandatory binding arbitration in both countries, completely resolving double taxation. If  $\varepsilon = 1$ , both countries claim to tax the disputed income even after MAP. This modeling choice captures the assumption that the MAP procedure or arbitration panel favors the initial report  $x_i$  of the firm.<sup>8</sup>

Dispute resolution procedures aimed at eliminating double taxation have implications beyond the mere allocation of tax payments. These procedures are often lengthy and resource-intensive for tax authorities (Martini et al. 2025) and may erode taxpayers’ trust in the fairness and efficiency of the system (Braun et al. 2020). Therefore, we additionally consider these *inconsistency costs*, and model them as an amount  $k \tau_i$  with  $k > 0$  incurred by each tax authority when national audits lead to double taxation. Countries with a higher tax rate thus have a larger share of revenue at stake, triggering more complex and costly resolution processes (Martini et al. 2025). High levels of  $k$  can occur when countries, such as the United States or India with a long average duration for arbitration cases, are part of the firm’s business activity. Avoiding these inconsistency costs is among the determining factors for tax authorities to initiate joint tax audits.

Table 1 summarizes the players’ payoffs for every possible state  $y_i$  and action choice in the national audit. Given that auditing  $x_i$  is a dominated strategy for tax auditor  $i$ , these choices are not included in the table.

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<sup>7</sup>Our model captures both dispute resolution procedures. However, since national litigation is less common than resolution through MAP or arbitration, we concentrate on the international mechanisms in the main text.

<sup>8</sup>The assumption is consistent with our interpretation of state  $y_B$ , in which any outcome supported by robust documentation is considered reasonable. Given the cooperative nature of joint tax audits, we expect a more balanced allocation of income between countries compared to the typically adversarial nature of ex post dispute resolution procedures such as MAP or arbitration. We specify this balanced allocation below.

Table 1: Payoffs in a national tax audit

		Low-tax country			High-tax country	
		Firm	Auditor $L$	Tax authority	Auditor $H$	Tax authority
State	$x_L, H$ audit	$-\tau_L$	0	$\tau_L$	$-c_H$	0
	$x_L, H$ no audit	$-\tau_L$	0	$\tau_L$	0	0
	$y_L, x_H, L$ audit	$-\tau_L(1 + \pi)$	$b - c_L$	$\tau_L(1 + \pi)$	0	0
	$x_H, L$ no audit	$-\tau_H$	0	0	0	$\tau_H$
State	$x_L, H$ audit	$-\tau_H(1 + \pi)$	0	0	$b - c_H$	$\tau_H(1 + \pi)$
	$x_L, H$ no audit	$-\tau_L$	0	$\tau_L$	0	0
	$y_H, x_H, L$ audit	$-\tau_H$	$-c_L$	0	0	$\tau_H$
	$x_H, L$ no audit	$-\tau_H$	0	0	0	$\tau_H$
State	$x_L, H$ audit	$-\tau_L - \varepsilon \tau_H$	0	$\tau_L(1 - k)$	$b - c_H$	$(\varepsilon - k) \tau_H$
	$x_L, H$ no audit	$-\tau_L$	0	$\tau_L$	0	0
	$y_B, x_H, L$ audit	$-\tau_H - \varepsilon \tau_L$	$b - c_L$	$(\varepsilon - k) \tau_L$	0	$\tau_H(1 - k)$
	$x_H, L$ no audit	$-\tau_H$	0	0	0	$\tau_H$

**Joint tax audit** Once both tax authorities opt for a joint tax audit, involving coordination cost  $K > 0$  for each authority, we assume that no further strategic decisions are made. National auditors no longer play an active role, and the authorities are assumed to reach a common agreement, as there is a strong commitment to reach an agreement once joint tax audits are in place.<sup>9</sup> As in national tax audits, we assume that joint tax audits reveal the state. In the consistent states, the revenue consequences are equivalent to those under national audits. In state  $y_B$ , however, the authorities agree on an income allocation that prevents double taxation. We model the joint audit outcome parsimoniously by assuming that, at the time of the joint audit decision, the share  $\kappa$  allocated to tax authority  $H$  is unknown.  $\kappa$  is drawn from a probability distribution with full support on  $[0,1]$ , and independent of  $x_i$ . We consider symmetric distributions, for

<sup>9</sup>As Braun et al. (2020, p. 24) note: “So far, almost all [joint tax audit] cases have been resolved and double taxation avoided”. Also, the assumption aligns with those made for Bilateral Advance Pricing Agreements (De Waegenaere et al. 2007) and Cooperative Compliance Programs (De Simone et al. 2013).



example,  $\kappa \sim U(0, 1)$ , with all players anticipating the expected share  $\mathbb{E}(\kappa) = \mathbb{E}(1 - \kappa) = 1/2$ .

Table 2 summarizes the players' payoffs for every possible state  $y_i$  and report  $x_i$ .

Table 2: Payoffs in a joint tax audit

		Firm	Tax authority $L$	Tax authority $H$
State	$x_L$	$-\tau_L$	$\tau_L - K$	$-K$
	$y_L$	$x_H$	$-\tau_L(1 + \pi)$	$\tau_L(1 + \pi) - K$
			$-K$	$-K$
State	$x_L$	$-\tau_H(1 + \pi)$	$-K$	$\tau_H(1 + \pi) - K$
	$y_H$	$x_H$	$-\tau_H$	$-K$
			$-K$	$\tau_H - K$
State	$x_L$	$-\frac{\tau_L + \tau_H}{2}$	$\frac{\tau_L}{2} - K$	$\frac{\tau_H}{2} - K$
	$y_B$	$x_H$	$-\frac{\tau_L + \tau_H}{2}$	$\frac{\tau_L}{2} - K$
			$\frac{\tau_H}{2} - K$	$\frac{\tau_H}{2} - K$

### 3.2 Strategies and objective functions

We now turn to the players' strategies and their objective functions. Since the firm observes the state, it conditions its strategy on this private information. In state  $y_L$ , the firm has a dominant strategy of reporting  $x_L$ , as it can be sure that this report will be accepted regardless of the subsequent decisions by other players. In state  $y_H$ , the firm chooses a mixed strategy reporting  $x_H$  with probability  $\alpha$  and  $x_L$  with probability  $1 - \alpha$ , maximizing  $\mathbb{E}[u_F(\alpha|y_H)]$ . In state  $y_B$ , it chooses a mixed strategy reporting  $x_H$  with probability  $\beta$  and  $x_L$  with probability  $1 - \beta$ , maximizing  $\mathbb{E}[u_F(\beta|y_B)]$ .

Both tax authorities observe the report  $x_i$ . Tax authority  $H$  chooses probability  $\mu_H(x_i)$  to conduct a joint tax audit, considering expected payoffs in a joint audit  $\mathbb{E}[v_H(JA|x_i)]$  and national audit  $\mathbb{E}[v_H(NA|x_i)]$ . Similarly, tax authority  $L$  chooses probability  $\mu_L(x_i)$  considering  $\mathbb{E}[v_L(JA|x_i)]$  and  $\mathbb{E}[v_L(NA|x_i)]$ . If no joint tax audit is established, the tax auditors come into play. Tax auditor  $H$  never audits  $x_H$ , since the auditor can only benefit from an audit of  $x_L$ . However, conditional on  $x_L$ , he chooses an audit probability  $\gamma$  by maximizing  $\mathbb{E}[u_H(\gamma|x_L)]$ . Analogously, tax auditor  $L$  never audits  $x_L$  and chooses an audit probability  $\delta$  by maximizing

$\mathbb{E}[u_L(\delta|x_H)]$ . We next show the players' objective functions given their available information when making their strategic decisions. We start with the tax auditors' audit decisions.

**Tax auditors' audit decisions** Conjecturing the firm's strategies  $\alpha$  and  $\beta$ , tax auditor  $H$ 's expected utility given report  $x_L$  is

$$\mathbb{E}[u_H(\gamma|x_L)] = \gamma[(\Pr(y_H|x_L) + \Pr(y_B|x_L))b - c_H], \quad (1)$$

with

$$\Pr(y_H|x_L) = \frac{\frac{1-p}{2}(1-\alpha)}{\frac{1-p}{2}(1-\alpha) + \frac{1-p}{2} + p(1-\beta)}, \quad (2)$$

$$\Pr(y_B|x_L) = \frac{p(1-\beta)}{\frac{1-p}{2}(1-\alpha) + \frac{1-p}{2} + p(1-\beta)}. \quad (3)$$

Thus, tax auditor  $H$  trades off the expected benefit of uncovering income shifting against the audit costs. Similarly, tax auditor  $L$ 's expected utility given report  $x_H$  is given by

$$\mathbb{E}[u_L(\delta|x_H)] = \delta[\Pr(y_B|x_H)b - c_L] = \delta \left[ \frac{p\beta}{p\beta + \frac{1-p}{2}\alpha} b - c_L \right]. \quad (4)$$

Notably, the expected benefit to conduct an audit increases for both tax auditors when tax rule inconsistency  $p$  is higher.

**Tax authorities' joint audit decisions** The tax authorities simultaneously decide on whether they opt for a joint audit. They conjecture the firm's reporting strategy, the other tax authority's joint audit strategy, and the auditors' audit strategies if no joint tax audit is established. Given a

report  $x_L$ , tax authority  $H$ 's expected payoff from a joint and national audit is

$$\mathbb{E}[v_H(JA|x_L)] = \Pr(y_H|x_L) \tau_H(1 + \pi) + \Pr(y_B|x_L) \frac{\tau_H}{2} - K, \quad (5)$$

$$\mathbb{E}[v_H(NA|x_L)] = \gamma[\Pr(y_H|x_L) \tau_H(1 + \pi) + \Pr(y_B|x_L) (\varepsilon - k) \tau_H]. \quad (6)$$

Thus, upon observing report  $x_L$ , tax authority  $H$  prefers a joint audit if

$$\tau_H \left[ \Pr(y_H|x_L)(1 - \gamma)(1 + \pi) + \Pr(y_B|x_L) \left( \frac{1}{2} - \gamma(\varepsilon - k) \right) \right] \geq K. \quad (7)$$

Tax authority  $H$ 's trade-off conditional on  $x_L$  is as follows. On the cost side, joint audits incur additional coordination costs and the authority loses expected tax revenues from double taxation. On the benefit side, it taxes the income and imposes an additional penalty if no national audit occurs in  $y_H$ , it taxes half of the income in  $y_B$ , and, most importantly, it saves the inconsistency costs when double taxation would occur in a national audit.

Conditional on  $x_L$ , tax authority  $L$ 's expected payoffs from a joint and national audit is

$$\mathbb{E}[v_L(JA|x_L)] = \Pr(y_L|x_L) \tau_L + \Pr(y_B|x_L) \frac{\tau_L}{2} - K, \quad (8)$$

$$\mathbb{E}[v_L(NA|x_L)] = \tau_L - \gamma[\Pr(y_H|x_L) \tau_L + \Pr(y_B|x_L) \tau_L k]. \quad (9)$$

Thus, tax authority  $L$  prefers a joint audit if

$$\tau_L \left[ \Pr(y_B|x_L) \left( \gamma k - \frac{1}{2} \right) - \Pr(y_H|x_L) (1 - \gamma) \right] \geq K. \quad (10)$$

Intuitively, preventing the inconsistency costs arising from double taxation is the only advantage for authority  $L$  in this case. Other than that, a joint tax audit has negative revenue implications and induces the coordination cost  $K$ . Overall, tax authority  $L$  and  $H$  choose  $\mu_i(x_L)$  so as to

maximize

$$\mathbb{E}[v_i(\mu_i(x_L))] = \mu_i(x_L)\mu_{-i}(x_L)\mathbb{E}[v_i(JA|x_L)] + (1 - \mu_i(x_L)\mu_{-i}(x_L))\mathbb{E}[v_i(NA|x_L)]. \quad (11)$$

The following lemma simplifies the equilibrium analysis. The proof is in the Appendix B.

**Lemma 1.** *If the firm reports  $x_L$ , the joint audit incentive for tax authority  $H$  is always higher than for tax authority  $L$ . Thus, the binding constraint to consider is (10).*

Lemma 1 establishes that in the equilibrium analysis, it suffices to focus on tax authority  $L$ 's joint audit decision when the firm reports  $x_L$ . If (10) does not hold, no joint tax audit can occur.

