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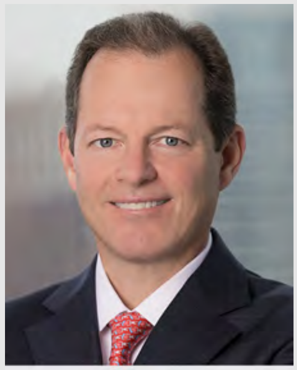

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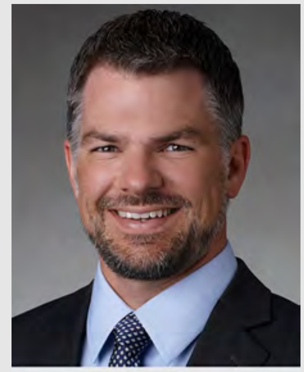

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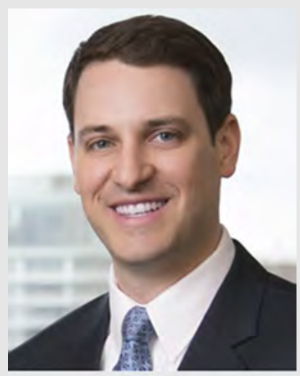

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In this article, the authors highlight the movement toward increased transparency and how that translates into additional compliance burdens, concluding that country-by-country reporting is here to stay.

Over the last decade, an unprecedented number of tax transparency measures has been introduced in the global business community. Those measures, many adopted as part of the OECD base erosion and profit-shifting project, reflect the collective response from G-20 members and the OECD following the 2008 global financial crisis. Specifically, the BEPS project culminated in a series of 15 actions to curb tax avoidance by multinational enterprises.

While the jury is still out on whether those actions are fulfilling their goals, there has been one very tangible effect on MNEs — reporting. And lots of it. There is no better example of that than country-by-country reporting under BEPS action 13.[1]

Since 2016 MNEs worldwide have struggled to comply with the CbC reporting requirements. This article is meant to provide an update on the status of the CbC reporting process and an overview of the regulatory landscape.

I. State of CbC Reporting

A. Where Are We Now?

More than 90 countries have adopted CbC reporting rules; several more have either adopted draft rules or signaled an intent to adopt new rules soon. The model rules in action 13 were treated as the minimum standard to which jurisdictions had agreed, although some jurisdictions deviated from the model rules. Fortunately, from a consistency standpoint, most jurisdictions simply adopted the OECD's model rules, largely using a cut-and-paste approach.

As a refresher, the CbC report is made up of three tables:

- Table 1 provides an overview of specific financial information by tax jurisdiction, including revenue (broken out by related and unrelated parties), profit before taxes (PBT), accrued and cash taxes, assets, and head count;
- Table 2 lists all constituent entities (including branches and permanent establishments) and their primary activities; and
- Table 3 provides a free-form space for any additional information or explanation the taxpayer deems necessary to supplement tables 1 and 2.

While the United States largely adopted CbC reporting in line with OECD rules, readers responsible for U.S. compliance will note that the associated U.S. CbC report (Form 8975) has a different feel from the OECD table orientation as described above. Despite those formatting differences, the information is virtually the same. The information in Form 8975 is ultimately converted by the IRS into the OECD table structure before exchange with other tax authorities.

In a perfect world (as intended when CbC reporting was agreed to), an MNE would have to file a CbC report only in its home country (or surrogate, if the home country does not have CbC rules), and the information would be exchanged under existing relationships. The OECD has reported that as of July, there are more than 2,400 exchange relationships among tax authorities. As a result, most MNEs might not have to file a CbC report locally — that is, a secondary filing — but that is not always the case.

As most U.S. taxpayers know, the United States decided to forgo the multilateral competent authority agreement (MCAA) approach, which would have provided the necessary exchange language for all covered jurisdictions — that is, cosigning jurisdictions — with which the United States has an underlying exchange agreement, such as a tax treaty or tax information exchange agreement. Instead, the United States is using bilateral exchange agreements. One consequence of that approach is that for U.S. MNEs, a secondary filing may be required in many jurisdictions.