Next, we turn to the decisions when the firm reports  $x_H$ . As this report cannot stem from state  $y_L$ , tax authority  $H$ 's expected payoffs in a joint and national audit are

$$\mathbb{E}[v_H(JA|x_H)] = \Pr(y_H|x_H)\tau_H + \Pr(y_B|x_H)\frac{\tau_H}{2} - K, \quad (12)$$

$$\mathbb{E}[v_H(NA|x_H)] = \Pr(y_H|x_H)\tau_H + \Pr(y_B|x_H)\tau_H - \delta\Pr(y_B|x_H)k\tau_H. \quad (13)$$

Thus, tax authority  $H$  prefers a joint audit if

$$\tau_H\Pr(y_B|x_H)\left(\delta k - \frac{1}{2}\right) \geq K. \quad (14)$$

In this case, tax authority  $H$  trades-off the benefit of preventing inconsistency costs against the negative revenue effect of splitting the tax base and the coordination cost. Similarly, we obtain tax authority  $L$ 's expected payoffs

$$\mathbb{E}[v_L(JA|x_H)] = \Pr(y_B|x_H)\frac{\tau_L}{2} - K, \quad (15)$$

$$\mathbb{E}[v_L(NA|x_H)] = \delta[\Pr(y_B|x_H)(\varepsilon - k)\tau_L]. \quad (16)$$

Thus, tax authority  $L$  prefers a joint audit if

$$\tau_L \Pr(y_B|x_H) \left( \delta(k - \varepsilon) + \frac{1}{2} \right) \geq K. \quad (17)$$

The trade-off resembles the one for tax authority  $H$  after a report  $x_L$ . Notably, we cannot establish a similar result as in Lemma 1 when the report is  $x_H$ . While the joint audit incentive for tax authority  $L$  is higher when  $K = 0$  due to  $\delta(k - \varepsilon) + \frac{1}{2} > \delta k - \frac{1}{2}$ , this need not be the case when the coordination costs  $K$  are high.<sup>10</sup> Overall, tax authority  $L$  and  $H$  choose  $\mu_i(x_H)$  so as to maximize

$$\mathbb{E}[v_i(\mu_i(x_H))] = \mu_i(x_H)\mu_{-i}(x_H)\mathbb{E}[v_i(JA|x_H)] + (1 - \mu_i(x_H)\mu_{-i}(x_H))\mathbb{E}[v_i(NA|x_H)]. \quad (18)$$

**Firm decisions** The firm conjectures the auditors' audit decisions and the probabilities that a joint audit is established  $\mu_L(x_i)\mu_H(x_i)$ . As explained above, the firm always reports  $x_L$  in state  $y_L$ . In state  $y_H$ , the firm trades-off the costs and benefits of aggressive income shifting  $1 - \alpha$ . Then, the firm's expected utility is given by

$$\begin{aligned} \mathbb{E}[u_F(\alpha|y_H)] = & -\alpha\tau_H - (1 - \alpha) [\mu_H(x_L)\mu_L(x_L)\tau_H(1 + \pi) + \\ & (1 - \mu_H(x_L)\mu_L(x_L))(\gamma\tau_H(1 + \pi) + (1 - \gamma)\tau_L)]. \end{aligned} \quad (19)$$

From the perspective of the firm, joint tax audits and a national audit by auditor  $H$  are equally threatening, as both lead to a repayment of the tax and a penalty when it reports  $x_L$  in  $y_H$ .

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<sup>10</sup>Lemma 1 is driven by our modeling choice for the inconsistency costs, that is,  $k\tau_i$ . If we model fixed inconsistency costs  $k$  independent of  $\tau_i$ , Lemma 1 would not hold and the implications are similar to those in our setup when the report is  $x_H$ . By contrast, with fixed inconsistency costs, we could establish a similar lemma where (14) is the binding constraint when the report is  $x_H$ . Our results remain qualitatively unchanged for fixed inconsistency costs.

In state  $y_B$ , the firm trades off the costs and benefits of moderate income shifting with probability  $1 - \beta$ . The firm's expected utility is given by

$$\begin{aligned}\mathbb{E}[u_F(\beta|y_B)] = & - \left[ \frac{\tau_L + \tau_H}{2} \right] [\beta \mu_H(x_H) \mu_L(x_H) + (1 - \beta) \mu_H(x_L) \mu_L(x_L)] \\ & - \beta (1 - \mu_H(x_H) \mu_L(x_H)) [\delta (\tau_H + \varepsilon \tau_L) + (1 - \delta) \tau_H] \\ & - (1 - \beta) (1 - \mu_H(x_L) \mu_L(x_L)) [\gamma (\tau_L + \varepsilon \tau_H) + (1 - \gamma) \tau_L].\end{aligned}\quad (20)$$

When no joint audit is established, the firm's objective functions are fully in line with our benchmark model. Further, when tax authorities agree on a joint audit, for example after report  $x_L$ , the firm can prevent double taxation by choosing  $\beta = 0$ . Since the same outcome can also be achieved when joint audits are conducted after  $x_H$  and the firm chooses  $\beta = 1$ , this gives rise to multiple equilibria. We discuss this in more detail in the next section.

## 4 Equilibria

### 4.1 General remarks

In this section, we characterize the equilibria. Our equilibrium concept is Perfect Bayesian Equilibrium as defined in Gibbons (1992). When multiple equilibria arise for the same parameter values, we focus on those that are weakly payoff dominant (i.e., all players are weakly better off and at least one is strictly better off). For example, we exclude equilibria in which the firm's expected tax payments and the auditors' expected payoffs are identical to that in another equilibrium, but tax authorities incur higher deadweight losses (inconsistency and coordination costs).<sup>11</sup> We also rule out equilibria that rely on firm randomization in state  $y_B$  to

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<sup>11</sup>Harsanyi and Selten (1988) develop strict payoff dominance as a criterion for equilibrium selection, noting that weak payoff dominance is a possible refinement.

induce a joint tax audit, as these only occur for extremely high inconsistency costs. Overall, we obtain equilibria that are institutionally plausible.<sup>12</sup>

The following observation underscores the role of De Waegenaere et al. (2006) as our benchmark model.

**Observation.** *Suppose there are no inconsistency costs ( $k = 0$ ). Then, only national audits will be conducted, and we obtain equilibria  $I^{NA}$  to  $VI^{NA}$  with strategic tax auditors.*

The observation can be directly seen from the tax authorities' expected utilities. If we neglect inconsistency costs, tax authority  $L$  never prefers a joint audit when observing  $x_L$  (see equation 10) and tax authority  $H$  never prefers a joint audit when observing  $x_H$  (see equation 14). Since a joint audit requires consent of both authorities, this implies that only national audits are conducted. We postpone the proof that equilibria  $I^{NA}$  to  $VI^{NA}$  exist to Proposition 1 to 5.

The various national audit equilibria crucially depend on the residual double taxation risk  $\varepsilon$  and the tax rule inconsistency  $p$ . The intuition behind the national audit equilibria is as follows. For a given level of  $\varepsilon$ , an increase in inconsistency generally induces auditors to adopt more rigorous audit strategies. This, in turn, reduces aggressive income shifting by the firm, but may generally increase or decrease moderate income shifting. The increase in audit aggressiveness also increases tax authorities' expected inconsistency costs. If the authorities want to conduct a joint tax audit, a sufficiently high inconsistency  $p$  ensures credible off the equilibrium path (national audit) threats. Moreover, for a given level of  $p$ , an increase in  $\varepsilon$  generally discourages moderate income shifting. While this does not discourage joint tax audits per sé, it increases the range where national audit equilibria are feasible.

More specifically, the national audit equilibria depend on threshold values for the probability of double taxation, namely  $\varepsilon_1^* = (\tau_H - \tau_L) / \tau_H$  and  $\varepsilon_2^* = \pi + (\tau_H - \tau_L) / \tau_H$ , as well as threshold values for tax rule inconsistency, namely  $p_1^*$ ,  $p_2^*$  and  $p_3^*$ .<sup>13</sup> We will show that the thresholds are

<sup>12</sup>As Korn and Schiller (2003) point out, equilibrium refinements should identify those equilibria that are (likely to be) observed in reality.

<sup>13</sup>Compared to our model, De Waegenaere et al. (2006) differ on one key dimension. In our model, tax auditors conduct national audits, while in their model, these are conducted by the tax authorities themselves. Tax

defined as

$$p_1^* = \frac{c_H}{2(b - c_H) + c_H}, \quad p_2^* = \frac{(b - c_H)c_L + (b - c_L)c_H}{(b - c_H)c_L + (b - c_L)c_H + 2(b - c_H)(b - c_L)}, \text{ and}$$

$$p_3^* = \frac{(b - 2c_H)c_L}{(b - 2c_H)c_L + 2(b - c_L)(b - c_H)}.$$

The value  $p_1^*$  reflects the value of  $p$  for which auditor  $H$  would be indifferent between auditing and not auditing reports  $x_L$  if the firm would never engage in aggressive income shifting but always engages in moderate income shifting. The value  $p_2^*$  ( $p_3^*$ ) is the value of  $p$  for which auditor  $H$  would always audit (auditor  $L$  audits with positive probability) when the residual double taxation risk is high, that is,  $\varepsilon > \varepsilon_2^*$ . Similar to the benchmark model, our assumptions guarantee that  $0 \leq p_1^* \leq p_2^* \leq 1$  and  $0 \leq p_3^* \leq p_2^* \leq 1$ .

Tax authorities' joint tax audit decisions will also depend on threshold values for inconsistency costs. Therefore, we will only discuss two  $\varepsilon$ -cases, namely  $\varepsilon < \underline{\varepsilon}$  and  $\varepsilon > \bar{\varepsilon}$ , where

$$\underline{\varepsilon} = \min \left\{ \frac{\tau_H - \tau_L}{\tau_H}, \frac{\tau_H(1 + \pi) - \tau_L}{2\tau_H} \right\} \quad \text{and} \quad \bar{\varepsilon} = \varepsilon_2^* = \frac{\tau_H(1 + \pi) - \tau_L}{\tau_H}.$$

Intuitively, the case when the residual double taxation risk is low ( $\varepsilon < \underline{\varepsilon}$ ) occurs when the countries participate in mandatory binding arbitration or when their tax rate differential is high. By contrast, the case when this double taxation risk is high ( $\varepsilon > \bar{\varepsilon}$ ) occurs if the tax rate differential is low and no binding arbitration exists.

To keep the following Propositions concise, we report only the outcomes of the joint audit decisions  $\mu_L^*(x_L)\mu_H^*(x_L)$  and  $\mu_L^*(x_H)\mu_H^*(x_H)$  in the main text. The individual decisions  $\mu_i^*(x_L)$  and  $\mu_i^*(x_H)$ , as well as the specific values of mixed strategies (where applicable) and the proofs, are provided in the Appendix B.

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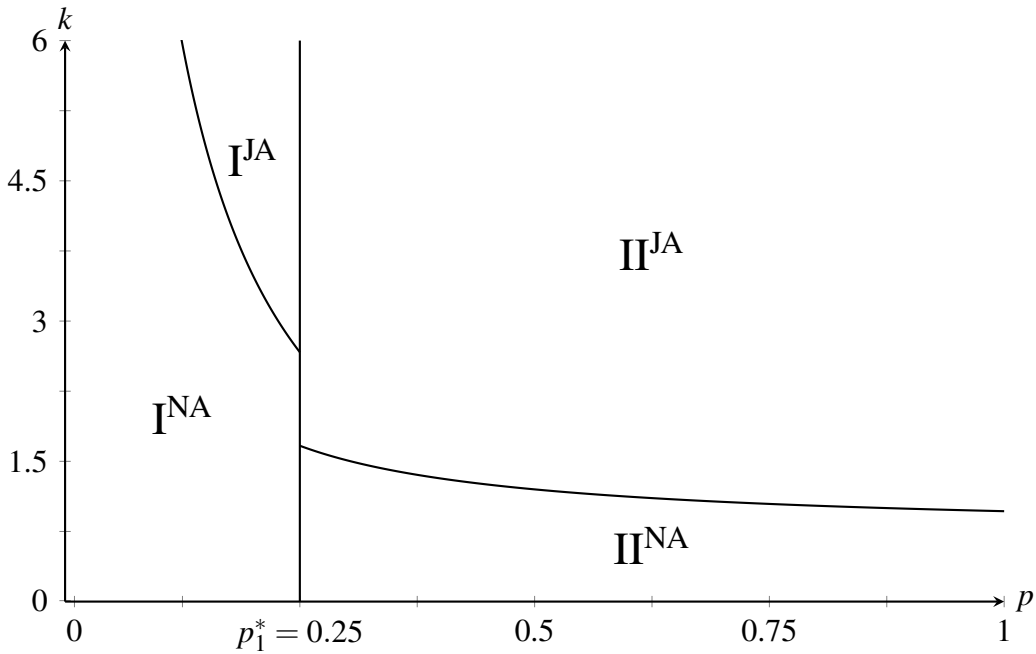
authorities directly consider the revenue implications of the audit, particularly  $\varepsilon\tau_i$  in state  $y_B$ , while auditors receive a fixed benefit  $b$ . Therefore, while  $\varepsilon_1^*$  and  $\varepsilon_2^*$  remain identical, the threshold values for tax rule inconsistency become independent of  $\varepsilon$  in our model.



## 4.2 Low residual double taxation risk

To begin, let us preview the different equilibria regions when the residual double taxation risk is low  $\varepsilon < \underline{\varepsilon}$  in Figure 2, depending on the probability of tax rule inconsistency  $p$  and inconsistency cost  $k$ . Importantly, the equilibrium that is played crucially depends on the specific country-pair combination in which the firm's business activity takes place. The intuition for all equilibria regions is illustrated in Figure 4 in the Appendix A. There, we provide a parsimonious classification for potentially observed equilibria, taking Germany as a fixed part of the country-pair combination.<sup>14</sup>

Figure 2: Equilibria regions when residual double taxation risk is low



Notes: Parameters are  $\tau_H = 30\%$ ,  $\tau_L = 15\%$ ,  $\pi = 30\%$ ,  $b = 0.1$ ,  $c_H = 0.04$ ,  $c_L = 0.06$  and  $K = 0.07$ , requiring  $\varepsilon < \underline{\varepsilon} = 0.4$ .

When the residual double taxation risk is low, the following equilibria arise when  $p$  is smaller than  $p_1^*$ .

<sup>14</sup>Germany is a global pioneer with regard to joint tax audits (Braun et al. 2020, Criclivaia 2020), making it a particularly fitting example.

**Proposition 1.** *If  $p < p_1^*$  and*

*(i) if  $k < k_I^*$ , we obtain equilibrium  $I^{NA}$ .*

*The firm chooses a mixed reporting strategy  $\alpha^*$  in  $y_H$  and always reports  $x_L$  in  $y_B$  ( $\beta^* = 0$ ).*

*The tax authorities do not conduct joint tax audits. Auditor  $H$  chooses a mixed auditing strategy  $\gamma^*$  of reports  $x_L$ , and auditor  $L$  never audits reports  $x_H$  ( $\delta^* = 0$ ).*

*(ii) if  $k > k_I^*$ , we obtain equilibrium  $I^{JA}$ .*

*The firm chooses a mixed reporting strategy  $\alpha^*$  in  $y_H$  and always reports  $x_L$  in  $y_B$  ( $\beta^* = 0$ ).*

*The tax authorities conduct joint tax audits of reports  $x_L$  with probability  $\mu_L^*(x_L)$ , and no joint tax audits of reports  $x_H$ . Auditor  $H$  chooses a mixed auditing strategy  $\gamma^*$  of reports  $x_L$ , and auditor  $L$  never audits reports  $x_H$  ( $\delta^* = 0$ ).*

In equilibrium  $I^{NA}$ , no joint tax audits are established because the (expected) inconsistency costs are too low ( $k < k_I^*$ ), particularly for tax authority  $L$ . Further, there is no pure strategy with regard to auditor  $H$ 's national audit strategy  $\gamma^*$  and aggressive income shifting  $\alpha^*$ . Intuitively, when auditor  $H$  always audits ( $\gamma = 1$ ), the firm will never engage in aggressive income shifting ( $\alpha = 1$ ); but then the relatively low inconsistency  $p < p_1^*$  implies that auditor  $H$  would not audit anymore ( $\gamma = 0$ ). However, if auditor  $H$  does not audit, the firm would prefer to always engage in aggressive income shifting ( $\alpha = 0$ ), which incentivizes auditor  $H$  to always audit. Thus, the only equilibrium is in mixed strategies  $\gamma^*$  and  $\alpha^*$ . Also, as the residual double taxation risk is low, the firm prefers to always engage in moderate income shifting  $\beta^* = 0$ . Consequently, auditor  $L$  never audits  $\delta^* = 0$ .

In equilibrium  $I^{JA}$ , some joint tax audits of reports  $x_L$  are conducted when the (expected) inconsistency costs are sufficiently high ( $k > k_I^*$ ). In addition, the same notion for auditor  $H$ 's audit strategy and aggressive income shifting as in equilibrium  $I^{NA}$  applies, requiring randomization  $\gamma^*$  and  $\alpha^*$ . The reason that only *some* reports  $x_L$  are jointly audited is as follows. If tax authority  $L$  always opted for a joint audit ( $\mu_L(x_L) = 1$ ), the joint audit would always

be established (see Lemma 1). Then, aggressive income shifting would be deterred ( $\alpha = 1$ ), and the relatively low inconsistency  $p < p_1^*$  implies that auditor  $H$  would not audit ( $\gamma = 0$ ). This, however, mutes the off the equilibrium path audit threat of auditor  $H$ , leading to expected inconsistency costs of zero. Then, tax authority  $L$  would prefer a national audit ( $\mu_L(x_L) = 0$ ) to avoid the joint audit coordination cost  $K > 0$ . By contrast, due to  $k > k_I^*$ , the (expected) inconsistency costs in the national audit equilibrium  $I^{NA}$  are so high that tax authority  $L$  wants to conduct some joint tax audits. Thus, the equilibrium requires mixed strategy  $\mu_L^*(x_L)$ .

Equilibria  $I^{NA}$  and  $I^{JA}$  correspond to settings with limited disputes over the application of tax rules and country pairs with binding arbitration or sufficiently different tax rates. Equilibrium  $I^{NA}$  is likely when both countries consistently apply the OECD Transfer Pricing Guidelines and exhibit relatively moderate MAP durations. Many transaction within the European Union, for example, among Germany (high-tax) and Ireland (low-tax) could fall into this category. By contrast, equilibrium  $I^{JA}$  would require a country pair characterized by significantly prolonged MAP or arbitration procedures.

Next, we turn to the equilibria that arise when  $p$  is larger than  $p_1^*$ .

**Proposition 2.** *If  $p > p_1^*$  and*

(i) *if  $k < k_{II}^*$ , we obtain equilibrium  $II^{NA}$ .*

*The firm always reports  $x_H$  in  $y_H$  ( $\alpha^* = 1$ ) and  $x_L$  in  $y_B$  ( $\beta^* = 0$ ). The tax authorities do not conduct joint tax audits. Auditor  $H$  always audits reports  $x_L$  ( $\gamma^* = 1$ ), and auditor  $L$  never audits reports  $x_H$  ( $\delta^* = 0$ ).*

(ii) *if  $k > k_{II}^*$ , we obtain equilibrium  $II^{JA}$ .*

*The firm always reports  $x_H$  in  $y_H$  ( $\alpha^* = 1$ ) and  $x_L$  in  $y_B$  ( $\beta^* = 0$ ). The tax authorities always conduct joint tax audits of reports  $x_L$ , and never of reports  $x_H$ . Auditor  $H$  would always audit reports  $x_L$  ( $\gamma^* = 1$ ), and auditor  $L$  never audits reports  $x_H$  ( $\delta^* = 0$ ).*

In equilibrium  $\Pi^{\text{NA}}$ , no joint tax audit is established because the (expected) inconsistency costs are too low for tax authority  $L$  to initiate one ( $k < k_{II}^*$ ). Compared to equilibrium  $I^{\text{NA}}$ , auditor  $H$  has now sufficient incentives to always audit report  $x_L$  due to  $p > p_1^*$ , although the report solely stems from moderate income shifting. Thus,  $\alpha^* = \gamma^* = 1$  arise simultaneously, and, together with  $\beta^* = \delta^* = 0$ , constitute this pure strategy equilibrium.

In equilibrium  $\Pi^{\text{JA}}$ , the inconsistency costs are sufficiently high ( $k > k_{II}^*$ ) that both tax authorities always initiate joint tax audits after a report  $x_L$ . Compared to equilibrium  $\Pi^{\text{NA}}$ , the authorities' joint audit decision neither changes the firm's income shifting decisions nor the auditors' audit strategies. The reason is that, from the firm's perspective, both the joint and national audit are qualitatively identical in uncovering aggressive income shifting. Also, the firm still prefers to always engage in moderate income shifting, as the resulting joint audit eliminates double taxation and yields a higher payoff than the otherwise certain tax payment of  $\tau_H$ . Importantly, our equilibrium concept requires auditor  $H$  to act optimally off the equilibrium path. The resulting audit threat ( $\gamma^* = 1$ ) ensures that authority  $L$  opts for the joint audit to avoid the inconsistency costs that would otherwise arise in a national audit.

Equilibria  $\Pi^{\text{NA}}$  and  $\Pi^{\text{JA}}$  reflect situations with substantial disputes over the application of tax rules, but where dispute resolution mechanisms to eliminate double taxation are in place. Transactions involving many European countries and Italy are likely to fall under equilibrium  $\Pi^{\text{JA}}$ , as Italy is known for unilateral transfer pricing adjustments (Diller et al. 2021).

Corollary 1 emphasizes two additional implications of the equilibria.

**Corollary 1.** *The required inconsistency costs for joint tax audits approach to infinity when  $\tau_L = 0$ , and are (significantly) higher when tax rules are consistently applied ( $p < p_1^*$ ).*

First, we find that joint tax audits do not occur with tax haven countries ( $\tau_L = 0$ ), as the required inconsistency costs  $k_I^*$  and  $k_{II}^*$  get extremely high. Second, we find that when tax rule inconsistency is low, joint tax audits require significantly higher inconsistency costs ( $k_I^* \gg k_{II}^*$ ) to be worthwhile for the authorities. Put differently, joint audits are less likely in low- $p$

environments unless the (expected) inconsistency costs stemming from MAPs or arbitration are very high. The requirement  $k > k_I^*$  could reflect extremely long and resource-intensive MAPs, as, on average, in cases involving the United States (Martini et al. 2025). By contrast, if  $k > k_{II}^*$ , joint audits may become attractive even under average MAP or arbitration durations. Notably, marginal increases in  $p$ , especially around the threshold  $p_1^*$ , can substantially expand the joint audit equilibrium range, as auditor  $H$ 's strategy changes discontinuously.

The strategies of the players are summarized in Table 3 when the residual double taxation risk is low.

Table 3: Equilibria strategies (low residual double taxation risk)

Strategy	Equil. I <sup>NA</sup>	Equil. II <sup>NA</sup>	Equil. I <sup>JA</sup>	Equil. II <sup>JA</sup>
$\mu_L(x_L)\mu_H(x_L)$	0	0	$\mu_L^*(x_L)$	1
$\mu_L(x_H)\mu_H(x_H)$	0	0	0	0
$\alpha$	$\alpha^*$	1	$\alpha^*$	1
$\beta$	0	0	0	0
$\gamma$	$\gamma^*$	1	$\gamma^*$	1
$\delta$	0	0	0	0

### 4.3 High residual double taxation risk

Now, we turn to the different equilibria regions when the residual double taxation risk is high ( $\varepsilon > \bar{\varepsilon}$ ). We preview the different equilibria in Figure 3.

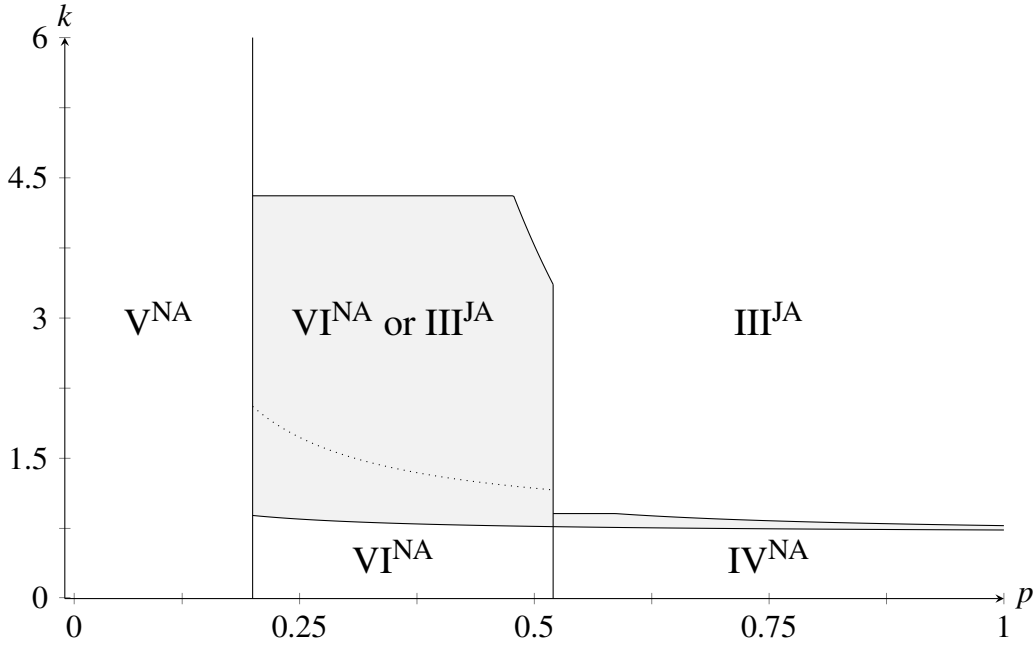
The following equilibria arise when  $p$  is smaller than  $p_3^*$ .

**Proposition 3.** *If  $p < p_3^*$ ,*

(i) *we obtain equilibrium  $V^{NA}$ .*

*The firm chooses a mixed reporting strategy  $\alpha^*$  in  $y_H$  and always reports  $x_H$  in  $y_B$  ( $\beta^* = 1$ ). The tax authorities do not conduct joint tax audits. Auditor  $H$  chooses a mixed auditing strategy  $\gamma^*$  of reports  $x_L$ , and auditor  $L$  never audits reports  $x_H$  ( $\delta^* = 0$ ).*

Figure 3: Equilibria regions when the residual double taxation risk is high



Notes: Parameters are  $\tau_H = 30\%$ ,  $\tau_L = 25\%$ ,  $\pi = 30\%$ ,  $b = 0.1$ ,  $c_H = 0.04$ ,  $c_L = 0.06$ ,  $K = 0.07$  and  $\varepsilon = 0.9 > 0.47 \approx \bar{\varepsilon}$ , implying  $p_3^* = 0.2 < p_1^* = 0.25 < p_2^* = 0.52$ . The gray area indicates regions where multiple equilibria exist. For example, within the gray area when  $p > p_2^*$ , equilibria  $IV^{NA}$  and  $III^{JA}$  cannot be ranked according to weak payoff dominance. Equilibrium  $I^{JA}$  lies out of the plot range and starts to exist for  $k > k_V^*|_{p=p_3^*} \approx 8.2$ , with  $k_V^*$  reaching its minimum value at  $p_3^*$ . The dotted line indicates the value of  $k$  above which equilibrium  $III^{JA}$  would be ex ante efficient when  $p_3^* < p < p_2^*$  (see Proposition 7 below).