While taxpayers have expressed frustration with U.S. reluctance to adopt the MCAA approach in favor of gradually entering bilateral agreements, the United States has exchange agreements with most treaty partners that have also adopted CbC reporting. Problems arise when a country imposes mandatory CbC reporting on local subsidiaries of foreign MNEs but is not a party to a treaty or TIEA in force with the United States. Contrary to OECD rules, many of those countries continue to require local filings. The OECD has made recommendations to address that, but the problem still exists.

MNEs — especially those with large geographic footprints — should carefully track where they may have secondary filing obligations so they do not run afoul of those rules. While we

[1] For the sake of brevity, this article assumes a general understanding of the CbC reporting paradigm. However, readers interested in a more thorough discussion on both the genesis and implementation of action 13 and the CbC report should read Thomas Herr, Raj Bodapati, and Rui Che, "Country by Country, Step by Step: Implementation Considerations for Country-by-Country Reporting by U.S. Multinationals," 24(23) *Bloomberg BNA Tax Management Transfer Pricing Report* (2016); and Kim Majure, Monica Zubler, and John DerOhanesian, "Country-by-Country Reporting: Are We There Yet?" *Bloomberg Daily Tax Report*, July 21, 2016.

are unaware of any reports of penalties applied to MNEs to date, if enforced, they can be stiff, ranging from monetary to criminal to cancellation of a business license.

As indicated, most countries have adopted the OECD rules almost verbatim. Some countries have issued guidance, which with few exceptions is based on the final action 13 report or taken from supplemental guidance provided by the OECD over the last four years.

Much of the early OECD guidance was addressed to tax authorities regarding specific aspects of reporting. For example, while related-party dividends are exempt from the definition of revenue in the final action 13 report, the report was silent on whether they should be included in PBT. Regrettably, the report simply stated that PBT should include all "extraordinary income and expense items," thus sowing seeds of confusion. Unsurprisingly, some jurisdictions adopted the interpretation that because related-party dividends were specifically exempted from related-party revenues (but not PBT), they should be included in PBT. Others took the opposite approach, concluding that because related-party dividends had been excluded from revenue, they should be excluded from PBT as well.

In September 2018 the OECD issued guidance indicating flexibility on the issue, saying jurisdictions could choose either approach with the strong recommendation that they simply require taxpayers to indicate via a Table 3 disclosure whether related-party dividends were included in PBT, and if so, for which jurisdictions. Only a handful of jurisdictions issued additional guidance or clarification in that regard. In November 2019 the OECD revised its position, stating that for all periods beginning on or after January 1, 2020, taxpayers must exclude related-party dividends from PBT. Given that, it is likely that future rounds of guidance will lean toward providing firm rules rather than offering interpretive flexibility.

B. Common Mistakes and Misconceptions

As with any new regime, there has been a fair amount of confusion regarding how reports are prepared. Given the nature of the data being reported, many readers will likely expect that most mistakes are in relation to Table 1, but the truth is that there are numerous common errors regarding the data reported on Table 2 as well. For example, taxpayers continue to mistakenly treat a branch or PE as resident in a jurisdiction other than where it is organized by identifying the location of both the branch or PE and its owner, thereby potentially flagging an issue that does not actually exist.

There are also some problems with tax identification numbers. First, many taxpayers believe that TINs are optional or simply nice to have, but that is not the case. TINs are a mandatory part of the reporting schema. If a constituent entity has not been provided a local TIN, only then are taxpayers instructed to enter "NOTIN" on the form.

Second, and this is primarily directed at U.S. taxpayers, local TINs are required in all cases. Many U.S. MNEs have foreign subsidiaries that have been issued U.S. employer identification numbers, which are incorrectly included on the report. Taxpayers incorrectly labeling entities as stateless (or not) on Table 2 is also common.

A third issue arises regarding the main activities of the constituent entities, which filers often view as an afterthought. Inconsistencies show up not only among filers, but even in individual reports, and can cause problems going into tax audits. For example, similarly situated constituent entities may be tagged as performing different activities, perhaps because of inconsistent internal metrics regarding the meaning of the term "main business activity," which is the standard for determining whether a particular main activity applies. Looking ahead to a potential transfer pricing audit, those inconsistencies could create unnecessary flags for tax examiners.