(ii)  $p_1^* < p < p_3^*$  and  $k > k_{II}^*$ , we obtain equilibrium  $II^{JA}$  (see Proposition 2 (ii)).

(iii)  $p_3^* < p_1^*$  and  $k > k_V^*$ , we obtain equilibrium  $I^{JA}$  (see Proposition 1 (ii)).

In equilibrium  $V^{NA}$ , the tax authorities prefer national audits over joint audits. Further, the firm engages in some aggressive income shifting  $\alpha^*$  but no moderate income shifting ( $\beta^* = 1$ ). The relatively low inconsistency implies that auditor  $H$  does not want to always audit. However, the national audit probability  $\gamma^*$  together with the high double taxation probability  $\varepsilon$  deter moderate income shifting. Although  $\beta^* = 1$  creates audit incentives for auditor  $L$ , the level of inconsistency is yet too low for auditing reports  $x_H$  ( $\delta^* = 0$ ). Interestingly, this national audit equilibrium exists independent of the size of inconsistency costs  $k$ . The reason is that

in this national audit equilibrium, the tax authorities do not incur any inconsistency costs in expectation. Hence, they have no incentive to conduct joint audits. Notably, this is the *only* national audit equilibrium with this characteristic.

The mere fact that tax authorities would always prefer a national tax audit when  $p < p_3^*$  does not imply that this equilibrium is actually played. As we show in Proposition 3 (ii) and (iii), joint audit equilibria do exist when  $p < p_3^*$ . First, consider the case  $p_3^* < p_1^*$  depicted in Figure 3, which occurs if auditor  $L$ 's audit cost  $c_L$  is not too high. Then, for very high inconsistency costs  $k > k_V^*$ , the firm prefers to play equilibrium  $I^{JA}$ , as the prevalence of some joint tax audits ( $\mu_L^*(x_L) > 0$ ) would reduce the firm's expected tax payments compared to equilibrium  $V^{NA}$  (see Proposition 6 below). In the figure,  $k_V^*$  is, however, outside the plot range, suggesting that this equilibrium is unlikely to occur when tax rate differences are low compared to when the differences are high. Second, consider the case  $p_1^* < p < p_3^*$ , which requires that  $c_L$  is higher than  $c_H$ . For example, in Figure 3,  $p_1^* < p_3^*$  would require  $c_L > 0.06$ , all else equal. When tax rule inconsistency takes these weakly intermediate values, the firm always prefers to play equilibrium  $II^{JA}$  as its resulting expected tax payments in state  $y_B$  are lower. Taken together, we cannot rank these potential national and joint audit equilibria according to weak payoff dominance and thus cannot make a prediction on which equilibrium will arise. However, we expect that firms will try to persuade tax authorities to conduct joint tax audits if they report the disputed income in the low-tax country.

The presented equilibria correspond to settings in which the difference in tax rates between the countries is similar and the residual risk of double taxation is substantial, but there are limited disputes on the application of tax rules. We expect that national tax audits are the likely outcome in these scenarios.

The following equilibria arise when  $p$  is larger than  $p_3^*$  but smaller than  $p_2^*$ .

**Proposition 4.** *If  $p_3^* < p < p_2^*$  and*

*(i) if  $k < k_{VI}^*$ , we obtain equilibrium  $VI^{NA}$ .*

*The firm chooses a mixed reporting strategy  $\alpha^*$  in  $y_H$  and  $\beta^*$  in  $y_B$ . The tax authorities do not conduct joint tax audits. Auditor  $H$  chooses a mixed auditing strategy  $\gamma^*$  of reports  $x_L$ , and auditor  $L$  chooses a mixed auditing strategy  $\delta^*$  of reports  $x_H$ .*

*(ii) if  $k > k_{III}^*$ , we obtain equilibrium  $III^{JA}$ .*

*The firm chooses a mixed reporting strategy  $\alpha^*$  in  $y_H$  and always reports  $x_H$  in  $y_B$  ( $\beta^* = 1$ ). The tax authorities always conduct joint tax audits of reports  $x_H$ , and never of reports  $x_L$ . Auditor  $H$  chooses a mixed auditing strategy  $\gamma^*$  of reports  $x_L$ , and auditor  $L$  would always audit reports  $x_H$  ( $\delta^* = 1$ ).*

In equilibrium  $VI^{NA}$ , the inconsistency costs are too low ( $k < k_{VI}^*$ ) for joint tax audits to be strictly preferred by the authorities despite the intermediate tax rule inconsistency  $p$ . Compared to equilibrium  $V^{NA}$ , auditor  $L$  now audits with positive probability  $\delta^* > 0$ , because state  $y_B$  is sufficiently likely when  $p > p_3^*$ . As a response, the firm engages in some moderate income shifting to balance the double taxation arising from the national audits by both auditors.

In equilibrium  $III^{JA}$ , the tax authorities always initiate joint tax audits after a report  $x_H$  when the inconsistency costs are sufficiently high ( $k > k_{III}^*$ ).<sup>15</sup> The other strategies on the equilibrium path are mostly in line with equilibrium  $V^{NA}$ . The firm engages in some aggressive income shifting  $\alpha^*$  and auditor  $H$  audits reports  $x_L$  with probability  $\gamma^*$ . A pure strategy by either of the two players cannot be sustained in equilibrium. Further, the firm chooses report  $x_H$  in state  $y_B$  ( $\beta^* = 1$ ), because auditor  $H$ 's audit threat and the relatively high double taxation amount deter moderate income shifting. Auditor  $L$  acts optimally off the equilibrium path and creates a credible threat that inconsistency costs after a report  $x_H$  occur ( $\delta^* = 1$ ), inducing the tax authorities to coordinate on a joint tax audit.

<sup>15</sup>Our equilibrium refinement to focus on weakly payoff dominant equilibria excludes equilibrium  $II^{JA}$  in this parameter range. As we show in section 5, the expected tax payments in  $II^{JA}$  are identical but the tax authorities' deadweight losses are higher.



Our results imply that when the inconsistency costs take intermediate values ( $k_{III}^* < k < k_{VI}^*$ ), both equilibria coexist and no prediction can be made concerning the equilibrium that will be played. Again, the firm will promote the use of joint tax audits as the expected tax payments are lower in expectation, while at least one tax authority is better off in the national audit equilibrium. Intuitively, the firm acknowledges that a certain minimum level of inconsistency costs  $k_{III}^*$  is necessary for an equilibrium, although it unambiguously prefers a joint tax audit independent of this minimum level. By contrast, one tax authority is only willing to give up the higher expected tax payments in the purely national audit equilibrium when the inconsistency costs exceed  $k_{VI}^*$ . In Figure 3, tax authority  $L$  is reluctant to give up the purely national audit for  $p_3^* < p < 0.48$ , while authority  $H$  is reluctant for  $0.48 < p < p_2^*$ . To sum up, only if the inconsistency costs are low (high), we can conclude that the pure national (partial joint) audit equilibrium will be played.

The presented equilibria correspond to settings in which the (in-)consistency in the application of tax rules takes intermediate values. Also, the equilibria require that the residual risk that double taxation prevails is high or that the tax rate differential between the countries is low. The former describes many transactions between European countries and non-European countries such as China and India, as the latter two reject mandatory binding arbitration in their tax treaties. The latter can occur even between European countries if the characteristics of the transaction favor national litigation over dispute resolution via MAP or arbitration.<sup>16</sup>

Lastly, we present the equilibria that arise when  $p$  is larger than  $p_2^*$ .

**Proposition 5.** *If  $p > p_2^*$  and*

*(i) if  $k < k_{IV}^*$ , we obtain equilibrium  $IV^{NA}$ .*

*The firm always reports  $x_H$  in  $y_H$  ( $\alpha^* = 1$ ) and chooses a mixed reporting strategy  $\beta^*$  in  $y_B$ . The tax authorities do not conduct joint tax audits. Auditor  $H$  always audits reports  $x_L$  ( $\gamma^* = 1$ ), and auditor  $L$  chooses a mixed auditing strategy  $\delta^*$  of reports  $x_H$ .*

<sup>16</sup>The threshold values for the required inconsistency costs can, for example, correspond to the three tertiles of average MAP duration of countries as reported in Appendix A.

(ii) if  $k > k_{III}^*$ , we obtain equilibrium  $III^{JA}$  (see Proposition 4 (ii)).

Equilibrium  $IV^{NA}$  constitutes an aggressive national audit equilibrium when the inconsistency costs are sufficiently low ( $k < k_{IV}^*$ ). Here, compared to  $VI^{NA}$ , the even higher level of inconsistency induces auditor  $H$  to adopt a pure audit strategy of always auditing  $x_L$ . Consequently, the firm does not engage in aggressive income shifting ( $\alpha^* = 1$ ). In addition, the firm engages in some moderate income shifting and auditor  $L$  audits some reports  $x_H$  with probability  $\delta^*$  that is higher than under  $VI^{NA}$ .

Since the national audit probabilities are higher in equilibrium  $IV^{NA}$  than in  $VI^{NA}$ , the required inconsistency costs for a joint tax audit decrease:  $k_{IV}^* < k_{VI}^*$ . Notably, Figure 3 shows that a range with coexistence of equilibria  $IV^{NA}$  and  $III^{JA}$  exists, but is negligible in terms of its expected occurrence. The reason is that both auditors' audit probabilities discontinuously increase, sharply increasing the authorities' expected inconsistency costs in  $IV^{NA}$ . When the inconsistency costs are sufficiently high ( $k > k_{III}^*$ ), we obtain  $III^{JA}$  in which joint tax audits are initiated after reports  $x_H$ . Interestingly, this joint audit equilibrium involves more aggressive income shifting as compared to the respective national audit counterparts  $IV^{NA}$  and  $VI^{NA}$ . As this result becomes more likely when the countries' tax rates are similar, we find that joint tax audits can lead to more aggressive income shifting to (non-traditional) low-tax countries.

Equilibrium  $III^{JA}$  typically arises when the residual double taxation probability is high and the countries disagree on the application of tax rules. The range in which this equilibrium is the unique outcome expands significantly when tax rules are inconsistently applied. We expect that joint tax audits are most commonly initiated by the respective authorities in such cases, even when inconsistency costs are moderate.

Table 4 shows the equilibria illustrated in Figure 3. We omit equilibria  $I^{JA}$  and  $II^{JA}$ , as these equilibria have already been depicted in Table 3.<sup>17</sup>

<sup>17</sup>The case  $\underline{\varepsilon} < \varepsilon < \bar{\varepsilon}$  does not lead to additional qualitative insights beyond the high residual double taxation risk case. While there is an additional national audit equilibrium when  $p_1^* < p < p_2^*$  and inconsistency costs are sufficiently low (equilibrium  $III^{NA}$ ), no additional joint tax audit equilibrium emerges. Further, we also

Table 4: Equilibria strategies (high residual double taxation risk)

Strategy	Equil. IV <sup>NA</sup>	Equil. V <sup>NA</sup>	Equil. VI <sup>NA</sup>	Equil. III <sup>JA</sup>
$\mu_L(x_L)\mu_H(x_L)$	0	0	0	0
$\mu_L(x_H)\mu_H(x_H)$	0	0	0	1
$\alpha$	1	$\alpha^*$	$\alpha^*$	$\alpha^*$
$\beta$	$\beta^*$	1	$\beta^*$	1
$\gamma$	1	$\gamma^*$	$\gamma^*$	$\gamma^*$
$\delta$	$\delta^*$	0	$\delta^*$	1

## 5 Economic effects of joint tax audits

### 5.1 Firm's expected tax payments

In this section, we examine how joint tax audits affect the firm's expected tax payments. Proposition 6 summarizes the result.

**Proposition 6.** *The existence of joint tax audits*

- (i) *increases the firm's expected tax payments when  $\varepsilon < \frac{\tau_H - \tau_L}{2\tau_H}$  and decreases them when  $\frac{\tau_H - \tau_L}{2\tau_H} < \varepsilon < \underline{\varepsilon}$  in equilibria  $I^{JA}$  and  $II^{JA}$  (low residual double taxation risk case);*
- (ii) *decreases the firm's expected tax payments in equilibria  $I^{JA}$ ,  $II^{JA}$  and  $III^{JA}$  when  $\varepsilon > \bar{\varepsilon}$  (high residual double taxation risk case).*

The effect of joint tax audits on expected tax payments is evaluated relative to the national audit benchmark that would prevail in their absence. Across all equilibria, the expected tax payments in the consistent states  $y_L$  and  $y_H$  remain unchanged. In state  $y_L$ , the firm always reports  $x_L$ , a dominant strategy that leads to a tax payment of  $\tau_L$ , irrespective of subsequent audit decisions. Similarly, in state  $y_H$ , the expected tax payment equals  $\tau_H$  in all equilibria.