That does not imply that there are no issues with Table 1: Indeed, we see many problems across taxpayers and reportable periods. Double counting of stateless revenue and profit continues to be a concern, with taxpayers either not including those items in the aggregated totals of the jurisdictions where the owner of the stateless entity is resident, or by double counting but including it in the wrong jurisdiction. Many taxpayers also fail to report same-country related-party transactions as related-party revenue on Table 1, mistakenly believing that only cross-border related-party transactions must be captured. Those are just a few of the common mistakes we continue to see, and as discussed below, that the OECD continues to address through additional guidance.

Preparing CbC reports is not the only area of confusion. There also seems to be a common misunderstanding concerning the exchange of CbC reports — specifically, the incorrect assumption that some affirmative act or request by a jurisdiction is required to trigger an exchange of taxpayer CbC data. Under the relevant agreements, tax authorities do not have to request CbC reports from foreign tax authorities. Rather, the exchange of CbC information is automatic: Think of it as a push, not a pull.

The operative question is simply whether there is an agreement in force between the home and local jurisdictions that provides for the automatic exchange of CbC reports. If so, the CbC reports are automatically exchanged within three months of the due date. As a point of reference, for taxpayers operating on a calendar-year basis, three years of CbC data have been shared among participating countries as of March 2020 (2016, 2017, and 2018).

Last, the data is transferred electronically using the common XML reporting schema developed by the OECD. As discussed in Part II, that makes the data analysis process much simpler because tax authorities do not need to be concerned with developing complex systems to format reports for review.

C. A Look Ahead

In accordance with the final action 13 report, the OECD is reviewing existing CbC rules. As part of that review, which began in early 2020, the OECD is considering whether modifications to the reporting requirements should be made, such as including additional or different data, the appropriateness of the revenue threshold, the effectiveness of filing and dissemination mechanisms, and the implementation of action 13.

The OECD held a public consultation in May to solicit input from taxpayers and other interested parties regarding potential changes to the CbC rules. Many speakers advocated making CbC reporting public, although taxpayers and advisers pushed back on that suggestion. Speakers expressed near unanimity that the aggregate reporting by jurisdiction is misleading, and that consolidated (or aggregated with eliminations for revenue and stated capital) would be better. Some speakers also pushed for additional data elements, as well as changes in how entities that are not resident in any jurisdiction are reported.

It is unclear where the OECD review will ultimately lead, but it seems unlikely that the reporting process will be made any easier for MNEs. Instead, the best we likely can hope for is added clarity on some of the rules and limited additional requests for MNE data.

Despite the lack of global consensus on the topic, the idea of public CbC reporting is still very much alive and, if nothing else, is actively discussed in the EU. Between automatic exchange of the OECD CbC reports and information provided in the context of a tax audit, the goal of public CbC reporting does not appear to be improved information for tax administrations; rather, it appears to be increased scrutiny by consumers and nongovernmental organizations.

To be fair, EU states are split on whether public CbC reporting should be adopted, but given that the EU has been on the forefront of tax transparency — for example, DAC3 (Council Directive (EU) 2015/2376)[2] and DAC6 (Council Directive 2011/16/EU) — efforts to require public reporting are worth monitoring.

Of course, the EU is not alone in considering public CbC reporting. The U.S. Financial Accounting Standards Board has also considered requiring public companies to disclose even more information about their income taxes in financial statement disclosures. Separate bills have been introduced in both houses of Congress over the last year regarding new public CbC disclosure rules.[3] Given the devastating effect of the COVID-19 pandemic on the global economy and the likelihood that its effects will be widespread and long-lasting, it is possible that more governments will turn to tax transparency measures such as public CbC reporting as a way

[2] First exchanges took place by September 30, 2017. *See* European Commission, "Combatting Corporate Tax Avoidance: Commission Presents Tax Transparency Package" (Mar. 18, 2015).

[3] *See, e.g.,* H.R. 5933, "Disclosure of Tax Havens and Offshoring Act."

to look for taxpayers with perceived inappropriate base erosion arrangements that can be audited, generating potential new taxable revenue.

If that was not enough, on a webcast in early May, the OECD hinted that more changes to CbC reporting could be coming to support the work being done on pillar 1 and pillar 2 as part of BEPS 2.0.