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have a considerable range where the purely national audit and partial joint audit equilibrium coexist when inconsistency costs take intermediate values. Depending on parameters, both joint audits after reports  $x_L$  and  $x_H$  can occur, with joint audits conditional on  $x_L$  (on  $x_H$ ) becoming more likely when  $\varepsilon$  is lower (higher).

To illustrate, consider equilibria  $\text{III}^{\text{JA}}$  and  $\text{IV}^{\text{NA}}$ . In  $\text{IV}^{\text{NA}}$ , the firm adopts a pure strategy  $\alpha_{\text{IV}^{\text{NA}}}^* = 1$ , reporting  $x_H$  in  $y_H$  and thereby paying  $\tau_H$  with certainty, since double taxation is not possible in the consistent state. By contrast, in  $\text{III}^{\text{JA}}$ , the firm randomizes in  $y_H$  with probability  $\alpha_{\text{III}^{\text{JA}}}^* = (b - 2c_H)/(b - c_H) > 0$ . However, the mere fact that it randomizes implies that the firm's expected tax payment from reporting  $x_L$  or  $x_H$  must be equal, that is,  $\tau_H$ . These observations suggest that any differences in tax payments induced by the presence of joint tax audits originate from the inconsistent state  $y_B$ .

We show that when the residual risk of double taxation is sufficiently low ( $\varepsilon < \frac{\tau_H - \tau_L}{2\tau_H}$ ), joint tax audits increase expected tax payments. This is because, in the corresponding national audit equilibria  $\text{I}^{\text{NA}}$  and  $\text{II}^{\text{NA}}$ , the firm engages in moderate income shifting ( $\beta^* = 0$ ), reporting disputed income in the low-tax country. Given the low residual risk of double taxation, the firm anticipates paying close to  $\tau_L$  on the disputed income in state  $y_B$ . By contrast, in a joint tax audit, the two authorities coordinate and agree to split the income, with tax authority  $H$  receiving a substantial share. As a result, expected tax payments rise to  $\frac{\tau_L + \tau_H}{2}$ . Thus, while joint audits eliminate double taxation, they also prevent the firm from fully leveraging the tax rate differential, thereby increasing its overall tax payments.

Further, we demonstrate that once the residual risk of double taxation becomes sufficiently high, joint tax audits reduce the firm's expected tax payments. Notably, this result holds irrespective of the residual double taxation risk case or the degree of tax rule inconsistency between the countries. The underlying mechanism is straightforward. Because joint tax audits require both authorities to agree on a common report (e.g., a common transfer price), a high residual risk of double taxation  $\varepsilon$  undermines the prospects of reaching such an agreement. This reflects a general coordination friction that mirrors findings on Bilateral Advance Pricing Agreements (De Waegenaere et al. 2007), and we also find this for joint tax audits when tax rule inconsistency is low ( $p < p_3^*$ ). When inconsistency is high ( $p > p_3^*$ ), however, the impact of  $\varepsilon$  becomes more complex. On the one hand,  $\varepsilon$  increases the thresholds  $k_{\text{IV}}^*$  and  $k_{\text{VI}}^*$ , thereby

narrowing the parameter regions where the equilibrium with joint audit is unique. On the other hand, it also expands the conditions under which equilibrium  $III^{JA}$  emerges, allowing joint audits to become viable over a wider range of inconsistency costs. Hence, the overall effect of  $\varepsilon$  on the occurrence of joint audits is ambiguous. While it raises coordination barriers from the authorities' perspective, it can simultaneously promote joint audits by making them more attractive to the firm due to lower expected tax payments.

## 5.2 Tax audit efficiency

In this section, we examine how joint tax audits affect tax audit efficiency. Since the firm's tax payments correspond to tax revenues for the authorities, they represent zero-sum transfers and do not affect efficiency. We define tax audit efficiency as the inverse of the tax authorities' expected deadweight losses, which arise from inconsistency and coordination costs. In other words, the lower these audit-related losses, the higher the tax audit efficiency.<sup>18</sup>

The following observation has already been used for equilibrium selection, but we highlight it explicitly due to its counterintuitive nature and conceptual significance.

**Corollary 2.** *Due to aggressive income shifting ( $1 - \alpha^* > 0$ ), tax audit efficiency in equilibrium  $III^{JA}$  is higher than in equilibrium  $II^{JA}$ .*

In particular, we apply Corollary 2 in the high residual double taxation risk case, selecting equilibrium  $III^{JA}$  over  $II^{JA}$  whenever both exist within the same parameter range. Given that the expected tax payments are identical, the lower deadweight losses in  $III^{JA}$  render it the weakly payoff-dominant outcome. A particularly striking implication of this result is that tax audit efficiency improves not *despite* but *because* of aggressive income shifting. While such

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<sup>18</sup>We exclude the tax auditors' payoffs from our definition of tax audit efficiency. This omission is without loss of generality in equilibria where auditor  $H$  plays a mixed strategy or is off the equilibrium path; auditor  $L$  always has an expected payoff of zero. In these cases, our efficiency concept effectively coincides with social welfare. Only in equilibria  $II^{NA}$  and  $IV^{NA}$  does it slightly understate overall welfare. However, under the plausible assumption that auditor  $H$ 's net benefit of uncovering income shifting  $b - c_H$  is negligible relative to tax revenues, inconsistency costs, and coordination costs, our efficiency measure remains a valid proxy for welfare.

behavior might initially appear to undermine enforcement objectives, it can in fact enhance efficiency in our setting. Specifically, the firm's willingness to shift income in the consistent state  $y_H$  allows joint audits to be more effectively directed toward genuine disputes, without distorting tax payments. Thus, aggressive income shifting, typically viewed as a concern, can serve a beneficial role in improving the allocation of audit resources between national and joint procedures.

Next, Proposition 7 summarizes how the existence of joint tax audits affects tax audit efficiency.

**Proposition 7.** *The existence of joint tax audits*

- (i) *increases tax audit efficiency in case the residual double taxation risk is low;*
- (ii) *can increase or decrease efficiency in case the residual double taxation risk is high.*

When the residual double taxation risk is low (part (i)), joint audits are efficient if implemented. However, they may not be established even when they would improve overall efficiency. Mutual consent ensures that both authorities benefit, yet also creates a coordination barrier. Tax authority  $L$  blocks cooperation, as it only considers its own avoided inconsistency costs and ignores potentially greater costs faced by tax authority  $H$ . This leads to coordination failures rooted in decentralized decision-making despite potential efficiency gains.

When the residual double taxation risk is high (part (ii)), joint tax audits can be inefficient. Consider equilibrium  $V^{NA}$  under low inconsistency ( $p < p_3^*$ ). This equilibrium is efficient because national audits only occur in consistent states, avoiding any deadweight losses in the inconsistent state. However, equilibria  $I^A$  and  $II^A$  may coexist, since the firm seeks to avoid high tax payments in the inconsistent state under national audits. Coordination on a joint audit equilibrium, even if inefficient, can still emerge, as all players' strategies are mutual best responses in these equilibria. This highlights a tension between individual rationality and

collective efficiency. Joint audits, while desirable from the firm's perspective, generate higher coordination burdens for the tax authorities.

These inefficiencies also arise at intermediate levels of tax rule inconsistency ( $p_3^* < p < p_2^*$ ). The dotted line in Figure 3 indicates the threshold above which equilibrium III<sup>JA</sup> is efficient. Below this line, joint audits may still emerge as equilibrium outcomes, but they are inefficient due to high coordination costs relative to expected inconsistency costs. This type of inefficiency is specific to joint tax audits and contrasts with other dispute prevention tools such as bilateral APAs (De Waegenare et al. 2007) or cooperative compliance programs (De Simone et al. 2013). The result arises because of the different firm behavior in equilibrium III<sup>JA</sup> as compared to VI<sup>NA</sup>. By never engaging in moderate income shifting when joint audits as an instrument exist, the firm facilitates these audits even for lower levels of inconsistency costs ( $k_{III}^* < k_{VI}^*$ ). Note that this mechanism is in contrast to the low residual double taxation risk case, where the firm always engages in moderate income shifting *independent* of the respective joint or national audit equilibrium.

Overall, our analysis reveals two interesting results. First, joint tax audits tend to be least efficient precisely when firms are most likely to promote them. Second, we find that marginal increases in tax rule consistency at  $p = p_2^*$  can be detrimental to tax audit efficiency, as they may trigger premature coordination. However, marginal increases in consistency at  $p = p_3^*$  always increase tax audit efficiency, highlighting the non-trivial role of harmonizing tax rules (De Waegenare et al. 2006, Diller et al. 2025).

## 6 Conclusions

We investigate tax authorities' use of joint tax audits in cross-border tax cases of a multinational firm. Joint tax audits have emerged as a coordinated enforcement tool, aimed at resolving potential tax disputes early before cases escalate into costly resolution procedures. Our model features a firm's income shifting decisions, tax authorities' joint audit decisions, and, when

these are not established, tax auditors' national audit decisions. We pose two interrelated research questions. First, under what circumstances do joint tax audits arise? Second, how do joint audits affect the firm's expected tax payments and tax audit efficiency, measured by the tax authorities' expected deadweight losses from auditing?

We find that whether joint tax audits arise depends on the firm's residual double taxation risk *absent* joint tax audits. When this risk is low (e.g., due to mandatory binding arbitration), joint audits only occur if they reduce tax authorities' expected deadweight losses, comprising coordination and inconsistency costs, relative to national audits. However, not all efficiency-enhancing joint audits are established, as mutual consent by all authorities is required. When the residual double taxation risk is high and tax rule inconsistency is not too low, joint audits can occur more often, as the required inconsistency costs are lower than under low double taxation risk.

The result that more joint audits *can* occur does not imply that these *must* occur. Unless the required inconsistency costs are sufficiently high, the tax authorities favor national audits, while the firm prefers (some) joint audits due to lower expected tax payments. If joint audits occur when the residual double taxation risk is high, their occurrence does not guarantee improvements in tax audit efficiency although both authorities give their consent. The reason is that the firm alters its income shifting behavior, which can trigger inefficient joint audits. In particular, joint audits tend to be most inefficient when firms are most likely to promote them.

Our findings have regulatory implications. When the residual double taxation risk is low, a regulatory cost-sharing mechanism that reallocates coordination costs from the low-tax to the high-tax authority could enable more coordinated enforcement and efficient outcomes. This is because the low-tax authority blocks some efficient joint audits in these cases. For example, the Fiscalis Programme within the European Union can fulfill this objective if specifically designed for that purpose. By contrast, when the residual double taxation risk is high, a third-party cost-sharing approach involving the firm is more suitable, as either tax authority may block the



joint audit. If the firm shares part of the coordination burden, such mechanisms could better align the firm's preferences with overall efficiency goals.

This study offers guidance for future empirical research. In particular, the introduction of DAC7 provides a valuable opportunity to examine changes in tax audit efficiency, as it establishes a legally binding framework for joint tax audits within Europe and encourages their broader use. Empirical analyses could focus on the effect of joint audits on audit completion times in cross-border settings. Such analyses would require detailed cross-country data on audit outcomes and durations, as well as proxies—potentially survey-based—for the degree of tax rule inconsistency. Key control variables include country-pair MAP durations and tax rate differentials. As an alternative approach, researchers could investigate whether and to what extent the broader use of joint tax audits affects the number of APAs or MAPs initiated. Since these procedures are generally considered costly and time-consuming, a reduction in their use may indirectly signal greater tax audit efficiency.

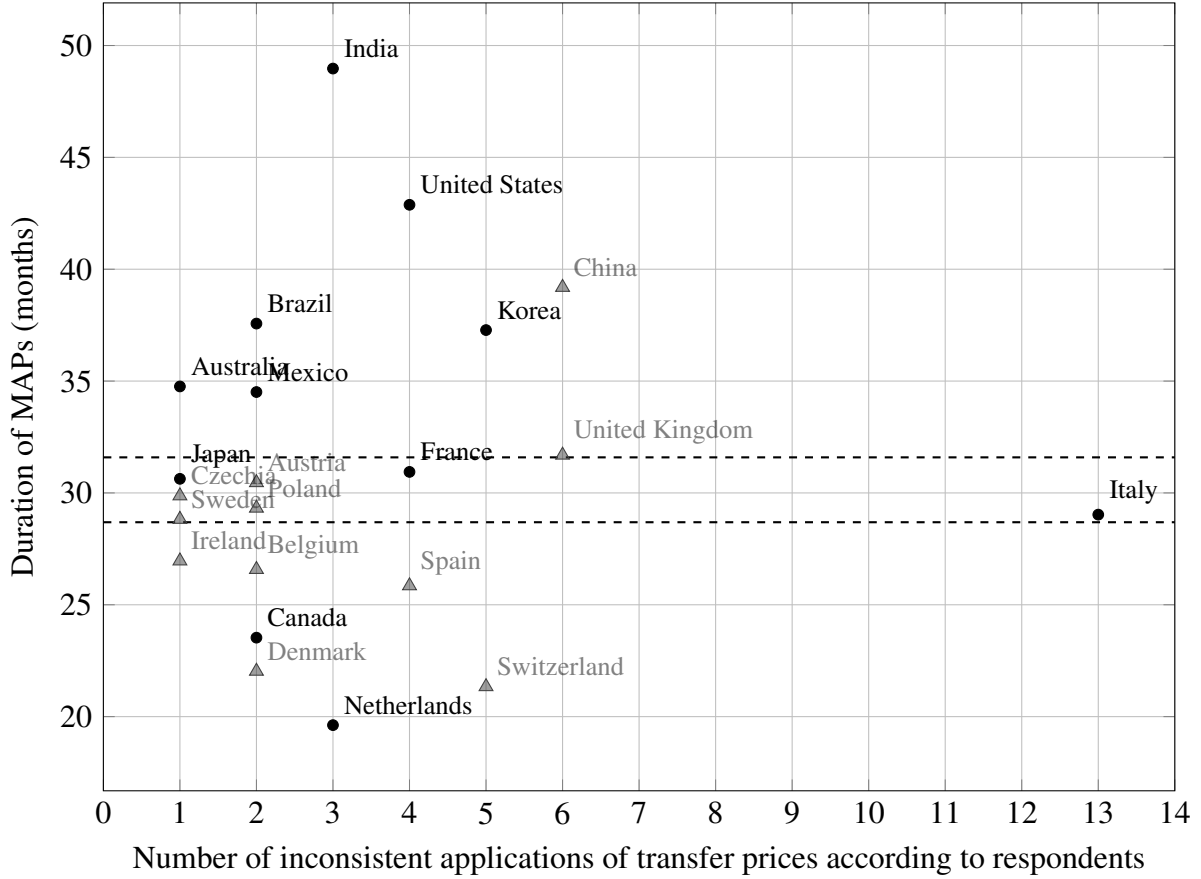
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## Appendix A

Figure 4: Duration of MAPs and transfer pricing inconsistencies after tax audits from a German perspective



*Notes:* The figure ranks countries by the average duration of MAPs in months (based on Martini et al. (2025)), which we use as a proxy for  $k$ , and by the number of transfer pricing inconsistencies identified after tax audits from a German perspective (data based on a survey of German transfer pricing practitioners (Diller et al. 2021), as reported in Diller et al. (2025)), which serves as a proxy for  $p$ . We caution that the survey is not necessarily representative for the German firm population but nevertheless gives an indication of how inconsistent applications of transfer prices  $p$  can be approximated. Countries are color-coded based on their corporate tax rate differential relative to Germany (data from Martini et al. (2025)): black circles indicate a low differential ( $< 4.8$  percentage points), gray triangles a high differential ( $> 4.8$  percentage points), with the threshold corresponding to the median. Dashed horizontal lines indicate the 33rd and 66th percentiles of MAP duration (28.7 and 31.6 months, respectively); these thresholds are also used to classify countries into low, medium, and high values of  $k$ .

## Appendix B

For the equilibrium proofs, let us define the following functions

$$\begin{aligned}\Phi_H^{x_L} &= \tau_H \left[ \frac{\frac{1-p}{2}(1-\alpha)(1-\gamma)(1+\pi)}{\frac{1-p}{2}(2-\alpha)+p(1-\beta)} + \frac{p(1-\beta)}{\frac{1-p}{2}(2-\alpha)+p(1-\beta)} \left( \frac{1}{2} - \gamma(\varepsilon - k) \right) \right], \\ \Phi_L^{x_L} &= \tau_L \left[ \frac{p(1-\beta)}{\frac{1-p}{2}(2-\alpha)+p(1-\beta)} \left( \gamma k - \frac{1}{2} \right) - \frac{\frac{1-p}{2}(1-\alpha)}{\frac{1-p}{2}(2-\alpha)+p(1-\beta)} (1-\gamma) \right], \\ \Phi_H^{x_H} &= \tau_H \frac{p\beta}{p\beta + \frac{1-p}{2}\alpha} \left( \delta k - \frac{1}{2} \right), \\ \Phi_L^{x_H} &= \tau_L \frac{p\beta}{p\beta + \frac{1-p}{2}\alpha} \left( \delta(k - \varepsilon) + \frac{1}{2} \right).\end{aligned}$$

In addition, let us introduce the following notation.

**Definition.** For a given equilibrium  $\omega \in \Omega$ , where  $\Omega$  is the set of all equilibria identified in this paper, we define  $k_i^x = (\Phi_i^x)^{-1}(K|\omega)$  as the unique value of  $k$  that solves  $\Phi_i^x = K$  with  $x \in \{x_L, x_H\}$ , given that all strategies are at their equilibrium values under equilibrium  $\omega$ .

### Lemma 1

We have to show that  $\mathbb{E}[v_H(JA|x_L)] - \mathbb{E}[v_H(NA|x_L)] \geq \mathbb{E}[v_L(JA|x_L)] - \mathbb{E}[v_L(NA|x_L)]$ , which simplifies to  $\Phi_H^{x_L} \geq \Phi_L^{x_L}$ . Consider  $\gamma = 1$ , which is sufficient to show the result, as  $\gamma = 1$  decreases  $\Phi_H^{x_L}$  and increases  $\Phi_L^{x_L}$ . Simplifying yields  $\tau_H(k - \varepsilon + \frac{1}{2}) \geq \tau_L(k - \frac{1}{2})$ . With  $\varepsilon \leq 1$  and  $\tau_H \geq \tau_L$ , Lemma 1 is shown.

### Low residual double taxation risk equilibria

Let us note that the requirement  $\varepsilon < \varepsilon_2^*/2$  guarantees that equilibrium  $\text{III}^{\text{JA}}$  does not exist in the low residual double taxation risk case (see proof of Proposition 4 and 5 (ii)).  $\text{III}^{\text{JA}}$  weakly payoff dominates all other equilibria in which joint tax audits occur (see also Proposition 6 and 7).

**Proposition 1 (i)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = \mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$ , and

$$\alpha^* = \frac{(1-p)(b-2c_H) + 2p(b-c_H)}{(1-p)(b-c_H)}, \beta^* = 0, \gamma^* = \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L}, \delta^* = 0,$$

constitutes equilibrium  $I^{NA}$  when  $\varepsilon < \underline{\varepsilon} = \min \left\{ \frac{\tau_H - \tau_L}{\tau_H}, \frac{\tau_H(1+\pi) - \tau_L}{2\tau_H} \right\} = \min \{\varepsilon_1^*, \varepsilon_2^*/2\}$ ,  $p < p_1^* = \frac{c_H}{2(b-c_H)+c_H}$  and  $k < k_I^*$ , where  $k_I^* = (\Phi_L^{x_L})^{-1}(K|I^{NA})$ .

The firm is willing to randomize in  $y_H$ , because a report  $x_L$  yields payoff  $\gamma^*(-\tau_H(1+\pi) - \tau_L(1-\gamma^*)) = -\tau_H$ , which equals the payoff from reporting  $x_H$ .  $\alpha^*$  is feasible because  $p < p_1^*$  ensures  $\alpha^* < 1$ . In state  $y_B$ , the firm chooses  $\beta^* = 0$ , as reporting  $x_H$  yields a payoff of  $-\tau_H$  and reporting  $x_L$  a payoff of  $-\tau_L - \varepsilon\tau_H\gamma^* > -\tau_H$  due to  $\varepsilon < \varepsilon_2^*$ . Auditor  $H$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_L$  yields a payoff of  $\frac{(1-p)(1-\alpha^*)+2p}{(1-p)(1-\alpha^*)+(1+p)}b - c_H = 0$ . Auditor  $L$  chooses  $\delta^* = 0$  since  $\beta^* = 0$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$  due to  $\delta^* = \beta^* = 0$ . Tax authority  $L$  chooses  $\mu_L^*(x_L) = 0$ , because under this equilibrium,  $\Phi_L^{x_L} < K$  as long as  $k < k_I^*$ . From Lemma 1, we know that  $\Phi_L^{x_L} < \Phi_H^{x_L}$ . Thus, we have  $\mu_H^*(x_L) \geq 0$ .

**Proposition 1 (ii)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$ ,  $\mu_H^*(x_L) = 1$ ,  $\beta^* = 0$ ,  $\delta^* = 0$ , and

$$\alpha^* = \frac{(1-p)(b-2c_H) + 2p(b-c_H)}{(1-p)(b-c_H)}, \gamma^* = \frac{((1-p)(2-\alpha^*) + 2p)\frac{K}{\tau_L} + (1-p)(1-\alpha^*) + p}{2pk + (1-p)(1-\alpha^*)},$$

$$\mu_L^*(x_L) = \frac{\tau_H - (\gamma^*\tau_H(1+\pi) + (1-\gamma^*)\tau_L)}{\tau_H(1+\pi) - (\gamma^*\tau_H(1+\pi) + (1-\gamma^*)\tau_L)},$$

constitutes equilibrium  $I^A$  when  $\varepsilon < \underline{\varepsilon} = \min \{\varepsilon_1^*, \varepsilon_2^*/2\}$ ,  $p < p_1^* = \frac{c_H}{2(b-c_H)+c_H}$  and  $k > k_I^*$ , where  $k_I^* = (\Phi_L^{x_L})^{-1}(K|I^{NA})$ .

The firm is willing to randomize in  $y_H$ , because a report  $x_L$  yields payoff

$$-\tau_H(1+\pi)[\mu_L^*(x_L) + (1-\mu_L^*(x_L))\gamma^*] - \tau_L(1-\mu_L^*(x_L))(1-\gamma^*) = -\tau_H,$$

which equals the payoff from reporting  $x_H$ .  $\alpha^*$  is feasible because  $p < p_1^*$  ensures  $\alpha^* < 1$ . In state  $y_B$ , the firm chooses  $\beta^* = 0$ , as reporting  $x_H$  yields a payoff of  $-\tau_H$  and reporting  $x_L$  a payoff of  $-\mu_L^*(x_L)\frac{\tau_L+\tau_H}{2} - (1-\mu_L^*(x_L))(\tau_L + \gamma^*\varepsilon\tau_H) > -\tau_H$ , as with  $\mu_L^*(x_L) = 0$  and  $\gamma^* = 1$ , a sufficient condition for the inequality is found to be  $\varepsilon < \varepsilon_1^*$ . Auditor  $H$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_L$  yields a payoff of  $\frac{(1-p)(1-\alpha^*)+2p}{(1-p)(1-\alpha^*)+(1+p)}b - c_H = 0$ .  $\gamma^*$  is feasible because  $\gamma^* < 1$  requires  $k > \left[ ((1-p)(1-\alpha^*) + (1+p))\frac{K}{\tau_L} + p \right] / 2p$ , which is guaranteed when  $k > k_I^*$ . Auditor  $L$  chooses  $\delta^* = 0$  since  $\beta^* = 0$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$  due to  $\delta^* = \beta^* = 0$ . Tax authority  $L$  is willing to randomize, because under this equilibrium,  $\Phi_L^{xL}(\alpha^*, \beta^*, \gamma^*) = K$ .  $\mu_L^*(x_L)$  is feasible because  $\mu_L^*(x_L) > 0$  requires  $k > k_I^*$ . From Lemma 1, we know that  $\Phi_L^{xL} < \Phi_H^{xL}$ . Thus, we have  $\mu_H^*(x_L) = 1$ .

**Proposition 2 (i)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = \mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$ , and

$$\alpha^* = 1, \beta^* = 0, \gamma^* = 1, \delta^* = 0,$$

constitutes equilibrium  $\Pi^{\text{NA}}$  when  $\varepsilon < \underline{\varepsilon} = \min\{\varepsilon_1^*, \varepsilon_2^*/2\}$ ,  $p > p_1^* = \frac{c_H}{2(b-c_H)+c_H}$  and  $k < k_{II}^*$ , where  $k_{II}^* = (\Phi_L^{xL})^{-1}(K|\Pi^{\text{NA}})$ .

In state  $y_H$ , the firm chooses  $\alpha^* = 1$  because when  $\gamma^* = 1$ , a report  $x_L$  yields payoff  $-\tau_H(1+\pi) < -\tau_H$ , where the latter equals the payoff from reporting  $x_H$ . In state  $y_B$ , the firm chooses  $\beta^* = 0$ , as reporting  $x_H$  yields a payoff of  $-\tau_H$  and reporting  $x_L$  a payoff of  $-\tau_L - \varepsilon\tau_H > -\tau_H$

due to  $\varepsilon < \varepsilon_1^*$ . Auditor  $H$  chooses  $\gamma^* = 1$ , since  $\frac{2p}{(1+p)}b - c_H > 0$  when  $p > p_1^*$ . Auditor  $L$  chooses  $\delta^* = 0$  since  $\beta^* = 0$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$  due to  $\delta^* = \beta^* = 0$ . Tax authority  $L$  chooses  $\mu_L^*(x_L) = 0$ , because under this equilibrium,  $\Phi_L^{x_L} < K$  as long as  $k < k_{II}^*$ . From Lemma 1, we know that  $\Phi_L^{x_L} < \Phi_H^{x_L}$ . Thus, we have  $\mu_H^*(x_L) \geq 0$ .

**Proposition 2 (ii)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$ ,  $\mu_L^*(x_L) = \mu_H^*(x_L) = 1$ , and

$$\alpha^* = 1, \beta^* = 0, \gamma^* = 1, \delta^* = 0,$$

constitutes equilibrium  $\Pi^{JA}$  when  $\varepsilon < \underline{\varepsilon} = \min\{\varepsilon_1^*, \varepsilon_2^*/2\}$ ,  $p > p_1^* = \frac{c_H}{2(b-c_H)+c_H}$  and  $k > k_{II}^*$ , where  $k_{II}^* = (\Phi_L^{x_L})^{-1}(K|II^{NA})$ .