II. Tax Audits and Data Analysis

A. Global Tax Audits

Beginning with the first exchange of CbC data in 2018, tax authorities have demonstrated an increased interest and willingness to use CbC reports as part of their tax audit selection and examination process. Unsurprisingly, and as originally envisioned, several European tax authorities have used CbC reports filed with their jurisdictions to identify companies for additional review. In some cases, tax authorities are using the CbC report as a factual check against the company's internal records, tax returns, transfer pricing documentation, and other reporting positions. One MNE was required to provide a detailed reconciliation of the information in its CbC report and its local file and local tax returns, including a list of employees, job titles, and salary costs, as well as a breakdown of other costs reported in prior tax returns. Another tax authority used information in a European MNE's CbC report to guide its information collection and due diligence activities, resulting in over 80 information document requests issued to subsidiaries operating in foreign countries, as identified in the CbC report.

In other cases, tax authorities have used CbC reports as evidentiary support for transfer pricing adjustments. Indeed, one European tax authority used the report (accompanied by other internal and external resources) to support a recharacterization of an MNE's transfer pricing arrangements. Specifically, it proposed a recharacterization from a contract manufacturing and research and development operation using a cost-plus form of remuneration to a profit-split method based largely on the relative head count totals reported in the MNE's CbC report. That recharacterization resulted in a sizable proposed adjustment and reallocation of the MNE's profit but the taxpayer successfully challenged it.

While most of the stories concerning the use of CbC data originate in Europe, tax authorities in Asia have also requested copies of taxpayers' CbC reports. Recent reports have also indicated that the OECD's International Compliance Assurance Programme has been reviewing and analyzing CbC reports. Collectively, that indicates growing interest in using CbC data to identify perceived inappropriate base erosion arrangements by MNEs. As tax authorities become more confident with the information in CbC reports, we anticipate its increased use to identify taxpayers for examination and as an element of the transfer pricing theories used to support proposed adjustments. Of course, while the CbC reports appear to be guiding some of the examination activities by tax authorities globally, there is no indication yet that the IRS has jumped on that bandwagon.

B. Preparing for Tax Audits: Best Practices

As much time as it takes to simply compile the required data and produce a CbC report, sophisticated taxpayers know that the reporting process does not end there. Taxpayers should be analyzing their data with no less care and scrutiny than tax authorities do. At a minimum, MNEs should use the guidelines in the OECD's 2017 handbook on tax risk assessment to assess their own CbC data. The handbook identifies 19 risk indicators from an MNE's CbC report regarding potential BEPS activity. It also repeatedly mentions several key ratios that serve as indicators of high or low risk, including related-party revenue to total revenue, profit per employee, pretax return on equity, and effective tax rate.

Ideally, MNEs and tax authorities should benefit equally from information sharing and transparency, but the reality is that only tax authorities have access to large enough amounts of CbC data to run sophisticated data analytics to extract meaningful insight. While many taxpayers have used the OECD risk assessment handbook to run basic Excel interpretations of their CbC data, a recent report described the tax authorities' risk assessment technology as "extreme modeling" or "machine learning." For example, one tax authority's year-over-year ratio analysis integrates multiple databases, modeling techniques, and variables.[4] Also, tax authorities have an added advantage of comparing multiple CbC reports in similar industries, sizes, or jurisdictions, whereas taxpayers do not have access to those data to perform similar analyses.

Another example of advanced modeling techniques involves the Australian Taxation Office's use of risk filters and factors. ATO Deputy Commissioner Jeremy Hirschhorn has said that "in terms of the risk factors, there are the 19 put out by the OECD, but we actually have more than 100 that we apply to international dealings."[5]

The IRS is also prioritizing the implementation of advanced data analytics throughout its operations, including enforcement. Among its main objectives are improving digital tools by investing in analytics and visualization software and developing processes to support analytics in IRS operations.[6] Indeed, the 2020 budget request includes a provision for expanding the IRS's data analytics capabilities, stating that the agency will use resources to make effective use of new data sources (such as BEPS CbC reporting), "and lead a data-driven culture change."

It is our understanding that the IRS has not used CbC reports collected thus far for active risk assessment and tax audit selection. The data are there for tax examiners to use at their discretion, however, and it is only a matter of time before they become a regular part of the IRS risk assessment process. The agency recently updated its Statistics of Income Tax Stats website to include aggregated CbC report data submitted by taxpayers for the 2016 and 2017 tax years. The publication of those statistics is intended to increase transparency and provide MNEs and other tax authorities with tools to analyze the potential misalignment of taxes, income, and business activity.

Unfortunately, the IRS data suffer from major limitations, including that rather than providing complete CbC data as received from taxpayers, the IRS uses estimates based on a sample of CbC reports without explaining the sampling technique. While more than 7,000 CbC reports were filed globally in 2016,[7] the IRS sample for that period was limited to 1,101 CbC reports.[8]

While well-resourced tax authorities such as the IRS and the ATO are developing the ability to crunch the numbers, the OECD has recognized that not every tax authority will be able to do the same. Accordingly, it developed a tax risk assessment questionnaire (TRAQ) and is developing a tax risk evaluation and assessment tool (TREAT) to help tax authorities interpret CbC reports. Although TREAT has not been released to the public, it is our understanding that it will attempt to analyze an MNE's CbC report using the 19 indicators identified and discussed in the OECD risk assessment handbook.

TRAQ is meant to be provided by tax administrations to an MNE to collect additional information when possible tax risk indicators appear to be present in the group's CbC report. For better or worse, TRAQ does not appear to aid the risk assessment process by performing complex calculations or data analysis. Rather, it considers a baseline using averages or percentiles and highlights data points that fall too far above or below a set number. It is then left to the taxpayer to explain the results in the context of the risk assessment handbook.

Unlike the handbook, TRAQ appears to look at each risk factor independently, even though the handbook seems to suggest that the 19 factors should be analyzed in the aggregate. That type of aggregate analysis is difficult and could be a Herculean task for many MNEs, which face an ever-increasing amount of compliance. To assist MNEs with that multifactor analysis, KPMG LLP has developed a CbC risk assessment tool that analyzes 35 factors to identify the overall risk profile for each jurisdiction in which an MNE operates. KPMG has also developed an anonymous database of CbC data that interested

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[4] Aurélie Barnay et al., "Four Innovations Reshaping Tax Administration," McKinsey & Co. (Jan. 29, 2018).

[5] EY, "Tax Administration Goes Digital" (2017).

[6] IRS, "Advance Data and Analytics."

[7] OECD, Tax Talks #11 (Jan. 29, 2019).

[8] It is unclear whether that is the sample used by the IRS, an estimate of the total based on the sample, or the true total received by the IRS. The IRS indicates only that the tax jurisdiction detail exceeds the total because some MNEs filed information for more than one jurisdiction.

MNEs have contributed to and which allows them to benchmark their CbC reports against other groups.

CbC reports prepared in connection with even the most benign tax structures can be riddled with false positives — that is, information that may seem to indicate aggressive tax planning but in fact reflects an innocuous structure. For example, most U.S. MNEs prepare their reports using U.S. generally accepted accounting principles financial data. Depending on the facts, the data in the CbC report might bear little relation to the local statutory or tax accounts. It is not unusual to find that Country A has a low or negative effective rate per the CbC report (again, based on U.S. GAAP), but that the rate is more in line with the local statutory rate. For that reason, taxpayers must analyze their own CbC reports, preferably before they are finalized and filed.

Most taxpayers likely perform routine reconciliations to ensure the data reported are complete and correct. It is not enough to stop there, however, because one of the next steps taxpayers should take is to perform year-over-year analysis (or even multiyear analyses). We know tax authorities are looking for large — or even not so large — swings in data from Year 1 to Year 2 (and perhaps Year 3, and so on). Taxpayers should have a general understanding of the factors driving those changes. In many cases, the data is simply incorrect; while the overall totals might tie with the consolidated financials, related-party revenue or expenses often land in the wrong jurisdictions. If the data is correct and major changes still exist between tax years, consider whether those swings are a result of market conditions, mergers and acquisitions, or something else. It is much easier to answer those questions during the preparation process rather than digging for answers years later when the tax authorities are raising those questions in the context of an examination.

While CbC reporting is the primary focus of this article, it would be remiss not to mention the master and local file components of action 13. Importantly, taxpayers cannot forget that while the CbC report may not be prepared at the same time as or even by the same individuals or internal groups who prepare the other transfer pricing documentation, the master file, local files, and CbC reports should be viewed as one package. In an ideal world, the three documents would speak to and complement each other. If nothing else, it is imperative that they do not contradict each other. We have, however, started to see proactive taxpayers prepare the CbC report before the master and local files are finalized to ensure consistency and potentially preempt any misunderstandings.