In state  $y_H$ , the firm chooses  $\alpha^* = 1$  because when  $\mu_L^*(x_L)\mu_H^*(x_L) = 1$ , a report  $x_L$  yields payoff  $-\tau_H(1 + \pi) < -\tau_H$ , where the latter equals the payoff from reporting  $x_H$ . In state  $y_B$ , the firm chooses  $\beta^* = 0$ , as reporting  $x_H$  yields a payoff of  $-\tau_H$  and reporting  $x_L$  a payoff of  $-(\tau_L + \tau_H)/2 > -\tau_H$ . Auditor  $H$  chooses  $\gamma^* = 1$  off the equilibrium path, since  $\frac{2p}{(1+p)}b - c_H > 0$  when  $p > p_1^*$ . Auditor  $L$  chooses  $\delta^* = 0$  since  $\beta^* = 0$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$  due to  $\delta^* = \beta^* = 0$ . Tax authority  $L$  chooses  $\mu_L^*(x_L) = 1$ , because under this equilibrium,  $\Phi_L^{x_L}(\alpha^*, \beta^*, \gamma^*) > K$  if  $k > k_{II}^*$ . From Lemma 1, we know that  $\Phi_L^{x_L} < \Phi_H^{x_L}$ . Thus, we also have  $\mu_H^*(x_L) = 1$ .



### Corollary 1

First, let us make the required inconsistency costs for joint audit equilibria explicit. These are

$$k_I^* = \frac{\left[ (1+p+(1-p)(1-\alpha^*)) \frac{K}{\tau_L} + (1-p)(1-\alpha^*) + p \right] \frac{\tau_H(1+\pi)-\tau_L}{\tau_H-\tau_L} - (1-p)(1-\alpha^*)}{2p},$$

$$k_{II}^* = \frac{(1+p)\frac{K}{\tau_L} + p}{2p}.$$

It is straightforward to see that  $\lim_{\tau_L \rightarrow 0} k_I^* = \infty$  and  $\lim_{\tau_L \rightarrow 0} k_{II}^* = \infty$ , as  $\alpha^*$  is independent of  $\tau_L$ .

Second, observe that  $k_{II}^* < k_I^*$ , because  $\Phi_L^{x_L}$  increases in  $\alpha$  and increases in  $\gamma$ . As  $\gamma$  and  $\alpha$  are higher under equilibrium  $\Pi^{\text{NA}}$  than under  $\Gamma^{\text{NA}}$ ,  $k_{II}^* < k_I^*$  is shown.

### High residual double taxation risk equilibria

#### Proposition 3 (i)

We show that  $\mu_H^*(x_H) = \mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$ ,  $\mu_L^*(x_H) \geq 0$  and

$$\alpha^* = \frac{b-2c_H}{b-c_H}, \beta^* = 1, \gamma^* = \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L}, \delta^* = 0,$$

constitutes equilibrium  $V^{\text{NA}}$  when  $\varepsilon > \bar{\varepsilon} = \frac{\tau_H(1+\pi)-\tau_L}{\tau_H}$  and  $p < p_3^* = \frac{(b-2c_H)c_L}{(b-2c_H)c_L + 2(b-c_H)(b-c_L)}$ .

The firm is willing to randomize in  $y_H$ , because a report  $x_L$  yields payoff  $\gamma^*(-\tau_H(1+\pi) - \tau_L(1-\gamma^*)) = -\tau_H$ , which equals the payoff from reporting  $x_H$ . In state  $y_B$ , the firm chooses  $\beta^* = 1$ , as reporting  $x_H$  yields a payoff of  $-\tau_H$  and reporting  $x_L$  a payoff of  $-\tau_L - \varepsilon\tau_H\gamma^* < -\tau_H$  due to  $\varepsilon > \bar{\varepsilon}$ . Auditor  $H$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_L$  yields a payoff of  $\frac{1-\alpha^*}{2}b - c_H = 0$ . Auditor  $L$  chooses  $\delta^* = 0$  since auditing report  $x_H$  would yield  $\frac{2p}{2p+(1-p)\alpha^*}b - c_L < 0$ , which is due to  $p < p_3^*$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_L) = 0$  due to  $\delta^* = 0$  and  $\beta^* = 1$ , and  $\mu_L^*(x_H) \geq 0$  as well as  $\mu_H^*(x_L) \geq 0$ .

**Proposition 3 (ii)**

See proof of Proposition 2 (ii), which is independent of  $\varepsilon$  when  $p_1^* < p < p_3^*$ .

**Proposition 3 (iii)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = 0$ ,  $\mu_H^*(x_L) = 1$ ,  $\beta^* = 0$ ,  $\delta^* = 0$ , and

$$\alpha^* = \frac{(1-p)(b-2c_H) + 2p(b-c_H)}{(1-p)(b-c_H)}, \gamma^* = \frac{((1-p)(2-\alpha^*) + 2p)\frac{K}{\tau_L} + (1-p)(1-\alpha^*) + p}{2pk + (1-p)(1-\alpha^*)},$$

$$\mu_L^*(x_L) = \frac{\tau_H - (\gamma^* \tau_H(1+\pi) + (1-\gamma^*)\tau_L)}{\tau_H(1+\pi) - (\gamma^* \tau_H(1+\pi) + (1-\gamma^*)\tau_L)},$$

constitutes equilibrium  $I^A$  when  $\varepsilon > \bar{\varepsilon} = \frac{\tau_H(1+\pi) - \tau_L}{\tau_H}$ ,  $p < p_1^* = \frac{c_H}{2(b-c_H) + c_H}$  and  $k > k_V^*$ , where  $k_V^* > k_I^* = (\Phi_L^{x_L})^{-1}(K|I^{NA})$ .

The proof follows the similar logic as the one for Proposition 1 (ii). The key difference is that, in state  $y_B$ , the firm is willing to choose  $\beta^* = 0$  less often, as reporting  $x_L$  yields a payoff of  $-\mu_L^*(x_L)\frac{\tau_L + \tau_H}{2} - (1 - \mu_L^*(x_L))(\tau_L + \gamma^* \varepsilon \tau_H)$ , which strictly decreases in  $\varepsilon$  ( $\gamma^*$  and  $\mu_L^*(x_L)$  are independent of  $\varepsilon$ ). Also, observe that  $\lim_{\varepsilon \rightarrow \bar{\varepsilon}, k \rightarrow k_I^*} -\mu_L^*(x_L)\frac{\tau_L + \tau_H}{2} - (1 - \mu_L^*(x_L))(\tau_L + \gamma^* \varepsilon \tau_H) = -\tau_H$ , which equals the payoff of reporting  $x_H$ . Thus, for  $\varepsilon > \bar{\varepsilon}$ ,  $\beta^* = 0$  additionally requires that  $\gamma^*$  is sufficiently low, since  $\gamma^*$  strictly decreases in  $k$ . With  $\lim_{k \rightarrow \infty} -\mu_L^*(x_L)\frac{\tau_L + \tau_H}{2} - (1 - \mu_L^*(x_L))(\tau_L + \gamma^* \varepsilon \tau_H) > -\tau_H$ , there exists a threshold value  $k_V^* > k_I^*$ , such that  $\beta^* = 0$  is the firm's best response and equilibrium  $I^A$  obtains.

**Proposition 4 (i)**

We show that  $\mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$ ,  $\mu_L^*(x_H) = 0$  or  $\mu_H^*(x_H) = 0$ , and

$$\alpha^* = \frac{(b-c_L)(b(1+p) - 2c_H)}{(b-c_H)b(1-p)}, \beta^* = \frac{(b(1+p) - 2c_H)c_L}{(b-c_H)2bp},$$

$$\gamma^* = \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L}, \delta^* = \gamma^* \frac{\tau_L - \tau_H(1+\pi - \varepsilon)}{\varepsilon \tau_L},$$

constitutes equilibrium VI<sup>NA</sup> when  $\varepsilon > \bar{\varepsilon} = \frac{\tau_H(1+\pi)-\tau_L}{\tau_H}$ ,  $p_3^* = \frac{(b-2c_H)c_L}{(b-2c_H)c_L+2(b-c_H)(b-c_L)} < p < p_2^* = \frac{(b-c_H)c_L+(b-c_L)c_H}{(b-c_H)c_L+(b-c_L)c_H+2(b-c_H)(b-c_L)}$  and  $k < k_{VI}^*$ , where  $k_{VI}^* = \min \{k_L^{xL}, \max\{k_L^{xH}, k_H^{xH}\}\}$  and  $k_i^x = (\Phi_i^x)^{-1}(K|VI^{NA})$ .

The firm is willing to randomize in  $y_H$ , because a report  $x_L$  yields payoff  $\gamma^*(-\tau_H(1+\pi) - \tau_L(1-\gamma^*)) = -\tau_H$ , which equals the payoff from reporting  $x_H$ .  $\alpha^*$  is feasible because  $p < p_2^*$  ensures  $\alpha^* < 1$ . The firm is willing to randomize in state  $y_B$ , as reporting  $x_L$  and  $x_H$  yield a payoff of  $-\tau_H - \varepsilon\tau_L\delta^* = -\tau_L - \varepsilon\tau_H\gamma^*$ .  $\beta^*$  is feasible because  $p > p_3^*$  ensures  $\beta^* > 0$ . Auditor  $H$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_L$  yields a payoff of  $\frac{(1-p)(1-\alpha^*)+2p(1-\beta^*)}{(1-p)(2-\alpha^*)+2p(1-\beta^*)}b - c_H = 0$ . Auditor  $L$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_H$  yields a payoff of  $\frac{2p\beta^*}{2p\beta^*+(1-p)\alpha^*}b - c_L = 0$ .  $\delta^*$  is feasible because  $\varepsilon > \bar{\varepsilon}$  ensures  $\delta^* > 0$ .

Tax authority  $L$  chooses  $\mu_L^*(x_L) = 0$  due to  $k < k_L^{xL}$ , and tax authority  $H$   $\mu_H^*(x_L) \geq 0$ . Further, either tax authority  $L$  or  $H$  choose  $\mu_i(x_H) = 0$  due to  $k < \max\{k_L^{xH}, k_H^{xH}\}$ . Concretely, if  $k_L^{xH} < k_H^{xH}$ , we have  $\mu_H(x_H) = 0$  and  $\mu_L(x_H) \geq 0$ ; otherwise we have  $\mu_L(x_H) = 0$  and  $\mu_H(x_H) \geq 0$ .

**Proposition 4 (ii)**

We show that  $\mu_H^*(x_H) = \mu_L^*(x_H) = 1$ ,  $\mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$  and

$$\alpha^* = \frac{b-2c_H}{b-c_H}, \beta^* = 1, \gamma^* = \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L}, \delta^* = 1,$$

constitutes equilibrium III<sup>JA</sup> when  $\varepsilon > \bar{\varepsilon} = \frac{\tau_H(1+\pi)-\tau_L}{\tau_H}$ ,  $p > p_3^* = \frac{(b-2c_H)c_L}{(b-2c_H)c_L+2(b-c_H)(b-c_L)}$  and  $k > k_{III}^*$ , where  $k_{III}^* = \max\{k_L^{xH}, k_H^{xH}\}$  and  $k_i^{xH} = (\Phi_i^{xH})^{-1}(K|III^{JA})$ .

The firm is willing to randomize in  $y_H$ , because a report  $x_L$  yields payoff  $\gamma^*(-\tau_H(1+\pi) - \tau_L(1-\gamma^*)) = -\tau_H$ , which equals the payoff from reporting  $x_H$ . In state  $y_B$ , the firm chooses  $\beta^* = 1$ , as reporting  $x_L$  yields a payoff of  $-\tau_L - \varepsilon\tau_H\gamma^*$  and reporting  $x_H$  a payoff of  $-(\tau_L + \tau_H)/2 > -\tau_L - \varepsilon\tau_H\gamma^*$  due to  $\varepsilon > \frac{\tau_H(1+\pi)-\tau_L}{2\tau_H}$ . Auditor  $H$  is willing to randomize because

not auditing yields a payoff of zero and auditing  $x_L$  yields a payoff of  $\frac{(1-p)(1-\alpha^*)}{(1-p)(2-\alpha^*)}b - c_H = 0$ . Auditor  $L$  chooses  $\delta^* = 1$  off the equilibrium path since  $\frac{2p}{2p+(1-p)\alpha^*} - c_L > 0$  when  $p > p_3^*$ .

The tax authorities choose  $\mu_H^*(x_H) = \mu_L^*(x_H) = 1$  due to  $k > k_{III}^*$ . Tax authority  $L$  chooses  $\mu_L^*(x_L) = 0$  due to  $\beta^* = 1$ , and tax authority  $H$  chooses  $\mu_H^*(x_L) \geq 0$ . In addition, equilibrium  $III^{JA}$  weakly payoff dominates  $II^{JA}$  whenever  $II^{JA}$  is feasible.