Once the CbC report has been prepared, taxpayers should take a step back and ensure that the CbC story agrees with the one communicated in other related documents. In fact, that should extend beyond action 13, and answer how those documents compare with the company's annual report, SEC Form 10-K, the website, and social media.

Lastly, it is important to think about how those documents relate to other tax transparency measures. In a nutshell, BEPS action 12 (mandatory disclosure) requires taxpayers to disclose aggressive tax planning arrangements. While global adoption of that recommendation has generally been slow relative to other tax transparency measures, it is about to kick into high gear. Building off action 12, the EU adopted DAC6, a mandatory disclosure regime requiring taxpayers and their advisers to report some cross-border arrangements as early as July 31, 2020. Those reports will be shared among EU states (likely including the United Kingdom, despite Brexit), and failure to comply comes with stiff monetary — and potentially criminal — penalties.

Other jurisdictions are in the process of adopting similar rules. Mexico, for example, has adopted a mandatory disclosure regime with reporting beginning January 1, 2021. Tying that back to CbC reporting, taxpayers should be cognizant of whether and to what extent data on the CbC report supports — or worse, contradicts — data filed as part of a mandatory disclosure reporting. Similarly, taxpayers should consider whether data presented on the CbC report highlight an otherwise unreported transaction that should have been reported as part of DAC6. For example, related-party revenue accrued by constituent entities resident in low- or zero-taxed jurisdictions, or by stateless constituent entities, may trigger DAC6 reporting requirements.

It is easy to become overwhelmed by the volume of new compliance obligations stemming from recent tax transparency initiatives, and the trend suggests there is more to come. Even the largest companies often find themselves playing catch-up, moving from one compliance project to another without having adequate time to check off all the best practices boxes. Taxpayers need to start thinking about how to analyze their data in a way that lets them focus on other priorities.

C. Other Uses of CbC Reports

While tax transparency has been the primary intent for CbC reports, those reports have utility in other areas. They are a great source for summarizing the global footprint of any large multinational. In most cases, before the CbC reporting regime, companies never had a singular source or document summarizing key global metrics such as revenue, profit, assets, and head count by country. Now, with those data easily available in one place, executives can use it to better understand how their global operations are dispersed. Table 2 of the CbC report lists the main activities in each jurisdiction, offering a good perspective on items such as manufacturing footprint, dormant or redundant entities, and financing companies. That in turn allows companies to develop strategies accordingly — for example, by flagging the efficiencies that could be attained by eliminating unneeded entities. That is especially true for large MNEs in multiple jurisdictions.

A recent example of that is related to COVID-19 crisis management. Governments have offered many incentives that may apply to companies in different ways (for example, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) in the United States). Each of those government programs have detailed criteria that companies must satisfy to receive benefits and incentives. The CbC report should be one of the first documents a crisis management team reviews to better understand the key metrics of their operations in each jurisdiction. From that perspective, CbC reports can be quite helpful to companies.

Lastly, CbC reports have also been requested by independent auditors to understand companies' tax footprints and plan the tax provision review process. While the CbC report has no implication on financial statements, if it is available, an auditor might look to it as a way to understand the material intercompany transactions and prioritize its review and focus (similar to how tax authorities would use the report to scope their tax audits).

III. Conclusion

This article highlights how the movement toward increased transparency translates into additional compliance burdens. Importantly, BEPS action 13 (and CbC reporting in particular) is a minimum standard that all members of the inclusive framework have committed to adopting. That is important because while the OECD comprises just 36 countries, the inclusive framework has 137 members. The inclusive framework members committed to implementing the minimum standards in exchange for a seat at the table in developing the rules and recommendations of the BEPS project 15 actions.

As noted, more than 90 countries have implemented CbC rules (either in final or draft form), while nearly 50 others have signaled an intent to adopt them. Surprisingly, countries that are not even part of the inclusive framework have recently adopted CbC reporting legislation. Considering that the United Nations officially recognizes 195 countries, that means that in the next few years, more than 70 percent of countries will have adopted mandatory CbC reporting.

Why do we end on that note? Because, for better or for worse, CbC reporting is here to stay.[9] ■

[9] The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.