**Proposition 5 (i)**

We show that  $\mu_L^*(x_L) = 0$ ,  $\mu_H^*(x_L) \geq 0$ ,  $\mu_L^*(x_H) = 0$  or  $\mu_H^*(x_H) = 0$ , and

$$\alpha^* = 1, \beta^* = \frac{(1-p)c_L}{2p(b-c_L)}, \gamma^* = 1, \delta^* = \frac{\tau_L - \tau_H(1-\varepsilon)}{\varepsilon\tau_L},$$

constitutes equilibrium  $IV^{NA}$  when  $\varepsilon > \frac{\tau_H(1+\pi)-\tau_L}{\tau_H}$ ,  $p > p_2^* = \frac{(b-c_H)c_L+(b-c_L)c_H}{(b-c_H)c_L+(b-c_L)c_H+2(b-c_H)(b-c_L)}$  and  $k < k_{IV}^*$ , where  $k_{IV}^* = \min\{k_L^{x_L}, \max\{k_L^{x_H}, k_H^{x_H}\}\}$  and  $k_i^x = (\Phi_i^x)^{-1}(K|IV^{NA})$ .

In state  $y_H$ , the firm chooses  $\alpha^* = 1$  due to  $\gamma^* = 1$ . The firm is willing to randomize in state  $y_B$ , as reporting  $x_L$  and  $x_H$  yield a payoff of  $-\tau_H - \varepsilon\tau_L\delta^* = -\tau_L - \varepsilon\tau_H$ .  $\delta^*$  is feasible because  $p > p_2^*$  implies  $\beta^* < 1$ . Auditor  $H$  chooses  $\gamma^* = 1$ , since  $\frac{2p(1-\beta^*)}{2p(1-\beta^*)+1-p}b - c_H > 0$  when  $p > p_2^*$ . Auditor  $L$  is willing to randomize because not auditing yields a payoff of zero and auditing  $x_H$  yields a payoff of  $\frac{2p\beta^*}{2p\beta^*+1-p}b - c_L = 0$ .  $\delta^*$  is feasible because  $\varepsilon > \varepsilon_1^*$  ensures  $\delta^* > 0$ .

Tax authority  $L$  chooses  $\mu_L^*(x_L) = 0$  due to  $k < k_L^{x_L}$ , and tax authority  $H$   $\mu_H^*(x_L) \geq 0$ . Further, either tax authority  $L$  or  $H$  choose  $\mu_i^*(x_H) = 0$  due to  $k < \max\{k_L^{x_H}, k_H^{x_H}\}$ . Concretely, if  $k_L^{x_H} < k_H^{x_H}$ , we have  $\mu_H^*(x_H) = 0$  and  $\mu_L^*(x_H) \geq 0$ ; otherwise we have  $\mu_L^*(x_H) = 0$  and  $\mu_H^*(x_H) \geq 0$ .

**Proposition 5 (ii)**

See proof of Proposition 4 (ii).

**Proposition 6**

The firm's expected tax liabilities in the equilibria with joint tax audits are given by

$$T_{IJA} = \frac{1-p}{2} (\tau_L + \tau_H) + p \left[ \mu_L^*(x_L) \frac{\tau_L + \tau_H}{2} + (1 - \mu_L^*(x_L)) (\tau_L + \varepsilon \gamma_{IJA}^* \tau_H) \right],$$

$$T_{IIJA} = \frac{1-p}{2} (\tau_L + \tau_H) + p \left[ \frac{\tau_L + \tau_H}{2} \right] = T_{IIIJA}.$$

The change in expected tax liabilities induced by the existence of joint tax audits requires comparing the above expected tax liabilities and the liabilities in the respective national audit benchmark that would be played if joint tax audits did not exist. These benchmark equilibria depend on the low or high residual double taxation risk case.

First, consider the low residual double taxation risk case. The expected tax liabilities in the national audit equilibria are

$$T_{INA} = \frac{1-p}{2} (\tau_L + \tau_H) + p [\tau_L + \varepsilon \tau_H \gamma_{INA}^*],$$

$$T_{IINA} = \frac{1-p}{2} (\tau_L + \tau_H) + p [\tau_L + \varepsilon \tau_H].$$

When  $p > p_1^*$ , the change in expected tax liabilities is given by

$$T_{IJA} - T_{IINA} = p \left[ \frac{\tau_L + \tau_H}{2} - \tau_L - \varepsilon \tau_H \right] = p \left[ \frac{\tau_H - \tau_L}{2} - \varepsilon \tau_H \right].$$

Thus, we can see that increasing tax liabilities  $T_{IJA} - T_{IINA} > 0$  require  $\varepsilon < \frac{\tau_H - \tau_L}{2\tau_H}$ . Also, observe that  $\frac{\tau_H - \tau_L}{2\tau_H} < \min \left\{ \frac{\tau_H - \tau_L}{\tau_H}, \frac{\tau_H(1+\pi) - \tau_L}{2\tau_H} \right\} = \underline{\varepsilon}$ , such that the threshold for increasing and decreasing tax liabilities is unique in the low residual double taxation risk case.

When  $p < p_1^*$ , the change in expected tax liabilities is given by

$$\begin{aligned} T_{I^{JA}} - T_{I^{NA}} &= p \left[ \mu_L^*(x_L) \frac{\tau_L + \tau_H}{2} + (1 - \mu_L^*(x_L)) (\tau_L + \varepsilon \gamma_{I^{JA}}^* \tau_H) - \tau_L - \varepsilon \tau_H \gamma_{I^{NA}}^* \right] \\ &= p \left[ \mu_L^*(x_L) \frac{\tau_H - \tau_L}{2} + \varepsilon \tau_H [(1 - \mu_L^*(x_L)) \gamma_{I^{JA}}^* - \gamma_{I^{NA}}^*] \right] \end{aligned}$$

Since the firm is indifferent in state  $y_H$  in both equilibrium  $I^{NA}$  and  $I^{JA}$ , this necessarily implies that  $\mu_L^*(x_L) + (1 - \mu_L^*(x_L)) \gamma_{I^{JA}}^* = \gamma_{I^{NA}}^*$ . Inserting and simplifying yields

$$T_{I^{JA}} - T_{I^{NA}} = p \mu_L^*(x_L) \left[ \frac{\tau_H - \tau_L}{2} - \varepsilon \tau_H \right],$$

with the identical implications as for  $T_{II^{JA}} - T_{II^{NA}}$ . This shows part (i).

Concerning part (ii), let us note the expected tax liabilities in the national audit benchmarks

$$\begin{aligned} T_{V^{NA}} &= \frac{1-p}{2} (\tau_L + \tau_H) + p \tau_H, \\ T_{VI^{NA}} &= \frac{1-p}{2} (\tau_L + \tau_H) + p \left[ \tau_L + \varepsilon \tau_H \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L} \right], \\ T_{IV^{NA}} &= \frac{1-p}{2} (\tau_L + \tau_H) + p [\tau_L + \varepsilon \tau_H]. \end{aligned}$$

When  $p < p_3^*$ ,  $T_{II^{JA}} - T_{V^{NA}} < 0$  can be observed straightforwardly. Further, the *existence* of equilibrium  $I^{JA}$  in the high residual double taxation risk case requires  $T_{I^{JA}} - T_{V^{NA}} < 0$ . In the proof of Proposition 3 (iii), we show that these situations exist when  $k > k_V^*$ . Lastly, we show that  $T_{III^{JA}} - T_{VI^{NA}} < 0$ , which also implies  $T_{III^{JA}} - T_{IV^{NA}} < 0$ :

$$T_{III^{JA}} - T_{VI^{NA}} = p \left[ \frac{\tau_H - \tau_L}{2} - \varepsilon \tau_H \frac{\tau_H - \tau_L}{\tau_H(1+\pi) - \tau_L} \right].$$

Since  $T_{III^{JA}} - T_{VI^{NA}}$  decreases in  $\varepsilon$ , it is sufficient to show that  $T_{III^{JA}} - T_{VI^{NA}} < 0$  when  $\varepsilon = \bar{\varepsilon} = \frac{\tau_H(1+\pi) - \tau_L}{\tau_H - \tau_L}$ . Inserting  $\bar{\varepsilon}$  and simplifying yields  $T_{III^{JA}} - T_{VI^{NA}} = -p(\tau_H - \tau_L)/2 < 0$ . This completes the proof of part (ii).

**Corollary 2 and Proposition 7**

Let us make the authorities' deadweight losses in all equilibria explicit. In the equilibria with joint tax audits, these are given by

$$\begin{aligned} L_{IJA} &= \mu_L^*(x_L)K(2 - (1-p)\alpha^*) + p(1 - \mu_L^*(x_L))\gamma_{IJA}^*k(\tau_L + \tau_H), \\ L_{IIJA} &= (1+p)K, \quad L_{IIIJA} = (2p + (1-p)\alpha_{IIIJA}^*)K. \end{aligned}$$

In the purely national audit equilibria, we have

$$\begin{aligned} L_{INA} &= pk(\tau_L + \tau_H)\gamma_{INA}^*, \quad L_{IINA} = pk(\tau_L + \tau_H), \quad L_{VNA} = 0, \\ L_{IVNA} &= pk(\tau_L + \tau_H)[\beta_{IVNA}^*\delta_{IVNA}^* + (1 - \beta_{IVNA}^*)], \\ L_{VINA} &= pk(\tau_L + \tau_H)[\beta_{VINA}^*\delta_{VINA}^* + (1 - \beta_{VINA}^*)\gamma_{VINA}^*]. \end{aligned}$$

To begin, we show that equilibrium III<sup>JA</sup> weakly payoff dominates II<sup>JA</sup>. Considering  $T_{IIIJA} = T_{IIJA}$ , this requires  $L_{IIJA} > L_{IIIJA}$ , which holds because  $\alpha_{IIIJA}^* < 1$ .<sup>19</sup> This proves Corollary 2.

Next, we show that the existence of joint tax audits increases tax audit efficiency when the residual double taxation risk is low. We show the underlying mechanics of the proof only for  $L_{IINA} > L_{IIJA}$ ; the proof for  $L_{INA} > L_{IJA}$  works similarly. Considering that equilibrium II<sup>JA</sup> only exists for  $k > k_{II}^* = \frac{(1+p)\frac{K}{\tau_L} + p}{2p}$ ,<sup>20</sup> we get

$$\begin{aligned} L_{IINA} - L_{IIJA} \Big|_{k=k_{II}^*} &= p \frac{(1+p)\frac{K}{\tau_L} + p}{2p} (\tau_L + \tau_H) - (1+p)K \\ &= \frac{p(\tau_L + \tau_H)}{2} + (1+p) \left( \frac{\tau_L + \tau_H}{2\tau_L} - 1 \right) K > 0, \end{aligned}$$

<sup>19</sup>Here, we exemplify that the auditors' ex ante expected payoffs can be frequently neglected from an efficiency perspective. In equilibrium II<sup>JA</sup>, the auditors' expected payoffs are zero, as they are off the equilibrium path. In III<sup>JA</sup>, auditor  $L$ 's expected payoff is zero for the same reason. For auditor  $H$ , the ex ante expected payoff is  $\frac{1-p}{2}\gamma_{IIIJA}^*[-c_H + (1 - \alpha_{IIIJA}^*)(b - c_H)]$ . With  $\alpha_{IIIJA}^* = \frac{b-2c_H}{b-c_H}$  and further simplification, we see that auditor  $H$ 's expected payoff is also zero.

<sup>20</sup>Note that the efficient threshold is  $k_{II}^{eff} = \frac{K(1+p)}{\tau_L + \tau_H} < k_{II}^*$ .

due to  $\frac{\tau_L + \tau_H}{2\tau_L} > 1$ . This shows Proposition 7 (i).

When  $p < p_3^*$  in the high residual double taxation risk case, we can have equilibrium  $I^A$  and  $II^A$ . Observe that the national benchmark  $V^{NA}$  implies  $L_{V^{NA}} = 0$ . Thus,  $L_{I^A} > 0$  and  $L_{II^A} > 0$  imply that when  $p < p_3^*$  and the equilibria with joint tax audits would be played, the existence of joint tax audits decreases tax audit efficiency. For  $p_2^* < p < p_3^*$ , consider the limiting case  $\tau_L = \tau_H$ . Then, because both  $\gamma_{V^{NA}}^*$  and  $\delta_{V^{NA}}^*$  converge to zero, we have  $\lim_{\tau_L \rightarrow \tau_H} L_{V^{NA}} = 0 < L_{III^A} = (2p + (1-p)\alpha_{III^A}^*)K$ , as  $\alpha_{III^A}^*$  is independent of  $\tau_i$ . Similarly, joint tax audits can also be efficient in the high residual double taxation risk case, because  $\lim_{k \rightarrow \infty} L_{V^{NA}} = \infty > L_{III^A}$  and  $\lim_{k \rightarrow \infty} L_{IV^{NA}} = \infty > L_{III^A}$ . This shows Proposition 7 (ii).

Also, observe that for  $p > p_3^*$ , the range in which a joint tax audit equilibrium exists increases, that is,  $k_{III}^* = \max \left\{ \left( \frac{K}{\tau_H} (2p + (1-p)\alpha^*) + p \right) / 2p, \left( \frac{K}{\tau_L} (2p + (1-p)\alpha^*) + p(2\varepsilon - 1) \right) / 2p \right\} < k_{II}^* = \left( (1+p)\frac{K}{\tau_L} + p \right) / 2p$ . This can be observed straightforwardly for the limiting case  $\alpha^* = 1$ , which strictly increases  $k_{III}^*$ .